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Corporations - Contract between Corporation and Its Controlled Affiliate to Allocate More than Proportionate Share of Tax Saving to Dominant Corporation Violates Its Fiduciary Duty to Minority Shareholders of Affiliate

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CORPORATIONS—CONTRACT BETWEEN CORPORATION AND ITS CONTROLLED AFFILIATE TO ALLOCATE MORE THAN PROPORTIONATE SHARE OF TAX SAVING TO DOMINANT CORPORATION VIOLATES ITS FIDUCIARY DUTY TO MINORITY SHAREHOLDERS OF AFFILIATE.

Case v. New York Cent. R.R. (N.Y. 1963)

The defendant, New York Central Railroad Company (hereinafter called Central), owned a majority of the stock in the Mahoning Coal Railroad Company (hereinafter called Mahoning). In 1957, Central increased its holdings in Mahoning to eighty per cent in order to qualify under current tax law[1] to file a consolidated return with Mahoning. Then, by reason of its control, it caused Mahoning to enter a contract with it by which any tax savings accruing to Mahoning as a result of the consolidated return would be allocated in the proportion of ninety three per cent to Central and seven per cent to Mahoning.[2] The minority stockholders of Mahoning brought suit claiming a violation of the fiduciary duties owed them by Central as majority stockholder.

The relief sought by the plaintiffs was rescission of the allocation agreement and an accounting of all moneys received by Central from Mahoning pursuant to the contract for the tax years 1957-60. The Appellate Division with two judges dissenting, reversed the lower court and *held* the allocation agreement unfair and unenforceable against the minority stockholders. It further directed the defendant to account for all moneys received under the agreement. *Case v. New York Cent. R.R.*, ... App. Div. ...., 243 N.Y.S.2d 620 (1963).

The court, in holding this agreement invalid, found that there was a fiduciary relationship between Central, as majority stockholder in Mahoning, and the plaintiffs as minority stockholders, which required fairness in dealings between the affiliates. It cited scant precedent in the

1. INT. REV. CODE OF 1954, §§ 1501-04.

2. Since 1884, Central had owned a majority of the stock of Mahoning and had been the lessee of Mahoning's railroad under an agreement by which Central paid all maintenance and operating expenses of the railroad and, in addition, paid to Mahoning 40% of gross earnings. In 1957, Central acquired additional stock of Mahoning in order to qualify Mahoning as an "affiliate" under the 1954 revision of the Internal Revenue Code *(Ibid.)* and allow it to file a consolidated return, thus permitting Mahoning's net profits to be setoff against Central's net losses.

Had Mahoning filed separate returns for the years in question, 1957-1960, its total tax liability would have been $3,825,717.43. The filing of consolidated returns caused Mahoning's net profits to be totally offset by Central's losses and effected a saving of the entire tax liability. The agreement in dispute here, provided for distribution of this tax saving, and by its terms, the sum of $3,556,992.15, or approximately 93%, was allocated to Central. The balance of the tax saving, $268,725.28, or 7%, was the net saving to Mahoning. This saving then, in theory, became a potential dividend to the stockholders of Mahoning which gave the 20% minority stockholders a dividend expectancy of $53,751.05, or approximately 1.5%, of the original tax saving, and gave to Central, as 80% stockholders, $3,771,966.38, or 98.5% of the total tax savings. It is because of this disproportionate distribution of Mahoning's tax saving that the minority stockholders allege a breach of fiduciary duty by Central as controlling majority stockholders.

particular field of allocation of tax savings. *Western Pac. R.R. v. Western Pac. R.R.*[3] had settled the proposition that, in the absence of agreement, the tax saving would fall where it may. That case, however, did not involve any agreement and could not answer the problem presented here. The only case cited which did involve an agreement to allocate tax savings to one other than the one benefited by it was *Alleigro v. Pan American Bank.*[4] That case also involved a parent and subsidiary corporation. The court there held the agreement invalid, but on the theory that the allocation represented a preferential dividend which was not ratified by the stockholders. The court in the instant case did not reach that question and stated that it was unnecessary to do so. The avoidance of that problem seems to be correct. The basic question is whether such an agreement between affiliates is fair. Although a finding that any money transferred under such an agreement is in fact a preferential dividend would a fortiori require a finding that the agreement was unfair, if it is found unfair on the more general ground of fiduciary duty, as it was here, it is logically unnecessary to proceed further.

The basic problem of fairness is best highlighted by the dissenting opinion. It argues that since Mahoning would have paid all the money to the federal government as tax liability, the savings, "whatever percentage, . . . represents income that Mahoning's minority stockholders would never have realized had there been no agreement."[5] The point the opinion makes is simply, if there is no injury, but in fact benefit to Mahoning, how can the contract be unfair? To understand why the simplicity of this argument may entrap the unwary, it is necessary to examine first how the fiduciary duty is created and the burdens it imposes.

Generally, a fiduciary relationship arises in those cases in which one holds a position of superiority and influence over the interest of another so that the latter is forced to rely upon the good faith and fair dealings of the former.[6] The law gives the majority shareholders the right to control, but requires that those who have this control act with the utmost good faith.[7] Thus where the majority control causes the corporation to enter a profitable transaction, the minority may not be excluded from a fair participation in the fruits of the deal.[8]

3. 197 F.2d 994 (9th Cir. 1951).
4. 149 So. 2d 45 (Fla. 1963).
5. Case v. New York Cent. R.R., 243 N.Y.S.2d 620, 626 (App. Div. 1963).
6. Schweickhardt v. Chessen, 329 Ill. 637, 161 N.E. 118 (1928); Small v. Nelson, 137 Me. 178, 16 A.2d 473 (1940).
7. In Allied Chem. & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 1, 120 Atl. 486 (1923), the court said:

> The same considerations of fundamental justice which impose a fiduciary character upon the relationship of the directors to the stockholders will also impose . . . a like character upon the relationship which the majority of the stockholders bear to the minority. . . . Unless the majority in such case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs.

Id. at 12-13, 120 Atl. at 491.
8. Southern Pac. Co. v. Bogert, 250 U.S. 483, 488, 39 S.Ct. 533, 535 (1918).

In *Case,* Central, as majority stockholder of Mahoning, had nominated all directors, of whom five were officials of Central and one an official of one of its other subsidiaries. Where one corporation controls another by holding a majority of the stock, and elects its own employees to control the board of directors, contracts between the two corporations must be regarded as if between a corporation and its directors, and should be governed by the same principles.[9] The general rule seems to be that such transactions are subject to the careful and close scrutiny of the courts,[10] and according to the weight of authority such contracts will be set aside unless they are fair and reasonable.[11]

The dissent recognizes the nature of the relation when it says "that the agreement was one made by Central with itself,"[12] but it fails to apply the standard demanded. The traditional bargaining mechanism of the market place which determines values to be received in the normal agreement is obviously not present in dealings between a dominant and a dominated corporation. The courts attempt to compensate for the balance acquired in the free market by inserting the fairness test. Although this test affords the fiduciary more latitude than the strict duties of the trustee which prohibits any self-dealing[13] it still provides a constant reminder to directors, officers and majority stockholders that the minority interests will be protected when equity requires.

The essence of the test of fairness is whether or not, under all the circumstances, the transaction carries the earmarks of an arm's length bargain.[14] Thus, while all contracts between a dominant and a dominated corporation are not void, the element of fairness must be present. The majority in *Case* recognizes that "there cannot be effective independent bargaining among affiliates,"[15] and applied the proper test when it held that Central, as majority stockholder, owed a duty of fairness in its dealings with Mahoning.

The defendant argues that it was only through Central's *independent* decision to make increased investment in additional stock and its *consent* to file a consolidated return that a tax saving was realized. The apparent thrust of this argument was that the contract was based on adequate consideration and thus should be enforceable. Even assuming this issue to be arguable in spite of the fairness required, the majority adequately and logically answers this argument by saying that "this was not an act of

9. Ripley v. International Rys., 8 N.Y.2d 430, 436, 209 N.Y.S.2d 289, 292 (1960); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 195-96, 123 N.E. 148, 151-52 (1919); Farmers' Loan & Trust Co. v. New York & No. R.R., 150 N.Y. 410, 429-30, 44 N.E. 1043, 1048-49 (1896).

10. Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238 (1939); Twin-Lick Oil Co. v. Marbury, 91 U.S. 328 (1875).

11. Montgomery Traction Co. v. Harmon, 140 Ala. 505, 37 So. 371 (1904).

12. Case v. New York Cent. R.R., 243 N.Y.S.2d 620, 626 (App. Div. 1963).

13. RESTATEMENT (SECOND), TRUSTS § 170, comment *b*; § 206 (1959).

14. Pepper v. Litton, 308 U.S. 295, 306-07, 60 S.Ct. 238, 245 (1939).

15. Case v. New York Cent. R.R., 243 N.Y.S.2d 620, 623 (App. Div. 1963).

Central that was a matter of free choice."[16] They express the view that, in the light of the obvious saving to the affiliated corporations, Central had a "duty" to qualify Mahoning by increasing its investment in stock up to eighty per cent.[17] The majority thus relies on the well-recognized principle that a pre-existing duty will not support a new promise and, therefore, the contract is void for lack of consideration. However, even if the court had reached the opposite conclusion on this issue, the most important and determinative issue here was whether the contract was fair.

Case was a unique situation which was the product of the Internal Revenue Code provisions "permitting" affiliated corporations to file consolidated returns.[18] These provisions recognize the realities of big business and allow a large corporate complex to file income tax returns as one unit. The Code provisions contain an inherent ambiguity in requiring the "consent" of each corporation in an affiliated group,[19] and on the other hand, in specifying eighty per cent ownership of the subsidiary by the parent.[20]

The requirement of consent by both parties gives some weight to Central's position that the contract was fair, and to Mr. Justice Jackson's argument in his dissenting opinion in *Western Pac. R.R. v. Western Pac. R.R.*[21] Jackson argued that the loss corporation had a right to ask for compensation for the use of its loss privilege and said "indeed, it is probable that the intention of the statute . . . was to provide salvage for the loser, not profit for one which sustained no loss."[22] The argument can then be made that the consent requirement would have permitted Central to refuse to allow Mahoning the benefit of its tax loss.

However, there is an intrinsic fallacy in the argument as used here. The Code clearly calls for eighty per cent ownership.[23] This factor plus the realities of corporate organization make it clear that the decision as to Mahoning's consent was made only by the dominant corporation, and the subsidiary's "consent" was automatic. Central's consent was compelled by its duty to the affiliate. Thus, while automatic consent may be sufficient to meet the standard of the tax provision, it has no bearing on collateral allocation agreements. Given the fiduciary duty of Central, the court simply determined that the contract was unfair and void.

There is an apparent dearth of authority concerning the effects of consolidated returns on the rights of the stockholder. The federal tax provisions involved clearly provide no answer since they merely allow certain advantages if a corporate complex so organizes itself to meet the

16. *Id.* at 624.
17. The additional investment of $1,000,000 is hardly significant in proportion to the tax saving of $3,825,717.43 over the period 1957-1960.
18. INT. REV. CODE OF 1954, §§ 1501-04.
19. INT. REV. CODE OF 1954, § 1501.
20. INT. REV. CODE OF 1954, § 1504(a)(1).
21. 345 U.S. 247, 73 S.Ct. 656 (1953). The majority opinion in this case was involved only with procedural aspects. It did not disturb the holding of the lower court on the merits. Western Pac. R.R. v. Western Pac. R.R., 197 F.2d 994 (9th Cir. 1951).
22. *Id.* at 277, 73 S.Ct. at 671.
23. INT. REV. CODE OF 1954, § 1504(a)(1).