Upstream Financing and Use of the Corporate Guaranty

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UPSTREAM FINANCING AND USE OF THE CORPORATE GUARANTY

I. Introduction

A. Upstream Financing

Upstream financing is a useful tool for affiliated corporations seeking to make the most efficient use of combined resources. Essentially, "upstream" financing occurs when a subsidiary corporation loans its parent money or guarantees its parent's obligations. It is to be distinguished from cross-stream (subsidiary to subsidiary) or downstream (parent to subsidiary) financing, and from financing between brother-sister corporations, although these transactions are analogous.

Affiliated corporations use upstream financing when the parent needs extra capital, either for current operations or for a new venture, and cannot otherwise obtain the financing due to past restrictions on debt or insufficient collateral. For example, a situation might arise involving a business opportunity that is best suited for the parent. Although a financing institution might not be willing to finance the parent on the strength of its credit alone, the subsidiary's guaranty may provide the protection which the bank needs. In this way the parent can benefit from the opportunity which otherwise would have been lost, and the corporate group as a whole also benefits.

Upstream financing can be accomplished by the use of loans or by the use of a guaranty. Various considerations influence the choice between these alternatives. If the subsidiary's assets are cash, cash equivalents, or assets that can easily be turned into cash, a loan may be appropriate. The availability of outside capital is a major consideration, involving not only the question of whether the corporation can obtain access to the capital, but also whether interest rates and other terms are more favorable than those which the subsidiary can offer. Restrictions on the use of the subsidiary's funds may also greatly influence the choice of financing. For example, restrictions which may be determinative are those which creditors or preferred stockholders have placed on the subsidiary, limiting its ability to issue new bonds, execute loans, or mortgage assets. If these types of restrictions are present, a loan may be impossible; depending on the restriction, however, a guaranty may be a feasible alternative.

The law regulating upstream loans is less complex than that concerning the use of guaranties, and this relative simplicity might be determinative. In the many circumstances in which a loan is not practical, however, the corporate guaranty can be extremely valuable for financing existing ventures, promoting expansion, and establishing new enterprises. This note will therefore focus on the use of the corporate guaranty for upstream financing.

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1 Brother-sister corporations are two separate entities which are related only by the fact that a common stockholder owns over 50% of the stock of each corporation.
2 A guaranty is a promise to pay in the event that the principal defaults. See text accompanying note 8 infra.
3 See text accompanying note 8 infra.
B. Problems Involved

If an upstream guaranty is utilized and the venture is a success, problems generally do not arise. Rather, it is when the venture fails and enforcement of the guaranty is sought that its validity is questioned. The ensuing lawsuit generally is a result of the corporation’s failure to honor the guaranty, often due to a lack of funds or bankruptcy. The institution that accepted the guaranty sues the corporation and the defense of ultra vires⁵ is invoked by the corporation. Another situation in which a lawsuit may result from the guaranty involves attempted payment of the guaranty by the corporation. At this time, stockholders or intra vires⁶ creditors may sue the corporation to enjoin payment, claiming that payment would be ultra vires.

The underlying basis of such challenges is the fact that the corporations involved in upstream financing are legally separate entities which are assumed to exist to further their own separate interests, not those of related companies. Therefore, the courts often insist that the subsidiary benefit from a guaranty to prevent a finding that the guaranty is a misuse of the subsidiary’s assets and hence unenforceable.

Although tangible benefit to the subsidiary may not occur, affiliated corporations are often operated in such a way that when one of the corporations benefits, the others also benefit, at least indirectly. Therefore, at the outset, when attempting to procure financing, affiliated corporations present themselves as an economic unit which desires to employ the subsidiary’s assets for the benefit of the parent. The corporations argue that they actually are an integrated economic unit; if the parent is benefited, so is the group.

When such ventures fail and the parties confront each other in court, however, corporations often attempt to avoid legal responsibilities by arguing that they are legally separate entities and that the subsidiary did not benefit from the venture. Therefore, the guaranty was ultra vires and is unenforceable by the creditors. These contradictory arguments framed by corporate counsel for tactical reasons in the course of litigation have contributed to a lack of uniformity in case law.

The fact that corporate guaranty problems do not arise in isolation poses yet another obstacle to a clear understanding of the law in the area. Questions concerning corporate guaranties are usually presented in the midst of various other corporate problems, arising long after execution of the guaranty. For example, the guaranty issue is often raised in bankruptcy proceedings, or in litigation concerning alleged abuse of the corporate system.

Contributing further to judicial difficulty in the matter is the fact that subsidiary-parent guaranties involve a mixture of corporate guaranty law and fiduciary duty law. These two areas are directly applicable to upstream financing, yet the extent to which any given court will rely on each approach is unclear. Moreover, courts seldom segregate the issues involved, which increases the difficulty of ascertaining the appropriate test to be used in evaluating the

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⁵ An ultra vires act is an act which is beyond the scope of the powers of a corporate charter or act of incorporation.

⁶ Intra vires means within the scope of corporate powers.
validity of the guaranty. In addition, the obscurity of the common law in each of these two areas makes it even more difficult to find a suitable test for upstream guaranties.

Despite these problems, there are certain tests which courts frequently apply to determine the validity of an upstream guaranty. One such test is the benefit test. As previously noted, courts often require a benefit to the guarantor corporation so that the transaction ostensibly fulfills a corporate purpose of the guarantor and is therefore not ultra vires. The concept of "benefit" cannot, however, be defined precisely. For example, securing a future sale might constitute a benefit. Consummating a transaction which will improve a corporation's public image might also be said to benefit that company. Since the concept of benefit involves the potential for such a wide range of results, courts have often required that the benefit be "direct." It is questionable whether this requirement has helped, however, since courts also vary considerably in their interpretation of the term "direct."

Financing institutions are hesitant to accept an upstream guaranty because of the lack of judicial uniformity in the field and the corresponding uncertainty surrounding the enforceability of such guaranties. This obviously hampers the effectiveness of an otherwise useful tool. In order to make this financing technique more acceptable to creditors and therefore more available for corporate use, a greater degree of predictability must be achieved. Consistent, uniform judicial treatment of "upstream" guaranties could promote upstream financing while still protecting creditors and minority stockholders. Financing institutions could then accept these guaranties with a reasonable expectation that they would be upheld. This would obviously promote a more efficient use of the resources of affiliated corporations.

In order to propose an appropriate judicial response to upstream guaranties, the effect of both corporate guaranty law and fiduciary duty law must be considered. Moreover, many state statutes are applicable, and the effect of these statutes on the common law must also be analyzed. Once these areas have been analyzed individually, it will then be possible to consider how the courts might combine them to achieve a uniform standard by which to judge upstream financing transactions.

II. The Corporate Guaranty

A. The Common Law

Whenever a corporation guaranties a note as an accommodation, there is a strong possibility that the guaranty will be voidable as ultra vires. When sustaining this defense the courts emphasize the fact that the plaintiff knew that

7 See text accompanying note 13 infra.
9 See text accompanying note 15 infra.
10 For a complete discussion of the corporate guaranty, see Kreidmann, supra note 8.
the guarantor was receiving none of the funds and that the guaranty was solely
to accommodate the borrower.¹¹

Courts vary in their methods of determining when these guaranties will be
enforced. In the absence of statutes,¹² an empowering provision in the guar-
antor’s corporate charter will often be sought. If there is no such provision,
many courts are reluctant to find an implied power. However, other courts
recognize such a power and will enforce the guaranty if the “transaction can
reasonably be said to be incidental to the conduct of the business authorized by
the charter.”¹³

The key to the decisions appears to be in identifying a “benefit” to the
guarantor corporation. In addition to express and implied power to execute
guaranties, most courts require that the guarantor corporation “directly benefit”
from the transaction. The determination of whether a benefit is direct or in-
direct appears to be the major problem underlying corporate guaranty law.

Direct benefit is an intangible concept which may be viewed quite differ-
ently by different courts, especially since the question is one of degree. Strictly
speaking, it would seem that direct benefits would include only such things as a
sale, a future sale, or the assured re-payment of a loan that was previously
questionable. However, varying corporate situations arise involving “grey” areas
as to which reasonable persons could differ in deciding whether the benefit is
direct or indirect.¹⁴ Indeed, cases exist in which courts faced with substantially
identical facts have reached opposite conclusions.¹⁵

An additional problem involves the fact that some courts, while actually
seeking a benefit, employ different wording in framing their tests. An example
of this is the use of the “reasonably incidental to the conduct of business”
standard. On first impression this test appears to be different from the direct
benefit test. Anything “incidental to the conduct of business” would benefit the
corporation, but the wording of the test does not call for such a strict interpre-
tation of benefit as the “direct” benefit test purports to do. Using this “incidental
to the conduct of business” test, courts have allowed a brewing corporation to
become a surety on a liquor bond for a saloon keeper,¹⁶ a corporation to become
a guarantor of a valuable employee’s payment for furniture,¹⁷ and a corporation
to guaranty a customer’s debt to another to allow the debtor to stay in business.¹⁸

The results in these cases could have been the same, however, even if the
court had applied the “direct” benefit test due to the wide variance in de-

¹¹ Id. at 231. See also Foster v. Merkle-Korff Gear Co., 233 Ill. App. 302 (1924); Farmers’ & Traders’ Bank v. Thixton, Millett & Co., 199 Ky. 69, 250 S.W. 504 (1923).
¹² See text accompanying note 26 infra.
¹³ See Kreidmann, supra note 8, at 231; see also Credit Co. v. Howe Machine Co., 54 Conn. 337, 8 A. 472 (1886); Central Trust Co. v. Smurr & Kamen Mach. Co., 191 Ill. App. 613 (1915); Monument Nat’l Bank v. Globe Works, 101 Mass. 57 (1869).
¹⁴ See Kreidmann, supra note 8, at 233, for a discussion of which benefits have been held
to be direct or indirect in the past.
¹⁵ See Kreidmann, supra note 8, at 233; see also Central Lumber Co. v. Kelter, 201 Ill.
503, 66 N.E. 543 (1903); W. C. Bowman Lumber Co. v. Pierson, 110 Tex. 543, 221 S.W.
930 (1920).
¹⁶ Horst v. Lewis, 71 Neb. 365, 98 N.W. 1046 (1904).
¹⁷ M. Burg & Sons v. Twin City Four Wheel Drive Co., 140 Minn. 101, 167 N.W. 300
(1918).
terminations of what constitutes "direct." Due to this variance, the two tests appear to be so similar that uniform wording would produce substantially the same results while making the law much easier to follow and apply.

To further complicate the matter, a court's view of what constitutes a direct benefit may vary depending on who is suing. If the intra vires creditors or the stockholders are suing, the transaction is more likely to be considered ultra vires since the courts are more protective of these parties than they are of the corporation when the party seeking to enforce the guaranty is the plaintiff. It appears that the courts are often seeking to reach what is perceived as a "fair" result, and as a consequence the bases for the decision of what is direct or indirect vary; they frequently appear tailored to support the results which the courts seek to attain.

If the court cannot fit the transaction into an allowable category, there is at least one alternative to declaring the guaranty unenforceable as ultra vires. When the equities are clearly with the lending party, yet the transaction appears to have been ultra vires, the court may apply the doctrine of estoppel if the guarantor corporation has accepted some benefits. The justification for applying this doctrine is that the corporation should not seek to retain benefits and reject burdens.

The use of the estoppel doctrine still involves a benefit analysis, but benefits need not be direct. For example, in *McCornick & Co. v. Citizen's Bank,* the bank guarantied its customer's drafts. The bank was later estopped from setting up a defense of ultra vires, since it had benefited from securing and holding the banking business of a good customer.

If the creditor had knowledge of the potential unenforceability of the guaranty, however, a court may refuse to apply estoppel or may even refuse to apply the usual benefit analysis. In *Wm. Filene's Sons Co. v. Gilchrist Co.,* the subsidiary corporation guarantied a lease of the parent corporation. The parent corporation defaulted on the lease and the lessor attempted to enforce the guaranty. The lessor-plaintiff argued that the benefit test was satisfied since the subsidiary benefited by having a non-competitive store in that location. Before execution of the guaranty, however, the lessor had been aware that the guaranty might be ultra vires if a benefit was not found. The court decided that the guaranty was being used to the personal advantage of the majority stockholder and refused to consider any equitable principles since the creditor had been aware of the potential problem.
B. Statutory Change

All of the foregoing tests have been developed through the common law. Recently, however, many states have enacted statutes that alter these traditional approaches dramatically. For example, one type of statute prohibits guaranties except by a vote of two-thirds of the shares of all classes of stock. This can be an advantage to financing institutions and corporations seeking to convince the institutions to accept the guaranty, because no benefit, direct or incidental, need be shown. However, this type of provision can be impractical in all but the smallest corporations since attempting to secure approval from a large group of stockholders is costly and impractical.

Other statutes have more directly expanded the power to guaranty. An important example of this type of statute is the Model Business Corporation Act, which simply states:

Each corporation shall have power:

(h) To make contracts and guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises, and income.

Another example is a Georgia statute, which allows a corporation "to make any purely accommodation guaranty, indorsement, or contract of suretyship" if its charter so provides. Similarly, a North Carolina statute gives a corporation the power "[t]o enter into contracts of guaranty or suretyship or make other financial arrangements for the benefit of its personnel or customers or suppliers." This statute is of limited utility in upstream financing situations, however, since another North Carolina statute simultaneously requires stockholder approval for issuance of a corporate guaranty of the indebtedness of a related corporation.

Although these statutes expand corporate guaranty powers, interpretations of the statutes vary. Some courts may still require a direct benefit, regardless of the statute, while other courts will not inquire into benefit at all. This variation in approach is readily apparent in interpretations of corporate charter authorization clauses. Some courts will adamantly require a direct benefit in addition to an empowering provision in the charter, whereas other courts will require no benefit at all when such a provision is present.

27 1 MBCA § 4(h) (1974). This section has been adopted identically or identically in substance in Hawaii, Indiana, Mississippi, Montana, Nebraska, New Mexico, Oregon, Utah, Washington, and Wyoming. Comparable statutes have been enacted in Alabama, Alaska, Arkansas, Colorado, Delaware, Georgia, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New York, North Carolina, North Dakota, South Carolina, South Dakota, Tennessee, Texas, Virginia, and the District of Columbia. For other provisions, see MBCA.
29 N.C.GEN. STAT. § 55-17(b)(3) (Supp. 1959).
31 See Kreidmann, supra note 8, at 241.
Many recent statutes follow another provision of the *Model Act* and abolish the defense of ultra vires except in a few situations. This type of statute precludes the use of the defense by the corporation when the financing institution attempts to enforce the guaranty. It provides that no act shall be invalid by reason of lack of capacity or power unless the claim is asserted by a) a shareholder to enjoin the doing of the act; b) the corporation or its representatives against the officers or directors; or c) the Attorney General to enjoin the act or to dissolve the corporation.

This statute makes it much less important for the creditor to inquire into the power of the corporation to guaranty or to predict whether the guarantor corporation will benefit from the transaction. As discussed previously, the major problem in seeking to enforce an upstream guaranty is the lack of a recognizable benefit to the subsidiary. Since this is true, creditors are reluctant to accept this type of financing. With the abolishment of this defense as to creditors, the prospect of finding lenders willing to finance under such an arrangement improves.

Even in a state which adopts the *Model Act*, however, the possibility of stockholder intervention exists. The *Model Act* provides that stockholders may enjoin any act by claiming that the act is beyond the power of the corporation. A Texas case, *Inter-Continental Corporation v. Moody*, involved a statute substantially the same as this *Model Act* provision. In *Inter-Continental*, Moody procured funds from a financing institution to loan to the corporation. These loans were used to purchase investments which were allegedly for the benefit of the president. The corporation, *Inter-Continental*, entered into a contract which provided for a fee to be paid to Moody for procuring the loans. During the trial for collection of the fee, the evidence tended to show that the loans were for the personal benefit of the president, and since there was no direct benefit to the corporation, the contract was actually ultra vires. Since Texas had abolished the ultra vires defense, however, *Inter-Continental* could not assert it. To overcome this difficulty, *Inter-Continental* found a stockholder who was willing to intervene. An interlocutory appeal was taken to determine if this was allowable. The appellate court held that intervention was proper and it instructed the lower court to enjoin payment to Moody if the loans were found to be for the personal benefit of the president.

Even in those states which restrict the ultra vires defense, financing institutions contemplating acceptance of an upstream guaranty must therefore con-

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33 1 MBCA § 7 (1974).
35 See Empire Steel Co. v. Omni Steel, 378 S.W.2d 905 (Tex. Civ. App. 1964), where the Texas statute is applied to preclude the assertion of the defense of ultra vires. See also Cooper Petroleum Co. v. LaGloria Oil & Gas Co., 423 S.W.2d 645 (Tex. Civ. App. 1967).
38 Id. at 591.
sider the possibility of stockholder intervention. Although the Model Act does provide for possible damages when a corporate act is enjoined, the lender should consider whether this protection would be adequate should resort to the courts be necessary.

C. Application to Upstream Financing

Recent case law and statutory change illustrate the trend toward enforcement of guaranties. This has been accomplished in the common law by a "generous interpretation" of the direct benefit test. As previously noted, the use of the direct benefit and similar tests has allowed enforcement of guaranties on employees' debts and customers' debts, as well as many other transactions that can hardly be said to directly benefit the corporation. Although companies cannot always depend on such a generous interpretation of benefit, the trend appears to be in this direction. This development is important even in states with liberal guaranty statutes, since even though the statute may allow a guaranty, courts may still look for some benefit or furtherance of the corporate purpose. Finally, legislative expansion of the power to guaranty and the abolition of the ultra vires defense shows that the legislatures, as well as the courts, intend to promote enforcement of guaranties.

This expansive trend in the general field of corporate guaranty law obviously affects upstream guaranties. Whereas a subsidiary may not be "directly" benefited by a venture in which the parent has become involved and which the subsidiary has guarantied, in many situations it is obviously to the subsidiary's benefit to have a profitable parent. The subsidiary is often dependent on the parent for various needs; advertising, publicity, finances, and supplies are but a few of the possible advantages the subsidiary may receive. These benefits should be considered by the court as sufficient to meet the "direct" benefit test if the courts are to carry out the liberal intent of the statutory provisions relating to the enforcement of guaranties generally.

In Stromberg-Carlson T. Mfg. Co. v. George C. Beckwith Co., this type of benefit was accepted by the court as sufficient to uphold a guaranty. Although the case involved a guaranty between brother-sister corporations, the situation is analogous to upstream guaranties. The president of the guarantor corporation owned "most of the stock" of the guarantor corporation and all of the stock of an unrelated corporation. The first corporation guarantied the debt of the latter and the court upheld the guaranty. The court said that the defendant guarantor

39 The majority stockholders who planned the transaction may want to solicit a minority stockholder to do the intervening in order to prevent the guaranty from being enforced. Often this includes paying his expenses.
41 See text accompanying note 16 supra.
42 See note 14 supra.
43 See note 31 supra.
45 Although the subsidiary is financing the parent now, in other situations, past or future, the parent may help finance the subsidiary.
46 193 Minn. 255, 258 N.W. 314 (1935).
corporation had interests to protect in securing credit for the debtor. The guarantor corporation had a strong interest in the debtor corporation continuing in business and meeting the previous obligations which the guarantor corporation had incurred in the debtor's behalf.

This is directly analogous to the situation in which a subsidiary has loaned the parent money in the past. The court in *Stromberg-Carlson* enforced the guaranty, paying particular attention to the property interest involved. In the words of the court:

> While a corporation cannot become a surety on obligations in which it has no interest, it may guarantee the obligations of its subsidiary companies; and this doctrine has been extended to permit it to guarantee the obligations of others where the purpose is to promote or protect its own rights or property interests, or to accomplish some legitimate object of financial benefit to it...\(^{47}\)

This rationale makes it relatively simple to uphold downstream financing without inquiring into previous interfinancing due to the parent's stock interest in the subsidiary. Finding a property interest of the subsidiary in the parent is more difficult. However, a property interest seems to include previous loans and could conceivably include other "rights" which the subsidiary wishes to protect, such as the right to help the parent continue in business, which would be a legitimate financial benefit to the subsidiary. Of course this has not yet become a majority rule, nor even a "trend in the law," and therefore it cannot be heavily relied on in planning a similar transaction.

III. Minority Interests: The Fiduciary Duty Doctrine

A. Tests

The law involving minority interests is as unsettled as corporate guaranty law.\(^{48}\) The basic problem underlying this area is that majority stockholders, including parent corporations, have the potential to exert their power for personal reasons, to the detriment of the minority. To avoid such abuses, a fiduciary duty is held to exist when the majority stockholders become involved in the management of the business.\(^{49}\) In a parent-subsidiary context, this means that the parent, if involved in the affairs of the subsidiary, owes a fiduciary duty to the subsidiary's minority stockholders.

Various tests have been used to determine when the fiduciary duty has been violated. The most frequently used test examines a transaction as if the parties were independent to determine whether the parties would have entered into

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47 *Id.* at 315. *Accord In re* Duncan & Goodell Co., 15 F. Supp. 550 (D. Mass. 1936), where the court allowed a downstream guaranty to protect the interest of the corporation in the subsidiary.

48 For a complete discussion, see Comment, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, 74 *Yale L. J.* 338 (1964).

this transaction had not been this relationship. This analysis involves basic contract bargaining principles, such as arms-length dealing and consideration. If these factors are present, it is assumed that the parties would have made the decision in the same way regardless of the identity of the other party.\textsuperscript{50}

Often the test of good faith is substituted for, or used in conjunction with, the “arms-length” test. This entails inquiry into whether the majority stockholders who controlled the transaction acted in good faith, with the corporation’s interests in mind, and not to carry out personal objectives. Of course, “good faith” is quite a subjective concept which is difficult to define in a particular case.\textsuperscript{51}

The business judgment rule and the intrinsic fairness test are two alternative approaches commonly applied to evaluate the fairness of parent-subsidiary transactions.\textsuperscript{52} Of these alternative approaches, the intrinsic fairness test has been the one most often utilized in the past. When the intrinsic fairness test is applied, the burden is on the defendants to show that the transaction was made in good faith and in the best interests of the subsidiary; the presumption is against the parent.

For example, in \textit{Taussig v. Wellington Fund, Inc.},\textsuperscript{53} the stockholders of the parent challenged the use of the goodwill of the name of the parent by the subsidiary. Since a majority of the directors who controlled the transaction were not disinterested in it, the court said that it was not required to accept the business judgment of the directors. The court stated:

When directors are thus interested in and obligated to both transferor and transferee, a court of equity is not obligated to accept the directors’ judgment, but may and, indeed, should require them to prove to the court’s satisfaction that the [transaction] has been equitable.\textsuperscript{54}

The business judgment rule, on the other hand, simply asks whether the management has made a sound business decision and requires the plaintiff to prove “gross and palpable over-reaching” in order to overturn the managers’ decision.\textsuperscript{55} The presumption here is in favor of the parent. This rule tends to disregard the minority’s interests for the sake of non-interference with management decisions.\textsuperscript{56}

In a recent Delaware case, \textit{Sinclair Oil Corporation v. Levien},\textsuperscript{57} the court expanded the scope of the business judgment rule in cases involving parents and subsidiaries by limiting the applicability of the intrinsic fairness test to situations

\textsuperscript{50} See note 48 \textit{supra}, at 339; see, \textit{e.g.}, Pepper \textit{v. Litton}, 308 U.S. 295, 306-07 (1939); Geddes \textit{v. Anaconda Mining Co.}, 254 U.S. 590, 599 (1921).

\textsuperscript{51} Id. at 342-43.


\textsuperscript{53} 313 F.2d 472 (3d Cir. 1963). \textit{See also} Sterling \textit{v. Mayflower Hotel Corp.}, 33 Del. Ch. 20, 89 A.2d 862 (1943).

\textsuperscript{54} Id. at 479.


\textsuperscript{56} Id. at 477.

\textsuperscript{57} 280 A.2d 717 (Del. 1971).
marked by self-dealing. In general, self-dealing "relates to transactions wherein a trustee, acting for himself and also as trustee, a relation which demands strict fidelity to others, seeks to consummate a deal wherein self-interest is opposed to duty." When applying "self-dealing" to parent-subsidiary affairs, the Levien court interpreted the term somewhat differently: "[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."

In this case, Sinclair Oil Corporation held 97% of the stock of Sinclair Venezuelan Oil Company (Sinven). The board of directors of Sinven was comprised of directors nominated by Sinclair. Since these directors were not independent, they owed a fiduciary duty to the minority stockholders of Sinven. In this derivative action, Sinven's minority stockholders argued that Sinven had paid excessive dividends due to Sinclair's need for cash. The minority interest also contended that the intrinsic fairness test should be applied and that the burden of showing fairness was therefore on the parent. The court decided that this transaction did not involve self-dealing since a portion of the money was received by the minority stockholders; the majority received nothing that the minority did not receive. Since self-dealing was not involved the business judgment rule became the applicable test and the court let the managers' decision stand.

A similar approach, recently adopted by a New York court in Case v. New York Central Railroad Company, applies the advantage/disadvantage test to determine whether to apply the business judgment rule or to delve more deeply into questions of fairness. When this test is applied, the plaintiff must show advantage to the parent and disadvantage to the subsidiary or the court will not examine the fairness of the transaction.

Case involved an allocation of tax benefits due to offsets of gains and losses between the parent and the subsidiary. The allocation gave some benefits to the subsidiary, but most of the benefits flowed to the parent. Since the subsidiary lost no money, the court refused to examine the fairness of the transaction, stating, "in the absence of this kind of disparity [advantage/disadvantage] the business judgment of corporate officers will not be interfered with." The rationale for the disparity requirement seems to be that if no one has been hurt, the courts will look no further. Such a view, however, ignores the fact that perhaps the subsidiary should have benefited and did not. Also, when the subsidiary has been put to a disadvantage but the parent has not benefited (possibly due to a bad bargain), courts adopting this test would not investigate the transaction.

59 280 A.2d 717, 720 (Del. 1971).
60 Another example of a situation in which self-dealing has been held not to be present is when a third party has some control over the transaction, or sets the terms of the bargain. See Getty Oil Co. v. Skelly Oil Co., 255 A.2d 717 (Del. Ch. 1969). See also Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967), where the business judgment rule is applied.
62 Id. at 611, 204 N.E.2d at 646.
B. Corporate Opportunity Doctrine

In addition to the factors examined above, corporations utilizing upstream financing must consider the diversion of corporate opportunity doctrine. This doctrine is applicable when an opportunity comes before an individual who owes a fiduciary duty to a corporation. If the opportunity is one that the corporation can and should use, the individual cannot usurp the corporation's opportunity to do so. The doctrine is important in the context of fiduciary duty of the parent to the subsidiary, since the subsidiary's assets are being used to finance a business venture. Thus, the question arises as to whether the subsidiary should also be entitled to the benefits of the venture.

This is not necessarily the situation presented in upstream financing, however, for various reasons. First, the subsidiary corporation may not be in the same line of business as the parent, and to envision the subsidiary taking the opportunity would be unrealistic from a business point of view. Second, the subsidiary may be supplying only a portion of the financing; the guaranty may simply be additional security to secure a commitment from a bank.

In Maxwell v. Northwest Industries, Inc., for example, Northwest Industries (NWI) was a conglomerate which owned 97% of the stock of Philadelphia & Reading Corp. (P&R), a subsidiary with an unrelated line of business. NWI desired to acquire another subsidiary and borrowed a significant amount of the money from P&R. After NWI had purchased a certain amount of stock, it decided not to complete the acquisition and sold at a substantial profit the stock which it had purchased. P&R's minority stockholders argued that this was a diversion of P&R's opportunity, and that P&R should receive the profit from the sale. The court held that the opportunity was not P&R's because P&R did not have the requisite amount of public securities to meet the terms of the exchange offer, had restrictions in a loan agreement limiting the issuance of new debt securities (which would have been necessary to effect the entire purchase), and had "adopted" a corporate policy not to become involved in this type of transaction. The court also noted that the parties intended all along that the transaction would be that of NWI, and that if there had been a loss, the entire loss would have been that of NWI.

It seems, then, that when considering whether a certain opportunity may fall within the scope of the corporate opportunity doctrine, it is important to ascertain the economic interests and objectives of the corporations. A recent article suggested that in any inquiry into a possible diversion of corporate opportunity, "[T]he scope of the fiduciary's duty will be determined by the ex-

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63 See Walde, supra note 52, at 481. See also Westerly Theatre Operating Co. v. Pouzner, 162 F.2d 821 (1st Cir. 1947); Lutherland, Inc. v. Dahlen, 357 Pa. 143, 53 A.2d 143 (1947); Loft, Inc. v. Guth, 23 Del. Ch. 138, 2 A.2d 225 (1938); Johnston v. Greene, 35 Del. 479, 121 A.2d 919 (1956).

When the corporations use loans for upstream financing, potential diversion of assets below stated capital must also be considered. See Sears v. Weissman, 6 Ill. App. 3d 827, 286 N.E.2d 777 (1972), for an illustration of the problem.

64 See 339 N.Y.S.2d 547 (1972).

65 See also Meuller v. Mac Ban, 132 Cal. Rptr. 222, 62 Cal. App. 3d 258 (1976), where the intrinsic fairness test is applied in the diversion of corporate opportunity context.

66 See note 52 supra.
pectations of the corporation and by its need to conduct its business adequately. There must be some close association between the opportunity and the prospective activities and interests of the corporation.\textsuperscript{67}

Corporate officers must review all of the preceding problems and tests when considering upstream financing. Unlike the situation in which the parent controls 100\% of the subsidiary, when minority stockholders own part of a subsidiary, the corporations considering upstream financing must consider more than statutory allowance of guaranties and the related benefit analyses. The parent must make certain that the transaction is fair to the subsidiary, and cannot proceed in complete disregard of the subsidiary's interests. In addition, corporate officers must determine that the subsidiary could not have used the opportunity as well as the parent.

C. Upstream Financing—A Progressive Approach

Since the intrinsic fairness test has been the test most frequently utilized in the past in parent-subsidiary transactions,\textsuperscript{68} this is the test that business managers must plan to encounter if their transaction is tested in court. However, recent progressive approaches to these problems have been adopted by some courts and may be the trend in the future. \textit{Hayman v. Morris},\textsuperscript{69} gives some insight into the manner in which some courts may treat upstream financing when stockholders are suing. The court in this case approached a problem involving upstream loans and guaranties in a stockholder derivative suit in a unique, business-oriented manner. The parent (IFC) was a holding company. IFC invested in second preferred stock of its subsidiary (IAC), including a call agreement which allowed IFC at its option to redeem its investment for cash by retiring the stock. IFC later borrowed from IAC and also secured guaranties from IAC of certain IFC obligations. When the loans were made, restrictions were put on the call agreement so that the stock could not be called except as to sums in excess of the outstanding loans.

The subsidiary subsequently discontinued business due to poor business conditions. In this derivative action, the minority stockholders argued that when the loan agreement was made, it purported to allow redemption of second preferred stock in excess of the loan. They contended that the agreement was therefore ultra vires, since there was a possibility when the loan was made that there would not be funds available for the first preferred holders. Payment to the second preferred holders would not be legal in these circumstances.

After business difficulties were encountered, IFC lowered the interest rate on the loans below what it had previously been. The stockholders alleged that this was also ultra vires as an abuse of power.

The court applied the business judgment rule to these problems, holding that the loans were not ultra vires. According to the court:

\begin{itemize}
\item \textsuperscript{67} \textit{Id.} at 482.
\item \textsuperscript{68} See text accompanying note 52 \textit{supra}.
\item \textsuperscript{69} 46 N.Y.S.2d 482 (1943).
\end{itemize}
The loans made . . . would seem within the proper scope of business judgment by the directors of IAC under all the circumstances particularly in view of the relations between IFC and IAC, the joint corporate problem, and the so-called "moral duty" on IAC to assist IFC.\(^{70}\)

This case is a rather broad interpretation of the business judgment rule. The court viewed the transactions from the standpoint of the managers as *joint corporate managers* and did not consider what result an independent bargainer would have reached. The court left untouched the managers' decisions as to how to handle corporate transactions as a group. Few courts have been so willing to accept similar transactions without looking more deeply into questions of fairness.\(^{71}\)

IV. Solving the Problem of Legal Uncertainty in Upstream Financing

A. Blending guaranty and fiduciary duty law: A feasible solution

Currently, business managers and financing institutions must consider all of the preceding aspects of the law when deciding to use upstream financing. To alleviate this task and to promote the use of upstream financing, courts should arrive at a rational combination of these tests to use when considering an upstream financing problem. Although such a combination of tests may not be the best solution to the problems involved in upstream financing it appears to be the most feasible method that one could suggest to the courts or legislatures as a uniform solution to the problem. Although other and perhaps better solutions amounting to more radical departures from current law will be discussed below,\(^{72}\) a workable solution can be achieved by blending certain aspects of corporate guaranty and fiduciary duty law.

The effect of recent changes in guaranty law has been to make creditors more willing to accept the guaranty. When minority stockholders' interests are involved as well, courts should continue to promote this method of financing while still protecting the minority. When courts have attempted to do this, however, they have failed to apply any particular test with consistency,\(^{73}\) and this lack of consistency has impaired the effectiveness of upstream financing.

The basic test for the validity of a corporate guaranty in the absence of particular statutes\(^{74}\) (and often even at times when statutes are applicable) is an inquiry into whether there is some benefit to the corporation or, as this has been applied by some courts, whether the guaranty is incidental to the conduct of the business.\(^{75}\) The most common tests used to determine whether a fiduciary duty to a minority interest has been violated are "intrinsic fairness" or "business

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\(^{70}\) Id. at 489.

\(^{71}\) In *dicta*, the court considered as valid IFC's argument that IAC owed IFC a "duty" to make funds available. *Id.* at 490.

\(^{72}\) See text accompanying note 85 infra.

\(^{73}\) Hayman v. Morris, 46 N.Y.3d 482 is a good example of this. See also Gotshal v. Mill Factors Corp., 289 F. 1005 (2d Cir. 1923).

\(^{74}\) As previously noted, even when a statute is directly applicable, courts may look for a benefit. See text accompanying note 31 supra.

\(^{75}\) See text accompanying note 10 supra.
In order to solve the problem of uncertainty that now exists in the law, the best corporate guaranty tests and fiduciary duty tests should be combined in a consistent manner.

In order to accomplish this, two similar tests can be substituted to govern all cases involving upstream guaranties. The first test would be applied in most instances and would involve a merging of business judgment (fiduciary duty law) and benefit (guaranty law). The second test would only be applicable when the court felt a stricter test should be applied, particularly when "self-dealing" was involved. This test would merge intrinsic fairness and benefit.

Under this streamlined inquiry, whenever a court finds a benefit or furtherance of corporate purpose, it should also find that the business judgment test has been met. This is because corporate officers using sound business judgment will act in furtherance of a corporate purpose, thus benefiting the company. Therefore, if a court can find some benefit or some corporate purpose served by the transaction, the assumption should be that the corporate managers used sound business judgment, since the presumption is in favor of the parent.

The inquiry into benefit under this test should not require the subsidiary to receive most of the benefits, but merely require the parent not to ignore the subsidiary's interests. A California case comes very close to applying this rationale. In *Woods Lumber Co. v. Moore,* the court combined the business judgment rule with an implied power test which essentially amounted to an inquiry into benefit:

> The question whether or not a contract of guaranty comes within the reasons above mentioned [implied powers] is one which is to be primarily "determined by the corporation, or those to whom the management of its affairs is intrusted" . . . The court cannot determine that it is beyond the powers of the corporation, unless it clearly appears to be so as a matter of law . . . managers "are not limited in law to the use of such means as are usual or necessary to the objects contemplated by their organization, but, where not restricted by law, may choose such means as are convenient and adapted to the end . . ."  

When the court feels compelled to impose a stricter test, particularly due to self-dealing, the second test would be applied. As a part of this, the courts can require a more direct benefit to show that the interests of the subsidiary have been considered.

By combining the tests in this manner, the court can choose one of two tests to apply in an upstream financing situation. The benefit-business judgment test should be chosen unless self-dealing is involved or the court feels it is appropriate to apply a stricter test in particular instances. In any event the focus will be on benefit; an indirect benefit will be necessary for the first test and a more direct benefit will be necessary for the stricter test.

Of course potential problems still exist due to the uncertainty reflected in

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76 See text accompanying note 48 supra.
78 *Id.* at 907.
79 These tests should also be applied to wholly-owned subsidiaries as a way of protecting intra vires creditors.
the decisions concerning what constitutes a "direct" benefit. Nevertheless, use of this approach should require the court to isolate the upstream financing transaction from any other corporate problems and to specify which of the two tests is being applied. Because of this, case law should develop as to which benefits will be accepted under each test, thus giving some direction for future transactions.

B. Application of the law to hypothetical situations

In order more thoroughly to analyze the potential uses of upstream financing and to determine how the courts will probably treat various problems, it is useful to consider some hypothetical situations. Current law will be applied to each hypothetical, followed by an application of the proposed combined tests.

#1) The parent is a service company. A wholly-owned subsidiary is created and all real property is transferred to it. Some time after this is done, the parent needs to borrow money. Having few assets to use as collateral, the parent uses the subsidiary to guaranty the loan.

This problem is one of the easiest to solve, since it involves a wholly-owned subsidiary. Minority interests do not come into play, so intrinsic fairness or even business judgment need not be considered. In the absence of a statute, and, indeed, often when a statute is present, benefit or furtherance of corporate purpose must be found. In this hypothetical, the subsidiary derives its income from the parent as rent and has a strong interest in the parent's profitability. This situation would be analogous to Stromberg-Carlson, a case in which the corporation had an interest in the related corporation staying in business to meet past obligations. In Case #1, the guarantor subsidiary has a strong interest in the parent staying in business in order for the subsidiary to survive; the subsidiary's profitability depends on the continued existence of the parent.

Also of great significance to 100%-owned subsidiaries are the statutes which preclude the use of the defense of ultra vires. If no minority stockholders are involved, even if the guaranty is without benefit to the subsidiary, the only people who can complain are the attorney general or a representative of the corporation. If corporate assets are not actually being diverted, and fraud is not involved, the guaranty will probably be enforceable.

Application of the proposed combined test would result in the use of the least restrictive test, since the subsidiary is wholly-owned and minority interest problems need not be considered. Therefore, only some indirect benefit must be found since the presumption is in favor of validity. Since the subsidiary is dependent on the parent for rent, benefit is present and the guaranty would be valid and enforceable.

#2) The parent is a holding company with two unrelated subsidiaries. The parent owns 100% of Subsidiary #2 and 90% of Subsidiary #1. Subsidiary #1 is a capital-intensive manufacturer. Subsidiary #2 is a retailer with most of its...
assets consisting of inventory. Subsidiary #2 has an opportunity to expand its line but the banks will not accept inventory as collateral. Subsidiary #1's equipment is free from mortgages or liens and the bank will accept Subsidiary #1's guaranty on a loan to Subsidiary #2.

This is a typical cross-stream financing situation involving a guaranty and minority interests. It is directly analogous to an upstream financing situation in which the parent's line of business is unrelated to that of the subsidiary. Since intrinsic fairness has been the test most heavily relied on by most states in the past for parent-subsidiary dealings, this strict test should be assumed for analysis purposes as far as fiduciary duty law is concerned. Even Delaware, which has restricted the intrinsic fairness test to transactions involving self-dealing, may still apply this test in a situation similar to Case #2. Whereas the situation involved here does not involve a specific transaction in which one controlling corporation reaps benefits to the exclusion of the other, the potentiality for this state of affairs is present. Therefore, even a court applying this rule may find self-dealing and apply the intrinsic fairness test.

According to the test, corporate managers or financing institutions seeking to uphold a guaranty must prove good faith in order to meet the fairness burden. As one recent comment emphasized, however, "the concept of good faith has been employed in the case-law of parent-subsidiary disputes chiefly as a make-weight to reinforce the court's disapproval of defendant's objectives. . . ."

Therefore, if the directors keep the subsidiary's interests in mind, it would seem that the courts will not disapprove and will hold that good faith was present.

To satisfy guaranty law tests, direct benefit must also be shown. Since the only benefits Subsidiary #1 will gain in the hypothetical situation are the intangible benefits of being part of the group, it might be advisable to arrange a profit-sharing contract to assure Subsidiary #1 of some of the potential benefits of Subsidiary #2's expansion. Another alternative to consider, either separately or in conjunction with this contract, is stockholder approval, if it is feasible.

The use of the proposed test would simplify this process. The court would choose the strict test and seek a direct benefit. None appears to be present here, and in the absence of a profit-sharing contract, stockholder approval, or other statutory device, the guaranty would be struck down.

V. Seeking the Best Solution

Commentators have suggested many solutions to the problems raised by corporate guaranties and contracts involving minority interests. These will be briefly considered in order to determine their potential impact on upstream financing. As previously noted, these solutions may not be as practically applicable as the proposed combination of guaranty and fiduciary duty law; however, they should be considered as potential future solutions.

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82 See note 48, supra at 343.
83 See text accompanying note 94 infra.
84 See text accompanying note 26 supra.
One recent proposal would give a corporation the statutory power to make a guaranty for any person or corporation if the guarantor can reasonably expect to benefit directly or indirectly. A decision by the board of directors would be binding. Stockholders could bring suit prior to the execution of the guaranty contract and claim that there would be no benefit. After execution of the guaranty, the stockholder's only recourse would be against the directors.

This type of statute would obviously simplify upstream guaranty law. Even though there might still be some question as to the definition of benefit, the decision would have to be made in advance. This proposal would give creditors more protection, since after the guaranty contract is formed minority stockholders could only assert their claims against directors.

Another commentator suggests using an "expectation" test. The expectation test defines fairness in terms of the expectations of the stockholders at the time they enter into the relationship. In upstream financing this would essentially mean that the minority stockholders should understand that, if necessary, the corporation will use the subsidiary to finance the parent's operations. The validity of this test, however, would depend on how stockholders acquired their stock. If it were acquired through an outright purchase, the test would be reliable, since the purchaser would have known he was purchasing an interest in a controlled corporation. Often minority interests are created through consolidations, however, and a stockholder becomes involved in a situation which he did not contemplate at the time he purchased the stock. Due to these problems, the use of this suggestion as a means of solving upstream financing problems is questionable at best.

Another commentator suggests a "contractually-supported investment" as a means of avoiding use of the corporate guaranty. Basically, the use of this device in an upstream financing context contemplates an outside financing institution loaning money to the parent to enable it to produce some type of goods or services. The financing institution, however, will not rely on the parent's credit and seeks the extra protection of a guaranty from the subsidiary. Instead of a guaranty, a non-cancellable contract is entered into between the parent and the subsidiary whereby the subsidiary promises to purchase the goods that are produced by the parent to the extent of the loan payments. Since this is a noncancellable contract, the subsidiary must pay for the goods whether produced or not. The financing institution is assured in this way that the parent will have ample funds to pay back the loan. The creditor relies on the non-cancellable contract as a third-party beneficiary and a guaranty is avoided. It is unclear how a court will view the contractually-supported investment, since it is a new

85 See note 4 supra.
86 This proposal concerns a recent Texas statute.
87 See note 48 supra.
88 Dwyer, A Legal and Business Examination of the Contractually Supported Investment in Relation to the Corporate Guaranty, 23 SYRACUSE L. REV. 33 (1972).
89 The subsidiary becomes a conduit for the sales up to the amount of the loan payments; if there is a loss, the subsidiary pays to the extent of the loan. If there is a profit, it belongs to the parent since goods in excess of the loan amount are not part of the contract. This may cause the transaction to be viewed as a sham since the subsidiary is a mere conduit. In order for this type of contract to work, it would seem that the subsidiary must either have a need for the goods or receive part of the profits of a successful venture.
development and has not been tested. It has been suggested, however, that the courts could view this as an "informal guaranty" and invalidate it. If this tool is accepted by the courts, in many situations the possibility of using the contractually supported investment should be considered by corporate officers as a feasible alternative to an upstream guaranty.

The recommendation that affiliated corporations be viewed as a unit in proper circumstances appears to be the most viable solution to the upstream financing problem. "Proper circumstances" would encompass any situation in which business managers treat the corporations as a unit for any purpose. As one author writes:

The more the subsidiary is integrated into the economic unit the less its interest—a yardstick to define the fairness—is easy to define. Its well-being depends to some unmeasurable degree on the group's well-being. . . .

When business managers treat the corporations as a unit, so should the courts. This would be accomplished by denying corporations the opportunity to claim limited liability due to separate legal status when attempting to avoid the responsibility of the guaranty. Any tests devised, however, should protect minority interests from gross abuse or "gross and palpable overreaching." The closest that courts have come to doing this is by the use of the business judgment test in fiduciary duty law. Since this test views corporations as they are viewed by corporate managers, expansion of situations in which this test is applied furthers the goal of "treating corporations as a unit."

Although American jurisdictions have not widely accepted the theory which views affiliated corporations as a "unit," German law does adopt the concept. A German statute allows affiliated corporations to form a "domination contract." A "domination contract" allows the parent to allocate opportunities and financing in any fashion that it feels will benefit the group as a unit. The German law allows parents and subsidiaries to choose between forming a domination contract or being treated under previous laws (comparable to United States laws) with additional reporting requirements.

In order to form a domination contract, there must be at least 50% control by the parent and centralized management. Any action taken under the contract must benefit the group. The minority is protected in unique ways; any losses incurred by the subsidiary are reimbursed by the parent, the group must adopt a compensation scheme (profit contract), the domination and profit contracts must be approved by three-fourths of the stockholders, and the subsidiary must maintain adequate capital reserves.
The prime advantage of this statute is that it gives legal recognition to an integrated corporate system. The interests of the corporate group are optimized. It is apparent how a similar statute would eliminate many upstream financing problems. Once a corporation elected to form a domination contract, the previously discussed tests would be unnecessary. An upstream guaranty would be allowed and the domination contract would provide the method of allocating profits and losses.

If corporations did not elect domination contracts, strict rules should apply, completely disallowing these inter-corporate transactions. The tests previously devised would therefore not be necessary whether there was a domination contract or not. This type of statute is preferable to the current law because it is more uniform; the various tests are no longer necessary and therefore predictability is promoted. Inter-company financing is promoted while giving protection to companies which do not wish to be involved in inter-company transactions.

Passage of a statute similar to the German model may not be readily acceptable in the United States since the separate entity structure is fairly well engrained in corporate law. However, statutes could be proposed in the United States which would still follow the basic "theme" of viewing affiliated corporations as a unit when appropriate. A statute allowing upstream/cross-stream guaranties with provisions for compensation would serve this purpose.

The economic unit concept has not been ignored by some courts in this country, as previously seen in *Hayman v. Morris*, in which the court treated problems arising in parent-subsidiary affairs as joint corporate problems. In *Aeronca, Inc. v. Style-Crafters, Inc.*, the court refused to inquire into an inter-company account when asked to do so by a third party. The court said the rule of close scrutiny did not apply to ordinary business transactions as long as the rights of others were not involved. In other words, the court let the businesses operate as a unit as much as possible.

A similar attitude was demonstrated in *Cleary v. Higley*, in which a transaction occurred whereby the subsidiary was "forced" by the parent to sell its stock. The transaction took place pursuant to a reorganization plan; the corporations had current liabilities in excess of current assets and receivership proceedings were pending. Therefore, quick action was necessary. The court said that "forcing" the subsidiary to sell its stock was "necessary" in the circumstances. The New York court did not require the parent to prove fairness in every transaction and required four circumstances to be present in order to shift the burden of proving fairness to the directors:

1) loss to the subsidiary; 2) undue profit made by the parent at the expense of the subsidiary; 3) acts committed to secure or promote a selfish parental interest; and 4) a fraud on the part of the interested directors in carrying out the challenged transaction.

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96 The problem with the German law is that when a domination contract is not elected, the same problems that occur in the United States are still present. To cure this, in the absence of a domination contract, these inter-company transactions should be disallowed.

97 46 N.Y.S.2d 482.

98 546 F.2d 1094 (4th Cir. 1976).

99 154 Misc. 158, 277 N.Y.S. 63 (1934).

100 Id. at 78.
This test relies very heavily on business judgment. The court will refuse to examine the fairness of a transaction unless the preceding criteria are met. The Cleary court noted that this test gives the parties the substance of their bargain. Furthermore, it comports with reality by treating the corporations as a unit. As the court said in Cleary:

Commercial transactions are common between subsidiary and parent corporations, where the stockholders of one may be different from the stockholders of the other. Indeed, it is often one of the very reasons for the creation of subsidiary corporations, that arrangements mutually advantageous to both may be entered into between the two corporations. Such transactions are usually fair to both corporations. Indeed, the presumption is that the directors of a corporation act fairly and honestly rather than unfairly and dishonestly.101

The same attitude was exhibited, although to a lesser extent, in Gotshal v. Mill Factors Corporation.102 In that case three companies were controlled by the same stockholder and operated as a unit. An agreement was made jointly by them with a factor, authorizing both the transfer of amounts from one company’s account to the other and the use of merchandise as collateral for advances to the others. This method of financing benefited all of the corporations by reducing factor commissions and inducing the factor company to make loans in “...disregard [of] corporate entity in favor of business unity...”.103

The agreement was held to be incidental to the conduct of business and therefore not ultra vires, since advantages of the agreement flowed to each corporation. Since the agreement contemplated “disregard of entity” when formed, holding the corporation to the terms of the agreement did not equate to holding one corporation liable for the debts of another.

VI. Conclusion

The two fields of law that are generally applied when considering the validity of an upstream guaranty, fiduciary duty law and corporate guaranty law, have been the subject of recent common law expansion and statutory change. This change has been in the direction of a more liberal interpretation of corporate powers and toward enforcement of guaranties. Of course, this makes the use of upstream guaranties much more feasible than in the past. However, upstream guaranties have received little judicial attention and the field is far from achieving desired predictability. Therefore, it is advisable that before corporations enter into such a transaction, the officers or corporate counsel carefully analyze the various aspects of the contemplated arrangement. This analysis should include an ascertainment of the types of benefits accruing to all involved parties, as well as an examination of the effect of the transaction on minority interests.

101 Id. at 77.
102 289 F. 1005 (2d Cir. 1923).
103 Id. at 1006.
Ideally, legislation could be enacted which would give corporations the opportunity to be treated as a unit. In the meantime, however, greater certainty is needed in both corporate guaranty law and fiduciary duty law in order to better predict judicial response to upstream financing and thereby make the use of the guaranty more acceptable to financing institutions. In the absence of structural change, the two-pronged approach suggested in this note would simplify the process of determining in advance the applicable standard for judging a guaranty. This simplicity would lend predictability and order to this field of the law.

Janette Aalbregtse
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