the CEO to do what is required to prevent the payment of bribes by the company's drivers. The CEO has complied and the result has been an increase in costs such that the company no longer can operate at a profit. The CEO proposes that the company sell all its tractors (the part of the rig that contains the engine and cab) and hire independent tractor owners to haul the company's trailers. What is your reaction?

2. DUTY OF LOYALTY

A. DIRECTORS AND MANAGERS

Bayer v. Beran

49 N.Y.S.2d 2 (Sup.Ct.1944).

. . .

To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the "business judgment rule." . . . "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient." Pollitz v. Wabash R. Co., 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of "responsibility" is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.

The "business judgment rule," however, yields to the rule of undivided loyalty. This great rule of law is designed "to avoid the possibility of fraud and to avoid the temptation of self-interest." Conway, J., in Matter of Ryan's Will, 291 N.Y. 376, 406, 52 N.E.2d 909, 923. It is "designed to obliterate all divided loyalties which may creep into a fiduciary relation. . . ." Thatcher, J., in City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 132, 51 N.E.2d 674, 676. "Included within its scope is every situation in which a trustee chooses to deal with another in such close relation with the trustee that possible advantage to such other person might influence, consciously or unconsciously, the judgment of the trustee. . . ." Lehman, Ch. J., in Albright v. Jefferson County National Bank, 292 N.Y. 31, 39, 53 N.E.2d 753, 756. The dealings of a director with the corporation for which he is the fiduciary are therefore viewed "with jealousy by the courts." Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378, 380. Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict

between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided. . . . "Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director 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." Pepper v. Litton, 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed. 281.

The . . . "advertising" cause of action charges the directors with negligence, waste and improvidence in embarking the corporation [Celanese Corporation of America] upon a radio advertising program beginning in 1942 and costing about $1,000,000 a year. It is further charged that they were negligent in selecting the type of program and in renewing the radio contract for 1943. More serious than these allegations is the charge that the directors were motivated by a noncorporate purpose in causing the radio program to be undertaken and in expending large sums of money therefor. It is claimed that this radio advertising was for the benefit of Miss Jean Tennyson, one of the singers on the program, who in private life is Mrs. Camille Dreyfus, the wife of the president of the company and one of its directors; that it was undertaken to "further, foster and subsidize her career"; to "furnish a vehicle" for her talents.

Eliminating for the moment the part played by Miss Tennyson in the radio advertising campaign, it is clear that the character of the advertising, the amount to be expended therefor, and the manner in which it should be used, are all matters of business judgment and rest peculiarly within the discretion of the board of directors. Under the authorities previously cited, it is not, generally speaking, the function of a court of equity to review these matters or even to consider them. Had the wife of the president of the company not been involved, the advertising cause of action could have been disposed of summarily. Her connection with the program, however, makes it necessary to go into the facts in some detail.

Before 1942 the company had not resorted to radio advertising. While it had never maintained a fixed advertising budget, the company had, through its advertising department, spent substantial sums of money for advertising purposes. In 1941, for example, the advertising expense was $683,000, as against net sales for that year of $62,277,000 and net profits (before taxes) of $13,972,000. The advertising was at all times directed towards the creation of a consumer preference which would compel or induce the various trade elements linking the corporation to the consumer to label the corporation's products so that the consumer would know he was buying the material he wanted. The

labeled "Celanese," were different from rayon, chemically and physically; that its products had qualities, special and unique, which made them superior to rayon. The company had never called or designated its products as rayon.

As far back as ten years ago, a radio program was considered, but it did not seem attractive. In 1937, the Federal Trade Commission promulgated a rule, the effect of which was to require all celanese products to be designated and labeled rayon. The name "Celanese" could no longer be used alone. The products had to be called or labeled "rayon" or "celanese rayon." This gave the directors much concern. As one of them expressed it, "When we were compelled to put our product under the same umbrella with rayon rather than being left outside as a separate product, a thermo-plastic such as nylon is, we believed we were being treated in an unfair manner and that it was up to us, however, to do the best we could to circumvent the situation in which we found ourselves. . . . All manner of things were considered but there seemed only one thing we could do. We could either multiply our current advertising and our method of advertising in the same mediums we had been using, or we could go into radio."

The directors, in considering the matter informally, but not collectively as a board, decided towards the end of 1941 to resort to the radio and to have the company go on the air with a dignified program of fine music, the kind of program which they felt would be in keeping with what they believed to be the beauty and superior quality of their products. The radio program was not adopted on the spur of the moment or at the whim of the directors. They acted after studies reported to them, made by the advertising department, beginning in 1939. A radio consultant was employed to advise as to time and station. An advertising agency of national repute was engaged to take charge of the formulation and production of the program. It was decided to expend about $1,000,000 a year, but the commitments were to be subject to cancellation every thirteen weeks, so that the maximum obligation of the company would be not more than $250,000.

So far, there is nothing on which to base any claim of breach of fiduciary duty. Some care, diligence and prudence were exercised by these directors before they committed the company to the radio program. It was for the directors to determine whether they would resort to radio advertising; it was for them to conclude how much to spend; it was for them to decide the kind of program they would use. It would be an unwarranted act of interference for any court to attempt to substitute its judgment on these points for that of the directors, honestly arrived at. The expenditure was not reckless or unconscionable. Indeed, it bore a fair relationship to the total amount of net sales and to the earnings of the company. . . . That a program of classical and semiclassical music was selected, rather than a variety program, or a news commentator program, furnishes no ground for legal complaint. True, variety programs

have a wider popular appeal than do musicals, but it would be a very sad thing if the former were the only kind of radio programs to be used. Some of the largest industrial concerns in the country have recognized this and have maintained fine musical programs on the radio for many years.

Now we have to take up an unfortunate incident, one which cannot be viewed with the complacency displayed by some of the directors of the company. This is not a closely held family corporation. The Doctors Dreyfus and their families own about 135,000 shares of common stock, the other directors about 10,000 shares out of a total outstanding issue of 1,376,500 shares. Some of these other directors were originally employed by Dr. Camille Dreyfus, the president of the company. His wife, to whom he has been married for about twelve years, is known professionally as Miss Jean Tennyson and is a singer of wide experience.

Dr. Dreyfus, as was natural, consulted his wife about the proposed radio program; he also asked the advertising agency, that had been retained, to confer with her about it. She suggested the names of the artists, all stars of the Metropolitan Opera Company, and the name of the conductor, prominent in his field. She also offered her own services as a paid artist. All of her suggestions as to personnel were adopted by the advertising agency. While the record shows Miss Tennyson to be a competent singer, there is nothing to indicate that she was indispensable or essential to the success of the program. She received $500 an evening. It would be far-fetched to suggest that the directors caused the company to incur large expenditures for radio advertising to enable the president's wife to make $24,000 in 1942 and $20,500 in 1943.

Of course it is not improper to appoint relatives of officers or directors to responsible positions in a company. But where a close relative of the chief executive officer of a corporation, and one of its dominant directors, takes a position closely associated with a new and expensive field of activity, the motives of the directors are likely to be questioned. The board would be placed in a position where selfish, personal interests might be in conflict with the duty it owed to the corporation. That being so, the entire transaction, if challenged in the courts, must be subjected to the most rigorous scrutiny to determine whether the action of the directors was intended or calculated "to subserve some outside purpose, regardless of the consequences to the company, and in a manner inconsistent with its interests."

After such careful scrutiny I have concluded that, up to the present, there has been no breach of fiduciary duty on the part of the directors. The president undoubtedly knew that his wife might be one of the paid artists on the program. The other directors did not know this until they had approved the campaign of radio advertising and the general type of radio program. The evidence fails to show that the program was designed to foster or subsidize "the career of Miss Tennyson as an artist" or to "furnish a vehicle for her talents." That her participation in the program may have enhanced her prestige as a singer is no ground for subjecting

the directors to liability, as long as the advertising served a legitimate and a useful corporate purpose and the company received the full benefit thereof.

The musical quality of "Celanese Hour" has not been challenged, nor does the record contain anything reflecting on Miss Tennyson's competence as an artist. There is nothing in the testimony to show that some other soprano would have enhanced the artistic quality of the program or its advertising appeal. There is no suggestion that the present program is inefficient or that its cost is disproportionate to what a program of that character reasonably entails. Miss Tennyson's contract with the advertising agency retained by the directors was on a standard form, negotiated through her professional agent. Her compensation, as well as that of the other artists, was in conformity with that paid for comparable work. She received less than any of the other artists on the program. Although she appeared with greater regularity than any other singer, she received no undue prominence, no special build-up. Indeed, all of the artists were subordinated to the advertisement of the company and of its products. The company was featured. It appears also that the popularity of the program has increased since it was inaugurated.

It is clear, therefore, that the directors have not been guilty of any breach of fiduciary duty, in embarking upon the program of radio advertising and in renewing it. . . .

It is urged that the expenditures were illegal because the radio advertising program was not taken up at any formal meeting of the board of directors, and no resolution approving it was adopted by the board or by the executive committee. The general rule is that directors acting separately and not collectively as a board cannot bind the corporation. There are two reasons for this: first, that collective procedure is necessary in order that action may be deliberately taken after an opportunity for discussion and an interchange of views; and second, that directors are the agents of the stockholders and are given by law no power to act except as a board. . . . Liability may not, however, be imposed on directors because they failed to approve the radio program by resolution at a board meeting.

It is desirable to follow the regular procedure, prescribed by law, which is something more than what has, at times, thoughtlessly been termed red tape. Long experience has demonstrated the necessity for doing this in order to safeguard the interests of all concerned, particularly where, as here, the company has over 1,375,000 shares outstanding in the hands of the public, of which about 10% are held by the officers and directors.

But the failure to observe the formal requirements is by no means fatal. . . . The directorate of this company is composed largely of its executive officers. It is a close, working directorate. Its members are in daily association with one another and their full time is devoted to the business of the company with which they have been connected for many

years. In this respect it differs from the boards of many corporations of comparable size, where the directorate is made up of men of varied interests who meet only at stated, and somewhat infrequent, intervals.

The same informal practice followed in this transaction had been the customary procedure of the directors in acting on corporate projects of equal and greater magnitude. All of the members of the executive committee were available for daily consultation and they discussed and approved the plan for radio advertising. While a greater degree of formality should undoubtedly be exercised in the future, it is only just and proper to point out that these directors, with all their loose procedure, have done very well for the corporation. Under their administration the company has thrived and prospered. . . .

The expenditures for radio advertising, although made without resolution at a formal meeting of the board, were approved and authorized by the members individually, and may in no sense be considered to have been ultra vires. The resolution adopted by the board on July 6, 1943, with all of the directors present, except two who were resident in England, while expressly ratifying only the renewal of the broadcasting contract, may be deemed a ratification of all prior action taken in connection with the radio advertising. When this resolution was adopted, the Celanese Hour had been on the air to the knowledge of all the directors for eighteen months. Moreover, acceptance and retention of the benefits of the radio advertising, with full knowledge thereof, was as complete a ratification as would have resulted from any formal all-inclusive resolution. . . .

On the entire case, the directors acted in the free exercise of their honest business judgment and their conduct in the transactions challenged did not constitute negligence, waste or improvidence. The complaint is accordingly dismissed on the merits.

NOTE

Late-nineteenth-century courts generally held that a corporation could freely void any contract between it and one of its directors or officers. By the early twentieth century, courts hesitated to let firms void their contracts so easily. As a result, if a disinterested majority of directors had ratified a contract and if the complaining party could not prove it unfair, the courts generally held the contract valid. *Bayer* takes the rule one step further: because the contract is fair, it is valid even though disinterested directors have not formally ratified it.