INTERESTED AND INTERLOCKING DIRECTORS' CONTRACTS

By ROBERT KESSLER*

DESPITE THE BIBLICAL INJUNCTION that no man can serve two masters,[1] "insiders" (directors, officers or controlling shareholders) frequently have dealings with their own corporations, large or small, and have been doing so since the business corporation was invented. Not infrequently, these dealings take the form of transactions between two corporations in which the insider shares positions.

Typical examples include a director who sells property to his corporation,[2] or whose corporation contracts to furnish products, services, or loans to another corporation of which he is also a director or in which he has a financial interest.[3] Especially in large corporations, the problem has frequently surfaced in the fixing of executive compensation.[4] More recently, the conflict problem has involved such recondite areas as allocation of tax losses between parents and their subsidiary corporations.[5]

It is also present in the recent and much-litigated area of mergers, which have frequently followed the current rash of tender offers.[6]

---

* Professor of Law, Fordham University. A.B., Yale University, 1949; J.D., Columbia University, 1952; LL.M., New York University, Member New Jersey and New York Bars.

1. *Matt.* 6:24; *Luke* 16:13.

2. *E.g.,* New York Trust Co. v. American Realty Co., 244 N.Y. 209, 155 N.E. 102 (1926) (sale of real property by director's family trust to his corporation); Burland v. Earle, ,1902. A.C. 83 (sale of lithograph plant by director to his corporation); North-West Trans. Co. Ltd. v. Beatty, ,1887. 12 A.C. 589 (sale of ship by director to his company).

3. *E.g.,* Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918) (contract for sale of electricity to manufacturing company); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942) (intercompany loans).

4. *E.g.,* Beard v. Elster, 160 A.2d 731 (Del. 1960) (stock option plan); Lieberman v. Becker, 155 A.2d 596 (Del. 1959) ("phantom" stock option plan upheld); Berkwitz v. Humphrey, 163 F. Supp. 78 (N.D. Ohio 1958) (similar plan, contrary result).

5. *E.g.,* Case v. New York Cent. R.R. Co., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965); Western Pac. R.R. Corp. v. Western Pac. R. Co., 197 F.2d 994 (9th Cir. 1951), *rev'd on other grounds,* 345 U.S. 247 (1953). *See also* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (allegations that parent caused subsidiary to pay out too large dividends to subsidiary's detriment, and prevented subsidiary from enforcing a contract with another subsidiary); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 958 (rev. perm. ed. 1975) (issuance of stock to directors or officers) [hereinafter cited as FLETCHER].

6. *See, e.g.,* Santa Fe Indus., Inc. v. Green, 97 U.S. 1292 (1977). *See also* F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS §§ 5.13, 5.14, 5.15, 5.32 (1975). Objectors to mergers formerly framed their complaints in terms of common law principles of unfairness. More recently, purported violations of Federal Securities Laws, notably Securities Exchange Act § 10(b), 15 U.S.C.A. § 78; (j), and its

In one aspect the subject of insider and related-corporation transactions is only a part of the more general field of fiduciary duties of management.[7]

Books could be, and in some cases have been, written on any one of these facets of fiduciary duty.[8]

Fortunately, although all may qualify as interested or interlocking directors' transactions, these cases, and recent statutes, have tended to prescind the treatment of intra- and inter-corporate management transactions from the compensation,[9] general fiduciary,[10] and third-party obligations[11] aspects of the overall divided loyalty problem.

---

implementing Rule 10 b-5, 17 C.F.R. § 240.10b-5, have been relied on in the attempt to secure relief. This trend will undoubtedly be reversed by the *Green* decision.

Only rarely (*see, e.g.* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 38 A.L.R.2d 425 (Del. 1952)) has the objection been framed in terms of an unfair interlocking directors' transaction, although the merger approval frequently is initiated by just such a decision by common directors. Such a merger authorization, it should be noted, is a covered "transaction" even under the old California-Model Act provision.

7. The entire field would include competition by a director or officer with his corporation, preemption of corporate opportunities, and even individual insider dealings with shareholders in the corporation's securities, and duties to the shareholders as a group à la Zahn v. Transamerica Corporation, 162 F.2d 36 (10th Cir. 1947) and Jones v. H. F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Reptr. 592, 460 P.2d 464 (1969).

8. *See, e.g.,* G. WASHINGTON, V. ROTHCHILD, T. NESS & R. SOBERNHEIM, COMPENSATING THE CORPORATE EXECUTIVE (3d ed. 1962) (2 vols.).

9. Today, the "interest taint" poses only a minor problem in the executive compensation area (due to widespread use of disinterested "compensation committees," SEC mandated disclosure, and shareholder approval). The principal areas of litigation revolve about the "reasonableness" of the compensation, and the related questions of whether or not "consideration" (a quid pro quo) has passed to the corporation in exchange for it. Many of the statutes discussed below, in a separate paragraph, expressly, and without the qualifications imposed on other interested directors contracts, remove the interest taint, even where the directors are fixing their own compensation. Thus, *e.g.,* the present New York statute, N.Y. Bus. Corp. Law § 713 (McKinney Supp. 1976) provides:

> (e) Unless otherwise provided in the certificate of incorporation or the by-laws, the board shall have authority to fix the compensation of directors for services in any capacity.

10. A duty of loyalty (as well as care) is frequently imposed by statute today. *See, e.g.,* CAL. CORP. CODE § 309(a), effective Jan. 1, 1977:

> A director shall perform the duties of a director, including the duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

N.Y. BUS. CORP. LAW § 717 (McKinney 1963), first sentence:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

11. Obligations to non-insider shareholders are increasingly protected by judicial expansion of S.E.C. Rule 10b–5. *See, e.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner &

This article will be confined, therefore, to more traditional difficulties, once the exclusive concern of case law but now more and more the province of attempted statutory resolution.[12]

Smith, Inc., 495 F.2d 228 (2d Cir. 1974), protecting untipped purchasers against both non-trading tippers, and their trading tippees even though neither tippers nor tippees were traditional insiders. A similar expansion in the duties of insiders to outsiders in individual transactions with the latter has occurred even on the state law level. *See* H. HENN, LAW OF CORPORATIONS § 239, at 473 (2d ed. 1970) [hereinafter cited as HENN.]

Directors will normally represent the majority shareholders, since, even with cumulative voting where chosen or required, they will ordinarily reflect that majority. This will obviously be true in the parent-subsidiary situation. Any unfairness to the minority shareholders as a class can, even in the absence of appropriate state law precedents, be redressed by merely citing Pepper v. Litton, 308 U.S. 295 (1939), the "all-purpose" case for majority shareholder fiduciary duty to the minority. Courts are not loathe to use it when they feel that management has been unfair to the minority shareholders. *See, e.g.,* Zahn v. Transamerica Corp., 162 F.2d 36 (3rd Cir. 1947); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Reptr. 592, 460 P.2d 464 (1969).

12. At least 29 jurisdictions currently have statutes on the subject. *See* ARIZ. REV. STAT. § 10–041 (Supp. 1975); CAL. CORP. CODE § 310 (West 1976) (replacing CAL. CORP. CODE § 820, repealed effective Jan. 1, 1977); CONN. GEN. STAT. ANN. § 33–323 (West Supp. 1976); DEL. CODE tit. 8, § 144 (1975); FLA. STAT. ANN. § 607.124 (West Supp. 1975); GA. CODE ANN. § 22–716 (Supp. 1975); IND. CODE ANN. § 23–1–10–6 (Burns Supp. 1972); IOWA CODE ANN. § 496 A. 34 (West Supp. 1976); KY. REV. STAT. ANN. § 271A. 205 (Baldwin Supp. 1974); LA. REV. STAT. ANN. § 12:84 (West 1969); ME. REV. STAT. tit. 13A, § 717 (1974); MICH. COMP. LAWS ANN. § 450.1545 (1973); MISS. CONST. Art. 7, § 194 (1972); MISS. CODE ANN., § 79–3–67 (1972); NEB. REV. STAT. § 21–2040.01 (1974); NEV. REV. STAT. § 78.140 (1973); N.J. STAT. ANN. § 14A: 6–8 (West Supp. 1976); N.Y. BUS. CORP. LAW § 713 (McKinney Supp. 1976–77); N.C. GEN. STAT. § 55–30 (1975); OHIO REV. CODE ANN. § 1701.60 (Page Supp. 1975); OR. REV. STAT. § 57.265 (1975); PA. STAT. ANN., tit 15, § 1409.1 (Purdon Supp. 1976); R. I. GEN. LAWS § 7–1.1–37.1 (Supp. 1974); S.C. CODE § 12–18.16 (Supp. 1975); TENN. CODE ANN., § 48–816 (Supp. 1975); VT. STAT. ANN. tit. 11, § 1888 (1973); VA. CODE § 13.1–39.1 (Supp. 1975); W. VA. CODE § 31–1–97 (1975); WIS. STAT. ANN. § 180.355 (Supp. 1975); WYO STAT. § 180.355 (Supp. 1975).

As to the contrasting European treatment of insider conflict of interests problems, *see* A. CONARD, CORPORATIONS IN PERSPECTIVE § 12 (1976).

The Mississippi constitutional and statutory provisions are unique among general corporation provisions on the subject in forbidding a person interested in a competing business from serving on the board of directors of a corporation without majority shareholder consent.

The early California provisions, CAL. CORP. CODE § 820 (West 1955), (derived from CAL. CIV. CODE § 311 which became the model for so many of the later enactments, has recently been repealed, and replaced (Stats. 1975, c.682), by CAL. CORP. CODE § 310 (West 1976), effective Jan. 1, 1977, as part of that state's recension of its corporation law. Throughout this article references to the old or original California provision or to the California-MODEL ACT provision are to repealed CAL. CORP. CODE § 820.

It should be noted that the new section (CAL. CORP. CODE § 310) represents a concession of the inadequacy of the original provision, and an attempt, albeit inadequate, to modify it in a manner consonant with that suggested herein. *See also* note 23 *infra.*

The possible application of many of these statutes to antinodal situations as a result of the broadness of the term "transaction" used in many of them should be

CASE LAW

Understandably, due to the length of time the "problem" has existed, a large body of case law was built up as to the circumstances under which such self-dealing transactions would be allowed.

Starting with an absolute disqualification, the law has become more and more liberal. Thus, in 1946 Ballantine could state the "black letter" law on interested directors' contracts as follows:

> The inflexible English rule of disqualification of directors to deal with their corporation in their own behalf is not adopted in American law, if there is independent representation and if the transaction is proved fair.
>
> * * *
>
> In most American jurisdictions, 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. The weight of authority is that a contract with a director is not voidable if (a) there is a disinterested quorum and voting majority, and (b) if the director successfully bears the burden of showing the fairness of the transaction.[13]

This common law development has been traced by Professor Marsh in a widely cited 1966 article appearing in *The Business Lawyer*.[44] He concludes:

> By 1960 it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.[15]

---

noted, however, and should also serve as a monition against attempts to grant unconditional validation upon compliance with any prescribed approval ritual.

13. H. BALLANTINE, CORPORATIONS, § 67, at 170-77 (rev. ed. 1946) [hereinafter cited as BALLANTINE]. For other text discussions *see* HENN, *supra* note 11, at § 238, at 465-470; N. LATTIN, LAW OF CORPORATIONS § 80 (2d ed. 1971) [hereinafter cited as LATTIN]; 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 439 (1959) [hereinafter cited as HORSTEIN]; FLETCHER §§ 913-988.

14. Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

15. *Id.* at 43.

Thus, according to Marsh, its fairness, rather than any participation (or lack of it) on the part of the director concerned was, by 1960, the common law test for whether or not an interested director's contract would be invalidated.[16]

Fairness as the sole criterion had become established even earlier in the area of contracts between corporations with interlocking directorates.[17]

STATUTORY DEVELOPMENT

Within the past few years, the common law rules have been largely displaced by statutory provisions, most of which have been patterned after the pioneering California law on the subject.[18]

Old California Corporations Code §820 provided:

> §820. Fiduciary Duty of Directors — Corporate Transactions Not Voidable Because of Director's Adverse Financial or Other Interest If Such Facts Disclosed — Transactions Not Voidable If Just and Reasonable — Common or Interested Director Counted in Determining Quorum. — Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation. No contract or other transaction between a corporation and one or more of its directors, or between a

16. Although HORNSTEIN § 439 seems to agree with Marsh, some authorities intimate that he has painted with too broad a brush on the development of the common law with regard to interested directors' contracts. *See* HENN, *supra* note 11, at § 238 at 466–67. FLETCHER, supra note 5, at § 921, at 383, although conceding that the majority rule is that interested directors' contracts can only be avoided if unfair, adds that "if the officer represents both parties to the transaction it is almost universally held that it is voidable merely because of the relationship." *See also* D. VAGTS, BASIC CORPORATION LAW, at 241 (1973), intimating that the New Jersey common law development was not as rapid as Professor Marsh indicated.

In any event, the Marsh rule appears to be the one which should be adopted: fairness is ultimately the only proper criterion for validity of interested and interlocking directors' contracts. Shareholder and disinterested director approval should, however, not be brushed aside as meaningless ritual. A contract receiving such approval is, as a practical matter, less likely to be unfair. Accordingly, the probative effect of such ratification on the ultimate issue of fairness should be given weight.

17. BALLANTINE, supra note 13, at § 67 *at* 179; HORNSTEIN, supra note 13, at § 439; W. CARY, CASES AND MATERIALS ON CORPORATIONS 490 (4th ed. abr. 1969) [hereafter cited as CARY]; Annot., 114 A.L.R. 299, supplemented by 33 A.L.R.2d 1060.

18. There were, of course, other statutes on the subject, some even earlier than the CALIFORNIA CIVIL CODE § 311 predecessor of CAL. CORP. CODE § 820. Some applied only to specialized corporations, and were restrictive. Others, like the California model, were designed to overrule the "strict" common law rule, applied in some cases, under which interested or interlocking directors' contracts were declared void or voidable regardless of fairness. While, in some cases, they still continue to influence the statutes of the states where they were originally enacted, they have not had the general influence of the California Act. For a discussion of these earlier statutes, *see* Note, *Corporations: Interlocking Directorates: Statutory Regulation of Dealings Between Corporations with Interlocking Directorates,* 23 CORNELL L. Q. 445 (1938).

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 of directors or committee and noted in the minutes, and the board or 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.

(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.[19]

The California provision found its way into the original New York statutory provision,[20] that of Delaware,[21] and finally into the

19. CAL. CORP. CODE § 820 (West 1955). *See, generally,* as to the section, 1 H. BALLANTINE & R. STERLING, CALIFORNIA CORPORATION LAWS § 78.01 (4th ed. 1973).

The North Carolina statute (N.C. GEN. STAT. § 55-30 (Replacement Vol. 1975)), like the California one, appears to validate the transaction if it has the requisite director or shareholder approval. *See, infra,* text at note 62.

Unlike the California, original New York and MODEL ACT provisions, however, it requires shareholder as well as director approval to be disinterested, and expressly fixes the burden of proof of fairness where the validating procedures are not followed. While the requisite approval may shift the burden of proof to the person attacking the transaction, it probably will not validate an unfair one. *Cf.* Fulton v. Talbert, 255 N.C. 183, 120 S.E.2d 410 (1961), Smith v. Robinson 343 F.2d 793 (4th Cir. 1965).

See the Connecticut statute, (CONN. GEN. STAT. ANN. § 33-323 (Supp. 1976)) as to apparent validation.

The South Carolina statute (S.C. CODE § 12-18.16), *infra* note 58, like the North Carolina one, disqualifies interested shareholders. BALLANTINE, supra note 13, at § 175a at 401, indicates that the majority common law rule did not disqualify interested shareholders from voting to ratify. *But, see* HENN, supra note 11, at § 238 at 469.

20. N.Y. BUS. CORP. LAW § 713 (McKinney 1963). The section was amended by 1965 N.Y. Laws, c.803. The current version of N.Y. Bus. Corp. Law § 713 (McKinney Supp. 1976) was enacted by 1971 N.Y. Laws, c.768, which repealed the prior section.

21. DEL. CODE tit. 8, § 144 (rev. ed. 1975).

1969 revision of the Model Business Corporation Act.[22] From these it has been picked up by a number of states[23] and will undoubtedly be

22. It was added to the old MODEL ACT in 1966 as § 37A, and retained in the 1969 revision. (*See* 1 MODEL BUS. CORP. ACT. ANN.]2,842 (1971).) ABA-ALI MODEL BUS. CORP. ACT § 41 (rev. ed. 1974), provides:

> § 41. Director conflicts of interest. — No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable *because of such relationship* or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:
>
> (a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or
>
> (b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or
>
> (c) the contract or transaction is fair and reasonable to the corporation.
>
> 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 such contract or transaction.

Here, and throughout this article, emphasis has been added in statutory quotations.

23. Although there are variations among some of them, in addition to Delaware, the current, Florida, Georgia, Indiana, Iowa, Kansas, Kentucky, Louisiana, Nebraska, Nevada, New Jersey, Oregon, Pennsylvania, Rhode Island, Tennessee, West Virginia and Wisconsin statutes are all basically similar to the old California-MODEL ACT paradigm.

The Arizona, new California, Maine, Maryland, Michigan, new New York, North Carolina, South Carolina, and Virginia statutes discussed *infra* under the heading "Statutes Expressly Fixing Burden of Proof", and the Connecticut statute discussed in note 31, *infra,* are all obviously modifications of the old California-MODEL ACT pattern.

Only the Mississippi and Vermont provisions, discussed respectively at notes 12, *supra* and 63, *infra,* are uninfluenced by the paradigm.

The Nevada statute (NEV. REV. STAT. § 78.140 (1973)) also follows the Delaware version, but with a rather puzzling addition to the quorum provision. It reads:

> 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, and if the votes of the common or interested directors are not counted at such meeting, then a majority of the disinterested directors may authorize, approve or ratify a contract or transaction.

A number of the statutes, *e.g.,* those of California (both old and new), Delaware, Georgia, Louisiana, Maine, Michigan, Nevada, New Jersey, New York (both old and new), North Carolina, Pennsylvania, Rhode Island, South Carolina and Tennessee, attempt to pin point the time at which the fairness is to be determined as the time of approval. Such an addition may be desirable as a caution to the trier of the facts not to place too much weight on the inevitably better judgment of hindsight. The corporation should not be allowed to escape from an imprudent contract *merely* because it involves interested or interlocking directors, since it would not be able to do

adopted by even more now that it has the Model Act stamp of approval.[24]

There are, of course, certain differences among the modular forms.[25] Basically, however, in the few cases construing them, they are, or have been, interpreted to be the same.

---

so where made in an arm's length transaction with a third party on this ground. (The corporation, of course, retains its right to proceed under common law or, in some cases, statute, *see e.g.*, N.Y. BUS. CORP. LAW §§ 717, 720, against the directors for their negligence in authorizing an improvident contract whether or not there is an interest taint.) See, in this regard, the proposed statute, *infra*. A provision that the crucial time for determining fairness is the time of adoption may remind the court that it should look at fairness as an impartial board, in an arm's length deal, would, at the time of entering into the transaction.

There is language in the *Globe Woolen* case suggesting otherwise ("He ,the director. takes the risk of an enforced surrender of his bargain if it turns out to be improvident"). While the New York statute may repudiate this somewhat vague suggestion that the time of suit is the relevant one for determining fairness, it is virtually impossible to absolutely foreclose all consideration of how the transaction turned out on the issue of its original fairness.

The statutes also differ on such matters as whether knowledge of the terms of the transaction by the board or shareholders is sufficient or whether it must be disclosed to them (obviously, knowledge, however acquired, should be sufficient), on whether the disclosure must be "in good faith" (if it's honest and full it should make no difference), on whether the approval must be "in good faith" (this, too, seems unnecessary — unless "good faith" approval is used instead of a requirement that the contract be fair — since the test should be, instead, whether or not "the adoption was brought about by unfair or improper means" (North-West Trans. Co. Ltd. v. Beatty, ,1887. 12 A.C. 589), a situation which should not exist where full disclosure or knowledge is present: the requirement of "good faith" approval, therefore, introduces an unnecessary additional uncertainty as to the effectiveness of the approval), and on whether votes are required or "consents" are sufficient (obviously, if written consents are sufficient under other provisions of the corporation law they should be here, as well), etc.

In general, the simpler the provisions are, the better (provided, of course, that they explicitly cover such desirable items as consents where they are normally permitted unless "vote" in elsewhere defined to include such consents). On the other hand, in a statute which clearly appears designed to validate the transaction if the formalities are observed; *see, e.g.*, the North Carolina statute discussed *infra*, it may not be out of place to require as it does, that the transaction be "specifically approved."

Other differences among the various statutes are discussed in the text and footnotes above and below.

24. The process has already begun. Thus MODEL BUS. CORP. ACT. ANN. 2d § 41,]3.01 (1973 Supp.) lists Indiana, Iowa, Nebraska and Wisconsin as having provisions "identical in substance to the MODEL ACT." *Id.* Paragraph 3.02 states that Kansas, Kentucky, Maine, Michigan, New York, and Rhode Island have provisions "comparable to the MODEL ACT," and adds that the Kansas provision is "identical in substance to Delaware". Note, however, the numerous additional statutes listed *supra*, in note 23 also based on the California-MODEL ACT provision. It is interesting to note that the California-MODEL ACT paradigm is less liberal than the common law rule as to interlocking directors' contracts. *See, e.g.*, ME. REV. STAT. tit. 13 A, § 717(3) (1971) which enacts the common law rule.

25. The old New York provision adds to the California provision that the interested or interlocking transaction will not be void or voidable "for this reason

INADEQUACY OF THE CALIFORNIA MODEL ACT PARADIGM

Despite a superficial appearance of clarity, not only the California statute but almost all of its progeny are, on examination, inherently ambiguous.

Thus, we are told that an interested or interlocking director contract is not "void or voidable" despite the director's presence or vote if the contract is "just and reasonable" or, in the Model Act language, "fair and reasonable."[26] If Marsh is correct, this is merely a codification of the commission law development.

But what then is the significance of impartial director or shareholder ratification? Since the statute makes these *alternatives* to fairness, will they serve to validate even an unfair contract?

It is, perhaps, not surprising that the directors in the leading *Remillard Brick* case[27] thought it would.

In that case two of the three directors of two brick manufacturing corporations formed a sales corporation (wholly owned by them) and caused the brick corporations to enter into contracts whereby "large profits that should have gone to the manufacturing companies were diverted to the sales corporation." The two directors who controlled a majority of the shares caused the manufacturing corporations to ratify the contracts. Despite the ratification, on full disclosure, the court voided the contracts on the ground that they were unfair and unreasonable to the manufacturing corporations.

---

alone", the Delaware statute uses "solely" because of the interested party's presence or vote, while the MODEL ACT uses "Because of such relationahip" or vote. One notable difference is that the Delaware statute, unlike the old California, New York or MODEL ACT versions, expressly applies to contracts between an interested officer and his own corporation.

A casual perusal of the section headings in FLETCHER'S, discussing the cases which have arisen, also indicates the inadequate coverage of not only the California but of many of the other present statutes. *See, e.g.,* FLETCHER § 942, "Officer acting as agent both for corporation and for adverse party"; § 943, "Transactions between corporation and firm of which officer is a member"; § 944, "Transactions between corporate officers as such and another corporation in which they are stockholders", etc.

26. *See also* the Maine, South Carolina and Tennessee statutes, using "fair and equitable," and the Delaware, Georgia, Louisiana, Nevada, Pennsylvania and Rhode Island statutes, using only "fair." "Just and reasonable" seems to boil down to "fair," and any additions to "fair" seem merely typical lawyer's redundancies. The test appears, therefore, to be identical: fairness, whatever varying content the courts choose to give to that term.

27. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66, 74 (1952). The effect of new CAL. CORP. CODE § 310(a), *infra,* on this case (disqualifying shares of an interested director from voting to ratify the transaction) should be noted.

The *Remillard* case thus holds that fairness is still required despite satisfaction of one of the other two alternative conditions of the statute. But then, if fairness is both necessary and sufficient, what is the point of the other alternatives?

It is no satisfactory answer to the conundrum that the California and Model Act provisions tacitly, and some of their progeny expressly, only remove the interest taint and do not purport to *validate* the contract for all purposes. For if it was solely the purpose of the statute to remove any lingering doubt that a contract might be invalid solely because of the director's participation, then the reference to fairness becomes unnecessary.[28]

Thus, statutes like that of Delaware and the original New York version are even more enigmatic than the California and Model Act provisions, since they expressly add that, despite compliance with any one of the three conditions, the interested or interlocking director contract shall not be voidable "solely" for the director's interest or participation, in Delaware or "for this reason alone" under the terms of the New York provision.

The addition of the fairness standard is, of course, completely unnecessary if the purpose is simply to remove the interest taint and not somehow to validate the contract.

On the other hand, since under the "borrowed statute" rule[29] the *Remillard* interpretation is presumed to be adopted by states enacting the California provision, if Marsh is correct that fairness is not only necessary but also the only ground on which the contracts can be validated, these statutes really add nothing to the law on the subject.

However, if ineffectual, they are at least less ambiguous than the original California statute and its closer Model Act copy.

Reading "solely" into both the old California and Model Act statutes, despite its actual omission is, of course, a possible interpretation and a fair one based on the introductory language used in them.

However, the result then is to render the statutes equally ineffectual as the Delaware and original New York revisions in establishing criteria for determining when a contract will or will not be enforced, *i.e.,* its underlying validity. Only by ignoring the

28. Consistent with this reasoning, the old Rhode Island statute omitted paragraph (c), the fairness ground, of the MODEL ACT provision. The current Act is discussed *supra*, at note 23.

29. The rule is summarized in Note, 43 HARV. L. REV. 623–24 as follows: "It is a well recognized rule of statutory construction that a legislature adopting the statute of a foreign jurisdiction presumably adopts it with the judicial construction obtaining in the state of origin at the time of its adoption."

California language "if the circumstances specified in *any* of the following subdivisions exist," or by reading "or" before subdivision (c) of the Model Act as "and," can the sections provide such guidance.

At least two states attempt to avoid the ambiguity inherent in the old New York, Delaware, and Model Act provisions, by drawing a substantive distinction between transactions approved in the prescribed statutory manner and those which are not. Thus, Kentucky[30] provides that where the contract or transaction is approved by a disinterested director or shareholder vote it will not be invalid unless "manifestly unfair." On the other hand, where the challenged transaction has not been so approved, it must be "fair and reasonable."

Connecticut,[31] on the other hand, applies the "manifestly unfair" test only to interlocking directors' contracts.

---

30. KY. REV. STAT. ANN. § 271A.205 (Baldwin, Supp. 1974) provides:

(1) No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable *solely because* of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:

(a) The contract or transaction is not *manifestly unfair* to the corporation and the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) The contract or transaction is not manifestly unfair to the corporation and the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(c) the contract or transaction is fair and reasonable to the corporation.

(2) 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 such contract or transaction. (Emphasis added.)

31. CONN. GEN. STAT. ANN. § 33-323 (West Supp. 1976) provides:

§ 33–323. Corporate transactions with directors and others.—

(a) A contract or transaction between a corporation and a director thereof or a member of his immediate family, or between a corporation and any other corporation, firm or other organization in which a director of the corporation and members of his immediate family have an interest, shall not be voidable, and such director shall not incur any liability, *merely because* such director is a party thereto or because of such family relationship or interest, if: (1) Such family relationship or such interest, if it is a substantial interest, is fully disclosed, and the contract or transaction is *not unfair to the corporation and is* authorized by (i) directors or other persons who have no substantial interest in such contract or transaction in such a manner as to be effective without the vote, assent or presence of the director concerned or (ii) *the written consent of all of the directors who have no substantial interest in such contract or transaction, whether or not*

Both statutes represent, in this regard, an improvement in clarity over their parents.

However, both retain the qualification that the transactions thus approved will not be invalid "solely" ("merely" in Connecticut's case) because of the interest taint.

Thus, they too fail to establish clear criteria for actual validity.[32]

---

such directors constitute a quorum of the board of directors; or (2) such family relationship or such interest, if it is a substantial interest, is fully disclosed, and the contract or transaction is approved by the affirmative vote of the holders of a majority of the voting power of the shares entitled to vote thereon; or (3) the contract or transaction is not with the director or a member of his immediate family and any such interest is not substantial, subject, however, to the provisions of subsection (b) of this section; or (4) the contract or transaction is fair as to the corporation.

(b) Subject to the provisions of subsection (a) of this section, a contract or transaction between two corporations with one or more common directors or officers shall not be voidable by a corporation, a party thereto or by a person succeeding to or otherwise entitled to exercise, the right of the corporation merely because of such relationship, if: (1) The contract or transaction is *not manifestly unfair* as to such corporation; or (2) the contract or transaction is approved by the affirmative vote of the holders of a majority of the voting power of the shares entitled to vote thereon of such corporation.

(c) No contract or transaction shall be voidable merely because a director of a corporation is a party thereto, or because of any relationship or interest of the type described in subsections (a) and (b) of this section, except by such corporation, if a party thereto, or by a person succeeding to, or otherwise entitled to exercise, the right of any such corporation. In any proceeding to void such contract or transaction, the court may, if it deems it equitable, rescind the contract or transaction in whole or in part, or award damages, or both, but the rights of third parties shall be protected.

(d) For the purposes of this section: (1) "Member of the immediate family" means spouse, parents and children; (2) "substantial interest" shall exclude: (i) the interest of a person in a corporation, firm or other organization as a debt or equity holder therein where the debt or equity held is less than ten per cent of the outstanding debt or equity, as the case may be, of such corporation, firm or other organization; (ii) the interest of a person in a corporation, firm or other organization by reason of being a director, officer or employee, or their equivalents, thereof; (iii) the interest of a director of a corporation or a member of his immediate family in another corporation, firm or other organization which arises by reason of the fact the corporation has a debt or equity interest in such other corporation, firm or other organization; (3) any contract or transaction between a corporation and a person, corporation, firm or other organization made in the ordinary course of business at standard prices or on terms not less favorable to the corporation than those offered by the person, corporation, firm or other organization to others shall be prima facie fair. (Emphasis added.)

See also note 68 *infra.*

32. It will be noted that, despite Connecticut's detailed provisions on families of directors, neither statute deals with the problem of officers' contracts with their own corporations.

VALIDATION OF THE UNDERLYING CONTRACT OR MERELY REMOVAL OF INTEREST TAINT?

It is submitted that all these statutes should provide some guidance as to underlying validity, rather than be confined to "erasing" a disqualification taint which Marsh claims was already eradicated by the case law development.

All of the statutes could, of course, be interpreted as providing some standard of validation, even if only inferentially.

The *Remillard* case requires fairness for the validation of affiliated contracts even though approved by the directors or shareholders pursuant to the other sections of the statute. Both the California statute and its progeny could, on the other hand, have been interpreted to require a showing of more than mere unfairness for invalidation of contracts where such ratification had taken place. Thus, "fraud," or "constructive fraud" could have been judicially required.[33] This would have made all three subdivisions equivalent in validation effect.

Both the terms "fraud" and "constructive fraud" are, however, conclusory in corporate law. One court on similar facts will find "constructive fraud" to exist,[34] another will not.[35] Distinctions between "mere unfairness" and "fraud," because they are only matters of degree on a vague spectrum, are impractical. "Fairness" too, however, is a very uncertain concept.[36] Like "negligence" no statute can be expected to define it with sufficient precision to be a pattern for decision in all factual contexts.

Obviously, then a distinction between mere unfairness and "manifest" unfairness[37] is doubly inadequate, since, not only is it subject to the inherent uncertainty in the meaning of "fairness," but

---

33. *See* Folk, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered,* 43 N.C.L. Rev. 768, 802 (1965), suggesting this interpretation. No statute appears to use the "fraud" or "constructive fraud" distinction in regard to such contracts.

34. Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946).

35. Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951).

36. Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825, *reh. denied* 293 N.Y. 859, 59 N.E.2d 446 (1944), and Espach v. Nassau & Suffolk Lighting Co., 293 N.Y. 463, 57 N.E.2d 835, *reh. denied* 293 N.Y. 859, 59 N.E.2d 447 (1944), both involving the same facts, demonstrate the impossibility of a precise definition of fairness in the context of modern corporate relationships. One corporation ("Long Island") owned all of the voting stock of a second ("Queens"), which in turn owned all of the voting stock of a third ("Nassau"). Naturally, there were interlocking directorates. What is a fair price for sales (of gas) from the third corporation to the second? A "fair" price to corporation three may be unfair to corporation two, and vice versa. The court's visceral reaction probably provides the most satisfactory solution.

37. *See* notes 30, 31 *supra.*

even verbally suggests a boundary more vague than that between fairness and "fraud."

Because of this ambiguity, the wisest interpretation of the existing statutory provisions appears to be in terms of allocation of the burden of proof.[38] This interpretation also provides the best guidance for legislative revision of these statutes to make them more effective solutions to the problem.[39]

Cases like *Globe Woolen Co. v. Utica Gas & Electric Co.*[40] suggesting the infinite varieties of imposition without direct interest or action, are perhaps the best proof of the inadvisability of any attempt to draft a statute, no matter how onerous the ritual of approbation, that completely insulates a transaction from judicial intervention.[51]

In that New York Court of Appeals decision, one Maynard was a director of both plaintiff woolen and defendant electric companies and chairman of the latter's executive committee. Although a principal stockholder of plaintiff, he had no financial interest in defendant. Through his dual position he negotiated two contracts between the two corporations whereby the defendant agreed to provide plaintiff with electricity, and guaranteed plaintiff a saving of $600 per month. Partly as a result of a miscalculation by defendant's employee and partly as a result of increased use by plaintiff of a process requiring more energy, the contract, if enforced, would have resulted in a loss of $300,000 to the defendant.

Characterizing the unfairness of the contracts as "startling," the Court of Appeals refused to enforce them, and ordered rescission.

---

38. This solution is, of course, not a perfect one, especially in the situation discussed in note 36 *supra*. It can be castigated as a form of "buck-passing." But a general test of fairness and an allocation of its burden of proof seem to be the best methods of securing the flexibility necessary to assure justice in the majority of cases, in a world in which absolute perfection is unfortunately not possible.

Any attempt to be more precise would necessitate dealing specifically with the requirements for validation of such diverse director "transactions" as issuance of stock to themselves, preemption of corporate opportunities, recapitalization, etc., an area probably best left to general fiduciary standards. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 48, introductory language. *Cf.* N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

39. A minor subsidiary advantage of a statute which merely shifts the burden of proof where the transaction receives the requisite approval is that it need not specifically detail the consequences or validity of a failure to follow the approved validation rubric. (*See* R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS — INCLUDING PARTNERSHIPS and LIMITED PARTNERSHIPS 661 (1976).)

40. 224 N.Y. 483, 121 N.E. 378 (1918).

41. A possible alternative, however, under a really comprehensive statute, is to validate the transaction, but make the wrongdoing individual responsible for it personally liable. The obvious incentive to use judgment-proof dummy directors militates against this choice.

Maynard presided at the executive committee meetings which approved them for defendant and he put forward the resolutions, but the contracts were adopted without his vote. In effect, the Court treated his "dominating influence" as the conceptual equivalent of a vote.

The case, of course, like *Remillard,* demonstrates that fairness rather than adherence to any technical formalities is the criterion for validity. Even more important, however, is the case's demonstration of the necessity for, despite its imprecision, the concept of fairness in the drafting of any statute on the subject, as well as the imprudence of granting a legislative stamp of approval to a transaction merely because of compliance with any statutory formula of adoption no matter how detailed. It should be noted that the *Globe* contracts would have passed muster under the approval provisions of not only the old California-Model Act paradigm but almost all of its progeny.

Because no draftsman can foresee all of the possibilities of unfairness and prevent them through the mechanics of approval, the only safe procedure is to provide the necessary guidance as to validity through a basic requirement of fairness coupled with a recognition of the customary principle that a business' judgments should be made by those having the greatest stake in its success and subject only to the equally recognized qualification that their power cannot be used to oppress minority interests. The only practical means for doing so seems to be through an allocation of the burden of proof of fairness which will give appropriate recognition to the significance of majority will, but will nonetheless protect an "outside" minority from overreaching by that majority.

Prior to enactment of its statute, the Delaware courts had arrived at the rule that independent[42] shareholder ratification shifted the burden of proof from the directors to shareholders attacking the affiliated transaction.[43] There were indications that

42. Alcott v. Hyman, 208 A.2d 501 (Del. 1965) indicates that shareholder ratification will shift, or at least lessen, the burden of proof, even on motion for summary judgment, but expressly refuses to pass on whether the ratification may be by an interested majority. *See also,* FLETCHER, *supra* note 5, at § 983.

43. Alcott v. Hyman, 208 A.2d 501 (Del. 1965) and cases cited. *See also* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) wherein the court stated:

> When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given. . . .
>
> where waste of corporate assets is alleged, the court notwithstanding independent stockholder ratification, must examine the facts of the situation. Its examination, however, is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary,

this was the common law rule in New York as well.[44] These decisions could supply the pattern for interpretation of all of the statutes.[45]

Thus, they could all be construed to validate interested and interlocking director's contracts where those seeking to uphold the

---

sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction.

The burden of proof remains on the person seeking to upset the transaction in the absence of "self-dealing" (which the court defines as the parent receiving something from the subsidiary to the exclusion of, and detriment to the subsidiary's minority shareholders), even in the parent-subsidiary situation, *i.e.*, where the parent owns enough shares to ratify the transaction in behalf of the subsidiary. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). See also the same case on remand, 300 A.2d 28 (Del. Ch. 1972).

44. Borden v. Guthrie, 23 App. Div. 2d 313, 260 N.Y.S.2d 769 (1965), *aff'd* 17 N.Y.2d 571, 215 N.E.2d 511, 268 N.Y.S.2d 330 (1966) (independent director approval of repurchase of stock from directors). *See also* Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942). BALLANTINE, *supra* note 13, at § 72a, at 184 n.83 cites this case as indicating that in an interlocking director situation, in New York, the burden of proof at common law was upon the person attacking the validity of the transaction. It is more appropriately explained in terms of a shift in the burden of proof where corporate action has been taken to remove the interest taint (in the case, a certificate of incorporation provision purporting to validate such contracts).

The only case from the court of appeals decided since the New York statutory provision was enacted, Rapoport v. Schneider, 29 N.Y.2d 396, 278 N.E.2d 642, 328 N.Y.S.2d 431 (1972), does not pass on the burden of proof.

45. Although the majority common law rule is that the person or corporation seeking to uphold the contract has the burden of proof (CARY, *supra* note 17, at 485, 490–92 — the rule is not universal), a number of cases in various jurisdictions indicate that shareholder or disinterested director ratification will go further, and validate the underlying contract, in the absence of fraud on the minority. (*See* FLETCHER, *supra* note 5, at §§ 979–982; BALLANTINE, *supra* note 13, at § 70, at 176). Most states refuse to give effect to even shareholder ratification of a "fraudulent" transaction. (CARY, *supra* note 17, at 499–50). It is also said that "waste" cannot be ratified (except by unanimous shareholder consent). Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1962).

Although it seems clear under the old California statute that failure to "meet the requirements" of § 820 will place the burden of proof on the defendants to show their good faith and the fairness of the contract to their corporation, (*see* Tevis v. Beigel, 156 Cal. App. 2d 8, 319 P.2d 98 (Ct. App. 1957), and *id.* 344 P.2d 360 (Ct. App. 1959)), it is by no means clear that following the ratification procedures of the statute will place the burden on the one attacking the transaction. It would seem, under the *Remillard* case, *supra* note 27, that the burden is not shifted. It should be noted that the first sentence of the section provides that directors and officers "shall exercise their powers in good faith, and with a view to the interests of the corporation", and the courts apparently consider this one of the "requirements" which must be met in addition to ratification. *See also* Jones v. H. F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Reptr. 592, 460 P.2d 464 (1969) holding that the majority shareholders owe a fiduciary duty to the minority, and apparently have the burden of proof of showing the inherent fairness of the transaction.

On the other hand, the second Tevis case recognizes that unanimous shareholder acquiescence can validate the underlying contract.

See text accompanying notes 26–29, *supra*.

See, generally, as to burden of proof, FLETCHER, *supra* note 5, at §§ 921, 921.1, 974, 974.1.

contract prove them fair, or on the other hand, if they have been approved by a disinterested quorum of the directors or by the shareholders, if those seeking to invalidate them fail to prove them *un*fair.

These common law formulations, evolved over a long period of time, provide a good basis for a statutory allocation of the proof burden giving proper weight to the various intracorporate interests.

STATUTES EXPRESSLY FIXING BURDEN OF PROOF

If the suggested burden of proof allocation is accepted as desirable it is of course wise that it be expressly mandated by the language of the statute.

A growing number of states[46] which base their statutes on the old California-Model Act paradigm have recently chosen to make such explicit reference to the burden of proof in their affiliated directors laws. Thus, the New York statute was amended in 1971 to rewrite the fairness provision as follows:

> (b) If such good faith disclosure of the material facts as to the director's interest in the contract or transaction and as to any such common directorship, officership or financial interest is made to the directors or shareholders, or known to the board or committee or shareholders approving such contract or transaction, as provided in paragraph (a), the contract or transaction may not be avoided by the corporation for the reasons set forth in paragraph (a). If there was no such disclosure or knowledge, or if the vote of such interested director was necessary for the approval of such contract or transaction at a meeting of the board or committee at which it was approved, the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was approved by the board, a committee or the shareholders.

The paragraph (a), referred to, sets forth the alternative director and shareholder approval conditions.

Ironically, however, paragraph (a) continues to purport only to remove the interest taint, rather than to validate the contract despite compliance with the statutory conditions.

---

46. They still, however, represent a distinct minority of the states having statutes on the subject. Ironically, they include both California and New York, whose statutes have been amended (New York's in 1971 and California's effective 1977) to depart markedly from their earlier versions which continue to have considerable influence in other states.

Like the Model Act provision, that paragraph of the New York statute also governs contracts between corporations where a director of one, although not a director of the other, is nonetheless a shareholder of the latter. This is apparently designed to plug a loophole under which a contract between two corporations is technically not an interlocking director contract unless there is some overlap in the formal management of both. New York adds the qualification that the interest be "substantial."[47] Unfortunately, what constitutes the "substantial interest" necessary to bring the statute into play is nowhere defined. Nor does the statute cover a contract between a dominant shareholder and his own corporation if he is prudent enough to refrain from taking a management position.[48]

Even the burden of proof provision itself is ambiguous in not squarely fixing the burden. Thus, in the absence of disinterested director or majority shareholder approval, which of the two corporations in an interlocking situation will have the burden of proving fairness? Presumably, it will be the corporation seeking to uphold the contract. However, the statute does not say so expressly.

Furthermore, paragraph (a)(1) after providing for approval by a disinterested majority of the board adds, "or, if the votes of the disinterested directors are insufficient to constitute an act of the board as defined in section 708 (Action by the board) ,majority vote of those present at a meeting at which at least a quorum is present., by unanimous vote of the disinterested directors." In the simplest situation, this could mean approval by a single disinterested director, at a meeting of a three-man board attended by only one interested and one disinterested director.[49] *Quaere* if the interested director was necessary for the approval?

Finally, the New York statute uses the ambiguous "for this reason alone" language in its introduction, thus intimating that even proof of fairness will not necessarily validate the contract, despite the language of paragraph (b), but merely remove the interest taint.

The Virginia statute rewrites the Model Act "fairness" provision as follows:

> (b) In any even no contract or other transaction described in subsection (a) of this section shall be void or voidable despite

47. *See also* the equally vague "material financial interest" of new CAL. CORP. CODE § 310, discussed *infra*.

48. N.Y. BUS. CORP. LAW § 713 added 1971, N.Y. Laws c. 768 (McKinney Supp. 1976–77).

49. Since its amendment in 1969 the Delaware statute (DEL. CODE tit. 8, § 144(a)(1)) apparently permits a similar, and it is submitted, undesirable result. (*See* H. HENN, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 368–69 (1974)).

> failure to comply with parts (i) or (ii) of subsection (a), provided that such contract or transaction was fair and reasonable to the corporation in view of all facts known to any officer or director at the time such contract or transaction was entered into on behalf of the corporation. In an action to obtain relief for the corporation on account of a contract or other transaction described in subsection (a) in which there was no compliance with parts (i) or (ii) of subsection (a) such contract or transaction may be avoided for the benefit of the corporation and the court may grant other appropriate relief unless the party seeking to uphold the contract or transaction sustains the burden of proving that such contract or transaction complied with the requirement of the first sentence of this subsection (b).

Although paragraph (a) retains the old California-Model Act language as to interest, this paragraph suggests an absolute validation of the contract or transaction where the disinterested directors or the shareholders approve (paragraph (a) (i) and (ii)).

It apparently at least shifts the burden of proof of unfairness to the one attacking the transaction where the formal approval has been obtained.

The language of the paragraph is not a model of clarity. A special problem is posed by the phrase "in view of all the facts known to any officer or director at the time such contract or transaction was entered into on behalf of the corporation." If a director knows of another directors' interest, as required by paragraph (a), is this knowledge alone sufficient to make the contract fair? Suppose, as in *Globe Woolen,* that the interlocking director knows of facts making the contract unfair, but the other disinterested directors who carry the approval do not but do know the interlock, is the contract fair? The provision seems too ambiguous to be a satisfactory model.

The Michigan statute is even more puzzling. After adopting the old California-Model Act provision in section 545, with the qualifying Delaware language that the contract "is not void or voidable solely because of" the interest, provided one of three alternative conditions is met,[50] it adds in a separate section:

> Sec. 546 (1) When the validity of a contract described in section 545 ,§450.1545. is questioned, the burden of establishing its validity on any of the grounds prescribed in section 545 is upon the director, officer, corporation, firm or association asserting its validity.[51]

50. MICH. COMP. LAWS ANN. § 450.1545 (1973).
51. MICH. COMP. LAWS ANN. § 450.1546(1) (1973).

The use of the word "validity" clearly suggests that compliance with the previous section will immunize the underlying contract, despite the "solely" language. Although one commentator has interpreted the section to demand that the director sustain the burden of proof of fairness whenever the contract is challenged,[52] the section does not expressly so require, except where the affiliated[53] person relies on the fairness ground, rather than on the disinterested director or majority shareholder alternatives. As to them, it merely requires that he sustain the burden of proving approval.

Accordingly, the statute could be interpreted contrary to the *Remillard* rule. It validates an unfair contract, provided it was approved by the shareholders or disinterested directors.

This would seem to ignore its obvious meaning. The word "validity" could be limited to removal of the interest taint. In short, the express provision on burden of proof makes no significant improvement.

Arizona does the opposite of Michigan. The Arizona statute follows the Model Act, but adds:

> B. Any person seeking to establish that a contract or transaction described in this section is void or voidable for any reason set forth in this section shall first prove by a preponderance of the evidence that the provisions of paragraphs 1, 2 and 3 of subsection A ,corresponding to Model Act (a), (b) and (c). are not applicable.

The effect of this rather peculiar afterthought is to place the burden of proof of unfairness upon the person attacking the transaction *whether or not* it has been approved by a disinterested board or the shareholders. If this is so, why bother with the other Model Act provisions?

The new California provision, too, fixes the burden of proof, but only where the contract or transaction has not been approved by disinterested shareholders' or directors' vote. California Corporation Code § 310 provides:

> § 310. Contracts in which director has material financial interest; 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

52. Wesner, *Corporations-Interested Directors Dealing With the Corporation — The Fairness Doctrine,* 37 MO. L. REV. 531, 534 (1972).

53. *See* text *infra,* at notes 76–78.

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.

In addition to the burden of proof provision, there are other the notable differences between the old and new laws: the disqualification of interested directors' shares in voting to approve the transaction and the additional condition that "the contract or transaction is just and reasonable to the corporation." These conditions must be met for disinterested director approval to be sufficient validation.

Although the introductory paragraph leaves room for invalidation (*i.e.,* the courts can insert the word "solely" before "because"), despite the approval under paragraphs (a) or (b), the intent of the statute appears to be that contracts or transactions approved in conformity with either of those paragraphs will be impervious to attack, *i.e.,* absolutely validated. But appearance is not necessarily reality, and the statute does not give a certain guide. Furthermore, if only paragraph (b) is relied upon, it is unclear as to which party will have the burden of proving fairness (*i.e.,* that it is just and reasonable). Presumably, the proof of *un*fairness will be on the person attacking the transaction. Otherwise, the director's approval will have no significance whatever, since paragraph (c) already states that the party relying on the contract or transaction will win if he proves it "just and reasonable" even though it is not approved by (or is not even submitted to) the disinterested shareholders or directors. However, the statute does not expressly say this. Legislative hesitancy renders this statute hardly more adequate

than New York's. Although it comports with the estimate of at least one authority as to the present status of the law,[54] the absolute disqualification of interested shareholders appears to impose a restriction at variance with the majority rule which does not debar shareholder ratification, despite their interest, where they act in good faith.[55]

The Maine statute is perhaps the clearest of those based on the old California-Model Act section because it differs significantly from its parents. It provides:

> § 717. Transactions between corporations and directors and officers
>
> 1. No transaction in which a director or officer has a personal or adverse interest, as defined in subsection 2, shall be void or voidable solely for this reason or solely because he is present at or participates in the meeting of the board, or of a committee thereof, which approves such transaction, or because his vote is counted, if
>
> A. The material facts as to his interest and as to the transaction are disclosed or are known to the board of directors or committee, and are noted in the minutes, and the board or committee authorizes, approves or ratifies the transaction by a vote sufficient for such purpose without counting the vote of the interested director or directors; or if
>
> B. Although the vote of the interested director or directors is decisive of approval or disapproval of the transaction, the material facts as to his interest and as to the transaction are disclosed or known to the shareholders, and the transaction is specifically approved by vote of the shareholders, whether or not the votes of interested shareholders are necessary for such approval; or if
>
> C. Although the requirements of paragraphs A and B have not been satisfied, the transaction is fair and equitable as to the corporation at the time it is authorized or approved, and the party asserting the fairness of the transaction establishes fairness.
>
> 2. A transaction in which a director or officer has a personal or adverse interest shall include
>
> A. A contract or any other transaction between the corporation and one or more of its directors or officers;
>
> B. A contract or any other transaction between the corporation and any corporation, partnership or association

54. HENN, *supra* note 49, at 460.

55. BALLANTINE, *supra* note 13, at 197; 19 C.J.S. § 783, at 157; CARY *supra* note 17 at 495-502.

in which one or more of its directors or officers are directors or officers or partners, or have a financial interest, direct or indirect; but the ownership of not over 10% of any class of stock issued by a corporation whose shares are traded on any national securities exchange or are regularly quoted by any member of a national or regional association of securities dealers shall not be considered "a financial interest."

3. No contract or other transaction by a corporation with any of its subsidiary, parent or affiliated corporations, or with another corporation in which there is a common director, shall be void or voidable solely for this reason, if the contract or other transaction is fair and equitable as of the date it is authorized, approved or ratified. The party asserting the unfairness of any such contract or transaction shall establish unfairness.

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

5. Except to the extent that the articles of incorporation or bylaws otherwise provide, the board of directors or the executive committee shall, without regard to this section, have authority to fix the compensation of directors for their services as directors, officers or in any other capacity.

The Maine statute is more precise in establishing who has the burden of proof than its New York counterpart where fairness is relied upon, in lieu of director or shareholder approval.[56] It also deals expressly with the troublesome parent-multi-subsidiary problem,[57] a notable omission in the other statutes. It covers contracts between a corporation and entities in which its officers or directors are dominant shareholders, and gives a negative definition of what constitutes a substantial interest on the part of such a shareholder in the case of a public issue corporation. Unfortunately, it does not deal with contracts between a corporation and its dominant shareholders, gives no corresponding specific definition of substantial interest in the case of smaller corporations, and by the "solely for this reason" language leaves unaffected the underlying validity of the contract, despite the corporation's compliance with the approval or proof of

56. ME. REV. STAT. tit. 13A, § 717 (1974).

Like the Maine statute, Nevada, although generally following the old California-MODEL ACT model (with the addition of officers), expressly provides that interested directors and officers can vote as shareholders.

57. *See* note 36 *supra*.

fairness burdens. Nonetheless, it provides the best starting point for drafting a really adequate statute following the Model Act pattern.

The South Carolina statute[58] also deserves consideration. It is very similar to the Maine one since, as the Maine revisers

---

58. S.C. CODE § 12-18.16 (Supp. 1975) provides:

,§ 8.16.. Transactions between corporations and directors and officers. — (a) No transaction in which a director or officer has a personal or adverse interest, as defined in subsection (b), shall be void or voidable *solely* for this reason or solely because he is present at or participates in the meeting or his vote is counted, if

(1) The material facts as to his interest and as to the transaction are disclosed or are known to the board of directors or committee and are noted in the minutes, and the board or committee authorizes, approves or ratifies the transaction by a vote sufficient for such purpose without counting the vote of the interested director or directors; or if

(2) Although the vote of the interested director or directors is decisive for approval or disapproval of the transaction, the material facts as to his interest and as to the transaction are disclosed or known to the shareholders and the transaction is specifically approved by vote of the shareholders without counting the votes of any shares owned or controlled by the interested director or officer; or if

(3) Notwithstanding the limitations contained in subparagraphs (1) and (2) of this subsection, the transaction is fair and equitable as to the corporation at the time it is authorized or approved, and *the party asserting the fairness of the transaction establishes fairness.*

(b) A transaction in which a director or officer has a personal or adverse interest shall include,

(1) A contract or any other transaction between the corporation and one or more of its directors or officers;

(2) A contract or any other transaction between a corporation and any corporation, partnership, or association in which one or more of its directors or officers are directors or officers or have a financial interest direct or indirect.

(c) No contract or other transaction by a corporation with (1) any of its subsidiary, parent, or *affiliated* corporations, or (2) with another corporation in which there is a common director, shall be void or voidable solely for this reason, if the contract or other transaction is fair and equitable as of the date it is authorized, approved, or ratified. The party asserting the unfairness of any such contract or transaction *shall establish* unfairness.

(d) Common or interested directors may always be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes, approves, or ratifies a transaction. Shares owned by any interested party may be counted in determining whether a quorum of shares is present at a meeting of shareholders which ratifies or approves a transaction.

(e) Except to the extent that the articles of incorporation or by-laws otherwise provide, the board of directors or the executive committee shall, without regard to the provisions of this section, have authority to fix the compensation of directors for their services as directors, officers, or in any other capacity. (Emphasis added.)

It will be noted that although the statute refers to "affiliated corporations," the term is not defined.

acknowledge, they used it as the starting point for their provision.[59] It represents an obvious improvement over the California-Model Act paradigm but is, of course, subject to similar criticisms as the Maine modification.

An obvious but significant difference between the South Carolina and Maine provision is that the former, like the new California section, expressly disqualifies the shares held by an interested director when he is voting as a shareholder to ratify the transaction.

The Maryland statute, enacted in 1976, basically follows the old California-Model Act model, but rearranges the provisions. It reads:

---

59. The Maine Revision Comment states:

Comment: This section, also has no equivalent in the MBCA. The corresponding provisions are, in particular, New York, McKinney's Business Corporation Law § 713, and South Carolina § 12–18.16.

The South Carolina variant has been chosen as the basic model in preference to the New York variant, due to some more desirable features in structure and in detail. Neither variant, however, seemed entirely satisfactory in substance.

Perhaps the biggest question is the one posed by the provision in subsection (a)(2), emphasized by square brackets. This provision, taken from the South Carolina Act (and not appearing in the New York variant) would seem to change the usual *common law rule that the interest of a shareholder, when voting as such is not disqualifying.*

The square-bracketed provision is recommended, however, because the situation is saved by subsection (a)(3); if the transaction is fair and equitable to the corporation, it will be valid even though it has been impossible to secure a disinterested majority vote either of directors or of shareholders. Thus, with the inclusion of subsection (a)(3), the law is really not changed substantially from the common law situation where a transaction has been approved by the shareholders because the interested directors hold a voting majority of the shares. The majority shareholders have generally been held to occupy a fiduciary or a quasi-fiduciary relationship with respect to the minority shareholders, so as to prevent them from forcing through transactions which are an unfair imposition on the minority interest. In the light of that line of case law, the recommended section does not significantly change the rights and duties of any of the interested parties.

The South Carolina variant is preferable in that it specifically allocates burdens of proof, *i.e.*, (a)(3), and in subsection (c).

Both the New York and South Carolina variants seemed unsatisfactory in their reference to "any corporation, partnership, or association" in which the director has any "financial interest, direct or indirect". A minor financial interest in a publicly-owned corporation should not be disqualifying. Therefore, language was added to subsection (b)(2) to exclude not over 5% ownership interest in such publicly held corporation from the definition of "financial interest."

This draft, following both South Carolina and New York, expressly authorizes the directors to set their own compensation in all respects.

It will be noted that the Maine legislature did not choose to follow the revisers' suggestion that it adopt the South Carolina disqualification of interested shareholders. The Maine specificity on the subject is desirable.

¶2-419. Interested director transactions.

(a) *General rule.* — If subsection (b) of this section is complied with, a contract or other transaction between a corporation and any of its directors or between a corporation and any other corporation, firm, or other entity in which any of its directors is a director or has a material financial interest is not void or voidable solely because of any one or more of the following:

(1) The common directorship or interest;

(2) The presence of the director at the meeting of the board or a committee of the board which authorizes, approves, or ratifies the contract or transaction; or

(3) The counting of the vote of the director for the authorization, approval, or ratification of the contract or transaction.

(b) *Disclosure and ratification.* — Subsection (a) of this section applies if:

(1) The fact of the common directorship or interest is disclosed or known to:

(i) The board of directors or the committee, and the board or committee authorizes, approves, or ratifies the contract or transaction by the affirmative vote of a majority of disinterested directors, even if the disinterested directors constitute less than a quorum; or

(ii) The stockholders entitled to vote, and the contract or transaction is authorized, approved, or ratified by a majority of the votes cast by the stockholders entitled to vote other than the votes of shares owned of record or beneficially by the interested director or corporation, firm, or other entity; or

(2) The contract or transaction is fair and reasonable to the corporation.

(c) *Counting common or interested directors in determining quorum.* — Common or interested directors or the stock owned by them or by an interested corporation, firm, or other entity may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee of the board or at a meeting of the stockholders, as the case may be, at which the contract or transaction is authorized, approved, or ratified.

(d) *Burden of proof; fixing of compensation.* — If a contract or transaction is not authorized, approved, or ratified in one of the ways provided for in subsection (b)(1) of this section, the

person asserting the validity of the contract or transaction bears the burden of proving that the contract or transaction was fair and reasonable to the corporation at the time it was authorized, approved, or ratified.

(2) This subsection does not apply to the fixing by the board of directors of reasonable compensation for a director, whether as a director or in any other capacity.[59a]

It will be noted that this statute follows New York in expressly providing that following the approval ritual will only remove the interest taint, because of the word "solely," like the South Carolina statute disqualifies interested directors when voting as shareholders, and expressly provides that the burden of proof of fairness will be on the person asserting validity where the transaction has not been approved by the disinterested directors or shareholders.

Its obvious inadequacies are the less than certain effect of such approval and the fact that it only applies to interested or interlocking directors' contracts.

In sum, even the states which have taken the wise road and attempted to improve on the old California-Model Act by expressly legislating on the burden of proof have not done a job which could not be improved upon even more.

Two other statutes should be mentioned.[60] Both differ from the California-Model Act prototype as interpreted, by expressly providing for validity of the underlying contract, as opposed to a mere erasure of the interest taint, and both enacted after the California statute but seemingly uninfluenced by it, are also express on the allocation of the burden of proof. These two interesting laws are those of North Carolina and Vermont.[61]

The North Carolina statute purports to validate corporate transactions "in which a director has an adverse interest" when approved by disinterested director or shareholder vote, on proper disclosure, or where the adversely interested party proves the transaction to be "just and reasonable." It reads:

§ 55-30. Directors' adverse interest.—(a) A corporation may, by action of its board of directors or otherwise, compensate its directors for their services as directors, salaried officers or otherwise.

59a. MD. CORP. & ASS'NS. CODE ANN. § 2-419.

60. *See also* CONN. GEN. STAT. ANN. § 33-323 (West Supp. 1976) and NEV. REV. STAT. § 78.140 (1973), discussed *supra* notes 31 and 23, respectively.

61. *See also* note 19 *supra*.

(b) No corporate transaction in which a director has an adverse interest is either void or voidable, if:

(1) With knowledge on the part of the other directors of such adverse interest, the transaction is approved in good faith by a majority, not less than two, of the disinterested directors present even though less than a quorum, irrespective of the participation of the adversely interested director in the approval, or if

(2) After full disclosure of all the material facts to all the shareholders, the transaction is specifically approved by the vote of a majority or by the written consent of all of the voting shares other than those owned or controlled by the adversely interested directors, or if

(3) The adversely interested party proves that the transaction was just and reasonable to the corporation at the time when entered into or approved. In the case of compensation paid or voted for services of a director as director or as officer or employee the standard of what is "just and reasonable" is what would be paid for such services at arm's length under competitive conditions.[62]

The statute has the virtue of simplicity. Unfortunately, the failure to define "adverse interest" also makes it vague, and leaves the coverage of interlocking director contracts uncertain.

It also poses the danger of apparent absolute validation of transactions regardless of their unfairness, although it attempts to guard against that danger by a disqualification, like that in South Carolina and Maryland, of shares owned by the interested directors.

The Vermont statute is typically laconic. It provides:

§ 1888. Contracts with directors

A contract may be made between a corporation and one or more of the directors, if the contract is approved by a quorum of the board of directors, the contracting director not being present. In entering into such contract, the directors shall act in good faith, and, if their good faith is attacked, the burden shall be upon them to prove it. Subject to these provisions, such contract shall be voidable by the corporation only in case it would have been voidable if made with a stranger. The term "contract" as used herein is intended to include loans, and corporation guarantees of personal obligations.[63]

---

62. N.C. GEN. STAT. § 55-30 (Repl. Vol. 1975).
63. VT. STAT. ANN. tit. 11, § 1888 (1973).

Thus, it validates interested directors' contracts except where they would be voidable if made with a stranger, a good shorthand for incorporating the ordinary law of contracts as to capacity, consent, consideration, and the like, without detailing these rules.

Although the burden of proof remains on the disinterested directors to justify the contract, despite approval pursuant to the statute, it should be noted that they must only prove their "good faith," persumably a less stringent burden than proving the fairness of the contrct. Vermont thus outdoes the Model Act in liberality!

Were it not for its silence as to interlocking directors' contracts, and the effect of shareholder ratification, this simple and clear provision would provide a better model than any of the verbose attempts to improve on the California-Model Act section.

The well known *Globe Woolen* case,[64] however, shows how easy it is to arrange for a technically impartial approval of a palpably unfair contract.

It should be observed that this statute, although exacting greater assurance of impartial approval than the archetype, gives in exchange greater assurance of the validity of the contract. This is a price many affiliates would be willing to pay.

It would, however, be dangerous to adopt a statute which validated an interested or interlocking directors' contract for all purposes simply because it was approved by a disinterested majority of the directors or a majority (even if, contrary to the California-Model Act provision, they too were required to be disinterested)[65] of the shareholders.

Most legislatures would be unwilling to enact a statute which would allow compliance with a statutory ritual[66] to make a genuinely unfair contract impervious to attack, and, as the *Remillard* case shows, fewer courts would enforce such a statute.[67]

64. Globe Woolen Co. v. United Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918). A director and principal shareholder of one corporation, did not vote at the executive committee meeting of the second approving contracts which the court held were unfair to it. The court held the contracts voidable anyhow, relying on the director's "dominating influence".

65. The New York statute, as originally enacted by 1961, N.Y. Laws c. 855, prohibited counting shares owned by interested directors. The limitation was amended out, by 1962, N.Y. Laws c. 834, prior to the effective date of the statute.

66. Any statute which purported to do so, adequately, would also have to deal not only with the difficult matter of preemption of corporate opportunities, but almost the entire agency subject of fiduciary duties of corporate officials to their employers. (*See generally,* LATTIN, *supra* note 13, at § 79.)

67. There are relatively few cases interpreting the interested director statutes. Generally, they have held that the statute did not affect preexisting law. (*See, e.g.,* Holi-Rest Inc. v. Treloar, 217 N.W.2d 517 (Iowa 1974); Noe v. Roussel, 299 So. 2d 481 (La. App. 1974), *rev'd,* 310 So. 2d 806 (La. 1975); Schoff v. Clough, 79 Nev. 193, 380 P.2d 464 (1974).

Again, however, such approval should be given some weight, and the most appropriate way of doing this is through a shifting in the burden of proof allocation.[68]

AFFILIATES

Obviously, a corporation should not be saddled with contracts which it would not have approved in an arm's length transaction.[69] This is presumably the point of the "fairness" or "just and reasonable" tests.

An effective statute which seeks to validate interested contracts should also deal with those in which a dominating influence,[70] making an arm's length transaction impossible, is exerted by one side even though technically not falling under the rubric of an interested directors' or interlocking directors' contract.

The old California statute only covers the traditional areas of conflict of interest.[71]

The Model Act and most of the others, including California, extend the coverage to contracts between a director's corporation and another entity in which he holds a management position (director or officer), or financial interest.[72] Thus, a director must be involved for the statute to apply. Only about half of the states with statutes extend their scope to officers as well.[73]

None cover transactions between corporations having a common dominant shareholder, or those between a dominant shareholder

68. The Connecticut statute, CONN. GEN. STAT. § 33–323 (Supp. 1976), like the others discussed in this segment of this article, also differs markedly from the California-MODEL ACT paradigm. It is puzzling in setting forth very detailed provisions designed to assure the fairness of the transaction, but not giving any definite assurance of validity (note the "merely because" language in § 33–323(a)). The statute is principally interesting for its "attribution rules" ("Member of the immediate family"), its negative definition of "substantial interest" (comp. present N.Y. BUS. CORP. LAW § 713(a)), and the concluding provision of paragraph (d) making contracts at "standard prices" or on "not less favorable" terms prima facie fair.

Certain of the exclusionary provisions of paragraph (d) may be overly broad in a statute expressly validating the challenged transaction. All of the matters covered by it, however, deserve consideration in the drafting of any such statutes.

See note 31 *supra* for text of the Connecticut statute.

69. This is a popular test. *See* HENN, *supra* note 49, at § 238 at 467. It is the test apparently applied under the California statute to determine fairness. *See* Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 260 P.2d 823 (Ct. App. 1953).

70. *See* Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

71. *See* CAL. CORP. CODE § 820 (West 1955).

The Vermont statute is even more limited, covering only interested, rather than interlocking directors' contracts. VT. STAT. ANN. tit. 11, § 1888 (1973).

72. *See* MODEL ACT § 41, and the Delaware, New Jersey, New York, Maine and Michigan statutes.

73. *See* Delaware, Kansas, Louisiana, Maine, Michigan, Nevada, Pennsylvania, Rhode Island, South Carolina and Tennessee.

and his own corporation where he chooses not to hold an office or directorship.[74]

Obviously, this deficiency in coverage is not too significant where the statute only removes the interest taint. It becomes crucial under a statute which purports to validate the underlying contract once the statute's conditions are met.

A significant shareholder can exercise a decisive influence on corporate actions even though he is not a director or officer. The Federal Securities Laws and the SEC rules promulgated thereunder recognize this.[75] Thus, for purposes of corporate recovery of short-swing profits not only directors and officers but also ten percent shareholders are considered "insiders."

The SEC has also come up with a useful word to cover persons in a control position with the corporation: "affiliate."[76] While in SEC parlance the latter term does not necessarily include directors and officers, the late Carlos Israels[77] felicitously applied it to interested and interlocking directors in their corporate contracts and it seems the more appropriate shorthand for whatever relationships are to be covered by the proposed statute, since devoid of the pejorative implications of the former expression.

"Affiliate" can be precisely defined in terms of extent of stock ownership,[78] thereby avoiding the ambiguous "financial interest" or even more uncertain "substantial financial interest" used in most statutes.

CONCLUSION

As the *Remillard* case shows, the California-Model Act provision is inherently ambiguous.

Those of its progeny which merely make express its meaning as interpreted in that case by adding that an affiliated contract "approved" under one of its alternative conditions will not be invalid "solely" because of the affiliation are, if not ambiguous, at best inadequate.

A satisfactory statute should do more than merely remove the interest taint. Guidance should be given as to when the contract will or will not be enforced despite the taint or its erasure.

74. *See* C. ISRAELS, CORPORATE PRACTICE 198 (2nd ed. 1969) [hereafter cited as ISRAELS].

75. *See, e.g.,* Securities Exchange Act of 1934 § 16, 15 U.S.C.A. § 78p (1) (1974); Id. § 14(d), 15 U.S.C.A. § 78n(d) (1974).

76. *See e.g.,* 17 C.F.R. Reg. §§ 230.251, 230.405 (1976), 17 C.F.R. Reg. § 240.12b-2 (1976).

77. ISRAELS at 195. (Unaccountably, the new edition of Mr. Israel's book, published subsequent to his death, omits the term except in the index.)

78. Persons making significant loans to the corporation could also be characterized as "affiliates" under the statutory definition in order to avoid circumvention. *See* the Connecticut statute, *supra* note 31.

It seems axiomatic that only a contract fair at the time it is entered into should be enforced and that this should be the ultimate criterion. It is, however, impossible to define "fairness" in such a way as to cover every factual situation in which the question will be presented.

The only solution, even though avowedly an imperfect one, is to leave the question of fairness to judicial or jury determination.

Some effect should, however, be given to an impartial intracorporate determination of the issue.

The most satisfactory combination of these considerations is to make fairness the test but to shift the burden of proof to those attacking the transaction where impartial intracorporate approval has been given.

The statutes which follow the original California-Model Act paradigm fail to make any express provision as to the effect of compliance with their three alternative modes of approval on the burden of proof. None of these which depart from this model by making a statement on the burden expressly provides as to the effect of sustaining even the burden of fairness of the contract on its underlying validity. In short, despite their greater specificity, these statutes are, therefore, hardly more adequate than their prototype.

The two statutes which purport to validate the underlying contract when their proof conditions are met are incomplete in their coverage, and thus do not supply satisfactory models either. They are, furthermore, subject to the danger that compliance with the prescribed approval ritual will saddle a corporation with disastrous obligations which would never have been approved in an arm's length transaction.

On the other hand, all of the above laws give useful insights into, and valuable language for, the drafting of a more adequate statute.

The following draft attempts to combine the best features of existing legislation and, hopefully, improve upon it. Perhaps it will at least provoke the consideration and discussion necessary for the development of a more perfect statute.

PROPOSED STATUTE ON INTERESTED AND INTERLOCKING DIRECTORS' CONTRACTS

§ [4]. *Director Conflicts of Interest.*

(a) This section shall only apply to a contract or other transaction between or among affiliates one or more of which is a corporation.[79]

79. The California-MODEL ACT paradigm only applies where a director or officer is somehow involved. This proposed statute will, by its definitions, apply also to

(b) No contract or other transaction between or among affiliates shall be void or voidable unless such contract or transaction would be void or voidable if made with a non-affiliate,[80] if the contract or other transaction is fair[81] to the corporate affiliate at the time it is authorized, approved, or ratified by that corporation.

(c) Except as provided in paragraph (d), the party asserting the fairness of the contract or other transaction shall have the burden of proving its fairness.[82]

(d) Notwithstanding the foregoing paragraph (c), the party asserting the unfairness of the contract or other transaction to a corporation shall have the burden of proving such unfairness as to that corporation, if either of the following conditions is met:

(A) The fact[83] that the contract or other transaction is with an affiliate is disclosed or known to the board of directors or committee of the corporation, and the board or committee

---

transactions between a corporation and an individual (or members of his family) or an entity or aggregate in which he has a significant financial interest, or corporations related by such financial ties, even though there is no overlap of official positions. Without the limitation here contained that one party must be a corporation, the section would also apply e.g., to transactions between related partnerships. While this might not be undesirable, such a provision would more appropriately be included in the Partnership Act, unless this section is to be excised from the corporation law and made a part of a general statute on fiduciary duties applicable to all business relationships.

80. This corresponds to the Vermont "stranger."

81. Fairness alone seems a sufficient standard, without the redundancies of "reasonable" or "just" added.

82. According to Marsh fairness is the ultimate test, and, as pointed out above, this burden represents the majority rule.

The term "party" probably needs no definition, since it is appropriately interpreted in both of its possible significations, contractual and procedural.

The language "asserting the fairness of the contract or other transaction" is taken from the Maine Act. (*See* text *supra* at note 56.) "Validity" could, of course be substituted for "fairness," or "seeking to uphold the contract or other transaction" used in lieu of the entire expression, since, from a pleading perspective, the party "asserting" fairness may turn out in some cases to be merely a defendant denying an allegation of unfairness in the complaint, rather than one affirmatively pleading it. However, an allocation of the proof burden different from the pleading one is not unknown in other contexts, and hence use of the original language should pose no real problems.

Some procedural experts may object to the simple term "burden of proof," rather than use of such terms as "production burden" and "persuasion burden" (*See* MODEL CODE OF EVIDENCE rules 1(2), (3), *but cf.* UNIFORM RULES OF EVIDENCE rule 1(4), (5)). Although "burden of proof" will be a clear enough term in most jurisdictions, conforming changes should, of course, be made where local practice rules so dictate.

83. The requirement of "good faith" disclosure, found, e.g., in the New York statute, seems to introduce an unnecessary additional ambiguity.

The characterization "material", as also contained in the New York statute, and those of Maine and Michigan, is deliberately omitted to avoid possible

authorizes, approves, or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of any director who is an affiliate; or[84]

---

importation into the state law of the judicial interpretations under the Federal Securities Laws of this term, although since the Supreme Court decision in TSC Industries v. Northway, Inc., 426 U.S. 438, 96 S. Ct. 2126 (1976), that may no longer be as undesirable as formerly.

The complementary effect of the Federal Securities Laws, where applicable, in insuring full disclosure of the terms of interested and interlocking directors' transactions should, however, be noted. (*See* Item 7(f) of Schedule 14A as to information required under SEC Rule 14a-3 for a proxy statement in a solicitation by a public issue corporation.)

84. As indicated in the text *supra*, the revised New York statute in effect provides that if there are not a sufficient number of disinterested directors, approval may be "by unanimous vote of the disinterested directors."

The New Jersey statute (N.J. STAT. ANN. § 14A: 6-8 (West)), although it puts fairness before director or shareholder approval in the sequence, basically follows the modular forms ("solely," "otherwise interested," directors, only), but adds as to permissible director approval "by unanimous written consent, provided at least one director so consenting is disinterested, or by affirmative vote of a majority of the disinterested directors, even though the disinterested directors be less than a quorum." This is, perhaps, an advance in clarity, but not in wisdom, over the new New York provision.

The provision in the proposed text is the same as that of MODEL BUS. CORP. ACT § 41(2), and requires that a disinterested majority of the directors at a meeting approve the provision. It presupposes a quorum and voting provision like MODEL BUS. CORP. ACT § 40 has been adopted by the State. That section provides:

> § 40. Quorum of directors
>
> A majority of the number of directors fixed by or in the manner provided in the by-laws or in the absence of a by-law fixing or providing for the number of directors, then of the number stated in the articles of incorporation, shall constitute a quorum for the transaction of business unless a greater number is required by the articles of incorporation or the by-laws. The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by the articles of incorporation or the by-laws.

The effect of the section is to preclude director approval where a majority of the board is interested.

On the other hand, in a corporation with five directors, two of whom are "affiliates" as to the transaction, if all five directors attend the meeting, approval requires the affirmative vote of all three of the disinterested directors. If only the three disinterested directors attend, the transaction will be approved by the affirmative vote of only two of them. While this result of the MODEL ACT provision may seem anomalous, it will tend to prevent subtle pressures from the interested directors (as in the *Globe Woolen* case) by discouraging their attendance. Needless to say, the transaction cannot be approved unless all three disinterested directors attend the meeting, since otherwise the needed disinterested majority cannot be obtained. In such a case, it seems wise to require that shareholder approval, under subparagraph (B), be sought, as is the effect of the MODEL ACT provision.

Under a provision like that of the New York or New Jersey statutes, in the example given, approval could be obtained at a meeting attended (and perhaps dominated) by only the two interested directors plus one of the disinterested ones. This seems overly liberal.

(B) The fact that the contract or other transaction is with an affiliate is disclosed or known to the shareholders entitled to vote and they authorize, approve, or ratify such contract or transaction by vote or written consent of the holders of a majority of the shares entitled to vote thereon.[85]

(e) Affiliates who are natural persons may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof, and may vote thereat; and shares otherwise entitled to vote and held by any affiliate may be counted in determining the presence of a quorum at a meeting of the shareholders, and the registered holders thereof may vote at any such meeting.[86]

(f) For purposes of this section the following definitions shall apply:

(A) "Affiliate"[87] shall mean (i) an officer or director of, and any person in control of, a corporation; (ii) a person of which an affiliate is an affiliate; (iii) a person that directly, or indirectly

---

85. As indicated above, certain states disqualify the shares held by interested directors from voting. Such provisions may have the effect of preventing any shareholder ratification where a majority of the shares are held by interested directors. They may also pose problems in the parent-subsidiary or parent-multi-subsidiary situations (*see e.g.*, the *Chelrob* or *Levien* cases). If a stricter rule than the one imposed by most statutes is desired, a compromise between absolute disqualification and the possibility of approval solely through the votes of interested parties is possible through a requirement of majority approval of the disinterested minority shareholders. An optional provision taking this middle road is set forth in the text at note 93 *infra*.

Both the South Carolina and new California provisions are, in one sense, too narrow in limiting the share disqualification to shares owned by interested director, or, in the case of South Carolina, directors and officers. On the other hand, the South Carolina provision introduces an undesirable litigation-producing uncertainty by also disenfranchising shares "controlled" by the director or officer.

The proposed optional provision attempts to correct both of these deficiencies.

86. This paragraph follows the modular forms in allowing interested directors to be counted in determining whether a quorum is present, and it is clear that a similar rule is to be applied on the shareholder level as well.

87. N.Y. BUS. CORP. LAW, (McKinney Supp. 1976–77) (a) provides for removing the interest taint in an interlocking case despite a "substantial financial interest". MODEL ACT § 41 brings its requirements into play in the interlocking situation where the director's corporation transacts with another corporation or entity in which he has any financial interest. Only two statutes define the requisite financial interest. Maine anomalously, only excludes ownership of less than 10% of any class of stock of public issue corporations from the interdicted interest. There would seem no reason for not considering a less than 10% interest in a close corporation as equally harmless. The Connecticut statute (CONN. GEN. STAT. ANN. § 33–323 (West Supp. 1976)), provides a better model.

A 10% ownership of a business or other entity would seem to be sufficient proof of a "substantial financial interest" (and seems preferable to a taint through

through one or more intermediaries, controls or is controlled by, or is under common control with the person. Notwithstanding the foregoing, for purposes of voting under paragraph (d)(A) a director shall not be deemed to be an affiliate unless the contract or other transaction voted upon is between such director as defined in this paragraph (f) and the corporation or with another person of which he is also an affiliate.

(B) "Person" shall mean an individual, corporation, firm, partnership, association, estate, trust or other entity.

(C) A person shall be deemed to be in control of a person where he or it owns more than ten percent in value of the outstanding securities of all classes of a person.[88]

(D) "Securities" shall mean shares of a corporation or association or other entity, whether or not entitled to vote; partnership interests; beneficial interests in an estate or trust;

---

any interest no matter how infinitessimal). But if so, there is no reason to use such vague terms as "substantial" or "material" financial interest at all.

Accordingly, it seems better to use the common Securities Law terms "affiliate" and "control", comprehensively but precisely defined to cover all genuinely significant financial interests direct and indirect.

It should be noted that the definitions will make the statute applicable not only to transactions between an interested director or officer and his corporation, as well as to transactions between (or among) corporations having common directors or officers, but also e.g., to transactions between a corporation of which a person is a director or officer and another corporation in which he owns a substantial financial interest, even though he is not an officer or director of the latter, transactions between a parent and its subsidiary or between common subsidiaries, etc., in short almost every conceivable relationship where an adverse interest may be present. *See,* however, note 92 *infra.*

The final sentence of paragraph (f)(A) is designed to allow the neutral directors to vote to approve a transaction, without sacrificing the generality of the term "affiliate" in other contexts, and without the necessity of introducing a definition of "disinterested". Thus, the effect will be to allow directors who are not themselves (or indirectly through members of their families) parties to contracts with the corporation to vote as directors to approve the transaction. It will, however, preclude a director who is also a director of the other corporation (or other entity, partnership, etc.) with which his corporation transacts from voting, as a director, to approve that transaction. The combined effect of these definitions and the substantive provisions of paragraphs (b), (c) and (d) is initially to include virtually every situation where a participant in the decision-making for a corporation might be subject to a divided loyalty because of some relationship with the other party to the transaction, but to carve out carefully circumscribed exceptions where impartial judgment is likely, or the dangers from partiality are not great.

88. The 10% figure could be reduced to 5% for greater safety, if desired. It should be noted that the simpler Connecticut provision may offer greater opportunity for evasion. Thus, under it, a person could own *all* of the shares of a class, provided the class constituted only 9% of the total shares outstanding. The percentage should be spelled out in terms of number or value of the securities.

and bonds, debentures, notes, or other evidences of indebtedness of any of the foregoing.[89]

(E) "Officer" and "director" shall include an individual's spouse,[90] children (including legally adopted children), grandchildren, parents, grandparents, brothers and sisters and any person which the individual or any of the foregoing controls.

(F) A person shall be deemed to own all securities of which it, or he or his spouse, children (including legally adopted children), grandchildren, parents, grandparents, brothers and sisters are the record or beneficial owners, and all securities owned of record or beneficially by any person which he or it, or any of the foregoing persons control.[91]

(G) This section shall not affect any liability otherwise imposed by law upon any director, officer or shareholder.[92]

---

89. An even more comprehensive definition of "security" could be used. *See, e.g.,* Securities Act of 1933, § 2(1) as amended, 15 U.S.C. § 77b(1)(1970). The one proposed seems sufficient, however, because of the general language at the end.

90. There are, of course, cases involving contracts between a corporation and the wife of an officer, as well as between a corporation and other entities in which a director has an interest. *See* FLETCHER, *supra* note 5, at § 946. There are, also, other possibilities of nepotism, as the name suggests. Broadening the statute to proscribe any more relationships than those covered here and under subparagraph (F) would, however, smack of an attainder of blood.

91. These attribution rules, based on INT. REV. CODE of 1954 § 318, are, of course, important to prevent an insider from putting his stock in the name of a relative to circumvent the statute.

92. This language is based on paragraph (f) of N.Y. BUS. CORP. LAW § 719 (McKinney 1963), the directors's statutory liability section, corresponding to ABA-ALI MODEL BUS. CORP. ACT § 48. It will, of course, preserve customary individual liability for such actions as improper dividends and other distributions of assets, and for negligence. Where, as *e.g.,* in New York (N.Y. BUS. CORP. LAW § 717) (McKinney 1963) and California (CAL. CORP. CODE § 309) a requirement of "good faith" on the part of directors and officers is imposed by statute, the provision makes it clear that liability for breach of such duties will not be affected.

Some jurisdictions, (*e.g.,* New York, *see* CARY, *supra* note 17, at 493 n.1) draw a distinction between actions to rescind a contract, and those to hold the directors personally liable for damages resulting from an improvident one, requiring a higher degree of proof of unfairness for the latter than the former. The provision will also preserve this distinction in treatment.

If this paragraph is enacted, its results may be more far-reaching, however, in particular jurisdictions. Common law liability for preemption of corporate opportunities will of course be continued.

It may also continue what may be a common law exception to the general rule that a properly approved interested director's contract will be enforced if fully disclosed and not unfair, found, *e.g.,* in the New York case of New York Trust Co. v. American Realty Co., 244 N.Y. 209, 155 N.E. 102 (1926), in which it was held that if a director purchased property with the intention of reselling it to his corporation he would be required to transfer it at cost even though the price to the corporation was not so unfair to it that it desired rescission.

While the authorities seem to interpret this case as a preemption of corporate opportunity case (*see* HENN, *supra* note 11, at § 237; LATTIN,*supra* note 13, at § 79), it

OPTIONAL ADDITION TO PROPOSED STATUTE

Notwithstanding the foregoing paragraph (d), the rule in paragraph (b) shall apply to the contract or other transaction where an affiliate or affiliates own a majority but less than all of the

seems to go beyond that doctrine in applying a more stringent fiduciary duty (on agency principles), with which the statute, in appropriate jurisdictions, should perhaps explicitly deal, if its rule is not to be preserved.

Obviously, in jurisdictions (*see* Schein v. Chasen; Gregorio v. Lum's, Inc., 478 F.2d 817 (2d Cir. 1973), *vacated* 416 U.S. 386 (1974)) which choose to follow the New York rule enunciated in Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), that a corporation can recover profits of corporate insiders on transactions in the corporation's stock made by the use of inside information, the insider liability will continue.

The most troublesome area of affiliated transactions is that involving parents and their subsidiaries, including subsidiaries dealing *inter se. See, e.g.,* the *Levien* case *supra* note 43 and the *Chelrob* case, *supra* note 36. Comp. Case v. New York Cent. R.R. Co., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965), with Western Pac. R. Corp. v. Western Pac. R. Co., 197 F.2d 994 (9th Cir. 1951), *rev'd on other grounds* 345 U.S. 247 (1953) *prior opinion aff'd.* 206 F.2d 495 (9th Cir. 1953) *cert. den.,* 346 U.S. 910 (1953); *app. dismissed,* 216 F.2d 513 (9th Cir. 1954). *See, generally* Note, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations,* 74 YALE L. J. 338 (1964).

A number of states recognize a fiduciary duty on the part of the parent, or other controlling shareholder, to the minority shareholders of the controlled corporation (FLETCHER, *supra note 5, at* §§ 5810–5812), and place the burden of proof of fairnesss on the controlling shareholder, at least under certain circumstances (*see, e.g.,* the *Levien case supra* note 43), where such domination is shown, as e.g., in the parent-subsidiary situation.

Paragraph (d) of the proposed statute would almost inevitable shift the burden of proof to the minority shareholders of any subsidiary corporation, since by definition the parent could ratify the contract or transaction in behalf of the subsidiary. Although by removing the interest taint, it is arguable that the California-MODEL ACT statutes already accomplish this result (the California cases, *see* note 45 *supra,* and the *Levien case, supra,* note 43, in Delaware, however, seem to ignore their state's interested director statutes in this situation), the proposed statute may by virtue of paragraph (d) change the law of jurisdictions enacting it, in this regard. (*See* FLETCHER, *supra* note 5, at §§ 944, 945.)

The effect of the concluding language of paragraph (g) ("or shareholder") would not alter this shift in the burden of proof, although it could be used by a court to impose at least a liability in damages on the part of the parent to the minority shareholders of the subsidiary in cases of imposition.

Although the statute could be drafted to make paragraph (d) unavailable in the parent-subsidiary situation, for example, by disqualifying the votes of an affiliate's shares in the ratification, or by expressly making paragraph (d) unavailable in a case where an affiliate was a majority or greater shareholder of the corporation ratifying the transaction (*see* FLETCHER, *supra* note 5, at § 983), or the subsidiary-subsidiary transaction (*see* the *Chelrob case*), it would not seem essential to exclude these situations from the general shift in the burden of proof accomplished by shareholder ratification not only because of the difficulty of determining who should have the burden, and drafting a provision to allocate it (*e.g.,* in the *Chelrob* situation should the parent or which one of the subsidiaries, or the minority shareholder of one have the burden of proof, since not all of the directors were common, and a director of one subsidiary properly gained concessions for his corporation from the directors of the other?) but also (a) because such a provision

shares entitled to vote of the corporation as to which it is asserted the contract or other transaction is unfair, unless the contract or other transaction is, in addition, authorized, approved, or ratified by the shareholders of that corporation by a vote of the holders of a majority of the shares entitled to vote thereon who are not its affiliates.[93]

---

would go counter to the usual common law rule on burden of proof in interlocking directors situations, which will, of course, normally be found in such parent-subsidiary cases, and (b) the plaintiff's problem of meeting the burden will probably not prove too great in cases of really unfair contracts.

It should be noted that the statute, as proposed, would fix the burden of proof in the *Chelrob-Espach* situation (where shareholders of both corporations complain of the unfairness) on the complaining minority shareholder of the particular subsidiary to prove the unfairness as to his corporation of the contract, assuming that the parent caused each corporation to ratify, i.e., the burdens would not conflict.

If only one of the corporations ratified, the problem would be somewhat more complex, but again conceptually resolvable, because of the language that the burden applies "as to that corporation".

The statute would also, of course, cover the *Globe Woolen* situation, but the burden would be on the corporation claiming unfairness, since, despite the common director, Maynard's, dominating influence over that corporation's executive committee, the transaction was approved by a majority of non-affiliates. (The effect of the present New York statute on that case is not completely certain. N.Y. BUS. CORP. LAW § 713(b) (McKinney Supp. 1976), text *supra* at note 47 removes the interest taint, since even if Maynard's domination were construed as the equivalent of voting, his vote was not necessary to the approval of the contract. *Quaere,* however, if this means the corporation cannot avoid the contract.)

For states desiring assurance of shareholder impartiality in the ratification, however, the optional provision in the text at footnote 93 might be used.

The proposed statute does not deal expressly with the matter of directors fixing their own compensation, although some of the recent statutes expressly authorize them to do so. (*See, e.g.,* N.Y. BUS. CORP. LAWS § 713(e) N.J. STAT. ANN. § 14A; 6-8(3). (West). Delaware gives the authorization in a separate statutory provision, DEL. CODE tit. 8, § 141(h).)

Such arrangements are, of course, a species of interested directors' contracts. ironically, although fraught with as great potential dangers of abuse as other affiliated contracts, the statutory provisions authorizing them do not contain the circumscriptions imposed on other interested directors' contracts.

Presumably, the compensation must still be reasonable, despite statutory silence on the matter.

Perhaps the directors also have the burden of proof on the fairness of their compensation, as apparently is the common law rule (*see* CARY, *supra* note 17, at 506), despite similar statutory silence.

The wisdom as well as the draftsmanship, of these statutes is dubious, since there would appear to be no good reason for treating such transactions differently from other interested directors' contracts.

In any event, if may be desirable for the statute to add some specific language as to whether or not the ordinary rules as to affiliated directors' contracts will apply to the fixing by the directors of their own compensation.

93. *See* note 85 *supra.* If this optional provision is used, it should be inserted after paragraph (d), as paragraph (e), and the subsequent paragraphs relettered.