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Section 250 may have some small effect on *ex parte* sister state decrees, but it is more likely to be superfluous or held unconstitutional depending on the amount of evidence the assailant is able to present.

In the area of foreign country decrees where a New York court is not bound by the constitutional mandate of full faith and credit, the application of section 250 will be open to debate. The effect of the act in this area is not likely to be recognized as a statutory overruling of *Rosenstiel* and prior case law.

One difficulty in understanding the New York legislators' intention in enacting section 250 is its past history. The same statute has had little or no effect in ten other enacting states for the past eighteen years. The inherent defects in draftsmanship would seem to prejudice the statute's chances for being constitutionally sustained under judicial scrutiny. The Supreme Court decisions in the area of divorce recognition since it was first enacted may indeed destroy the usefulness of the act.

When these factors are combined with the lack of legislative notes or comments to section 250, its existence is not easily reconciled with its supposed goals. It would appear that when the New York legislature finished reforming the divorce laws it added section 250 primarily to keep New Yorker's divorces before New York courts.

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THE "UNFAIR" INTERESTED DIRECTORS' CONTRACT UNDER THE NEW YORK BUSINESS CORPORATION LAW

According to the majority common law rule a contract between a director and his corporation, or between corporations with interlocking directorates, will be enforced if the contract is basically "fair" to the corporation but may be avoided if "unfair."[1] This rule seems to have been extended by section 713(a) of the New York Business Corporation Law, which provides in part:

> 713. Interested directors.—(a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or are financially interested, shall be either void or voidable for this reason alone or by reason alone that such director or directors are present at the meeting of the board, or of a committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose:
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> (1) If the fact of such common directorship, officership or financial interest is disclosed or known to the board or committee, and the

1. See generally 19 Am. Jur. 2d *Corporations* § 1307 (1965); Annot., 33 A.L.R.2d 1062, 1064 (1954).

> board or committee authorizes such contract or transaction by a vote sufficient for such purpose without counting the vote or votes of such interested director or directors;
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> (2) If such common directorship, officership or financial interest is disclosed or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of the shareholders; or
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> (3) If the contract or transaction is fair and reasonable as to the corporation at the time it is authorized by the board, a committee or the shareholders.

A literal reading of this statute indicates that the "interested director's contract" may not be "void or voidable for this reason alone" if any one of the three alternatives has been satisfied. Prior to the Business Corporation Law the courts of New York generally followed the common law rule requiring that these contracts be fair; hence section 713(a) on its face seems to offer a more lenient test in that the interested director must demonstrate merely that full disclosure of his position has been made to either the board or the shareholders. These provisions thus raise the intriguing question of whether disclosure alone will be sufficient to validate a transaction which was in fact *unfair* at the time of its approbation. The New York courts have followed a general trend toward increased liberality in the treatment of these agreements, although there appears to be no precedent enforcing an unfair interested directors' contract.[2] Nearly a century ago it was said that "every contract entered into by a director with his corporation may be avoided by the corporation within a reasonable time, irrespective of the merits of the contract itself."[3] The essence of this harsh rule was more firmly established in the landmark decision of *Munson v. Syracuse, G.&C. R.R.*,[4] and in many subsequent New York cases; oddly enough, *Munson* has never been directly overruled, at least prior to the appearance of section 713. However, a 1913 case held that an interested director's contract is valid when ratified by the shareholders of the corporation,[5] and another contemporary decision suggested that such transactions should be upheld if prefaced by open and honest disclosure on the part of the interested directors.[6] The emergence of the "fairness" standard as the functional (if not the formal) test was evident in the Court's treatment of *Globe Woolen Co. v. Utica Gas & Elec. Co.*,[7] where Judge Cardozo cautioned that "the constant duty rests on a trustee to seek no harsh advantage to the detriment of his trust, but rather to protest and renounce

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2. For a thorough inquiry into the "crazy-quilt of authority" of the common law in New York, including most of the cases herein cited, see Hoffman, *The Status of Shareholders and Directors Under New York's Business Corporation Law: A Comparative View*, 11 Buffalo L. Rev. 496, 558-69 (1962).
3. Metropolitan Elev. R.R. v. Manhattan Elev. R.R., 11 Daly 373, 503 (N.Y.C.C.P. 1884).
4. 103 N.Y. 59, 8 N.E. 355 (1886).
5. Goss v. Goss, 147 App. Div. 698, 132 N.Y. Supp. 76 (1st Dep't 1911), *aff'd*, 207 N.Y. 742, 101 N.E. 1099 (1913).
6. Billings v. Shaw, 209 N.Y. 265, 103 N.E. 142 (1913).
7. 224 N.Y. 483, 121 N.E. 378 (1918).

if through the blindness of those who treat with him he gains what is unfair."[8] The famous Supreme Court case of *Geddes v. Anaconda Copper Mining Co.*[9] established the rule that the burden of proving the basic fairness of the contract falls squarely upon the interested or common director who seeks to maintain the transaction,[10] although the strict application of this principle in New York was subsequently modified by *Everett v. Phillips*.[11] A later case involved a dispute concerning the fairness of a gas price fixed by a contract negotiated between corporations with interlocking directorates; it was held that the transaction might be avoided if unfair to the injured party despite the fact that the common directors had acted in good faith and upon the advice of competent engineers.[12] This decision suggests that the unfair interested director's contract may be avoided in New York regardless of other surrounding circumstances, and seemingly is in accord with the prevailing common law rule.

The impact of section 713(a) upon the common law has not yet been evidenced by judicial interpretation, and the thrust of the statute has been appraised solely in the writings of several legal scholars. Some inquiry has been directed at the question of whether the burden of proof has been placed on the interested director, following the *Geddes* rule,[13] or has been shifted conclusively to the plaintiff in accordance with the interpretation frequently given *Everett v. Phillips*.[14] It is generally agreed that the new statute is not explicit on this point,[15] and placement of the burden seems to remain in the same uncertain state that it was heretofore. With regard to the issue of the unfair contract, however, there is unanimous agreement that section 713(a) alone will not operate to affirm a transaction which was basically unfair at the time of its authorization.[16] A California statute, nearly identical to section 713(a),[17] has been construed to require fairness in interested director's contracts despite

8. *Id.* at 492, 121 N.E. at 381.
9. 254 U.S. 590 (1921).
10. "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness. . . ." *Id.* at 599.
11. 288 N.Y. 227, 43 N.E.2d 18 (1942).
12. Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944).
13. See *supra* note 10.
14. 288 N.Y. 227, 43 N.E.2d 18 (1942). See Kessler, *The New York Business Corporation Law*, 36 St. John's L. Rev. 1, at 76 n.306 and accompanying text (1961).
15. See Israels, Corporate Practice 208 (1963); Kessler, *supra* note 14, at 76.
16. See Israels, *op. cit. supra* note 15, at 135. "The important factor is that not even a statutory provision can operate to validate a basically unfair transaction." *Id.* at 208. "*Section 713 does not purport to deal with the validity of the contract or transaction*, and mere disclosure of a directors' interest will not alone serve to validate such a contract or transaction where there is evidence that the disclosure was not full and fair, unfair advantage was taken by the interested director, or some other impropriety or fraud characterized his dealings with the corporation." Hoffman, *supra* note 2, at 567. "Probably the qualifications in the statute and its Comment will be sufficient to preserve the rule that an unfair contract will be invalidated even where adopted without the interested directors' vote." Kessler, *supra* note 14, at 76.
17. Section 713(a) is a near-duplicate of Cal. Corp. Code § 820 (Deering 1947), with the notable exception that the "good faith" requirement in the California statute is not found in § 713 but has been made the subject of § 717 in the New York scheme.

technical compliance with the statutory disclosure provision,[18] and it is likely that the New York courts will incorporate this requirement into the interpretation of the new provision.[19]

The unfair contract casts upon the interested director a presumption of improper or "bad faith" motives, and the weight of the common law combined with the statutory interpretation given the California cases indicates that mere disclosure under section 713(a) will not operate to save a basically unfair contract. However, several questions still remain. What if the presumption of bad faith is effectively rebutted by the interested director? If this alone is not enough, might it make any difference if the interested director or his defendant corporation will suffer a substantial loss if the contract is avoided? Another problem is raised by the language of section 713(a)(3), directed at the transaction which is fair and reasonable "at the time it is authorized by the board, a committee or the shareholders." What of an agreement satisfying this requirement, but which develops into an unfair contract *after* its authorization?

Section 713(a) deals exclusively with interested director's contracts, stating that such contracts shall not be "void or voidable for this reason alone"; thus there is an implied invitation to subject the transaction to the tests imposed by other applicable portions of the statutory law. First among these is section 717, requiring directors to discharge their duties "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Also pertinent is section 720, providing in part that a director may be compelled to account for his negligent or willful violation of certain corporate duties.

Noting the coordinated thrust of these three sections, consider again the basic question of whether under any circumstances the unfair contract could—or should—be upheld under the new statutory scheme. The range of the various possibilities is illustrated in the following hypothetical situations:

> *D* is a director and large shareholder of both the *ABC* and *XYZ* corporations; there are no other common directors or shareholders. *ABC* and *XYZ* enter into a twenty-year lease by which *ABC* agrees to pay a fixed annual rent for the use of a large commercial building owned by *XYZ*. *D*'s interests have been fully disclosed to the boards of directors of both corporations. Five years later the state constructs an expressway exit immediately adjacent to the leased property. Commercial property prices skyrocket, and the fair rental value of the building in question climbs to approximately four times the contract price. *XYZ* now seeks to avoid the allegedly unfair agreement, relying solely on *D*'s common interest.

First. Assume *D* had "inside" information concerning the proposed exit prior to the authorization of the lease agreement, and sought to gain an advantage for *ABC*. Is there any possibility of saving the contract? Clearly not. *D* has

18. The best-known and most widely quoted case in point is Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

19. See Hoffman, *supra* note 2, at 566-67; Israels, *op. cit. supra* note 15, at 208.

breached the "good faith" requirement of section 717 and the lease may be avoided as having been basically unfair at its inception. Disclosure alone as provided in section 713 cannot operate to validate a transaction under circumstances such as these.

Second. Assume both parties had bargained in good faith, the rental price was fair when established, and there is no indication that plans for the exit were in existence when the agreement was reached. *ABC* argues that the contract was fair and reasonable when made, and that the common law rule is applicable only to transactions unfair at the time of their authorization. *XYZ* maintains that unfairness may be established by the *results* of the contract,[20] and further suggests that section 717 requires an interested director to seek avoidance or modification of an unfair transaction regardless of when the unfairness develops, in accordance with Judge Cardozo's reasoning in *Globe Woolen*.[21] There is substance to both arguments, and a decision either way could be justified by a careful balancing of equities.

Third. Assume the building is located in a city one hundred miles distant. Neither *ABC* nor *XYZ* were familiar with rental values in the area, and the contract price was set by a competent local real estate firm. Plans for the new expressway exit had been announced several months before, but that fact was not made known to the parties here, and its inflationary effect on nearby property was ignored by the local realtor in establishing the rental figure. Thus the contract actually was unfair when authorized, but was entered into in good faith and with due care according to the requirements of section 717. Many years ago it was argued in *Billings v. Shaw*[22] that the interested director should be given his advantages under the agreement if entered into in good faith, but the precise situation here seems to be controlled by *Chelrob*,[23] which held that good faith based on supposedly competent outside advice is not enough to save the unfair contract. The frequently expressed rationale of this and related cases is that the common director should not be permitted to reap "excessive profits" at the expense of the injured corporation.

Fourth. Assume the same facts as above, except *ABC* uses the building exclusively for dead storage and maintains that no excessive profits have been realized. This argument has more appeal than the last, but the courts might point out that the fruits of appreciation have flowered and ripened regardless of whether the defendant has bothered to pluck them.

20. In Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952) several consecutive annual sales contracts were attacked by the plaintiff; the trial court validated the contracts for the first year on the reasoning that the advantages were speculative when the contracts were made, but all later agreements were struck down since the results of the original contracts assured the defendants of unfair profits under the subsequent agreements. On appeal the first year's contracts were also held voidable, the rationale being that "all of the contracts are voidable not because profits were or were not certain, but because of the inherent nature of the transactions." *Id.* at 422, 241 P.2d at 76.

21. Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918). See note 8 *supra* and accompanying text.

22. 209 N.Y. 265, 103 N.E. 142 (1913).

23. Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944).

Fifth. Again assume the same basic facts, but *ABC* subsequently gave up its operations some two years after the agreement went into effect and subleased the remainder of its interest in the property to an unrelated third party, at the same rent called for in the orginal contract. Thus it is established that no excessive profits are involved, and also that *ABC* may be liable for sustantial damages to the sub-lessee if the agreement is avoided. In this instance a balancing of equities might well indicate that the "unfair" contract should be upheld, and statutory justification for this interpretation requires merely a literal interpretation of section 713(a) since full disclosure satisfying sub-paragraph (1) has been made.

These examples have been designed to suggest that in every dispute concerning an interested director's contract the court must first address itself to the question of whether there has been an abuse of the good faith and due care requirements of section 717. Good faith is specifically required in the California counterpart of section 713,[24] and there is no doubt but that bad faith or any other impropriety on the part of the interested director will be sufficient grounds to avoid the contract regardless of compliance with other provisions of the law. With regard to the unfair transaction, it is only after the requirements of sections 717 and 720 have been satisfied that attention should be directed to section 713(a), which at that point in the proceedings may serve three important functions:

> First, it should preclude the possibility of enforcing any prior agreement, by-law, or provision in the certificate of incorporation which is contrary to the conditions specified in this section.
>
> Second, the defendant's burden should be limited to showing full and honest disclosure by the interested director to either the board or the shareholders by whom the contract was authorized.
>
> Third, the contract in question *may* then be validated if either one of the disclosure requirements has been satisfied.

The common law "fairness" test tends to weigh the effects of the transaction heavily in favor of the plaintiff, while the defendant's interests are shrouded beneath a heavy presumption of wrongdoing;[25] thus the above proposal would prevent the interpretation of the new section from being blanketed by the occasionally inequitable common law standard. The interested director's contract is frequently of great mutual benefit to the parties involved, and the thrust of the law should be toward the protection of such agreements when entered into in good faith, with due care, and at arm's-length to as great an extent as possible. If a transaction is ultimately shown to have been unfair, then section 713(a) provides the statutory machinery to validate such a contract when justice and a balancing of equities so dictate.

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24. Cal. Corp. Code § 820 (Deering 1947).

25. Note the courts' struggle with the application of the "fairness" standard in Case v. New York Cent. R.R., 19 A.D.2d 383, 243 N.Y.S.2d 620 (1st Dep't 1963), *rev'd*, 15 N.Y.2d 150, 256 N.Y.S.2d 607 (1965).