Notre Dame Law Review

Volume 53 | Issue 2 Article 2

12-1-1977

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Ahmed Bulbulia

Arthur R. Pinto

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Recommended Citation

Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards*, 53 Notre Dame L. Rev. 201 (1977).
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STATUTORY RESPONSES TO INTERESTED DIRECTORS' TRANSACTIONS: A WATERING DOWN OF FIDUCIARY STANDARDS?

Ahmed Bulbulia*
Arthur R. Pinto**

I. Introduction

Twenty-seven states[1] have enacted statutory provisions dealing with interested directors'[2] transactions or contracts.[3] California was one of the first states to enact such a provision[4] and most of the statutes are modelled upon or similar to the California section.[5]

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* Associate Professor of Law, Seton Hall University Law Center, LLB 1965, London School of Economics, LLM 1967, University of Michigan Law School.
** Assistant Professor of Law, Seton University Law Center, A.B. 1969, Colgate University, J.D. 1972, New York University Law School.

1 ARIZ. REV. STAT. ANN § 10-041 (Supp. 1975); CAL. CORP. CODE § 310 (West Supp. 1976); CONN. GEN. STAT. ANN. § 33-323 (1960); DEL. CODE ANN. tit. 8 § 144 (1975); FLA. STAT. ANN. § 607.124 (West Supp. 1975); GA. CODE ANN. § 22-716 (Supp. 1975); IDAHO CODE § 30-142 (1967); IND. CODE § 23-1-10-6 (Burn 1972); KAN. STAT. ANN. § 17-6304 (1974); KY. REV. STAT. ANN. § 271A.205 (Supp. 1976); LA. REV. STAT. ANN. § 12:84 (West Supp. 1976); ME. REV. STAT. ANN. tit. 13-A § 717 (1964); MD. ANN. CODE § 2-419 (Supp. 1976); MICH. COMP. LAWS ANN. § 450.1545 (1973); MISS. CODE ANN. § 79-3-67 (1972); NEV. REV. STAT. § 78.140 (1967); N.J. STAT. ANN. § 14A:6-8 (Supp. 1976); N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1976); N.C. GEN. STAT. § 55-30 (1975); PA. STAT. ANN. tit. 15 § 1409.1 (Purdon Supp. 1976); R.I. GEN. LAWS ANN. § 7-1.1-37.1 (1970); S.C. CODE ANN. § 12-18.16 (Supp. 1974); TENN. CODE ANN. § 48-816 (Supp. 1974); VT. STAT. ANN. tit. 11 § 1888 (1973); VA. CODE ANN. § 13.1-39.1 (Supp. 1975); W. VA. CODE ANN. § 31-1-25 (Supp. 1976); WIS. STAT. ANN. § 180.355 (West Supp. 1975).

2 Some states have included officers under the purview of the statutes. *See, e.g.,* DEL. CODE ANN. tit. 8 § 144 (1975); GA. CODE ANN. § 22-716 (Supp. 1975), PA. STAT. ANN. tit. 15 § 1400.3 (Purdon Supp. 1976).

3 This article will not attempt to deal with those statutory provisions which may validate or invalidate specific transactions or contracts between interested directors or officers and their corporations. *See, e.g.,* DEL. CODE ANN. tit. 8 § 143 (1975) and MODEL BUS. CORP. ACT ANN. 2d § 47 (1971) dealing with loans to directors or officers. This article, however, focuses upon transactions between a corporation and a director, and upon transactions between two corporations, with directors common to both.

4 West Virginia and Rhode Island had statutory provisions predating the California statute but they have not served as a model for other states.

5 Although California has recently revised its corporation's law and its statutory provision on interested directors' transactions (*See* CAL. CORP. CODE § 310, 132-156), reference in the article to the California model will mean CAL. GEN. CORP. LAW § 820 (West 1955) which provides:

> Duty to act in good faith, effect of personal financial interest or common directorship. Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation. No contract of other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm, or association in which one or more of its directors are directors or are financially interested, is either void or voidable because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes or approves the contract or transaction, or because his or their votes are counted for such purpose, if the circumstances specified in any of the following subdivisions exist:
>
> (a) The fact of the common directorship or financial interest is disclosed or known to the board or directors or committee and noted in the minutes, and the board of committee authorizes, approves, or ratifies the contract or transaction in good faith by a vote sufficient for the purpose without counting the vote or votes of such director or directors.

These statutes specify the methods to enter into such transactions. Such transactions are permissible: 1) if approved by the board or shareholders, or 2) if the transaction is found to be fair. Since the statutes are phrased in the disjunctive, the question arises as to whether board or shareholder approval eliminates the consideration of the substantive fairness of the transaction. If fairness is eliminated, it would be a significant departure from traditional concepts of fiduciary duty. Given the importance of state law because of the recent reluctance of the Supreme Court to use federal securities law as a means of insuring fiduciary duty[6] and the possible broad scope of these statutes,[7] the elimination of substantive fairness by these statutes would remove an important protection for shareholders. This article will analyze the California model and its progeny[8] in an attempt to suggest a resolution of this issue.

II. The Common Law View

The common law view of interested directors' contracts or transactions has a varied history.[9] Early American courts[10] followed the traditional English rule[11] and held such contracts or transactions to be voidable at the option of the corporation. The underlying rationale for this rule was that directors, as fiduciaries,[12] have a duty of loyalty and therefore their interests should not conflict with those of the corporation. There was no inquiry into the fairness of the contract or transaction.[13] This rule was also applied to transactions between

(b) The fact of the common directorship or financial interest is disclosed or known to the shareholders, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of shareholders entitled to vote.

(c) The contract or transaction is just and reasonable as to the corporation at the time it is authorized or approved.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves, or ratifies a contract or transaction.

6 Green v. Sante Fe Industries, 97 S. Ct. 1292 (1977).

7 See note 33 *infra*.

8 All but three of the states (IDAHO CODE § 30-142 (1967); MISS. CODE ANN. § 79-3-67 (1972); and VT. STAT. ANN. tit. 11 § 1888 (1973)) found in note 1 *supra*, resemble California's model by using the alternative approach of board approval; shareholders approval or fairness.

9 *See* Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966), for an excellent analysis of the common law principles [hereinafter cited as MARSH].

10 *Id.* at 36; W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 917 (rev. perm. ed. 1975) [hereinafter cited as FLETCHER].

11 *See Aberdeen Ry. v. Blaikie Bros.*, 1854 [IMACQ 461]; L. GOWER, THE PRINCIPLES OF MODERN COMPANY LAW 478-79 (2d. ed. 1957).

12 Munson v. Syracuse Geneva and Corneng R. R. Co., 103 N.Y. 58, 73, 8 N.E. 355, 358 (1886). *See* H. BALLANTINE, ON CORPORATIONS § 66 (rev. ed. 1946) [hereinafter cited as BALLANTINE]. Some courts have analogized directors to trustees and have found the contracts to be voidable. *See, e.g.*, Knox Class Bottle Company v. Underwood, 228 Miss. 699, 89 So.2d 799 (1956). *See* Sealy, *The Director As Trustee*, 1967 CAMB. L. J. 83 (1967), which distinguishes corporate directors from trustees. Other courts have compared directors to "agents" who cannot self-deal with their principals. *See, e.g.*, Wardell v. Union Pacific R. R. Co., 103 U.S. 651 (1880). However, directors who act in their individual capacities generally are not viewed as agents. BALLANTINE at § 44. *But see* Twin Lick Oil Co. v. Marburry, 91 U.S. 328 (1876) which utilized both the trustee and agent rationale to void the contract.

13 It [the law] does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the the transaction, or refuses to enforce it, at the instance of the party when the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case.

Munson, supra note 12, at 74.

corporations with common directors (interlocking boards).[14]

A variety of reasons was offered by the early courts for this rule. One reason typically advanced was that since directors stand in a fiduciary relationship to the corporation, they cannot adequately represent both themselves and the corporation.[15] In other words, the corporation is entitled to representation by all the directors using their unbiased judgment.[16]

Courts have also indicated that when interests of the individual director conflicted with a duty he owed to the corporation, it was assumed that the director would favor his own interest.[17] In addition, the disinterested directors representing the corporation may inevitably be influenced by their co-director and that influence is difficult if not impossible to evaluate.[18]

A weakening of the early inflexible rule began as the courts accepted the idea that a majority of the disinterested directors could approve the agreement on behalf of the corporation, provided that the contract was fair.[19] Courts were initially more willing to depart from the inflexible rule in the case of transactions between interlocking boards. This resulted from a judicial recognition of the trend in modern business of intercorporate relationships and the prevalence of directors serving on more than one board.[20]

This modernized version of the rule validating contracts approved by a dis-

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14 MARSH, *supra* note 9, at 37-38. The rule also extended to parent-subsidiary relationships even in the absence of common directors. *Id.* at 38. *See generally* Note, *The Fiduciary Duty of Parent to Subsidiary Corporations,* 57 VA. L. REV. 1223 (1971) [hereinafter cited as VIRGINIA NOTE].

15 Note, *Legal Safeguards About Transactions Between A Director and his Corporation,* 83 U. PA. L. REV. 56, 57 (1934) [hereinafter cited as Note, *Legal Safeguards*].

16 BALLANTINE, *supra* note 46, at 171.

17 In Smith v. Pacific Vinegar & Pickle Works, 145 Col. 352, 78 P. 550, 554 (1904), the court states:

> The philosophy of this rule is quite apparent, and its inflexibility is the strongest safeguard which the law can offer for the protection of the interests of the beneficiary. The great purpose of the law is to secure fidelity in the agent. When one undertakes to deal with himself in different capacities—individual and representative—there is a manifest hostility in the position he occupies. His duty calls upon him to act for the best interests of his principal. His self-interest prompts him to make the best bargain for himself. Humanity is so constituted that, when these conflicting interests arise, the temptation is usually too great to be overcome, and duty is sacrificed to interest. In order that this temptation may be avoided, or, if indulged in, must be at the peril of the trustee, it has been wisely provided that the trustee shall not be permitted to make or enforce any contract arising between himself as trustee and individually with reference to any matter of the trust, nor will the court enter into any exmination of the honesty of the transaction.

18 In *Munson, supra* note 12, at 358, the court explains:

> [The law] cannot accurately measure the influence of a trustee with his associates nor will it enter into the inquiry, in an action by the trustee in his private capacity to enforce the contract, in the making of which he participated. The value of the rule of equity to which we have adverted, lies, to a great extent, in its stubbornness and inflexibility. Its rigidity gives it one of its chief uses as a preventive or discouraging influence, because it weakens the temptation to dishonesty or unfair dealing on the part of the trustees, vitiating, without attempt at discrimination, all transactions in which they assume the dual characters of principal and representative.

19 MARSH, *supra* note 9, at 40 n.18, and cases cited therein. The rationale for this rule was that a trustee could deal directly with the *cestui qui trust* if he took no advantage of his position, and he made full disclosure, and the transaction was fair and reasonable. Thus a director also should be able to deal similarly. *Id.* at 41. *See also* 2 SCOTT ON TRUSTS 1275-76 (2d. ed. 1956).

20 Note, *Restrictions on the Power of a Director to Contract with His Corporation,* 29 COL. L. REV. 338, 345-46 (1929). *See also,* Note, *The Validity of Contract Between Corporations with Common Directors,* 51 HARV. L. REV. 327 (1937).

interested majority, however, had its own rigid aspects. Some courts would not inquire into fairness to validate the transaction when the interested director was himself necessary either to constitute a quorum of the board or to constitute a majority to authorize the transaction.[21] This disinterested quorum rule was sometimes found inapplicable to interlocking boards.[22] Some state courts eventually abandoned the disinterested quorum requirement in all cases, leaving only an inquiry into fairness.[23]

Thus the common law moved from the traditional inflexible rule with its certainty of application,[24] to a more flexible but uncertain approach involving questions of fairness. This change has been justified in several ways.

The Supreme Court, for example, felt that it was desirable for those closely associated with a corporation to assist it, since those individuals would be the most interested and the "best qualified to judge of the necessity of that aid, and of the extent to which it may safely be given."[25] It has also been argued that the "exigencies of modern business" necessarily justified a change in the rule.[26] But as one leading commentator points out,

> One searches in vain in the decided cases for a reasoned defense of this change in legal philosophy, or for the slightest attempt to refute the powerful arguments which had been made in support of the previous rule. Did the courts discover in the last quarter of the Nineteenth Century that greed was no longer a factor in human conduct? If so, they did not share the basis of this discovery with the public; nor did they humbly admit their error when confronted with the next wave of corporate frauds arising out of the era of the formation of the "trusts" during the 1890's and early 1900's.[27]

III. Statutory Responses

The common law has moved from a predictable standard which rendered transactions with interested directors voidable at the option of the corporation to a more flexible, but uncertain standard, under which these transactions are valid, only if they are found to be fair. In 1931, California adopted a general statute dealing with these transactions.[28] While the statutory provision was designed to

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21 Comment, *Dealings Between Directors and Their Corporations—A Discussion of the "Disinterested Quorum" Rule Under Present Statutory Limitations in Michigan,* 34 U. DET. L.J. 42 (1956).

22 *See, e.g.,* Robotham v. Prudential Insurance Co., 64 N.J. EQ. 673, 53 A. 842 (Ch. 1903). LATTIN, *supra* note 9, at S931.

23 MARSH, *supra* note 9, at 43-44; FLETCHER, *supra* note 9, at S931. Most of the statutory provisions in note 1, *supra,* concern the necessity of an interested director's vote or his presence at a directors' meeting for the purposes of a quorum. Generally, these provisions allow the interested director's vote and allow his presence to be counted toward quorum.

24 LATTIN, *supra* note 10, at 291.

25 *Twin Lick, supra* note 12, at 330; BALLANTINE, *supra* note 12, at 173.

26 Ballantine, *Questions of Policy in Drafting a Modern Corporation Law,* 19 CAL. L. REV. 465, 476 (1931) [hereinafter cited as Ballantine, *Questions of Policy*].

27 MARSH, *supra* note 9, at 40.

28 CAL. CIV. CODE § 311 enacted in 1931 was amended in 1933 and then amended and retitled CAL. GEN. CORP. LAW § 820 in 1947. It was amended and retitled CAL. CORP. CODE § 310 in 1977. Each of these changes prior to 1977 involved changes in language but did not change the basic effect of the statute. For a discussion of the 1977 changes, *see* text accompanying notes 134-58 *infra.*

deal with the common law in the area which had developed in California,[29] it has greater significance since many states have enacted similar provisions or have relied heavily upon the California statute as a model.[30] Thus, unless there is a clear deviation from the California model, or legislative history in a given state indicates contrary intent, California's rationale and case law development should afford insight into the effect of similar statutes in other states.[31]

A. *The California Model*

Former section 820 of the California Corporation Code[32] (the "California Model") provided in essence that contracts or transactions[33] between a corporation and its directors[34] (either directly or indirectly through an interlocking board

29 Ballantine, *Questions of Policy, supra* note 26, at 475; Comment, *Corporations: Effect of Director's Adverse Interest or Conflicting Duties to Invalidate Contracts: California Civil Code Section 311,* 29 CAL. L. REV. 480 (1941) [hereinafter cited as Comment, *Corporations*].

30 *See, e.g.,* MODEL BUS. CORP. ACT ANN. 2d § 41 at 842; Commissioners' Comment, 20 N.J.S.A. 14A:6-8 (West Supp. 1976).

31 SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 329-37 (4th ed. Sands, 1973); BLACK, CONSTRUCTION AND INTERPRETATION OF THE LAWS 597-604 (2d ed. 1911). It is not necessary for the statute in question to be identical to the California model, nor is it necessary for the state legislature to manifest a clear intent to follow California in the formulation of the statute.

32 *See* note 5 *supra* for the text of statute in full. Former CAL. CORP. CODE § 820 has generally served as the model for the other statutes, in terms of both statutory language and as a guide for interpretation.

33 All the statutes use the term "transactions." The use of the term transaction significantly expands the coverage of the statutes. It is a term broader in scope than the term contract. United States Hoffman Mach. Corp. v. Eberstein, 150 Kan. 790, 96 P.2d 661, 663 (1940). Transaction could include "an act or agreement . . . having some connection with each other, in which more than one person is concerned, and by which the legal relations of such persons between themselves are altered." Baker v. S. A. Healy Co. 302 Ill. App. 634, 24 N.E.2d 228, 234. Thus the statute covers not only the usual contractual relationship contemplated in the common law but may include situations when the director unilaterally acts which adversely affects his corporation, *e.g.,* a dissolution. Northway Inc. v. TSC Industries, Inc., 361 F. Supp. 108, 115 (1973). It may also apply to sale of control; dividend policy; and recapitalizations. *See* MARSH *supra* note 9, at 57-65. It may also apply to corporate opportunities usurped by directors. *Cf.* FOLK, *infra* note 48, at 92-93. There has been a recent trend of going private transactions where minority shareholders have been frozen out of their corporation. Those transactions often involve board action with actual or potential conflicts of interest. *See generally,* Note, *Going Private,* 84 YALE L.J. 903 (1975). Thus, compliance with the statute and an inquiry into fairness may be required. *Cf.* Folk letter dated July 19, 1973 found in Northway Inc. v. TSC Industry, 512 F.2d 324, 337, n.27 (7th Cir. 1975). The use of other statutory provisions to effectuate going private, such as merger provisions with appraisal rights, should not preclude an inquiry into fairness. *Cf.* Singer v. Magnavox, N.Y.L.J. 5, 6 (Del. Supp. Ct. Oct. 4, 1977). Given the broad definition of transaction, a court conceivably could read the statute into many other situations.

34 The California model covers transactions with directors. Although the statute does not specifically deal with transactions between shareholders, who are not directors, and their corporation, it is possible to argue that they are also covered. If they are controlling shareholders, the transactions may be reached under the theory that the directors are in reality puppets of the shareholders. *Cf.* Zahn v. Transamerica Corporation, 162 F.2d 36 (3rd Cir. 1947), or that they were deputized. (*Cf.* Blau v. Lehman, 368 U.S. 403 (1962)), or under the theory of de facto directors. H. HENN, LAW OF CORPORATIONS § 206 (1970) [hereinafter cited as HENN]. In addition, the model does not deal with the problems of transactions with relatives of directors or the voting of relatives as directors on transactions with their relative who is a co-director. At the common law, courts scrutinized such transactions and should continue to do so under the statute. Knox Glass Bottle Co. v. Underwood, 228 Miss. 699; 89 So. 2d 799 (1956); Imberman v. Alexander, 16 Misc. 2d 330, 184 N.Y.S. 2d 801 (1959). *See* Kendrick, *Interested Director in Texas,* 21 S.W.L.J. 794, 798 (1967); Sarner v. Fox Hill, 199 A. 2d 6 (1964) (an attorney was disqualified). *See* CONN. GEN. STAT. ANN. § 33-323 (1960), which specifically includes spouse, parents and children as interested under the statute.

of a corporation in which the directors are financially interested)[35] are neither void nor voidable[36] because the directors are present or voting on the transaction if any of three circumstances have occurred: (1) disclosure of the common directorship or financial interest to the disinterested directors who in good faith and sufficient number[37] approve the transaction;[38] or (2) a similar disclosure to the shareholders who in good faith approve the contract;[39] or (3) the contract is "just and reasonable as to the corporation at the time it is authorized or approved."[40]

The language is clearly disjunctive in that all that is required under the statute is "any *one* of the following" circumstances (emphasis added).[41] On its face, the statute seems to allow enforcement of an unjust and unreasonable contract,[42] as long as the board of directors or shareholders approved the transaction pursuant to the statute.[43] Thus, it would appear that the statute has elimi-

35 The statute is not limited to interlocking boards but also includes firms or associations in which the director is interested.

36 Although the statute does not indicate who may void the transaction, at common law the corporation was deemed to have the requisite interest to pursue such an action. It is doubtful whether this approach is changed by the statute. *See* FLETCHER, *supra* note 10, § 977 at 493-94.

37 The California model provides that common or interested directors may be counted in determining the presence of the quorum of the board. Approval by the board must however be by a vote "sufficient for such purpose without counting the vote or votes of such director or directors." Section 820 (a). The provision leaves a variety of questions unanswered. For example, if the board consists of twelve members of which three directors are interested and attend the meeting and only five of the nine disinterested directors attend the meeting; if all vote in favor of the transaction, is their approval under the statute? There is a quorum which normally requires a majority, i.e., seven directors. Does "sufficient" approval require five disinterested directors, i.e., a majority of the directors present, or three disinterested directors, i.e., a majority of the quorum; or three disinterested directors, i.e., a majority of the disinterested directors present and voting? *See* Arsht & Stapleton, *Delaware General Corporation Law,* 25. BUS. LAW 287, 290 (1969). These questions have not been resolved by the California courts. *See* Kennerson v. Burbank Amusement. 120 Cal. App. 2d 157, 260 P.2d 823, 830 (1953). Since the statute is unclear, a court consistent with the idea of limiting conflicts of interest may require the more difficult requirement of a majority of disinterested directors present. *See* note 79 *infra,* for a discussion of the variation to this requirement in Delaware.

38 CAL. GEN. CORP. LAW § 820 (a) (West 1955).

39 *Id.* at § 820 (b).

40 *Id.* at § 820 (c).

41 All the statutes following the California model (except Michigan, Nevada and Virginia) substitute this language with "or" between the subsections dealing with shareholder or board approval. *See, e.g.,* DEL. GEN. CORP. LAW § 144, cited in full at note 76 *infra.* Originally, California used the disjunctive "or," but replaced it with the language in § 820 in 1947, and now uses "or" again. *See* note 134 *infra,* for the text of CAL. CIV. CODE § 310. We are unable to find any legislative history or case law which indicates that this change was significant.

42 California and North Carolina are the only states which use the terms "just and reasonable" in the statute. All the others deviate from the California model and use a term with the word "fair." There seems to be no basis for distinguishing between "just and reasonable" and "fair" thus they should be equated. *See* Remillard Brick Co. v. Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

43 A similar issue is whether Cal. Gen. Corp. Law Sec. 820 (c) would validate a fair contract which does not comply with subsections (a) or (b). *See* text accompanying notes 67-69 *infra. Cf.* Caminetti v. Prudence Mutual Life Ins. Ass'n, 62 Cal. App. 2d 945, 146 P.2d 15, 18 (1944). *But see* Scott v. Multi-Amp. Corporation, 386 F. Supp. 44, 67 (D.N.J. 1974). In *Scott,* the court held that all three subsections must be satisfied for a valid contract under New Jersey's adaptation of the California Model; N.J.S.A. 14A: 6-8. The court cites Israels, *The Corporate Triangle—Same Corporate Aspects of the New Jersey, New York and Delaware Statutes,* 23 RUT. L. REV. 615, 627 (1969) and *Remillard, supra* note 40. Both indicate that fairness is required in addition to shareholder or board approval under the statute. Although this would seem contrary to the disjunctive nature of the statute, neither suggests the *Scott* holding that one needs shareholder approval, board approval and fairness for all interested directors' transactions. In fact, in *Remillard* the court did not find majority

nated the requirement of fairness and correspondingly lowered the fiduciary responsibility of directors who deal with their own corporations.[44] If fairness is eliminated as an overriding principle by the statute, it would be a significant departure from the common law which has always required fairness. All that would then be required under the California model is disclosure of the director's interest to the board and shareholders and approval pursuant to the statute. Thus, minimum disclosure would become the substitute for fairness.[45]

Twenty-three states have enacted statutes which substantially conform to the California model of using a disjunctive approach requiring board or shareholder approval or fairness.[46] Different views have been expressed by the commentators on whether fairness is an overriding principle under these statutes. Most commentators argue for the continued use of fairness notwithstanding the disjunctive approach of the statute[47] while others advocate that fairness has been expressly eliminated.[48]

The first case to deal with the question of fairness in the context of the California model was *Remillard Brick Co.* v. *Dandini Co.*[49] Remillard Brick Co. (wholly owned by a Lillian Dandini), a minority shareholder of Remillard-Dandini Co., brought a derivative action on behalf of Remillard-Dandini and its wholly owned subsidiary San-Jose Brick Tile, Ltd. ("the manufacturing companies"). The suit sought to recover profits and declare void a contract between the manufacturing companies and Remillard-Dandini Sales Corporation ("the sales corporation"). The sales corporation was organized and wholly owned by defendants Stanley and Sturgis, who through proxies and contracts also controlled the manufacturing companies.

Initially, Stanley and Sturgis offered to purchase the shares in Remillard

approval by the disinterested directors yet, still inquired as to fairness. Under *Scott* the *Remillard* court would not have had to go further after that finding of no board approval. Thus *Scott*'s reliance on *Remillard* is unfounded. In addition, there is no support for the *Scott* approach in the legislative history of the California model or in the New Jersey Commentary.

44 The requirement of fairness has been viewed as a protection for shareholders. *See* text accompanying notes 163-199 *infra*, for a discussion of fairness.

45 Note that the California model requires minimum disclosure of interest by the director and not additionally the facts and circumstances as to the transaction. *But see* Armstrong Manors v. Burris, 193 Cal. App. 447, 14 Cal. Rptr. 338, 343 (1961). The following states follow the California model of requiring only minimal disclosure of interest: Arizona; Connecticut; Florida; Indiana; Kentucky; Maryland; Nevada; New Jersey; New York; North Carolina; Virginia; West Virginia; Wisconsin. *See* note 81 *infra* for those states which require full disclosure.

46 *See* note 8 *supra.*

47 Note, *The Status of The Fairness Test Under Section 713 of The New York Business Corporation Law,* 76 COL. L. REV. 1156, 1185; Note, *Interested Director's Contracts—Section 713 of The New York Business Corporation Law and The Fairness Test,* 41 FORD. L. REV. 639 (1973) [hereinafter cited as FORDHAM NOTE]. Kessler, *The New York Business Corporation Law,* 36 ST. JOHN'S L. REV. 1, 75-76, n.304 (1961). Comment, *The Voidability of Interested Director Contracts Under the Kansas Corporation Code,* 24 KAN. L. REV. 655, 673 (1976) [hereinafter cited as KANSAS NOTE]. Hoffman, *The Status of Shareholders and Directors under Business Corporation Law: A Comparative View,* 11 BUFF. L. REV. 496, 566-67 (1961-62); HORNSTEIN, *infra* note 65 (1968 pocket part at 210); LATTIN, *supra* note 9, at 293.

48 E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75 (1962) [hereinafter cited as FOLK]. Comment, Corporations *supra* note 29, at 485-86; Note, *The Fairness Test of Corporate Contracts with Interested Directors,* 61 HARV. L. REV. 335, 339 (1948) [hereinafter cited as HARVARD NOTE]. *Cf.* Note, *The Unfair Interested Directors Contract under New York Business Corporation Law,* 16 BUFF. L. REV. 841 (1967).

49 109 Cal. App. 2d, 405, 241 P.2d 66 (1952).

Brick Co. owned by Lillian Dandini. When she refused, they decided to separate the sales function from the manufacturing companies by setting up the sales corporation. A contract which transferred the sales function away from the manufacturing companies was entered into between the manufacturing companies and the sales corporation. Although a majority of the disinterested directors of the manufacturing companies did not approve the contract, the majority shareholders (i.e. Stanley and Sturgis) consented to the transaction. Defendants argued that since there was disclosure and shareholder approval, the statutory requirement had been satisfied and thus the contract was valid.

The Supreme Court of California rejected the defendant's contentions and voided the contract. The court held that "[e]ven though the requirements of Section 820 of the California Model are technically met, transactions that are unfair and unreasonable to the corporation may be avoided."[50] The court appears to have reached this conclusion by relying on the good faith requirement for all directors found in the first paragraph of the statute.[51]

The court could have reached the same result of voiding the contract without making fairness a mandatory requirement under the statute. It could have found that the defendants were not in technical compliance with the statute because the facts justified a finding that the directors acted in bad faith. The court described the defendant's action in such terms as "mulct; harsh and unfair"; and to "strip" a corporation of its assets.[52] These findings could easily have led to a conclusion of bad faith. There were also express findings by the trier of fact[53] of fraud and breach of the fiduciary duty to the minority shareholders by the controlling majority.[54] Despite these express findings, the *Remillard* court did not limit its decisions to situations where there is a showing of bad faith, fraud or breach of fiduciary duty. The important thing to note is that the court held that unfair transactions are voidable notwithstanding compliance with the shareholder approval requirement of the statute.[55]

50 *Id.* at 74.

51 *Id.* at 73. This seems to equate good faith with fairness. See Note, *Corporate Fiduciary Doctrine in the Context of Parents Subsidiary Relations,* 74 YALE L. J. 338, 342 (1964) [hereinafter cited as YALE NOTE]. *Contra* FOLK, *supra* note 48, at 88. Most cases which speak of good faith and fairness always refer to them separately, implying that they are not equitable. *See, e.g.,* Pepper v. Litton, 308 U.S. 296, 306 (1939); Mueller v. Macban, 62 Cal. App. 3d 258, 132 Cal. Rptr. 222 (1976). Yet in Pepper, the Supreme Court in articulating a test — i.e., an arm's length bargain—doesn't indicate whether the test is for fairness, good faith or both. *See* quotation from *Pepper* in text accompanying note 169 *infra.* In the context of the statute equating good faith and the statutory requirement of fairness would appear to be contrary to the rules of statutory construction. *See* CORPORATIONS *supra* note 29, at 485. However, it would not be contrary to statutory construction if the requirement of fairness in the statute were procedural fairness. *See* discussion of procedural fairness in text accompanying notes 64-69 *infra.*

52 *See* note 42 *supra* at 73-74.

53 *Id.* at 71.

54 *Id.* at 73. Controlling shareholders have been viewed as fiduciaries with respect to other shareholders. *See* Pepper v. Litton, 308 U.S. 296 (1939).

55 *Accord* KENNERSON, *supra* note 37. *See also* Schoff v. Clough, 380 P.2d 464, 465 (Nev. 1963). One commentator indicates that Noe v. Rousell, 310 So. 2d 806 (La. 1975), suggests that the *Remillard* approach is adopted in Louisiana under their statute. Note, *Corporations, Fiduciaries and Conflicts of Interests.* 36 LA. L. REV. 320, 325 (1975). A close examination of the case reveals that this contention is without substance. The court deals with the issue of burden of proof placing it upon the fiduciary (the liquidator) to show that the transaction was an arm's length affair without discussing the effect of the statute. There was no discussion of whether there was board or shareholder approval pursuant to the statute 310 So. 2d at 818-19.

In other words, the *Remillard* approach would allow interested directors' transactions to be voided if they were found to be unfair even though the specific requirements of the statute—disclosure to and approval of disinterested shareholders—had been complied with. Such a radical departure from the apparently obvious wording of the statute can only be justified in light of the legislative history of the California statute in conjunction with the common law development to that point. According to Henry Ballantine, a drafter of the statute, its purpose was an attempt to relax "the strictness of the California decisions to the effect that the interested directors' vote may not be counted toward a majority and that his presence may not be considered in determining whether a quorum of directors is present."[56] The drafters of the statute did not intend to affect the voidability of transactions which were unfair,[57] but to overcome the problems created by the "involvement" of interested directors in the approval or ratification process.[58] Thus the statute, by dealing only with the director's involvement, was aimed at curing procedural problems, not at assuring substantive fairness. If it were to be read as somehow limiting a court's ability to inquire into substantive fairness, it would clearly run contrary to developing common law on point which emphasized a concern for substantive fairness. The drafters wanted merely to clear up a procedural point and not to change the entire course of the common law dealing with fairness.[59]

On the other hand, it might be argued that if fairness is viewed as an overriding requirement, then the statutory provision of fairness as an alternative to board or shareholder approval would be mere "surplusage," and thus contrary to traditional principles of statutory interpretation.[60] This conclusion need not necessarily follow, however, if one views the statutory fairness requirement as being operative as a savings clause for certain procedural defects, *i.e.*, as a concern

56 BALLANTINE, *Questions of Policy*, *supra* note 26, at 475. Note that the statutory language itself indicates the contract is neither "void nor voidable because" of the voting or presence of the director thus leaving nonprocedural grounds for attacking a transaction.

57 According to Ballantine,

> It was the view of the majority of the committee on corporations, however, that transactions with a director or between corporations with common directors *should be merely voidable for unfairness* and not void or voidable at the option of the corporation by reason of the fact that such director participated in a quorum or a majority.

Id. at 476 (emphasis added).

But see changes in the California Corporation Law effective August 14, 1931 and analysis by legislative counsel bureau of assembly bill no. 1000 (Ch. 862) at 116 which indicates that the section was a means by which directors may avoid violating their fiduciary duty. The Analysis stated that any transaction with interested directors "*is valid* under the following circumstances *even though the interested director is present and voting* . . . [the circumstances are essentially subsections a through c of § 820]" (emphasis added). While this analysis may indicate that the statute is a validating provision, this validation may be limited by the previous quote which indicated that the validity may apply only to the problems under the common law of presence and voting by the director, leaving the question of fairness open.

58 *Id.* at 475. *See* BALLANTINE & STERLING, CALIFORNIA CORPORATION LAW (1949). Under the common law, a transaction would still have been voidable even though the interested director was not necessary for the vote or absented himself to avoid a conflict of interest. *See Note,* LEGAL SAFEGUARDS, *supra* note 15, at 60.

59 *See, e.g.,* Shlensky v. South Parkway Building Corp. 19 Ill.2d 268, 166 N.E.2d 739 (1960). *See* text accompanying notes 19-28 *supra,* for a discussion of the common law.

60 *Cf.* Comment, *Corporations, supra* note 29, at 485 indicates:

> May authorization or ratification in good faith be equated to a just and reasonable contract? Such a view would violate a cardinal rule of statutory interpretation by making subdivisions (a) and (b) largely surplusage.

MARSH, *supra* note 9, at 47.

for procedural fairness.[61] This concern with procedural fairness is consistent with the common law which looked at the presence or vote of the interested director[62] (procedural considerations) in addition to fairness.[63]

The fact that the statutory requirement of fairness focuses at the time of the authorization or approval of the transaction[64] further supports the view that the statutes are concerned with procedural not substantive fairness. Both the common law prior to the adoption of the statutes[65] and cases decided under the statutes[66] have viewed the substantive fairness of the transaction at dates subsequent to the approval—a view which is contrary to the statute.

This procedural savings clause of the statute may operate in those cases where there is a failure to comply with either board or shareholder approval as required by the statute. A court could review the board or shareholder approval process or lack thereof to determine if the failure to comply with the statute would affect procedural fairness. For example, a technical non-compliance with the California model such as a failure to note disclosures of "interest" in the corporate minutes, should not necessarily render a contract void. The savings clause could save the transaction as still being procedurally fair. Similarly, in the context of a closed corporation, all the facts may be known by all the directors and shareholders but there may be no formal approval pursuant to the statute. The transaction should still be valid because it was procedurally fair, given the full disclosure[67] and the usual informal manner in which close corporations are run.[68]

Thus, fairness under the statute, if viewed in a procedural context, leaves the question of substantive fairness open for judicial inquiry and is not precluded by the disjunctive approach of the statutes.[69]

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61 *Cf.* Williams v. Walker-Thomas Furniture Company 350 F.2d 445 (D.C. Cir., 1965) which involved the concept of "unconscionability" under § 2-302 of the Uniform Commercial Code (1962). The court in applying the concept looked at both procedural considerations (*e.g.*, the manner in which the agreement was entered into) and substantive considerations (*e.g.*, the terms of contract). *See* Leff, *Unconscionability And The Code—The Emperor's New Clause,* 115 U. PA. L. REV. 485 (1967).

62 *See* text accompanying notes 21-23 *supra,* for a discussion of the common law view.

63 *Cf. Harvard Note* note 47 *supra,* at 340. The Note suggests that fairness involves questions about the contract itself and the process of approval:

> In practice we have found that a court will look first to the terms of the contract, but this inquiry usually throws insufficient light on the question of whether acceptance of the contract was an exercise of business judgment. An examination of the conduct of the directors — as a coordinate line of inquiry — yields more illuminating data.

64 CAL. CIV. CODE § 820(c). Some statutes add the term "ratification." *See, e.g.,* Delaware *infra* note 78.

65 Roger v. Hill, 289 U.S. 582 (1933). Globe Woolen Co. v. Utica Gas and Electric Co., 224 N.Y. 483, 121 N.E. 379, 380-81 (1918).

66 *See Remillard, supra* note 42, at 76; Fliegler v. Lawrence, 361 A.2d 218, 221 n.2 (Del. 1976). Neither case makes reference to the statutes in making its determination of fairness at a date which conflicts with the statute.

67 The use of procedural fairness to save transactions which do not comply with the requirements of board or shareholder approval would normally mandate full disclosure of both the interest and the terms of the transaction. *Cf.* 2 HORNSTEIN, CORPORATION LAW AND PRACTICE 439 (1959) [hereinafter cited as HORNSTEIN].

68 Armstrong Manors v. Burris, 193 Cal. App. 2d 447, 14 Cal. Rptr. 338, 343 (1961) Brainard v. De La Montanya, 116 P.2d 66, 70 (1941).

69 If the statutory requirement of fairness is procedural in nature, then it could invalidate an otherwise fair transaction. For example, a corporation has ten directors of which six enter into a contract with the corporation. If the contract is substantively fair but all the disinterested directors vote against it, then the contract could be voided. This results from the failure to meet any of the statutory requirements. There has been no board or stockholder

The *Remillard* approach may also be justified if the statutes are viewed as only determinative of who has the burden of proof.[70] Under the common law, the burden of proving the fairness of a transaction was usually on the interested director.[71] Thus compliance with board of shareholder approval under the statute arguably would either lessen that burden[72] or shift it to those challenging the transaction.[73] Failure to comply with board or shareholder approval would, on the other hand, bring into play the fairness requirement of the statute. This requirement would then place the burden of persuasion on the interested director to prove substantive fairness. Although this approach is consistent with the disjunctive nature of the statute because substantive fairness remains an issue, a shifting of burden of persuasion to those challenging the transaction may create an insurmountable obstacle, thus *precluding* fairness. This would be contrary to the *Remillard* approach. To avoid this result, compliance with statute should only have the effect of removing the presumption of unfairness and only shift the burden of going forward to the plaintiffs.[74]

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approval pursuant to the statute. This result is consistent with the policy of requiring corporate interests in cases of self-dealing to be the concern of those disinterested directors.

70 Israels, *supra* note 43, at 627. There is no legislative history or intent by the draftsmen indicating that the California model was designed to deal with burden of proof. Chase v. Super-Cold Corporation, 328 P.2d 812, 814 (Cal. 1958). *But see* Tevis v. Beigel, 344 P.2d 360, 363 (Cal. 1959). There is no statutory language indicating that the statutes were designed for that purpose. In fact, some states have specifically included language which indicates that the burden shifts upon compliance with the statute. *See, e.g.*, Virginia and the new California statute. *See* part C of text, *infra*.

71 FORDHAM NOTE, *supra* note 47, at 664. *See, e.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921).

72 In *Scott*, *supra* note 36, the court held that the burden does not shift to those challenging the transaction under New Jersey's adaptation of the California Model. The court states that compliance with the statute "sets a less stringent standard for the requisite proof, substituting the preponderance of evidence test for the clear and convincing requirement." *Id.* at 68. The court relies on the Commissioners' Note accompanying N.J. STATS. ANN. 14A:6-8 which indicates that the statute was designed to change the rule of Abeles v. Adams Engineering Co., Inc., 35 N.J. 411, 173 A. 2d 246 (1961), which places the burden on the interested director to demonstrate by *"clear and convincing proof"* that the transaction is fair (emphasis supplied). The court reached that conclusion because the Commissioner's Note indicated that general equitable principles still apply to test the validity of transactions. The court also held that all three requirements of the statute (board approval, shareholder approval and the showing of fairness) must be met before the less stringent standard of proof would apply. *Id.* at 67. *See* text accompanying note 43 *supra*. To suggest that all three statutory requirements must be met to lower the standard appears absurd. This would require an interested director to first prove the transaction fair under the statute in order for him to then prove fairness under a less stringent test. But one way to rationalize this incongruity would be to view the statutory fairness requirement as procedural, thus a director showing board approval: shareholder approval and procedural fairness have a less stringent test to prove substantive fairness. *See* text accompanying notes 61-69 *supra*, for a discussion of procedural fairness.

73 *See* Israels, *supra* note 43. *Cf.* Tevis v. Beigel, 156 Cal. App. 2d 319 P.2d 98, 102-103 (1957). Some case law indicated that a charter or by-law provision allowing such transactions would at least "exonerate them from adverse inferences which might otherwise be drawn against them." Spiegel v. Beacon Participations 8 N.E. 2d 895, 907 (1937); *see also* Everett v. Phillips, 288 N.Y. 227. This is not shifting of the burden of persuasion, but only a removal of the inference unfairness, thus requiring plaintiffs to bear the initial burden of going forward.

74 Ward, *Some Notes on Transactors Involving Interested and Interlocking Directors in Pennsylvania*, 23 TEMP. L. Q. 107 1949. Under the common law some courts held the burden of persuasion was on the directors to prove fairness, *i.e.*, that the transaction was presumptively unfair. Other courts required those challenging the transaction to at least allege some facts or circumstances besides interest, which could appear to be unfair. That is, a burden of going forward was on the plaintiff. The burden of persuasion would still be on the interested directors to convince the court that the transaction was fair. *Id.* at 113. This view should be the effect of the statute since it is consistent with case law seemingly indicating that only the pre-

The California approach as reflected by *Remillard* with fairness as an overriding requirement, therefore, may be rationalized by the drafters' view as reflected by Ballantine; or by viewing the statutory requirement of fairness as a procedural savings clause; or by classifying the statutes as dealing with burden of going forward; or on a policy that fairness is necessary to protect shareholders.[75]

B. *The Delaware Approach*

Professor Ernest Folk maintains that the *Remillard* approach is inapplicable in Delaware because California has "a very different statute and a judicial point of view at variance with Delaware . . ."[76] He argues that the purpose and effect of the Delaware provision "is to *validate* a contract between a corporation and one or more of its directors or officers, or between a corporation and other entities which are linked by common directors or officers, if *any one of statutory tests is met*" (emphasis added).[77]

Section 144 of the Delaware Corporation Law[78] does differ from the

sumption of unfairness can be removed. *See* SPIEGEL, *supra* note 73. If the statute goes further and, upon compliance, places the burden of persuasion upon those challenging the transaction, it would often mean that this procedural rule would place an insurmountable burden on the plaintiffs. In actuality this could keep a court from scrutinizing a transaction and thus in effect eliminate fairness which is contrary to the *Remillard* approach.

75 This policy of protecting shareholders appears to be the principal argument of the commentators in note 47 *supra* for requiring fairness. *See* text accompanying notes 61-69 *supra* for a discussion of fairness.

76 FOLK, *supra* note 48, at 88 n.70. Delaware has been criticized as being overly protective of the interests of management or majority shareholders at the expense of minority shareholders. *See* Cary, *Federalism and Corporate Law—Reflection Upon Delaware,* 83 YALE L.J. 663 (1974); NADER, GREEN & SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976). California has been a leading exponent of the protection of minority shareholders. *See, e.g.,* Jones v. H. F. Ahmanson & Co., 81 Cal. Rptr. 592, 460 P.2d 464 (1969). *But see* Singer v. Magnavox, note 33 *supra.*

77 *Id.* at 75. *Cf.* Tennessee Dressed Beef Co. v. Hall, 519 S.W.2d 805, 808 (Tenn. 1975), *criticized in* Recent Developments, *Corporations Duty a Loyalty and Corporate Opportunity — Transactions Between Corporations with Common Directors,* 43 TENN. L. REV. 155 (1975). *But see* The Comment to the Model Act § 41 (which follows the California model and does not require full disclosure of the transaction) at 842 which initially indicates that "Its purpose is to establish statutory guidelines for determining the *validity* of transactions. . . . It *validates,* if the prescribed tests are satisfied, transactions with interested directors which common law rules often make voidable, if not void" (emphasis added). However, it later states that "The function of section 41 is *not to provide a basis for validating* for all purposes a contract or transaction . . . but simply to establish that such contract or transaction is not automatically void or voidable solely by reason of the director's interest." *Id.* at 844. This inconsistency arises because of the tension between the disjunctive nature of the statute which suggests validity and the courts' and commentators' senses of equity and the requirements of fiduciary duty which mandates fairness.

78 DEL. CODE ANN. tit. 8 § 144 (1975) reads:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if;
>
> (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

California statute.[79] The Delaware statute, unlike its California counterpart, has no general requirement of good faith for directors[80] although, like California, good faith is specifically required for board or shareholder approval.[81] Significantly, the disclosure requirement in California is limited to disclosure of the adverse interest,[82] while Delaware requires disclosure of "material facts as to his relationship or interest *and as to the contract or transaction* . . ."[83] (emphasis added). In essence, Delaware requires full disclosure.

If Folk's view is correct and it is a validating statute, then this requirement of full disclosure removes the question of fairness from judicial inquiry when the board or shareholders approve a transaction pursuant to the statute.[84] The question of the propriety of the transaction is then left to the board or shareholders, not the courts.[85] This view substitutes full disclosure for fairness.[86]

Is the Folk view justifiable? There appears to be no legislative history[87] to

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(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committte which authorizes the contract or transaction.

79 The Delaware statute unlike California specifically provides for board approval with "a majority of the disinterested directors even though the disinterested directors are less than a quorum." *See* note 37 *supra,* for a discussion of California requirements. This provision clearly does not require a majority of all the directors present. But the statute is unclear whether one needs a disinterested majority of the whole quorum or a majority of disinterested directors present. *Contra* ARSHT note 35 *supra.* Thus in the example in note 37 *supra,* the quorum was seven directors. Under the former approach the four disinterested directors are required, while under the latter, only three of the five disinterested are required.

80 *See* A. CONARD, CORPORATIONS IN PERSPECTIVE 34 (1976). This distinction from California should not be significant. Although the statute doesn't require good faith, Delaware case law views directors as fiduciaries operating within the business judgment rule which presumes good faith. Delaware Bar Association, Resource Document on Delaware Corporation Law 19 (1976) [hereinafter cited as RESOURCE DOCUMENT].

81 DEL. CODE ANN. tit. 8 § 144(a)(1), (2) (1975). The following states also require good faith approval by the shareholder: Georgia, Kansas, California, Louisiana, Nevada, New York, North Carolina, Pennsylvania, and Rhode Island.

82 *But see* Angelos Securities Corporation v. Ball, 20 Cal. App. 2d 436, 67 P.2d 158, 160 (1937).

83 The following states require full disclosure of both the interest and the facts as to the transaction: Delaware, Georgia, Kansas, Louisiana, Maine, Michigan, Pennsylvania, Rhode Island, South Carolina, Tennessee. *See* note 44 *supra,* for those states requiring only minimal disclosure of interest.

84 FOLK, *supra* note 48, at 82-86. *But see* Fliegler v. Lawrence, 361 A.2d 218 (Del. Sup. 1976), and text accompanying notes 102-05 *infra.*

85 Courts are reluctant to inquire into the decision-making of directors, or shareholders when the business judgment rule or shareholder ratification applies. Gottlieb v. Heyden Chemical Corp., 91 A.2d 57 (Del. 1952); Beard v. Elster, 160 A.2d 731, 737 (Del. 1960).

86 *See* text accompanying notes 114-22 *infra. See generally* Cary, *Corporate Standards and Legal Rules,* 50 CAL. L. REV. 408 (1962). According to Cary, full disclosure may have a prophylactic effect on controlling shareholders or directors in the context of publicly held companies. But full disclosure does not necessarily restrain the activity of such shareholders or directors in the context of smaller corporations, without public shareholders. It would not be surprising for a controlling shareholder to inform the minority of proposed oppression. *Cf. Remillard, supra* note 42, at 74.

87 There appears to be a general reluctance in Delaware to provide information on the deliberations of the 1967 revision of the Delaware Corporation Law for a variety of reasons. *See* Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967,* 117 U. PA. L. REV. 861, 863-70 (1969).

clarify the apparent statutory effect which validates contracts upon board or shareholder approval.[88] Prior Delaware case law arguably supports Folk's view.

Under Folk's view, the requirement of board approval under the statute appears to be an extension of the business judgment rule.[89] Delaware courts, prior to the enactment of the statute, did not inquire into the question of fairness whenever the business judgment rule was found to apply. That rule was used to uphold transactions whenever a disinterested majority of the board approved it.[90] The Delaware Supreme Court in articulating the rationale for this rule, indicated that, "At most, therefore, we find ourselves in the twilight zone where reasonable businessmen, *fully informed* might differ. We think, therefore, we are precluded from substituting our uninformed opinion for that of experienced business managers of a corporation *who have no personal interest in the outcome . . .*"[91] (emphasis added) The rule was inapplicable, however, whenever a majority of the board was interested.[92] According to Folk, the statutory requirement of board approval extends the application of the business judgment rule to situations where a majority of the board is interested. This results from the statutory language[93] which allows approval of a majority of disinterested directors even though they constitute less than a quorum.[94] Under this rule then, upon board approval pursuant to the statute, the only way to attack the transaction would be to prove that the business judgment rule should not apply.[95]

Since the requirements of the Delaware statute under Folk's view are in the alternative, good faith shareholder ratification with full disclosure would also preclude questions of fairness.[96] With such a ratification, a disinterested shareholder could only attack the transaction if he could show "the terms are so unequal as to amount to waste."[97] But Folk argues that the statute does not require

88 It is interesting to note that the RESOURCE DOCUMENT, *supra* note 80, prepared by the *Delaware Bar Association* in response to critics of Delaware corporate law ignores Section 144 and Folk's analysis of that section. The Document indicates that a director as a fiduciary should not profit from his position and further that, "[w]hen challenged, he must prove, that transactions in which he has interest are fair." *Id.* at 22.

89 FOLK, *supra* note 48, at 82-83.

90 BEARD, *supra* note 85, at 737-38.

91 *Id.* at 738-39.

92 GOTTLIEB, *supra* note 85. Approval by disinterested shareholders may insulate a transaction approved by the interested board from an inquiry of fairness. The court states: "[T]he entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully informed (share)holders." *Id.* at 59.

93 DEL. CODE ANN. tit. 8 § S144 (a) (1). FOLK, *supra* note 48, at 83. *See* note 79 *supra,* for a discussion of the language.

94 Under Folk's analysis, the statute changes *Gottlieb, supra* note 83. In that case a nine-member board, of which six directors were interested, approved of an option plan unanimously. In *Gottlieb,* the court still looked to fairness because there wasn't a disinterested quorum. Under the statute, since all three disinterested directors approved the transaction, fairness would not be an issue.

95 FOLK indicates that the business judgment rule does not apply to findings of:

> Fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the right of stockholders or "fraud or gross abuse of discretion" or "bad faith in the transaction" or if the transaction is "so manifestly unfair or to indicate fraud" or there "is a showing of gross and palpable overreaching."

See note 48, *supra* at 76.

96 DEL. CODE ANN. tit. 8 § 144 (a) (2); *id.* at 85-86. *Cf.* GOTTLIEB, *supra* note 85, at 59.

97 GOTTLIEB at 58. The transaction may be attacked if shown "that no reasonable businessman, fully informed as to the respective value and acting in good faith, could be expected to consider the bargain attractive to the corporation." *Id.* at 59.

the ratification of disinterested shareholders.[98] Under his view, a transaction ratified by interested shareholders could not be attacked for unfairness.[99] While the statute does not refer to interest when discussing shareholder approval,[100] nonetheless, a requirement that only disinterested shareholders may vote can be implied by the statute's requirement of good faith approval.[101] Otherwise, Folk's view is a significant departure from fiduciary duties under existing Delaware case law and such a departure would require a clear expression of legislative intent to do so.

A recent decision in Delaware indicates a view contrary to Folk's. In *Fliegler v. Lawrence*,[102] the Supreme Court of Delaware dealt with a Section 144 transaction where Agau Mines, Inc., ("Agau") a Delaware Corporation, had been granted an option to acquire another corporation whose stock was controlled by some of Agau's directors and shareholders. In return for the option, Agau transferred 800,000 shares of its stock to that corporation. The transaction was approved by the board of directors and the shareholders. Those attempting to uphold the transaction argued Folk's view that there was a validation of the transaction because of compliance with the statutory requirement of shareholder approval, even though there was no disinterested majority. The court rejected this contention and determined that fairness was still an issue notwithstanding the shareholder approval. The court stated:

> We do not read the statute as providing the broad immunity for which defendants contend. It merely removes "interested director" cloud when its terms are met and provides against invalidation of an agreement "solely" because such a director or officer is involved. Nothing in the statute sanctions unfairness to Agau or removes the transaction from judicial scrutiny.[103]

This view indicates that compliance with the statute does not necessarily validate transactions, but, like the California model and the *Remillard* approach, it leaves the question of fairness open. While the decision may be restricted to situations where there is approval by interested shareholders,[104] the emphasis on the term

98 FOLK, *supra* note 88. *Contra Fliegler, supra* note 84. Tennessee and North Carolina exclude all interested shareholders from voting while Maine and the new California statute exclude interested directors from voting their shares. Nevada specifically allows interested shareholders to vote.

99 *Id.* at 84-85.

100 DEL. CODE ANN. tit. 8 § 144 (a) (2).

101 *See* KANSAS NOTE, *supra* note 47, at 666. *But see* FOLK, *supra* note 48, at 86. In BEARD, *supra* note 85, at 737, the court indicates that ratification even by disinterested shareholders may "not supply the necessary element of good faith exercise of business judgment by Directors." Arguably, approval by only interested shareholders could not be in good faith. *See* note 79 *supra*, for a listing of those states which also require good faith approval. In those states which do not have a provision for good faith approval, a requirement of disinterest would depend upon the common law rule in that state. BLACK, *supra* note 31, at 360. If there is no such requirement of disinterested shareholders' approval and the statute is deemed to validate transactions, then in the case of an unfair transaction, one would have to argue under the limitations of shareholder ratification. *See* text accompanying notes 129-33 *infra*.

102 361 A.2d 218.

103 *Id.* at 222.

104 The court did not address itself to § 144 (a) (1) and whether or not board approval pursuant to the statute would preclude a review for fairness. The reason for not considering the issue was that the only disinterested director did not participate at the meeting in which the Board exercised the option. *Id.* at 222 n.3.

"solely" by the court could be a basis for arguing that fairness is also an issue where there is approval by the board of directors under the statute. Since "solely" appears in the introductory clause and was found applicable to the alternative of shareholder approval, it should likewise apply to the alternative of board approval.[105]

Even if *Fliegler* is restricted, or if the Folk view is adopted,[106] those transactions could still be attacked on other grounds. First, one could argue that full disclosure was not made. Second, one could argue that approval was not made in good faith either by the board or the shareholders. Third, the transactions do not fall within the business judgment rule or the shareholder ratification rule. Any of these grounds of attack may in substance be an indirect method of arguing fairness and thus be a means of retaining the fairness test.[107]

Some courts have taken the position that full disclosure may be a factor in determining fairness,[108] and one court has found that the failure to disclose is in itself unfair.[109] Full disclosure, however, has never been equated with substantive fairness.[110] Yet, under the Folk analysis, it appears that full disclosure has replaced fairness. This may not be significant because in self-dealing situations, there will rarely be full disclosure.[111] If a court concludes that the requirement of full disclosure has not been met,[112] then the fairness requirement of the statute would come into play.[113]

The good faith requirement of the Delaware statute is directed at both board and shareholder approval.[114] It is arguable that good faith *is* the equivalent of fairness under the statute.[115] While "good faith" can be viewed both subjectively and objectively,[116] it normally requires use of a subjective test.[117] Yet the statutory language focuses on good faith *board* or *shareholder* approval, *not* on the *individual* good faith of the directors or shareholders, thus implying an

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105 *See* SUTHERLAND, *supra* note 31, at § 4605, 56-57.

106 An adaptation of the Folk view appears to be adopted in the new California statute in the context of mere interlocking boards. *See* Part C *infra.*

107 *See* Part D *infra,* for a discussion of fairness.

108 Voss Oil Company v. Voss, 367 P.2d 977, 979 (1962).

109 State ex rel. Hays Oyster v. Keypoint System Co., 64 Wash.2d 375, 391 P.2d 979 (1964). *See* HORNSTEIN, *supra* note 67.

110 Note, *Corporation-Directors-Transactions Involving Conflicts of Interest,* 42 ORE. L. REV. 61, 65 (1962).

111 *Cf.* Popkin v. Bishop, 464 F.2d 714, 719 (2d Cir. 1972)

> In many if not most corporate self-dealing transactions touching securities, state law does not demand prior shareholder approval. In these situations it makes sense to concentrate on the impropriety of the conduct itself rather than on the "failure to disclose" it because full and fair disclosure will rarely occur.

But in the closed corporation context you may find full disclosure and knowledge by all shareholders of everything going on even when there is self-dealing and thus full disclosure would not protect the minority's interest. Remillard, *supra* note 42, at 74.

112 It would be necessary for those seeking the protection of the statute to initially convince the court that the statute's requirements are met. *Cf.* Tevis, *supra* note 70, at 363.

113 DEL. CODE ANN. tit. 8 § 144 (a) (3).

114 *Id.* at § 144 (a) (1) & (2).

115 REMILLARD, *supra* note 42, at 73. *See* note 49 *supra.*

116 KANSAS NOTE, *supra* note 47, at 665-66.

117 *Id.* In either case, the standard of what amounts to good faith may vary in different contexts. For instance, behavior that may be permissible in a large corporation may not be tolerated in a closed corporation. *See* Donahue v. Rodd Electrotype Co. and New England, 328 N.E.2d 505 (Mass. 1975).

objective standard.[118] Whether or not an objective or subjective test is used may not be significant because a court should in either case look to the facts and circumstances from which an inference of good faith or lack thereof could be drawn.[119] In so doing, a court must necessarily look to the substance of the transaction, which in essence would be an inquiry into fairness.[120]

Good faith would also be available to attack a transaction when a director or shareholder improperly influences or dominates other directors or shareholders.[121] Good faith may also allow a direct action against those interested and disinterested directors who approve an unfair transaction.[122]

The business judgment rule precludes judicial inquiry into decision making by a board because directors are presumed to be acting in best interest of the corporation.[123] Traditionally this rule was inapplicable whenever self-dealing was involved,[124] and when there was a majority of interested directors on the board.[125] As previously discussed, Folk argues that the statute has extended the business judgment rule to self-dealing situations even when the disinterested directors who approve the transaction are less than a quorum.[126] If this rule is demonstrated to be applicable, it is incumbent upon those challenging the transaction to show actual or constructive fraud, bad faith, manifest unfairness, or gross or palpable overreaching.[127] While these limitations on the business judgment rule do not appear to approach a fairness standard, one may argue that an unfair transaction amounts to fraud because of the breach of fiduciary duty. As one court indicated:

> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments, which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another or by which an undue and unconscientious advantage is taken of another. . . .[128]

118 It is impossible to infer a subjective state of mind from group activity like action by the board or shareholders as a whole.

119 Although a subjective test focusses on the state of mind of the person involved, it, like any fact, involves an inquiry into circumstances. In Efron v. Kalmanovitz, 249 Cal. App. 2d 187, 57 Cal. Rptr. 248, 251-52 (1967), the court in analyzing good faith in the context of an interested director's transaction indicated good faith is "used to describe that state of mind denoting honesty of purpose, freedom from intention to defraud, and generally speaking, means being faithful to one's duty or obligation." That is, a subjective test is employed. In their analysis of good faith, the court examined the transaction and found: "Upon substantial evidence that the contract entered into was, because of the terms of payment, not just and reasonable, that is, that it was unfair to the corporation, it follows that the contract was in that sense and that sense only not entered into in good faith."

120 The KANSAS NOTE suggests that an objective test should be used when a transaction is fair and a subjective test when it is unfair. *See* note 47, *supra* at 665.

121 *Id.*; *cf.* Globe Woolen Co. v. Utica Gas and Electric Co., 224 N.Y. 483, 121 N.E. 379 (1918).

122 *Cf. Recent Developments, supra* note 77, at 160. The business judgment rule which may protect the directors would only operate if it can be shown that informed directors exercised due care by directing "some thought and attention to the transaction they are asked to approve." FOLK, *supra* note 48, at 81.

123 *Beard, supra* note 85, at 738-39. FOLK, *supra* note 48, at 75. Arsht & Stapleton, *Delaware New Corporation Law: Substantive Changes,* 23 BUS. LAW 75, 81-82 (1967).

124 Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

125 FOLK, *supra* note 48, at 83.

126 *Id.*

127 *Id.* at 76.

128 Santa Fe Industries v. Green, 533 F.2d 1283 (2d Cir. 1976). The Supreme Court in reversing indicates that the Second Circuit's definition of fraud was inapplicable to SEC Rule 10b-5 of the Securities and Exchange Act of 1934 because of the specific requirement of

Compliance with shareholder ratification under the statute, according to Folk, validates the transaction even if the shares of the interested directors are needed for approval.[129] If that ratification rule applies, those challenging the transaction may have to show that the transaction amounts to waste,[130] fraud or oppression,[131] or even that the transaction is not "the product of honest business judgment."[132] These limitations to shareholder ratification are like those of the business judgment rule and arguably may also equate with a fairness standard.[133]

C. *New California Section 310*

In 1975, California enacted a new Corporations Code which was effective on January 1, 1977. Section 310[134] deals with interested directors' transactions

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scienter compelled by the Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In the context of self-dealing and breach of fiduciary duty the Second Circuit's definition should apply, because it would be unreasonable to require a shareholder to show actual intent. *See* text accompanying notes 177-84 *infra,* for a discussion of fraud as a test of fairness.

129 FOLK, *supra* note 48, at 83. Full disclosure must occur and there must be specific approval in good faith by the stockholder.

130 *Id.* at 84. If there is unanimous agreement the shareholders should be able to do as they please. *Id.*

131 Sneed, *The Stockholder May Vote as He Pleases; Theory and Fact,* 22 U. PITT. L. REV. 23, 39 (1960).

132 Arsht, *supra* note 123, at 82.

133 *See* text accompanying notes 123-28 *supra.* Since those shareholders who control a corporation have been found to be fiduciary to the minority shareholders, a vote involving their self-interest may involve a breach of duty which could come within the broad definition of fraud articulated in the text at note 128 *supra.* Sneed, *supra* note 131, argues that in those cases in which the interested directors' transactions are unfair, courts have found the transaction to be fraudulent and thus not subject to ratification.

134 CAL. CORP. CODE § 310 (West Supp. 1976) reads as follows:

> CONTRACTS IN WHICH DIRECTOR HAS MATERIAL FINANCIAL INTERESTS VALIDITY
>
> (a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest, is either void or voidable because such director or directors or such other corporation, firm or association are parties or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction, if
>
> (1) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the shareholders and such contract or transaction is approved by the shareholders (Section 153) in good faith, with the shares owned by the interested director or directors not being entitled to vote thereon, or
>
> (2) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the interested director or directors and the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified, or
>
> (3) As to the contracts or transactions not approved as provided in paragraph (1) or (2) of this subdivision, the person asserting the validity of the contract or transaction sustains the burden of proving that the contract or transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified.
>
> A mere common directorship does not constitute a material financial interest within the meaning of this subdivision. A director is not interested within the meaning of

and its language appears to be much clearer than the California model on the role of fairness. The statute has two different rules. One rule applies to cases in which a director contracts with his corporation directly or to cases where the contract is between two corporations in which the director has material financial interest.[135] The other rule applies to transactions between corporations with interlocking directors where the directors have no financial interest in either corporation *i.e.*, the outside director.

Under the first rule, if the transaction and interest[136] are fully disclosed or known to the shareholders and approved by them in good faith without counting the shares owned by the interested directors, then the transaction appears to be valid.[137] If the material facts as to both the transaction and interest are fully disclosed or known to the board which approves the transaction in good faith without counting the votes of the interested director *and* the transaction is "just and reasonable as to the corporation" at the point of board action, then the

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this subdivision in a resolution fixing the compensation of another director as a director, officer or employee of the corporation, notwithstanding the fact that the first director is also receiving compensation from the corporation.

(b) No contract or other transaction between a corporation and any corporation or association of which one or more of its directors are directors is either void or voidable because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction, if

(1) The material facts as to the transaction and as to such director's other directorship are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the common director or directors or the contract or transaction is approved by the shareholders (Section 153) in good faith, or

(2) As to contracts or transactions not approved as provided in paragraph (1) of this subdivision, the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified.

This subdivision does not apply to contracts or transactions covered by subdivision (a).

(c) Interested or common directors may be counted in determining the presence of a quorum at a meeting of the board or a committee thereof which authorizes, approves or ratifies a contract or transaction.

135 *Id.* The California model used the term financial interest. The requirements of the new California statute that the interest be material are consistent with the policy underlying the rules with regard to interested directors' transactions. *Cf.* Cary, *supra* note 86, at 410. The rationale for the rule is "to secure faithful discharge of duty, and at the same time, to close the door as far as possible against all temptations to do wrong." Indurated Concrete Corp. v. Abbott, 195 Md. 496, 74 A.2d 17, 20 (1950). Only a material financial interest might affect one's judgment. A "might" test should be used to determine materiality as consistent with limiting temptation. Thus materiality should not be a question only of actual amount of interest but should consider other factors including the size of the corporation; the holdings of other directors; the holdings of relatives and others associated with the director; the size of the benefit to the director; etc. Section 310(a) specifically excludes mere common directorship as meaning a material financial interest. In addition, the fact that a director who receives compensation votes to fix the compensation of another director, will not be considered a material financial interest.

136 California has adapted the Delaware approach of full disclosure of both interest and material facts as to the entire transaction. *See* note 83 *supra,* for the other states requiring full disclosure.

137 CAL. CORP. CODE § 310 (a) (1).

transaction also appears to be valid.[138] If the transaction is not approved pursuant to the alternatives of board or shareholder approval, then the statute requires that the person asserting the validity of the transaction must sustain the burden of proving the fairness of the transaction at the time it was authorized, approved, or ratified.[139] Thus if shareholder approval necessarily validates transactions, the fairness requirement has been eliminated.

Transactions between interlocking boards of corporations where none of the directors has a material financial interest fall under the second rule. As long as there is full disclosure to the board and subsequent approval by the disinterested directors acting in good faith, the transaction appears to be valid.[140] In the alternative, the transaction appears to be valid if there is shareholder approval.[141] Only if there is no such board or shareholder approval, must the transaction be established as "fair."[142] Thus in the case of mere interlocks, fairness would not be an issue if there were either board or shareholder approval pursuant to the statute.

This new statute, contrary to the original California model, appears to be a *validating* statute. There are several reasons for this conclusion. First, the title of the statute specifically says "validity."[143] Second, under the first rule there is a specific requirement of fairness when only the board approves a transaction, but not when there is shareholder approval; and there is no requirement of fairness under the second rule when either the board or the shareholders approve.[144] Thus fairness has been eliminated as an overall requirement because the express inclusion of it in one case impliedly excludes it in all others.[145] Third, the legislative history indicates that each alternative under the statute is for validation.[146]

Under the second rule, the elimination of fairness in the context of interlocking directors when there is board or shareholder approval seems justifiable. Although the California model made no distinction between transactions with interlocking directors and those between a corporation and its directors, the

138 *Id.* at § 310 (a) (2). Fairnesss under *Remillard, supra* note 42, was viewed at a later date notwithstanding the statute. *See* note 66 *supra.* This may now preclude courts from viewing fairness at a later date unless the courts in equity fear waste. *Cf. Rogers, supra* note 65, or view the statute as a codification of *Remillard. See* note 161 *infra.*

139 *Id.* at § 310 (a) (3).

140 *Id.* at § 310 (b) (1).

141 *Id.* The statute appears to eliminate the requirement of full disclosure to the shareholders. Arguably the requirement of approval in good faith by the shareholders mandates such disclosure.

142 *Id.* at § 310 (b) (2).

143 *See* SUTHERLAND, *supra* note 31, at § 47.03, 72-73. BLACK, *supra* note 31, at § 83, 244-52. Former CAL. GEN. CORP. CODE § 6 (West 1955), provided that the headings of the sections do not affect the "scope, meaning or intent" of the Corporation code. The new California General Corporation Law contains no similar provision, thus § 6 is repealed. BLACK, § 168. This would indicate an intent to give headings some meaning.

144 *Compare* CAL. CORP. CODE § 310 (a) (2) *with* (a) (1); and (b) (2) *with* (2) (1).

145 SUTHERLAND, *supra* note 31, at § 47.23. 123; BLACK, *supra* note 31 at § 72, 219.

146 California Legislative Assembly Select Committee on the Revision and the Corporation Code. Report of the Assembly Select Committee on the Revision of the Corporation Code 54-55 (1975) [hereinafter cited as Select Report]. The Select Report states that, "[a]s in prior law, alternative methods are stated to provide independent procedures for the *validation* of "interested transactions" (emphasis supplied). *Id.* at 54. Note that prior law didn't provide for alternative validation procedures. *See Remillard, supra* note 42, and discussion in Part A of text *supra.*

common law often distinguished the two situations.[147] This change in the new California statute is sound because it is only applicable in cases where there are common directors without a material financial interest in either corporation. If the directors have a material financial interest, then the transaction falls under the stricter first rule which requires fairness with board approval. The removal of fairness under the second rule appears to be based upon the business reality that certain individuals may sit on several boards as outside directors without a financial interest. Moreover, this use of outside directors may serve definite business advantages.[148] The common law rule against contracts between a corporation and its director is inapplicable in this context since a director without a substantial financial interest will normally not be influenced by self-interest, and thus will not unduly influence his board to enter into unfair contracts.[149]

Under the first rule, however, the elimination of fairness may be unsound. While there may be theoretical reasons to distinguish between approval by the board or shareholders,[150] this statutory change is significant and may work to the disadvantage of minority shareholders. The statute only requires approval by "the affirmative vote of a majority of the shares entitled to vote," (interested shareholders are not entitled to vote)[151] represented at a duly held meeting at which a quorum is present.[152] A quorum is normally a majority of the shares entitled to vote at a meeting.[153] Since the interested shares are not entitled to vote[154] on the approval of the transaction, the quorum focuses upon a majority of those entitled to vote on the issue.[155] Section 602(a) provides that this quorum requirement may be varied and lowered to one third if provided for in the certificate of incorporation.

The key is obtaining a majority of the disinterested shareholders which make up the quorum. For example, suppose that a corporation with 99 shares issued and outstanding, of which 33 shares are owned by interested directors, convenes a shareholder meeting to affirm an interested directors' transaction. If there is a provision in the certificate requiring a quorum of only one third of the share-

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147 MARSH, *supra* note 9, at 41-42, 66; BALLANTINE *supra* note 10, § 72. *See* text accompanying notes 22-24 *supra*, for a discussion of common law.

148 *See* Bishop, *Sitting Ducks and Decoy Ducks: New Trend in the Indemnification of Corporation Directors and Officers*, 77 YALE L.J. 1078 (1968), Myers & Pinto, *Corporations*, 1973-1974 N.Y.U. ANNUAL SURVEY OF AMERICAN LAW 485, 493-94.

149 *See* note 135 *supra*, for a discussion of material financial interest.

150 It may be that the statute requires fairness for board approval because of the difficulty in measuring the influence of the interested directors over the disinterested directors. MARSH, *supra* note 9, at 37. It may be that removal of fairness in the context of shareholder approval is recognition that the disinterested shareholders should be able to vote as they please and ratify voidable transactions. *But see* Sneed, *supra* note 131, who argues that the shareholder ratification rule rarely operated when there was unfairness.

151 § 310 (a) (1).

152 CAL. CORP. CODE § 153.

153 *Id.* at § 602(a).

154 CAL. CORP. § 310 (a).

155 CAL. CORP. § 112. Without this provision, arguably under § 602 (a) all that would have been necessary at a meeting, which dealt with more than the issue of the interested transaction, would be a majority of all shareholders and thus interested shares could have been counted for determination of the quorum. Under § 112, separate determinations must be made of the quorum. One determination would require a majority of all shares to transact business. The other would require only a majority of the disinterested shares when the interested transaction is dealt with.

holders entitled to vote[156] and only 22 shares of disinterested shareholders are represented, then the statute may serve to validate a transaction where only 12 shares out of a possible 66 were voted in favor of the transaction, *i.e.,* a majority of the disinterested shares represented at the meeting. The votes of these 12 shares completely eliminate the question of fairness from the court's consideration. This problem is aggravated by increasing the outstanding shares when there is limited attendance by disinterested shareholders.

This provision raises special problems in both the context of the closely held corporation and the publicly held corporation. In the closely held corporation, the principal shareholders may be family members. Under the first rule, it is conceivable that an unfair transaction could be ratified by a majority of financially disinterested shareholders which are represented at the meeting consisting of family held shares.[157] Thus a minority shareholder could be prejudiced unless those shares could be disqualified.[158]

In the publicly held corporation, it is generally recognized that the proxy machinery in the control of management precludes real decision-making on the part of most shareholders.[159] In fact the SEC Proxy Rules specifically preclude a shareholder from presenting counterproposals in management's proxy material.[160] Thus, a shareholder would be required to solicit proxies at his own expense to oppose the transaction.

The new California statute has codified the *Remillard* approach only in the context of board approval, and not in the context of shareholder approval.[161] Without fairness as an issue other grounds of attack must be used. One would have to argue lack of full disclosure; or a lack of good faith; or that the transaction were not subject to the shareholder ratification rule which as previously

156 If the amendment of the certificate to lower the quorum requirement is part of a plan to have an interested transaction approved it may require compliance with the interested director's statute. *See* broad definition of transaction in note 33 *supra.*

157 For example, a corporation with 100 shares of which the interested director owns 25 shares; his father owns 25 shares; his brother owns 25 shares; and another person owns 25 shares. An unfair contract could arguably be validated under the statute by the affirmative votes of the director's father and brother without regard to fairness.

158 Arguably, family members may be included as interested under the statute and thus be disqualified from voting. *See* note 34 *supra.* One may also argue breach of fiduciary dutv of the majority shareholders to the minority which may be more stringent in a closed corporation context. *See Donahue, supra* note 117.

159 *See* M. EISENBERG, A STRUCTURE OF THE CORPORATION. A LEGAL ANALYSIS 97 (1976) NADER, *supra* note 76, at 89. The S.E.C. recently announced a complete review of their proxy rules because of a concern for the ineffectiveness of shareholder democracy. There may also be a proposal to disallow the use of proxies by management. Hershey, *SEC Plans Review of Rules Governing Corporate Proxies,* N.Y. Times 1 Apr. 28, 1977 at 1. Such a disallowance appears justified when interested transactions are involved.

160 SEC Proxy Rule 14a-8 (a), 17 C.F.R. § 240, 14a-8 (a) (1974). One can argue that the decision to use the proxy machinery itself in the context of a proposal to approve the transaction under the statute must also comply with the statute. The vote of the board to submit the proposal may be viewed as a transaction. See the broad definition of transation in note 33 *supra. Cf.* EISENBERG, *supra* note 155, at 129. Since fairness is still required for such board approval, then fairness in this context conceivably may require counterproposals which are contrary to the proxy rules. *Id.* at 135-36.

161 The Select Report, *supra* note 146, at 55, indicates that the requirement of fairness with board approval under the statute was intended to codify *Remillard, supra* note 42. But that case involved a review of fairness when there had been interested shareholder approval, but no board approval. Yet the holding that fairness is an overriding requirement of the statute would also apply to board approval.

discussed may amount to an indirect inquiry into fairness.[162]

D. *The Role of Fairness Under the Statutes*

The previous discussion focused on the conflict between the California and Delaware approaches and the changes wrought by the new California Statute. The conflict centered on the treatment of substantive fairness as an overriding requirement when testing the validity of interested directors' transactions, even where the transaction was technically in compliance with the statute. If it is not an overriding requirement, fairness can still be an important consideration under the statutes as an alternative to board or shareholder approval.[163]

Commentators[164] and courts[165] view the requirement of fairness as sufficient protection of the interests of shareholders. In addition, the fairness test, as opposed to the earlier inflexible common law rule which voided transactions merely because of interest,[166] allows directors to engage in legitimate and desirable activity with their corporation.[167] An evaluation of these assertions will be considered by examining the difficulties inherent in the fairness concept.

Courts have used various tests in determining what constitutes fairness.[168] In *Pepper v. Litton,* the Supreme Court indicates that the dealings between a corporation and one in a fiduciary relationship

> are subject to vigorous scrutiny and where any of their contracts or engagements with the corporation is challenged, the burden is on the director or stockholder, not only to prove the good faith of the transaction, but also to show inherent fairness—from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction covers the earmarks of an arms length bargain.[169]

This classic and oft-quoted passage clearly sets forth the various elements of fairness which later courts have developed and used. Each of these elements, however, is difficult to apply. As a result, judicial development of the "fairness" concept has little uniformity. Some courts have concentrated on the requirement

162 *See* text accompanying notes 108-122 *supra,* for limits on the Delaware Approach.
163 *See, e.g.,* DEL. CODE ANN. tit. 8 § 144 (a) (3).
164 *See, e.g.,* FORDHAM NOTE, *supra* note 47, at 661.
165 *See, e.g.,* Shlensky v. South Parkway Building Corp., 19 Ill.2d 268, 168 N.E.2d 793, 801 (1960).
166 *See* text accompanying notes 9-27 *supra,* for a discussion of common law.
167 BALLANTINE, *supra* note 10, at § 67, 171 indicates that: "it has been found impractical to disqualify directors from any or all dealings with the corporation, for fear of possible dishonesty or unfairness, when they may have the greatest interest in its welfare and may be willing to deal with it upon reasonable terms. The policy of facilitating business has prevailed over the policy of removal of temptation."
168 Courts have used the terms "fairness" (*see, e.g., Remillard, supra* note 42), "inherent fairness" (*see, e.g., Pepper, supra* note 51), and "intrinsic fairness" (*see, e.g., Sinclair Oil Corporation, supra* note 124). Arguably, "fairness" is a broader concept viewing the transaction both procedurally and substantively; while the other concepts seem to focus on the terms of the transaction, i.e., substantive fairness. Courts using these terms do not seem to articulate any distinction.
169 *Pepper, supra* note 51, at 306-07.

of good faith,[170] and one court even appears to have equated it with fairness.[171] The "good faith" standard is problematic since it is unclear whether good faith should be viewed subjectively (the intention of the parties) or objectively (consideration of the contractual terms). If viewed subjectively, the actual belief or state of mind of the parties must be proven; while if one follows an objective standard, subjective protestations as to belief are not considered. In either case, however, the fairness of the transaction is relevant to the issue of good faith.[172] As a result, the good faith standard reduces to a tautology: Fairness is a function of good faith, which is determined by examining the fairness of the transaction. In other words, fairness itself may be a necessary element in proving good faith. Thus, good faith cannot be a useful test for determining fairness.

Other courts have focused their attention on the "arms-length bargain" test.[173] Under this test, it is the function of the court to determine whether the terms agreed to are within the range of terms that two parties with approximate bargaining equality would accept.[174] This test is difficult to apply because of the practical problem of finding a similar context to determine appropriate comparative values.[175] The arms-length bargain test has been criticized as being inappropriate in the parent-subsidiary context, because that situation does not lend itself to bargaining.[176]

The concept of fraud has also been used as an equivalent to the fairness concept.[177] If fraud in this context means actual fraud, then the court must find a wrongful intent on the part of the interested director. This places a heavy burden upon a plaintiff trying to set aside an "unfair" transaction.[178] Some courts have been willing to dispense with the requirement of showing wrongful

170 *See* cases cited in YALE NOTE, *supra* note 51, at 342.

171 *Remillard, supra* note 42.

172 *See* text accompanying notes 116-20 *supra*. *See* KANSAS NOTE, *supra* note 47, at 665-66.

173 Austrian et al. v. Williams et al., 103 F. Supp. 64, 75 (S.D.N.Y., 1952). *See also* Ewen v. Peoria v. E. Ry. Co., 78 F. Supp. 312, 316-17 (S.D.N.Y., 1948).

174 YALE NOTE, *supra* note 51, at 340.

175 Ewen, *supra* note 173. The court indicates that the arm's length bargain test may be the "ideal principle, if only it were in practice capable of application." *See also* HARVARD NOTE, *supra* note 48, at 337-39. *Cf.* Heller v. Boylan, 29 N.Y.S. 2d 657 (1941) *aff'd mem.*, 263 App. Div. 814, 32 N.Y.2d 131 (1941): Comparative valuation would especially be a problem in the closed corporation context. *Cf.* F. O'NEAL, SQUEEZE OUTS OF MINORITY SHAREHOLDERS, § 2.16 (1975).

176 *Ewen, supra* note 173. In *Ewen*, the arm's length bargain test was found inappropriate and instead, the court looked at the parameters of the deal to see if the subsidiary "would have been unwilling to accept less" and the parent "would have been unwilling to give more." *Id.* at 317. *See also* YALE NOTE, *supra* note 51, at 340, which argues that the test "ignores the economic leverage and decision-making powers possessed by the control group." The YALE NOTE maintains that shareholders' expectations in the context of parent-subsidiaries do not require a fairness test at the time of the transaction, but fairness should be viewed at the time and under the circumstances when the relationship of parent-subsidiary was "entered into or perhaps as of the last time when the complainant had a realistic chance of ending his participation therein," i.e., an "expectations test." *Id.* at 351. *But see* VIRGINIA NOTE, *supra* note 14, which argues against the fairness test and the expectations test and instead emphasizes an "advantage-disadvantage test." *See Sinclair Oil Corp., supra* note 124, at which in a parent-subsidiary context, the court initially used an "advantage-disadvantage test" which focused on the receipt of benefits to the exclusion of the subsidiary. If there was such an advantage to the parent company, then the court applied an intrinsic fairness test. *Sinclair* has been criticized in Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 680-81 (1974).

177 YALE NOTE, *supra* note 49, at 341; VIRGINIA NOTE, *supra* note 12, at 1229.

178 *Id.* at 341. Those courts using actual fraud as the test have rarely found in favor of the plaintiff. VIRGINIA NOTE at 1229 n.38.

intent by invoking the doctrine of constructive fraud.[179] But exactly when a court will be willing to invoke the doctrine of constructive fraud seems impossible to forecast because of the difficulty of defining the concept.[180] After examining the cases in which the doctrine had been defined, one writer concluded that "the results failed to fall into a discernable pattern."[181]

These tests used to determine fairness have a common weakness inherent in the concept of fairness itself. They are not subject to precise definition because they involve a primarily factual and circumstantial inquiry.[182] Thus, judges reviewing transactions would be called upon to make business judgments.[183] To further confuse matters, courts have often used some of these tests in "complimentary pairs" such as "fraud and constructive fraud" or "fraud and the arms length test," or "good faith and fairness."[184]

Because of the conceptual problems posed by the fairness test, the burden

179 *Id.* at 342; *see, e.g.,* Efron v. Kalmanovitz, *supra* note 119, at 157. According to the court, "Constructive fraud comprises all acts, omissions and concealments involving breach of legal or equitable duty, trust or confidence, and resulting in damage to another."

180 *Id.* "Fraud assumes so many shapes that courts and authors have been cautious in attempting to define it. Each case must be considered on its own facts."

181 YALE NOTE, *supra* note 51, at 342.

182 Austrian v. Williams, 103 F. Supp. 64, 76 (S.D.N.Y. 1952). As Ward, *supra* note 74, at 112, points out, "[u]sually the court will outline the facts of the case and then, after declaring the transaction fair or unfair, will paraphrase one of the above generalities as authority for its decision."

183 In *Heller, supra* note 175, Judge Collins articulates the problems faced by courts in determining fairness:

> Assuming, *arguendo,* that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity? Equity is but another name for a human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing this corporation than its stockholders?
>
> Yes, the Court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact — it would be the prime antithesis of justice; it would be a farce.
>
> If comparisons are to be made, with whose compensation are they to be made — executives? Those connected with the motion picture industry, radio artists? Justices of the Supreme Court of the United States? The President of the United States? Manifestly, the material at hand is not of adequate plasticity for fashioning into a pattern or standard. Many instances of positive underpayment will come to mind, just as instances of apparent rank overpayment abound. Haplessly, intrinsic worth is not always the criterion. A classic perhaps might produce trifling compensation for its author, whereas a popular novel might yield a titanic fortune. Merit is not always commensurately rewarded, whilst mediocrity sometimes unjustly brings incredibly lavish returns. Nothing is so divergent and contentious and inexplicable as values.
>
> Courts are ill equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province.
>
> Courts are concerned that corporations be honestly and fairly operated by its directors, with the observance of the formal requirements of the law; but what is reasonable compensation for his officers is primarily for the stockholders.

184 VIRGINIA NOTE, *supra* note 14, at 1231.

of proof is of critical importance.[185] By placing the burden on one party, courts can conclude that it has not been met without articulating the reasons a transaction is fair or unfair.[186] Additionally, many transactions may not be characterized clearly "fair," or "unfair." Thus, the allocation of the burden of proof would often be determinative of the litigation itself.[187]

The elusive character of the fairness concept and the differing standards courts apply leave the validity of prospective transactions uncertain. This uncertainty neither adequately protects shareholders nor does it necessarily encourage the legitimate activity of directors. Under the test, a transaction may be upheld as valid even though it may not be the best deal independent directors would have bargained for, thus sacrificing shareholder interests.[188] The uncertainty of the fairness test may also restrain a director from entering into legitimate transactions with a corporation. Yet it may, because of a fear that it will be voided, also encourage some directors to engage in abusive self-dealing because the uncertainty may allow or encourage a dishonest director to gamble on the uncertainty.[189]

In addition to the problems of the uncertainty of the fairness test, the occasions on which such transactions are questioned may be rare. A corporation is unlikely to bring a suit to rescind a transaction with one of its directors. Only with a change in management does the possibility of an action increase.[190] As a result, the shareholder derivative suit is often the only practical way to challenge interested director transactions. These difficulties, procedural as well as substantive, may in fact immunize most transactions.[191]

Even though the fairness concept engenders these difficulties in application, it remains the one method by which courts can scrutinize transactions to protect the minority shareholders. It represents a balance between the strict voidability rule of the earlier common law and the pro-management concepts of the business judgment rule. The possibility that a transaction may be challenged will force management and the directors to themselves carefully scrutinize interested directors' transactions. It thus remains a necessary concept, despite its limitations.

In the context of the publicly-held corporation there have been suggestions

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185 *Cf. Ewen, supra* note 173, at 317. If the burden is one seeking to void the transaction, it may be an insurmountable burden. Note, *The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review,* 63 COL. L. REV. 1086, 1102 (1963) [hereinafter cited as Note, *Nonratification Rule*].

186 *See, e.g.,* Stadley v. Pine Island Cooperative Association, 21 Cal. Rptr. 418 (1962).

187 Ward, *supra* note 74, at 112. *See* quote in note 179 *supra. See* text accompanying notes 70-75 *supra,* for a discussion of burden of proof.

188 FORDHAM NOTE, *supra* note 47, at 663-64; MARSH, *supra* note 9, at 57. This uncertainty allows jurisdiction with a bias towards management to potentially manipulate the concept in favor of management. This bias is exported to other states either through the Constitution's Full Faith and Credit Clause (U.S. CONST. art. IV, § 1) or through a rule of conflicts. RESTATEMENT (SECOND) CONFLICT OF LAWS § 809. *But see* Western Airlines Inc. v. Sobieski, 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961).

189 *Id.* at 663-64.

190 MARSH, *supra* note 9, at 55.

191 For example, posting security for expenses (*see, e.g.,* N.J.S.A. 14A:3-6(3); allegation of contemporaneous ownership (*see, e.g.,* FED. RULES CIV. PROC. rule 23.1(1), 28 U.S.C.A.); Possible payment of the corporation's attorney fees (*see, e.g.,* N.J.S.A. 14A:3-6(2); requirement of demand on directors (*see, e.g.,* CAL. CORP. CODE § 834(2)) and shareholders (*see, e.g.,* FED. RULES CIV. PROC. rule 23.1, 28 U.S.C.A.). *See also* Note *Nonratification Rule;* Comment, *Shareholder Validation of Directors' Frauds: The-Non-Ratification Rule v. The Business Judgment Rule,* 58 NW. U. L. REV. 807 (1964).

that Federal regulation[192] or requiring full disclosure[193] may protect shareholders. In the absence of congressional action on these proposals, the fairness concept under state law is increasingly significant. Given the current predilection of the Supreme Court to limit access to the Federal courts and to narrow the scope of Rule 10b(5);[194] the proxy rules,[195] and the insider trading rules,[196] rights and remedies under state law are becoming more important. In view of the potentially broad scope of these statutes,[197] the fairness requirement under state law may provide a remedy for aggrieved shareholders which is not available under federal law.

In the context of small corporations, fairness remains of even greater importance. Neither disclosure nor federal regulation is of assistance in this setting. The realities of small businesses often require transactions between directors and their corporation. Thus the fairness requirement is essential in this context to avoid the oppression of minority shareholders.

In both situations—publicly or closely held corporation—the fairness test admittedly has its weaknesses. Application of a concept which is subject to such varying interpretation leads almost inevitably to decisions which are apparently inconsistent. This inconsistency makes prediction of the validity of individual transactions very difficult. However, the test also has one great strength; it retains for the courts the measure of discretion necessary to protect shareholders from voiceless submission to potentially harmful interested directors' transactions.

IV. Conclusion

This article has focused on the effect of the statutory responses to interested directors' transactions. Such transactions are permissible under the majority of state statutes if they are either approved by the board or shareholders or if they are found to be fair. The disjunctive phrasing of the statute would appear to eliminate fairness as a consideration wherever there was approval. The removal of fairness as a factor in validating a challenged transaction would be a significant departure from the common law's zealous protection of the minority shareholder. Because of the limited scope of federal relief available in this area, state law is very important. The California statute and its progeny all treated the two factors of approval and fairness in the disjunctive, yet the courts have continued to consider fairness as an issue when examining the interested directors' transactions. Even if some courts adopt the disjunctive approach, however, the limits which can be placed upon the operation of either the business judgment rule or the shareholder ratification rule, arguably reduce to questions of fairness.

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192 Marsh, *supra* note 9, at 74-75; Nader, *supra* note 76.

193 Cary, *supra* note 86.

194 *See, e.g., Green, supra* note 6; *Ernst, supra* note 128; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

195 *See, e.g.,* TSC Industries v. Northway Inc., 426 U.S. 438 (1976).

196 *See, e.g.,* Foremost-McKesson Inc., v. Provident Securities Co., 96 S. Ct. 508 (1976) Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Reliance Electronic Co. v. Emerson Electronic Co., 404 U.S. 418 (1972).

197 *See* note 33 *supra.*

The new (1977) California statute appears to finally eliminate fairness only in the context of interlocking boards and disinterested shareholder approval by limiting fairness as a consideration to those transactions without disinterested shareholder approval or transactions where the directors on the interlocking boards had a substantial financial interest. This, however, could lead to the oppression of minority shareholders. In order to avoid this, the courts should continue to scrutinize the approval of the transactions to be sure of more than just technical compliance with the statute. This can be done if the fairness doctrine has some continuing validity despite its apparent elimination by the statute. The doctrine has proven its value through both a long tradition in common law and also continued application by the courts in the face of apparent statutory elimination. Until there is some effective alternative, the courts must retain the fairness test in examining interested directors' transactions.