FINDING SAFE HARBOR: CLARIFYING THE LIMITED APPLICATION OF SECTION 144

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ABSTRACT

Section 144 of the General Corporation Law of the State of Delaware was adopted for a limited purpose: to rescue certain transactions, those in which the directors and officers of a corporation have an interest, from per se voidability under the common law. That is all. Under its plain language, section 144 plays no part in validating transactions or in ensuring the business judgment rule's application. Over time, however, practitioners and courts have suggested a broader role for section 144, linking the statute to the common-law analysis of interested transactions. This article reviews the history of section 144, the language of the statute, and evidence of its overextension in judicial opinions, closing with a possible statutory revision to make clear the original intent of section 144's drafters.

Ultimately, this article attempts to clarify section 144's limited role and application by distinguishing the analysis under section 144 from the analysis under the courts' common-law fiduciary analysis. Every interested transaction is subject to review under the common law of breach of fiduciary duty. Section 144 merely determines whether the interested transaction will also be subject to the common law of voidability. Conflicts between judicial glosses on section 144 and the text of the statute itself suggest that practitioners should be aware of these principles and recognize that section 144 may provide less protection than they think it does.

I. INTRODUCTION

Section 144[1] was adopted in 1967 as part of the wholesale revision of the General Corporation Law of the State of Delaware (DGCL). By its own terms, section 144 deals with a specific sliver of transactions in which the

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[1]DEL. CODE ANN. tit. 8, § 144 (2006).

directors and officers of a corporation have an interest. Its stated purpose is to rescue those transactions from per se voidability if they qualify for safe-harbor protection under the statute. That is, section 144 does not validate those transactions; it merely prevents them from being invalidated due solely to any director's or officer's interest.

Over time, section 144 has been mentioned in circumstances far outside its intended application. That is, some practitioners and courts have suggested a broader role for section 144—either mentioning section 144 while performing an analysis under the common law or suggesting that compliance with section 144 does more than it actually does. The likely explanation for this unwarranted extension is that section 144 seems somehow linked to the common law because the three tests in section 144 (disinterested director approval, stockholder ratification, and fairness) were derived from the common law and share some features with the common-law tests.[2]

This article tries to clarify the original intent and limited application of section 144 by examining section 144's position in relation to the common-law analysis of interested transactions. We briefly retrace section 144's history and purpose, relying on contemporaneous accounts of the DGCL revision. We then parse the language of section 144 to demonstrate how and when it applies. Finally, we examine evidence of section 144's over-extension in opinions of the Delaware courts.

The basic construct of our thesis is that section 144, by design, has a limited purpose and application. With regard to the subset of interested transactions that it potentially covers, section 144's role can be summed up in a single sentence: it allows the courts to determine whether to analyze an interested transaction exclusively under the common law of breach of fiduciary duty or under both the common law of voidability *and* the common law of breach of fiduciary duty. Compliance with section 144 only removes the specter of voidability from an interested transaction covered by its terms, and it leaves to the common law the determination whether the transaction, now

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[2]*Cf.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 365 (Del. 1993) ("Enacted in 1967, section 144(a) *codified judicially acknowledged principles of corporate governance* to provide a limited safe harbor for corporate boards to prevent director conflicts of interest from voiding corporate action.") (emphasis added), *modified*, 636 A.2d 959 (Del. 1994). Of course, even if section 144 codified the business judgment rule, or some form of it, the statute is self-limiting. That is, it applies only to ensure that no interested-director transaction "shall be void or voidable solely for this reason." DEL. CODE ANN. tit. 8, § 144(a) (2006). Regardless of whether section 144 was born out of the common-law business judgment rule, section 144 does not apply the common-law fiduciary-duty analysis by its own terms. It is also important to note that section 144 was modeled in part on charter and bylaw provisions designed to vary the common-law rules relating to voidability of interested transactions. *See infra* note 21.

protected from being found void solely as a result of the offending interest, is otherwise invalid or leads to liability.

Put differently, if a transaction complies with the section 144 safe harbor, it will not be invalidated solely on the grounds of the offending interest, but will be analyzed under the common law regarding breach of fiduciary duty. Section 144 will then have nothing more to do with the transaction. If, by contrast, the transaction fails to comply with section 144, it will be analyzed under both the common law regarding voidability and the common law regarding breach of fiduciary duty.

The Delaware Supreme Court explicated the original purpose of section 144 in *Fliegler v. Lawrence* back in 1976.[3] The defendants in *Fliegler* attempted to use a stockholder ratification complying with section 144(a)(2) to escape a common-law fairness analysis, but the court denied their attempt.[4] "We do not read the statute as providing the broad immunity for which defendants contend. It merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved."[5] The court set forth in clear words the limited application of section 144: "Nothing in the statute . . . removes the transaction from judicial scrutiny."[6]

The Delaware Court of Chancery did something similar in its 2005 *Benihana* decision.[7] The court found that the "Board's approval of the [challenged] [t]ransaction meets the requirements of [section] 144(a)(1)," noting that the "section merely protects against invalidation of a transaction 'solely' because it is an interested one."[8] The defendants in *Benihana* took the position that, "if they meet the requirements of [section] 144(a)(1), the transaction is beyond the reach of entire fairness"[9]—a common misconception. The court stated "[t]hat is not necessarily correct," reiterating that "[s]atisfying the requirements of [section] 144 only means that the [challenged] [t]ransaction is not void or voidable *solely* because of the conflict of interest."[10] Thus, the court noted, "[E]quitable common law rules requiring the

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[3]361 A.2d 218, 221-22 (Del. 1976).

[4]*Id.*

[5]*Id.* at 222.

[6]*Id.*

[7]Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 174-75 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006).

[8]*Id.* at 185 (citing HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 114 n.24 (Del. Ch. 1999)).

[9]*Id.*

[10]*Id.*

application of the entire fairness standard on grounds other than a director's interest still apply."[11]

The lawyers' attempts to broaden section 144's reach in *Fliegler* and *Benihana* are understandable, and quite within their role as "zealous advocate[s]."[12] Unfortunately, certain statements in opinions of Delaware courts may lead the unwary to believe that, for example, compliance with section 144, standing alone, shields a transaction from entire-fairness review. We believe that the time has come for the Delaware courts to reiterate the limited application of section 144 and to make clear to all what section 144 does and does not accomplish.

II. THE HISTORY AND PURPOSE OF SECTION 144

Before section 144 was enacted, a contract or transaction in which a majority of voting directors or officers had an interest was generally presumed to be voidable.[13] This presumption was based in part on the notion that directors having an interest in a contract or transaction were incapable of

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[11] *Benihana*, 891 A.2d at 185.

[12] DEL. LAWYERS' R. OF PROF'L CONDUCT pmbl. § 8 (2008), *available at* http://courts.delaware.gov/Rules (follow "Delaware Lawyers' Rules of Professional Conduct" hyperlink).

[13] *See* Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652, 655 (Del. 1952) ("The interested character of the directors who voted for the stock option plan makes their action voidable only and thus subject to stockholders' ratification."); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938) ("The resolution of November 15, 1924, whereby Sanitary agreed to pay to Consolidated monthly management fees, adopted by a Board of Directors of which the appellants were a majority, was at the least a voidable transaction. In the first place, the votes of the appellants could not be counted in making up a majority of the Board. In the second place, dealing as they did with another corporation of which they were sole directors and officers, they assumed the burden of showing the entire fairness of the transaction. This burden they signally failed to maintain.") (citations omitted); Lofland v. Cahall, 118 A. 1, 8 (Del. 1922) (relying heavily on the fact that there was no one who acted objectively on behalf of the company when holding a transaction voidable), *aff'g* 114 A. 224 (Del. Ch. 1921). The *Potter* court states:

> That two corporations have a majority or even the whole membership of their boards of directors in common does not necessarily render transactions between them void; but transactions resulting from the agency of officers or directors acting at the same time for both must be deemed presumptively fraudulent, unless expressly authorized or ratified by the stockholders; and certainly, where the circumstances show . . . that the transaction would be of great advantage to one corporation at the expense of the other, especially where, in addition to this, the personal interests of the directors, or any of them, would be enhanced at the expense of the stockholders, the transaction is voidable by the stockholders within a reasonable time after discovery of the fraud.

Potter v. Sanitary Co. of Am., 194 A. 87, 91 (Del. Ch. 1937) (internal quotation marks omitted).

voting on its approval. In its 1948 *Blish*[14] opinion, for example, the Delaware Supreme Court stated the general rule to be that "where the Board meets to consider a proposition in which one of its members is personally interested, the interested Director loses pro hac vice his character as a Director and he cannot be counted for quorum purposes."[15] With no quorum, the board cannot duly authorize a transaction, and the transaction may be declared void.[16]

Similarly, in its 1952 *Kerbs* opinion,[17] the Delaware Supreme Court found that, because a profit-sharing plan was approved by only three disinterested directors on an eight-person board, "the plan failed to receive a legal majority of the directors' votes in its favor."[18] In this regard, the court stated: "It is the general rule that the votes of interested directors of a corporation will not be counted in determining whether proposed action has received the affirmative vote of a majority of the Board of Directors."[19] Thus, the question was one of due authorization and, under the common law, transactions that were not properly authorized could be declared void.[20]

It was to this line of cases—and to the draconian result of declaring void an otherwise fair transaction due solely to the fact that it was approved by interested directors—that Professor Folk pointed when describing the ameliorative effect of section 144.[21] Indeed, Professor Folk evidently believed

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[14]Blish v. Thompson Automatic Arms Corp., 64 A.2d 581 (Del. 1948).

[15]*Id.* at 602-03 ("Therefore, if during the course of a meeting a matter arises involving a Director's personal interest, a new count of those present should be had to determine whether or not a quorum exists without the interested Director.").

[16]*See, e.g.*, Belle Isle Corp. v. MacBean, 49 A.2d 5, 9 (Del. Ch.), *aff'd sub nom.* Belle Isle Corp. v. Corcoran, 49 A.2d 1 (Del. 1946).

[17]Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652 (Del. 1952).

[18]*Id.* at 658. After section 144's adoption, the court in *Marciano v. Nakash*, when discussing the *Kerbs* holding stated, "The [*Kerbs*] court concluded that the profit sharing plan was voidable based on the common law rule that the vote of an interested director will not be counted in determining whether the challenged action received the affirmative vote of a majority of the board of directors." Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987) (citing *Kerbs*, 90 A.2d at 658); Bovay v. H. M. Byllesby & Co., 38 A.2d 808 (Del. 1944).

[19]*Kerbs*, 90 A.2d at 658.

[20]*Cf., e.g.*, Hannigan v. Italo Petroleum Corp. of Am., 47 A.2d 169, 171-73 (Del. 1945).

[21]ERNEST L. FOLK, III, REVIEW OF THE DELAWARE GENERAL CORPORATION LAW 67 (1967). As Professor Folk noted: "The need for loosening the traditional common law restrictions on interested director transactions has been recognized in decisions validating by-laws varying the common law rules. These more flexible procedures clearly 'fill a legitimate need in the efficient functioning of the corporate enterprise.'" *Id.* (citations omitted). Section 144 was drafted partly to replace these bylaw (and charter) provisions. *Id.* ("A Delaware statute [in the form Professor Folk proposed] would in part codify decisional law, [and] in part replace by-law and charter provisions . . . ."). *Id.* Several examples of such pre-1967 bylaw or charter provisions appear in the case law. *See, e.g.*, Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 117 n.3 (Del. 1952); Lipkin v. Jacoby, 202 A.2d 572, 573-74 (Del. Ch. 1964); Gottlieb v. McKee, 107 A.2d 240, 242-43 (Del. Ch. 1954); Kaufman v. Shoenberg, 91 A.2d 786, 791 (Del. Ch. 1952); Martin Found., Inc. v. N. Am. Rayon

that "the certainty of a clear statutory rule should deter many unwarranted challenges to bona fide interested director transactions."[22] The purpose of section 144 was clear from the outset: "Section 144(a) is negative in effect. A contract or transaction covered by the statute is not void or voidable *solely* because those approving a transaction have a conflict of interest .... *The validating effect does not go beyond removing the spectre of voidability* ...."[23]

In their 1967 article discussing the revisions to the DGCL, S. Samuel Arsht and Walter K. Stapleton[24]—both of whom were involved in the DGCL drafting process—described the tight but distinct relationship between section 144 and the common law.[25] Arsht and Stapleton first reiterated the limited purpose of section 144, stating that the statute "specifies three situations in which the fact that an interested officer or director participated in authorizing the transaction will not affect the transaction's validity."[26] Noting that section 144 was merely a safe harbor, designed to remove the specter of *invalidity* of an interested transaction, they made clear that it did not play any role in ensuring the *validity* of such a transaction: "the effect of the statute is not necessarily to validate the transaction but simply to put it on the same footing as any other corporate transaction."[27] That is, once section 144 performs its function, the transaction is in the realm of the common law regarding breach of fiduciary duty, and the courts will apply the common law to determine the effect of that transaction and any remedies stemming from it (among others, liability or an injunction).[28]

Corp., 68 A.2d 313, 314 (Del. Ch. 1949).

[22]FOLK, *supra* note 21, at 67.

[23]ERNEST L. FOLK, III, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 82 (1972) (second emphasis added).

[24]The Honorable Walter K. Stapleton is now a senior judge on the U.S. Court of Appeals for the Third Circuit.

[25]S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75 (1967).

[26]*Id.* at 81.

[27]*Id.* at 82.

[28]What Arsht and Stapleton left unsaid, however, is the effect of subsection (a)(3)—the fairness inquiry. The common law and section 144 (each with a fairness standard but operating in their own spheres) seem to overlap where an interested transaction's fairness would both place the transaction within the section 144 safe harbor and allow the directors to overcome stockholder challenge to the validity of the transaction under a common-law entire-fairness inquiry. As we set forth below, the fairness determination, while virtually identical for both analyses, bears different consequences depending on whether the analysis is statutory under section 144(a)(3) or common law under entire fairness.

III. THE APPLICATION OF SECTION 144

The plain text of section 144 demonstrates its limited role in determining which common-law regime applies to interested transactions. Currently, section 144 provides:

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
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> > (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
> >
> > (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
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> > (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.
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> (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board

of directors or of a committee which authorizes the contract or transaction.[29]

Thus, section 144 does not apply to all potentially "interested" officer or director transactions—merely the limited subset of transactions identified in section 144(a)'s first paragraph (all such contracts or transactions are described in this article as "covered transactions," and the interest of the officer or director identified in the first paragraph of section 144(a) is sometimes referred to as the "offending interest"). The first leg of that paragraph addresses contracts or transactions between the corporation and one or more of its directors or officers. The second leg covers contracts or transactions between the corporation, on the one hand, and another enterprise in which the corporation's officers or directors are officers or directors or have a financial interest, on the other hand.

A "classic" self-dealing transaction between a corporation and one or more of its officers or directors would fall within the ambit of section 144—such as a company's decision to sell some of its assets to the chief executive officer (CEO) or a board's decision to award themselves stock options. Other transactions that might, at first blush, appear to be covered transactions may, upon closer scrutiny, be outside the scope of section 144. These kinds of transactions generally involve the "second leg" of section 144, particularly the portion addressing the "financial interest" of a director or officer in the corporation's counterparty. For example, a transaction between the corporation's CEO and the corporation's wholly owned subsidiary, in which the CEO leases to the subsidiary office space in a building she owns, would not fall under section 144, so long as the CEO is not an officer or director of, and has no financial interest in, the subsidiary.

In addition, if an officer's or director's self-interest arises solely as an anticipated result of a transaction, that transaction may not necessarily be a covered transaction under section 144. For example, where a director approves a merger between the corporation and a third-party bidder with the hope (which may or may not be reasonable) that the third-party bidder will name the director as the CEO of the surviving corporation (with commensurate compensation), section 144 would not apply unless the director were found to have a "financial interest" in the acquiring company.[30]

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[29]DEL. CODE ANN. tit. 8, § 144 (2006).

[30]*Cf.* Litle v. Waters, No. 12,155, 1992 Del. Ch. LEXIS 25, at *12-14 (Del. Ch. Feb. 10, 1992), *reprinted in* 18 DEL. J. CORP. L. 315, 323-24 (1993) (holding that a board's refusal to pay cash dividends was subject to entire-fairness review where the board was motivated to refrain from action based on personal financial interests to the detriment of plaintiff). By contrast, if the

Once the determination has been made that a contract or transaction is a covered transaction, the party seeking the benefit of the section 144 safe harbor must demonstrate compliance with one of section 144(a)'s three provisions. We review each of these provisions in detail.

A. *Section 144(a)(1)—Approval of Disinterested Directors*

A covered transaction may qualify for the section 144 safe harbor if it is approved by a "majority of the disinterested directors," acting in good faith and on an informed basis.[31] Thus, any determination whether a covered transaction qualifies for safe-harbor protection under section 144(a)(1) involves inquiries into the following three factors: (1) whether the approving directors were interested, (2) whether the disinterested directors were acting in good faith, and (3) whether the conflict or relationship of the interested directors or officers was fully disclosed to the disinterested directors.

1. Interest

A director will generally be found to be "interested"—and thus not a "disinterested director" under section 144(a)(1)—if he or she stands on both sides of the transaction or has a personal stake in the transaction that is not shared by the stockholders generally.[32] Financial interest, motives of entrenchment, fraud on the corporation or board, abdication of directorial duty, or sale of a director's vote all tend to show interestedness.[33] A director's significant stock ownership interest, however, does not create a disabling interest "unless the director somehow contrives to favor his own interests over those of other stockholders."[34] As the Delaware Supreme Court noted in *Cede & Co. v. Technicolor, Inc.*, "[A] director who receives a substantial benefit

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corporation enters into a merger agreement with a third party, and the agreement requires the corporation's inside directors to "roll over" their shares of the corporation into the purchaser in connection with a reverse triangular merger (i.e., immediately before the merger is effective, the inside directors surrender their shares of the corporation's stock in exchange for shares of the entity that, after the merger is effective, owns and controls the surviving entity), that arrangement could be a covered transaction, since the merger agreement would be a contract between the corporation, on the one hand, and another enterprise (i.e., the buyer) in which the directors of the corporation, by virtue of their agreement to roll over their shares of the corporation's stock into the buyer, have a "financial interest," on the other hand.

[31]DEL. CODE ANN. tit. 8, § 144(a)(1) (2006).

[32]*See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 & n.13 (Del. 2000).

[33]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993), *modified*, 638 A.2d 956 (Del. 1994); Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 & n.13 (Del. 2000).

[34]Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991).

from supporting a transaction cannot be objectively viewed as disinterested or independent."[35] In considering directorial interest, the courts have applied a different standard to transactions involving "classic self-dealing" (i.e., those in which the director stands on both sides of the transaction) than to those in which the director's alleged interest arises by virtue of some special benefit the director receives as a result of the transaction. In the former case, the section 144(a)(1) analysis is simple—the director is not disinterested.[36] In the latter case, however, the analysis of the alleged interest is far more nuanced.[37] In *Cinerama, Inc. v. Technicolor, Inc.*,[38] the Delaware Supreme Court, in the course of discussing section 144 (which it ultimately found was not applicable to the contested actions), suggested that a "subjective materiality" standard

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[35]*Cede & Co.*, 634 A.2d at 362.

[36]*See* Beneville v. York, 769 A.2d 80, 84 (Del. Ch. 2000).

> Although the defendants do not concede York's interest, their argument that he is disinterested is at odds with the plain language of [section] 144 and with settled case law. The Marketing Agreement was between CARNET, a company that York served as a CEO and director, and SYNERGY, a "corporation . . . in which [York, was a] director[] . . . [and] ha[d] a financial interest . . ." Thus York had a classic self-dealing interest in the Marketing Agreement. This suffices to render him interested and disabled from impartially considering a demand.

Id. (alterations and omissions in original) (footnote omitted). While there are arguments for importing a materiality standard into section 144, the plain text of the statute does not contain one. *See* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 887 & n.20 (Del. Ch. 1999).

[37]Guttman v. Huang, 823 A.2d 492, 502 & n.19 (Del. Ch. 2003).

> I reject this attempt to extend concepts designed to fit classic self-dealing transactions into another context that is quite different. In a typical derivative suit involving a transaction between a director and her corporation, that director is interested because she is on the other side of the transaction from the corporation and faces liability if the entire fairness standard applies, regardless of her subjective good faith, so long as she cannot prove that the transaction was fair to the corporation. In those circumstances, the director has always been considered "interested"[, *see, e.g.*, DEL. CODE ANN. tit. 8, § 144(a),] and it displays common sense for the law to consider that director unable to consider a demand to set aside the transaction between the corporation and herself.
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> In this case, the plaintiffs attack a myriad of stock sales, not between the defendant-directors and NVIDIA, but between the defendant-directors and marketplace buyers. As a matter of course, corporate insiders sell company stock and such sales, in themselves, are not quite as suspect as a self-dealing transaction in which the buyer and seller can be viewed as sitting at both sides of the negotiating table. Although insider sales are (rightly) policed by powerful forces—including the criminal laws—to prevent insiders from unfairly defrauding outsiders by trading on non-public information, it is unwise to formulate a common law rule that makes a director "interested" whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information.

Id. (footnote omitted).

[38]663 A.2d 1156 (Del. 1995).

would apply to the determination of director interest—i.e., the director "had 'some special characteristic that [made] him . . . especially susceptible to or immune to opportunities for self-enrichment or . . . evidence that [he] in fact behaved differently in this instance than one would expect a reasonable person in the same or similar circumstances to act.'"[39] The Delaware Court of Chancery, however, subsequently explained that *Cinerama*'s materiality standard does not apply to an analysis of director interest under section 144(a)(1), although the court did note that "[t]here is analytic force to the argument that [section] 144 should, like many statutes, be read as incorporating a 'materiality' element."[40]

2. Good Faith

The party seeking protection under section 144(a)(1) must demonstrate that the disinterested directors who approved a covered transaction acted "in good faith." Although the concept of good faith has seldom been addressed in the context of section 144(a)(1), the Delaware Court of Chancery's 2005 *Disney* opinion suggested that the disinterested directors would satisfy the "good-faith" component of section 144(a)(1) if, when considering the transaction, they were "mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies."[41] "On the other hand," the court noted,

> where the evidence shows that a majority of the independent directors were aware of the conflict and all material facts, . . . but acted to reward a colleague rather than for the benefit of the shareholders, the Court will find that the directors failed to act in good faith and, thus, that the transaction is voidable.[42]

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[39] *Id.* at 1167 (first alteration and omissions in original). For example, a payment of $25,000 might not affect the judgment of Bill Gates or Warren Buffett, though it may affect the judgment of the typical American wage-earner.

[40] *Huizenga*, 751 A.2d at 887 n.20. The court suggested that, even if section 144(a)(1) were construed to include a test for "materiality," such a test should not be confused with *Cinerama*'s "materiality" test to determine whether directors are interested in a "transaction to which [section] 144 does not apply." *Id.*

[41] *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 756 n.464 (Del. Ch. 2005).

[42] *Id.*

Thus, the *Disney* court construed the "good-faith" component of section 144(a)(1) to require an examination of the subjective motivations underlying the disinterested directors' approval of the transaction.[43]

3. Informed Decision

Finally, section 144(a)(1) requires that the decision of the disinterested directors, with regard to the covered transaction, be made on an informed basis. In *Kosseff v. Ciocia*,[44] the court of chancery described this as requiring that each disinterested director "be informed of the interested nature of the transaction [and] that each be informed of the facts material to the interests of the corporation regarding the transaction (that is, that each employ due care)."[45] Thus, the determination as to whether the directors acted on an informed basis for purposes of section 144(a)(1) requires demonstrating not only that the disinterested directors were advised of the conflict, but also that the directors exercised their fiduciary duty of due care.[46] In *Smith v. Van Gorkom*,[47] the Delaware Supreme Court explained this as the duty "to act in an informed and deliberate manner in determining whether to approve [a transaction] before submitting [it] to the stockholders."[48] The appropriate test under section 144(a)(1) is, therefore, whether the disinterested directors were adequately apprised of the material facts regarding the nature of the potentially

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[43]The Delaware Supreme Court's opinion in *Disney* elaborated on the concept of good faith, generally accepting the court of chancery's definition of "bad faith"—"intentional dereliction of duty, a conscious disregard for one's responsibilities"—as legally correct. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006).

[44]No. 188-N, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006).

[45]*Id.* at *7.

[46]*See also Disney*, 907 A.2d at 756 n.464.

> Under [section] 144(a), a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: 1) the approving directors were aware of the conflict inherent in the transaction; 2) the approving directors were aware of all facts material to the transaction; and 3) the approving directors acted in good faith. In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith).

Id.

[47]488 A.2d 858 (Del. 1985).

[48]*Id.* at 873.

disabling conflict *and* availed themselves of all reasonably available material information concerning the contract or transaction at issue.[49]

B. *Section 144(a)(2)—Approval of Stockholders*

A covered transaction may qualify for the section 144 safe harbor if it is approved by a majority of the stockholders entitled to vote on it, acting in good faith and on an informed basis. Notably, section 144(a)(2) does not, by its terms, require that the stockholder vote be that of the disinterested stockholders,[50] though some cases have described section 144(a)(2) as requiring just that.[51] For example, in *Solomon v. Armstrong*,[52] the Delaware Court of Chancery stated that, in the section 144(a)(2) context, "the [*Disney*] Court reaffirmed the settled proposition that shareholder ratification by a majority of the disinterested shareholders acts as a safe harbor in situations where directors' potentially conflicting self-interests are at issue."[53]

Although these cases do not describe the statutory basis for imposing the "disinterested stockholder approval" requirement, one may posit that the cases imposing that requirement were actually applying section 144(a)(2)'s "good-faith" requirement. That is, where a court references the vote of a "disinterested majority" approving a transaction under section 144(a)(2), the court may have presumed that the interested director or officer, in his or her capacity as a stockholder, was unable in good faith to consider the contract or transaction due to his or her conflicted interest. This interpretation is consistent with the contemporaneous gloss on the stockholder-approval requirement in section 144(a)(2), insofar as interested stockholders' votes will not be invalid per se, but they may be invalidated by a showing of bad faith.

The Folk Report, for example, states, "It is doubtful whether a disinterested shareholder requirement, would be worth the administrative difficulties it would entail. Once again, the 'good faith' requirement should

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[49]*See id.* at 872.

[50]*See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005) ("By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve.").

[51]*See In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1205 n.8 (Del. Ch. 1995) ("Under [section] 144(a)(1), a ratifying disinterested director vote has the same procedural effect as a ratifying disinterested shareholder vote under [section] 144(a)(2)."); *see also* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (stating that "approval by . . . disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste").

[52]747 A.2d 1098 (Del. Ch. 1999).

[53]*Id.* at 1115.

sufficiently guard against abuse."[54] Additionally, Professor Folk's 1972 analysis of the DGCL stated:

> One area of doubt grows out of the fact that some prior decisions appeared to require [stockholder] ratification to be voted by "disinterested" or "independent" stockholders. Such cases apparently regarded stockholders as "independent" if they "were not, on the record, controlled by the directors." Another case discounted ratification because of "the possible indifference, or sympathy with the directors, of a majority of the stockholders," and it was accordingly concluded that ratification of a stock option plan could not furnish the necessary requisite of "good faith exercise of business judgment by directors in dealing with corporate assets." . . . Despite this uncertainty and confusion, [section] 144(a)(2) is quite clear: stockholder ratification conforming to the disclosure and good faith requirements of the statute should effectively uphold an interested-director transaction. The statute does not require that the ratifying stockholders be "disinterested" or "independent," nor is there warrant for the courts to read such a requirement into the statute.[55]

Thus, so long as the board satisfies its duty of disclosure with respect to the offending interest at hand, the requisite vote of all stockholders—interested and disinterested alike,[56] subject to the "good faith" requirement—will grant a covered transaction the safe-harbor benefits of section 144. Few cases squarely address what constitutes an "informed" stockholder vote under section 144(a)(2). But when a board of directors submits any transaction to the stockholders for approval, it must comply with its fiduciary duty of disclosure and, to the extent the board is found to have so complied, the stockholder vote will be found to have been taken on an informed basis, as required under section 144(a)(2).[57]

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[54]FOLK, *supra* note 21, at 71; *see also* Arsht & Stapleton, *supra* note 25, at 82 ("Limiting the stockholder vote to disinterested stockholders was considered administratively unfeasible and seems unnecessary where the effect of the statute is not necessarily to validate the transaction but simply to put it on the same footing as any other corporate transaction.").

[55]FOLK, *supra* note 23, at 85-86 (footnotes omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 900 n.80 (Del. Ch. 1999) (discussing the historical common-law rules for ratification by interested stockholders).

[56]*But see* discussion *infra* note 102.

[57]Nebenzahl v. Miller, No. 13,206, 1993 Del. Ch. LEXIS 249, at *11 (Del. Ch. Nov. 8,

C. *Section 144(a)(3)—Fairness*

A covered transaction may also receive section 144's safe-harbor protection if it is fair to the corporation as of the time it is authorized, approved, or ratified.[58] Section 144(a)(3) therefore operates as a fail-safe mechanism, implicated only where the contract or transaction at issue was not properly approved by the disinterested directors under section 144(a)(1) or the stockholders under section 144(a)(2), or was otherwise incapable of approval under those subsections. Because section 144 operates in the disjunctive, a covered transaction need only comply with one of the three tests. If a covered transaction is approved in compliance with section 144(a)(1) or 144(a)(2), a court will not reach the question of entire fairness under section 144(a)(3).[59] As the Delaware Court of Chancery noted in *Nebenzahl v. Miller*,[60] "It certainly seems unlikely the General Assembly intended the same Director Defendants, who have made full disclosure and whose contemplated transaction has received the blessings of a majority of disinterested directors and a majority of shareholders, to defend against a claim the transaction was nonetheless unfair."[61] The plain text of the statute reveals its disjunctive

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1993), *reprinted in* 19 DEL. J. CORP. L. 834, 841-42 (1994) ("Section 144(a)(2) would protect the merger in the event of the required shareholder approval. It has not been alleged that the Proxy Statement failed to disclose the material facts of the merger, including the information about the contested 'special benefits' package."). Although a more detailed review of the duty of disclosure is outside the scope of this article, it may be generally noted that, under Delaware law, in disclosing matters relating to a significant transaction to a corporation's stockholders, the board must fully disclose all facts within its control that would be material to the stockholders' decision to approve or reject the transaction. *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1276-77 (Del. 1994); Clements v. Rogers, 790 A.2d 1222, 1236 (Del. Ch. 2001) ("The Delaware fiduciary duty of disclosure is not a full-blown disclosure regime like the one that exists under federal law; it is an instrumental duty of fiduciaries that serves the ultimate goal of informed stockholder decision making."). The information disclosed must be truthful and accurate. Zirn v. VLI Corp., 681 A.2d 1050, 1058 (Del. 1996) ("The goal of disclosure is . . . to provide a balanced and truthful account of those matters which are discussed in a corporation's disclosure materials."). *See generally* Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1112-15 (1996) (discussing the fiduciary duty of disclosure in the context of ratification). Where a board submits a covered transaction to the stockholders for ratification under section 144(a)(2), this duty of disclosure would extend not only to the contract or transaction itself, but also to the facts and circumstances surrounding the offending interest.

[58]Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 174 (Del. Ch. 2005) ("Even if the requirements of [section] 144(a)(1) were not met, Defendants still could avoid having the interested [covered transaction] rendered void or voidable by proving that it was 'fair as to the corporation' under [section] 144(a)(3)."), *aff'd*, 906 A.2d 114 (Del. 2006).

[59]It may, of course, scrutinize the transaction for entire fairness under the common law of breach of fiduciary duty.

[60]No. 13,206, 1996 Del. Ch. LEXIS 113 (Del. Ch. Aug. 26, 1996) (revised Aug 27, 1996), *reprinted in* 22 DEL. J. CORP. L. 779 (1997).

[61]*Id.* at *12-13, *reprinted in* 22 DEL. J. CORP. L. at 790-91.

nature: "If the General Assembly had so intended, Section 144(a)(3) would have been preceded by 'and' not 'or.'"[62]

The Delaware courts have construed the section 144(a)(3) requirement to mean that the corporation must demonstrate the entire fairness of the transaction.[63] In *Marciano v. Nakash*,[64] the Delaware Supreme Court noted that "a non-disclosing director seeking to remove the cloud of interestedness would appear to have the same burden under section 144(a)(3), as under prior case law, of proving the intrinsic fairness of a questioned transaction which had been approved or ratified by the directors or shareholders."[65] Thus, any covered transaction that fails to meet the requirements of section 144(a)(1) or 144(a)(2) will nonetheless fall within the safe harbor if those defending the covered transaction can demonstrate that it was arrived at through fair dealing and resulted in a fair price.[66]

IV. THE OVEREXTENSION OF SECTION 144

A. *Confusion Regarding Section 144's Proper Role*

Although some outliers have interpreted section 144 differently from the original intention for the statute, the Delaware courts have generally interpreted section 144 in the way it was intended. One case recognizing the issue is *In re Cox Communications, Inc. Shareholders Litigation*.[67] *Cox* explicitly dealt with an objection to a request for attorneys' fees, but the complaint in the underlying action challenged a going-private merger by the

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[62] *Id.* at *13, *reprinted in* 22 DEL. J. CORP. L. at 791 ("A requirement for a court to find 'the transaction fair to the corporation' seems to be relevant only where full disclosure has not been made to either a majority of disinterested directors or a majority of shareholders before obtaining their approval of the transaction."); *see also* FOLK, *supra* note 21, at 71-72 ("It is again stressed that the tests are alternative, any one of which validates the transaction, and the draft has made this clear to avoid any argument that, for example, the stricter 'fairness' test is read into the disinterested director or shareholder ratification tests.").

[63] *See, e.g.*, HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 114 (Del. Ch. 1999) (stating that "under [section] 144(a)(3), a 'non-disclosing interested director can remove the taint of interestedness by proving the entire fairness of the challenged transaction'") (quoting Cede & Co. v. Technicolor Inc., 634 A.2d 345, 366 n.34 (Del. 1993)).

[64] 535 A.2d 400 (Del. 1987).

[65] *Id.* at 405 n.3; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) ("The entire fairness test is codified and has been construed by this Court many times.") (citing DEL. CODE ANN. tit. 8, § 144(a)(3)).

[66] *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (defining entire fairness to involve scrutiny of fair price and fair dealing).

[67] 879 A.2d 604 (Del. Ch. 2005).

Cox family, which owned a controlling stake in Cox Communications.[68] The court briefly revisited the pertinent history of section 144's purpose, noting that Delaware corporate law "had long accepted the notion that it was unwise to ban interested transactions altogether"[69] and that the 1967 DGCL "addressed interested transactions by crafting a legal incentive system for vesting decision-making authority over such transactions in those who were not burdened with a conflict."[70] The court laid out section 144's methods for curing an interested transaction (majority of disinterested directors or stockholder ratification) and started to describe section 144 almost as a codification of the business judgment rule: "By those methods, respect for the business judgment of the board can be maintained with integrity, because the law has taken into account the conflict and required that the business judgment be either proposed by the disinterested directors or ratified by the stockholders it affects."[71]

The court paused, however, and reiterated the original intent of section 144. "Lest I be chastened by learned commentators on our law," Vice Chancellor Strine wrote, "I must hasten to add that [section] 144 has been interpreted as dealing solely with the problem of per se invalidity; that is, as addressing only the common law principle that interested transactions were entirely invalid and providing a road map for transactional planners to avoid that fate."[72] The Vice Chancellor went on to note that the "different question of when an interested transaction might give rise to a claim for breach of fiduciary duty—i.e., to a claim in equity—was left to the common law of corporations to answer. Mere compliance with [section] 144 did not necessarily suffice."[73] Nevertheless, the *Cox* court could not ignore the similarities between section 144 and the common law's business judgment rule: "[T]he common law of corporations also was centered on the idea of the business judgment rule and its approach to interested transactions looked much like that codified in [section] 144."[74]

The court in *HMG/Courtland Properties, Inc. v. Gray*[75] made the link between section 144 and the common law even clearer—and, again, correctly. The case involved real estate transactions in which the corporation sold

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[68] *Id.* at 605.
[69] *Id.* at 614.
[70] *Id.*
[71] *Cox*, 879 A.2d at 614.
[72] *Id.* at 614-15.
[73] *Id.* at 615.
[74] *Id.* (noting, however, the different standards of stockholder ratification used in section 144 and the common law).
[75] 749 A.2d 94 (Del. Ch. 1999).

property to two of its directors (and in which one of those directors took the lead in negotiating the sales for the corporation without disclosing his interest in the transactions).[76] The court noted that, although noncompliance with section 144's "disclosure requirement by definition triggers fairness review rather than business judgment rule review, the satisfaction of [sections] 144(a)(1) or (a)(2) alone does not always have the opposite effect of invoking business judgment rule review that one might presume would flow from a literal application of the statute's terms."[77]

That is, the court recognized that there was no necessary relationship between section 144 and the choice between entire fairness or the business judgment rule. While noncompliance with section 144(a)(1) or (a)(2) also happens to be the kind of action that deprives a board's approval of a covered transaction of the presumptions of the business judgment rule, section 144 does not play any role in determining which standard of review applies. As the court noted, "[S]atisfaction of [sections] 144(a)(1) or (a)(2) simply protects against invalidation of the transaction 'solely' because it is an interested one. As such, [section] 144 is best seen as establishing a floor for board conduct but not a ceiling."[78] As this article aims to make clear, section 144 is also the starting point, or "floor," for a court's analysis of a covered transaction: if section 144 is complied with, the floor starts in the common law of breach of fiduciary duty; if section 144 is not complied with, the floor starts in the common law of voidability.

B. *Why Section 144 is Overextended*

It is quite easy to see why courts and practitioners might refer to section 144 as sort of a shorthand even when discussing an analysis reserved to the common law: section 144's three factors are also used in the common-law analysis. That is, (1) approval by disinterested directors, (2) stockholder ratification, and (3) fairness of the transaction, are involved in both the section 144 safe harbor and the common law's transactional analysis. Section 144 and its three factors, therefore, easily slip into discussion of a common-law analysis, even though the two analyses are separate, with different specific factors and different purposes.[79] Whether this overextension is due primarily

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[76] *Id.* at 96.

[77] *Id.* at 114 n.24.

[78] *HMG/Courtland Properties*, 749 A.2d at 114 n.24 (citation omitted).

[79] It cannot be denied, however, that compliance with section 144 is a solid first step toward a transaction that also merits the presumption of the business judgment rule (or at least a shift in the burden of demonstrating entire fairness). *See* FOLK, *supra* note 21, at 74 ("Since the draft statute gives directors and officers a privilege of dealing with their corporation, they are unlikely to

to overreaching by practitioners, harmless inattention, or slipshod shorthand is not for this article; we merely point out that some language in the body of Delaware case law seems to conflate the two analyses in a manner that diverges from the original intent of section 144.

1. Director Approval and Stockholder Ratification

The best demonstration of the separateness of the section 144 and common-law analyses is that, although they use nominally similar factors (disinterested director approval and stockholder ratification), the factors in practice are different.

As noted above, section 144(a)(1) provides that a covered transaction will not be void or voidable solely as a result of the offending interest if it is approved by an informed "majority of the disinterested directors, even though the disinterested directors be less than a quorum."[80] Under the section 144 statutory analysis, so long as there is one informed, disinterested director on the board, and so long as he or she approves the transaction in good faith, the transaction will not be presumptively voidable due to the offending interest. In other words, a nine-member board with a single disinterested director may approve a covered transaction and reap the benefits of the section 144 safe harbor.

Under the common law, however, the factor is somewhat different; approval must be by a disinterested majority of the entire board. That is, a plaintiff may rebut the presumption of the business judgment rule by showing that "a majority of the individual directors were interested or beholden."[81] In the common-law analysis, therefore, a transaction approved by the nine-member board discussed above (with the single disinterested director) will be subject to the entire-fairness standard.[82] The standards are phrased similarly

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be held liable if the transactions are not voidable."). Of course, section 144 and the common-law analysis are two separate hurdles. Although the section 144 hurdle is often lower than the common-law hurdle, in certain cases (such as the fairness analysis under section 144(a)(3)), the two hurdles are of equal height.

[80]DEL. CODE ANN. tit. 8, § 144(a)(1) (2006).

[81]Gantler v. Stephens, No. 2392-VCP, 2008 Del. Ch. LEXIS 20, at *27 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 540 (2008); *see also* Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003) ("The rubric that plaintiff invokes is correct as a general matter—namely that when the majority of a board of directors is the ultimate decisionmaker and a majority of the board is interested in the transaction the presumption of the business judgment rule is rebutted."); Brehm v. Eisner, 746 A.2d 244, 257 (Del. 2000) ("In this case, the issues of disinterestedness and independence involved in the first prong of *Aronson* are whether a majority of the New Board, which presumably was in office when plaintiffs filed this action, was disinterested and independent.").

[82]Interestingly, if a covered transaction is one that may be approved by a committee of the board under section 141(c) of the DGCL, the committee (if composed of a majority of disinterested

for the statutory and common-law analyses, but they are in fact quite different.[83]

Likewise, section 144(a)(2) provides that a covered transaction will not be void or voidable solely by virtue of the offending interest if the transaction is approved by an informed, good-faith "vote of the shareholders."[84] Under section 144, therefore, the interested directors' own votes—in their roles as stockholders—can be counted to ensure that the covered transaction falls within the section 144 safe harbor, so long as they vote for the transaction in good faith. In a corporation in which the interested directors own fifty-five percent of the shares, they can theoretically reach the section 144 safe harbor if they approve the transaction, even if the other forty-five percent of the stockholders vote against the transaction.

Under the common law, again, a slightly different standard for ratification is used.[85] Common-law ratification of an interested transaction may be effectual "only if a majority of the *disinterested* shares outstanding were cast in favor of the transaction."[86] In the example given above, the transaction likely would not be ratified unless a majority of the forty-five percent of the outstanding shares held by the disinterested stockholders were cast in favor of ratifying the transaction.[87]

Though section 144 and its two approval factors are often used in shorthand to describe an analysis under the common law, this is a slipshod shorthand. The figure below sets forth a simplified view of the differences in

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directors) may approve the covered transaction, and that transaction would likely be entitled to the presumption of the business judgment rule as well as satisfy section 144(a)(1).

[83]Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a merger transaction that, although approved in compliance with section 144(a)(1) because its terms were approved by a special committee, nonetheless might have been reviewed for entire fairness because a majority of the board might have been interested).

[84]DEL. CODE ANN. tit. 8, § 144(a) (2006).

[85]*See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005).

> By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve. The common law, by contrast, only gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.

Id. (footnotes omitted).

[86]*In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 Del. Ch. LEXIS 158, at *55 (Del. Ch. Aug. 18, 2006), *reprinted in* 32 DEL. J. CORP. L. 654, 677 (2007) (emphasis added); *see also Gantler*, 2008 Del. Ch. LEXIS 20, at *60, *reprinted in* 33 DEL. J. CORP. L. at 554 (reiterating the requirement that a majority of the disinterested shares vote in favor of the covered transaction).

[87]*See generally* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (denying an attempt to use the ratification standards in section 144(a)(2) to cleanse a transaction in a common-law analysis).

these two factors depending on whether the factors are implicated in the statutory analysis or the common-law analysis.[88]

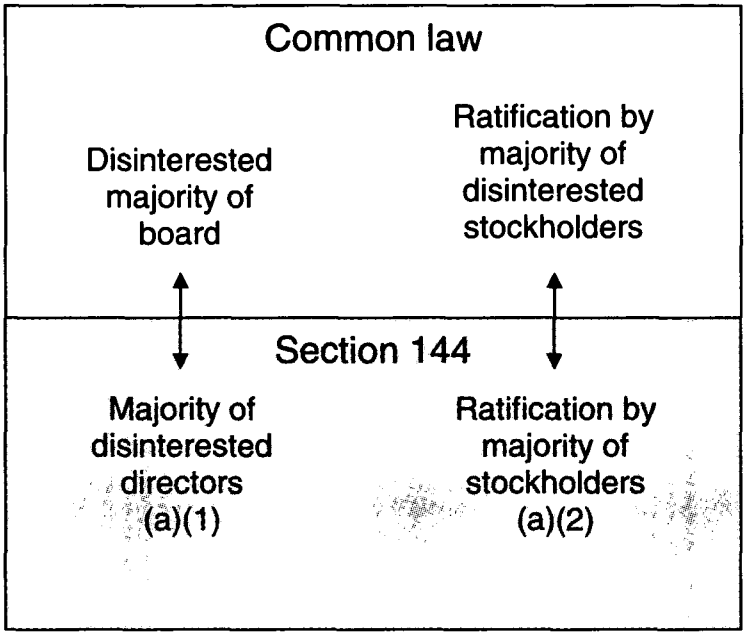

Fig 1. Distinction Between Common Law and Section 144

2. Fairness

Section 144 and the common law overlap even more when it comes to fairness—the factor set forth in section 144(a)(3). Confusion between section 144's fairness test and the common law's fairness test is undeniable, though the confusion may be mitigated by an observation that the two tests are virtually identical. As indicated above, the Delaware Supreme Court has stated that a party seeking to demonstrate compliance with section 144(a)(3) and a party seeking to demonstrate the entire fairness of a transaction have the same burden.[89]

While the fairness inquiry under section 144(a)(3) and the common-law entire-fairness test are virtually the same, their application is different. The purpose of the statutory inquiry is to determine whether a covered transaction

[88] *But see* discussion *infra* note 102.
[89] Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

is presumptively void or voidable as a result of the offending interest; the purpose of the common-law inquiry is typically to determine whether a transaction may be enjoined or may lead to liability.[90] The commonality of the fairness inquiry in each context may cause confusion; nevertheless, the realm of its application should always be clear. Moreover, given the relative paucity of case law applying section 144(a)(3) in a statutory fairness analysis, a simple rule of thumb is that most fairness inquiries are performed under the common law's analysis.

For the most recent example, the Delaware Court of Chancery's 2007 *Valeant* opinion—though it did not cite to section 144(a)(3)—performed a dual section 144/common-law review under entire fairness.[91] The plaintiff in *Valeant* sought damages from a corporation's director and officer for breach of the duty of loyalty related to a self-dealing transaction.[92] In its analysis, the court considered section 144 and determined that entire fairness was the appropriate standard of review because the transaction had not been approved under section 144(a)(1) or ratified under section 144(a)(2).[93] The court engaged in an in-depth analysis of entire fairness and ultimately found the price and process unfair.[94] The court therefore deemed the transaction voidable and found the defendant liable for breach of fiduciary duty.[95]

With respect to section 144, *Valeant*'s multi-step analysis may not have been clear, particularly because those steps seemed to occur all at once. But what actually happened is this: because neither (a)(1) nor (a)(2) had been complied with, the court had to undertake a section 144(a)(3) analysis to determine whether the transaction would be voidable solely for being an interested-director transaction. A section 144(a)(3) analysis involves scrutiny under the entire-fairness standard.[96] The court engaged in the entire-fairness analysis and found the transaction unfair.[97] The section 144 safe harbor therefore did not apply, and the common law of voidability did. The court accordingly deemed the transaction voidable.[98]

The court also applied the common-law rules for liability for breach of fiduciary duty. The test for entire fairness had already been performed, and the transaction failed the test, so the court could impose liability under the

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[90] *See id.* at 403-04.
[91] Valeant Pharms. Int'l v. Jerney, 921 A.2d 732 (Del. Ch. 2007).
[92] *Id.* at 735-36.
[93] *Id.* at 745-46.
[94] *Id.* at 746-50.
[95] *Valeant*, 921 A.2d at 752.
[96] *Id.* at 745.
[97] *Id.* at 746-50.
[98] *Id.* at 752.

common law for breach of fiduciary duty.[99] The two conclusions, however, were separate—voidability under the common law for interested transactions, and liability under the common law for breach of fiduciary duty.[100]

Had the court found the transaction to have been entirely fair, the likely scenario would have been: (1) the transaction complied with the section 144 safe harbor under section 144(a)(3), (2) the transaction would not have been voidable solely for the reason that it was an interested-director transaction, and (3) the court could then have scrutinized the transaction under the common law for breach of fiduciary duty. The court's analysis under the common law for breach of fiduciary duty likely would have relied on its earlier finding of entire fairness and would therefore have resulted in no liability.

C. *Evidence of Overextension*

Whether as a matter of misplaced shorthand, as a matter of litigants' confusion, or as a matter of inapt judicial phrasing, several Delaware cases have seemed to apply section 144 outside its limited scope. In *Marciano*, for example, the court stated that "approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."[101] This statement is partly correct[102] in that

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[99] *Valeant*, 921 A.2d at 752.

[100] *See id.* at 752 & n.45.

[101] Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987). By its own terms, however, section 144(a)(2) does not require *disinterested* stockholder ratification. Section 144 refers only to a "vote of the shareholders," making no mention of disinterested stockholders, who are part of the common-law analysis. DEL. CODE ANN. tit. 8, § 144(a)(2); *see also In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 615 (Del. Ch. 2005) (" By its own terms, [section] 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve. The common law, by contrast, only gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.") (footnotes omitted); *supra* text accompanying notes 85-88.

Nonetheless, it could be argued that *Marciano* represents a judicial gloss on section 144(a)(2) by the Delaware Supreme Court and that section 144(a)(2) now *does* require ratification by disinterested stockholders. While risk-averse practitioners should heed such warnings, we believe that *Marciano* is not a judicial gloss on section 144. First, section 144 was "unavailable" in *Marciano*, and the defendants did not even "attempt[] to invoke section 144," so the court's statement was merely dicta. *Marciano*, 535 A.2d at 404. Second, the court was not discussing per se invalidity, to which section 144 applies, but the common law of breach of fiduciary duty (including the business judgment rule), in which stockholder ratification requires a vote of the disinterested stockholders. *See Cox*, 879 A.2d at 615; *see also Marciano*, 535 A.2d at 404 (noting that, under the common-law analysis, "shareholder control by interested directors precludes independent review" and that, because "shareholder deadlock prevent[ed] ratification," section

compliance with section 144 *permits* invocation of the business judgment rule (in the sense that a transaction that is not void is eligible to receive scrutiny under the common law, which includes the business judgment rule). If a transaction fails to comply with section 144, it would be void under the common law, and the business judgment rule would never have a chance to apply. That is not, however, the interpretation that all other courts have put on *Marciano*'s statement; some later courts seemed to adopt an overextended view of section 144.[103]

In *Oberly v. Kirby*,[104] the Delaware Supreme Court stated that courts "will defer to the business judgment of outside directors that an interested transaction is fair to the corporation," citing section 144.[105] The court also noted that "section 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule."[106] If the court was suggesting that compliance with section 144 plays a role in the common-law presumption of the business judgment rule, it would seem the court was incorrect.[107] The way to read *Oberly*'s statement as

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144(a)(2) did not apply). Third, the contemporaneous drafting history suggests that section 144(a)(2) was not intended to apply only to disinterested stockholders. *See supra* text accompanying notes 54-55. Fourth, it is not always true that ratification of disinterested stockholders provides the protection of the business judgment rule; for example, if a controlling stockholder is involved in the transaction, such a ratification will only shift the burden of entire fairness. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

For these four reasons, a similar statement in the *Cede* case should also not be considered judicial gloss on section 144. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors, [section] 144(a)(1), or the disinterested shareholders, [section] 144(a)(2), provides business judgment protection.") (citing *Marciano*, 535 A.2d at 405 n.3, *modified*, 636 A.2d 956 (Del. 1994)). The statement in *Cede* is even more problematic, as it also purports to rewrite section 144(a)(1), modifying the test to approval by a "disinterested board," rather than by the disinterested directors. We also note that section 144 did not apply in *Cede*. *See infra* note 111.

[102]But compliance with section 144 merely ensures that a transaction will not be found void or voidable *solely* because directors are interested in the transaction. *See* DEL. CODE ANN. tit. 8, § 144(a) (2006). Section 144, by definition, *allows* review for other transactional defects, such as gift or waste, and entire fairness can easily apply if a majority of the board is interested, for example, even if section 144 is complied with.

[103]*See, e.g.*, Rosser v. New Valley Corp., No. 17,272-NC, 2005 Del. Ch. LEXIS 81, at *16-19 (Del. Ch. May 27, 2005).

[104]592 A.2d 445 (Del. 1991).

[105]*Id.* at 465 n.14 (citing DEL. CODE ANN. tit. 8, § 144(a)(1)).

[106]*Id.* at 466.

[107]Not only is this a faulty extension of section 144's limited statutory purpose, but it also fails to recognize that, even if a merger is approved by a committee of disinterested directors, the board's decision will not necessarily receive the presumption of the business judgment rule unless a majority of the board was disinterested in the merger and so long as the merger is not a transaction with a controlling stockholder. *See* Gantler v. Stephens, No. 2392-VCP, 2008 Del. Ch. LEXIS 20, at *27 (Del. Ch. Feb. 14, 2008), *reprinted in* 33 DEL. J. CORP. L. 528, 540 (2008).

consistent with section 144's proper application is that section 144 removes the "interested-director taint" of a transaction and *allows*—but does not mandate—the application of the business judgment rule. That is, as discussed above, compliance with section 144 ensures that a court's analysis of a transaction begins at the level of the common law of breach of fiduciary duty, which could potentially include the presumption of the business judgment rule.[108]

The Delaware Supreme Court, four years later, quoted *Oberly*'s language in *Cinerama, Inc. v. Technicolor, Inc.*[109] The court in *Cinerama*—noting that, in neither case, did section 144 apply[110]—was more careful with its language and set forth the similarities between section 144 and the common law. The court suggested that *Oberly* had merely "relied upon the provisions in . . . [section 144] to illustrate the general principle that, as to the duty of loyalty," approval by disinterested directors can restore the presumption of the business judgment rule.[111] As the court of chancery held, in a passage quoted with approval[112] by the *Cinerama* court, section 144 "does not deal with the question of when will a financial interest of one or more directors cast on the board the burdens and risks of the entire fairness form of judicial review."[113] "Rather," the court of chancery stated, section 144 "deals with the *related* problem of the conditions under which a corporate contract can be rendered 'un-voidable' solely by reason of a director interest."[114] The language in

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> The burden is on the party challenging the decision to establish facts rebutting the presumption [of the business judgment rule]. Generally, that party must allege sufficient facts from which the court could reasonably infer (1) *a majority of the individual directors were interested* or beholden or (2) the challenged transaction was not otherwise the product of a valid exercise of business judgment.

Id. (emphasis added) (footnotes omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a plaintiff's burden of asserting facts sufficient to overcome the business judgment rule).

[108]The *Valeant* court in 2007 recognized this: "[S]ection 144 allows a committee of disinterested directors to approve a transaction and, at least potentially, bring it within the scope of the business judgment rule." Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 745 (Del. Ch. 2007).

[109]663 A.2d 1156, 1170 (Del. 1995).

[110]*Id.* at 1169 ("In this appeal, Cinerama acknowledges that Section 144 is not directly applicable to this case."); *id.* at 1170 (stating that "[i]n *Oberly*, . . . Section 144(a) did not apply to the action being contested"). Notably, it was the Delaware Supreme Court that injected section 144 into the case originally. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 350 (Del. 1993) (directing the court of chancery to "address[] the relevance and effect of the interested-director provisions of [section 144] upon," among other things, "the business judgment rule's requirement of director loyalty"), *modified*, 636 A.2d 956 (Del. 1994).

[111]*Cinerama*, 663 A.2d at 1170.

[112]*Id.* at 1169 (noting that the "Court of Chancery properly began its consideration of Section 144 with the following comment").

[113]*Id.* (internal quotation marks omitted).

[114]*Id.* (emphasis added) (internal quotation marks omitted).

Cinerama therefore recognizes that, although section 144 and the common law share factors (disinterested director approval, stockholder ratification, and fairness review), their inquiries are separate.[115]

The minor unclarity in the language of *Oberly* and *Cinerama*, however, may have led to later cases further extending section 144 beyond its original purpose. In *Wheelabrator*,[116] the Delaware Court of Chancery suggested that "application of [section] 144(a)(1)" played a part in the court's decision that "the review standard applicable to th[e] merger [in question] is business judgment, with the plaintiffs having the burden of proof."[117] If what the court meant was that approval by a majority of the disinterested directors, by removing the transaction from the clutches of the common law regarding voidability and placing the transaction into the realm of the common law regarding liability, allowed for the application of the business judgment rule, it was correct. But section 144 has no effect on whether business judgment or entire fairness applies. For example, if a majority of the board were interested in a covered transaction, a stockholder-plaintiff challenging the transaction could, on that basis, rebut the presumption of the business judgment rule—even though section 144(a)(1) may have been complied with.

The Delaware Court of Chancery's 1996 *Nebenzahl* decision went even further, suggesting that "[s]ection 144 may provide the protection of the business judgment rule to self-interested directors who approve a transaction shareholders later challenge" and that, if the director satisfied section 144, the stockholder-plaintiff would have to "bear the burden of pleading facts which allege the transaction to be unfair."[118] Even more strongly, the court stated that "[c]ompliance with Section 144 provides the protection of the business judgment rule and removes the taint of director self-interest in a transaction."[119] But a breach of the duty of care could lead to review for entire fairness, even if the transaction complied with section 144(a)(2). The court's statement represents an overextension of section 144's power and purpose. *Nebenzahl* did, however, correctly note that a plaintiff who proves a covered transaction unfair can both impose liability on directors *and* render the transaction voidable[120]—a point rarely recognized regarding the dual fairness inquiries inherent in the statutory and common-law analyses.

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[115] *Cinerama*, 663 A.2d at 1169.

[116] *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995).

[117] *Id.* at 1205 & n.8.

[118] Nebenzahl v. Miller, No. 13,206, 1996 Del. Ch. LEXIS 113, at *10 (Del. Ch. Aug. 26, 1996) (revised Aug. 29, 1996), *reprinted in* 22 DEL. J. CORP. L. 779, 789-90 (1997).

[119] *Id.* at *10-11, *reprinted in* 22 DEL. J. CORP. L. at 790.

[120] *Id.* at *11, *reprinted in* 22 DEL. J. CORP. L. at 790. The transaction would not be voidable solely by reason of the offending interest, however, if the covered transaction complied

In the 2000 *Cooke v. Oolie* case, the Delaware Court of Chancery recognized that section 144 did not apply to the transaction in question.[121] Nevertheless, the court stated that "[u]nder [section] 144(a)(1), this Court will apply the business judgment rule to the actions of an interested director, who is not the majority shareholder, if the interested director fully discloses his interest and a majority of the disinterested directors ratify the interested transaction."[122] Again, section 144 is unrelated to the business judgment rule's application per se—and the presumption of the business judgment rule, with regard to a transaction, can be rebutted even if section 144(a)(1) is complied with. It seems that the court in *Cooke* merely used the concept of the section 144 "safe harbor" as a shorthand to refer to the factors of ratification by disinterested directors or ratification by stockholders.[123] For example, the court stated that "satisfying the requirements of the safe harbor provision would have merely shifted the burden of proving entire fairness to the plaintiffs."[124] But when a controlling stockholder is involved, approval by a special committee of disinterested directors (enough to reach the safe harbor of section 144(a)(1)) is not *itself* enough to shift the burden of proof.[125] The *Cooke* court was, however, correct when it noted that "the rationale behind the Legislature's creation of the [section 144] safe harbor is on all fours with [the] . . . disinterested directors' ratification of the challenged action currently before the Court."[126] The rationale was the same, though the factors are a little different in the common-law analysis.

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with section 144(a)(1) or (a)(2). *Cf.* Reddy v. MBKS Co., 945 A.2d 1080, 1087-88 & n.15 (Del. 2008) (holding an interested transaction void where no disinterested directors voted on the transaction, where (apparently) no stockholders ratified the transaction, and where the interested director could not prove the transaction was fair).

[121]No. 11,134, 2000 Del. Ch. LEXIS 89, at *44 & n.39 (Del. Ch. May 24, 2000), *reprinted in* 26 DEL. J. CORP. L. 609, 627 & n.39 (2001).

[122]*Id.* at *44, *reprinted in* 26 DEL. J. CORP. L. at 627.

[123]The court did, however, also suggest that section 144 played some role in determining liability, which it does not. *See id.* at *46 n.41, *reprinted in* 26 DEL. J. CORP. L. at 628 n.41 ("Once the plaintiffs demonstrate interest, the burden shifts to the defendants to show that one of [section] 144's safe harbor provisions protects *them* and the transaction.") (emphasis added).

[124]*Id.*

[125]*See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("The mere existence of an independent special committee . . . does not itself shift the burden"; the courts engage in "careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness.") (omission in original) (internal quotation marks omitted); *see also* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 891 (Del. Ch. 1999) (discussing a merger transaction that, although approved in compliance with section 144(a)(1) by virtue of the independent special committee approval, nonetheless might have been reviewed for entire fairness because a majority of the board might have been interested and because the special committee might not have been sufficiently independent).

[126]*Cooke*, 2000 Del. Ch. LEXIS 89, at *45, *reprinted in* 26 DEL. J. CORP. L. at 628.

While other examples of misstatements about section 144 may exist, it is not our goal to find them all. For years practitioners have pushed hard in both directions—either to reap a protective benefit from the "penumbras" and "emanations"[127] of section 144 or to drain the three safe-harbor factors of any effect—and it is no surprise that the courts have engaged in use of shorthand when sorting out such disputes. Some might think that this article has no purpose, seeing as how it merely restates something that is, by most accounts, perfectly clear from the statutory language alone. But we believe that the confusion about section 144 causes problems for practitioners, and headaches for the courts, and that a restatement by the Delaware courts of the proper role and structure of section 144 would be a great service to all. The problem with allowing section 144 to bleed into the common law is that it can lead to more confusion, unintended redundancies, and incorrect legal advice to clients.[128]

V. CONCLUSION

Although section 144 was designed to provide a safe harbor against the specter of voidability for a limited subset of transactions in which directors of the corporation were interested and that would have been found voidable under the pre-1967 common law, it has, in the years following its adoption, been misconstrued to provide business-judgment protection to transactions complying with its terms. This result has no basis in the statute itself; the legislative history surrounding the adoption thereof, and certain cases interpreting the statute, dispel such a proposition. Section 144 is extremely limited in scope: it merely provides that a covered transaction will not be

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[127]Griswold v. Connecticut, 381 U.S. 479, 484 (1965) (stating that "specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance").

[128]First, practitioners might mistakenly rely on section 144 to avoid entire-fairness review. *See supra* text accompanying notes 3-11 (discussing *Fliegler* and *Benihana*). Second, practitioners might give their clients legally inaccurate advice. For example, in the 1985 *Lewis v. Fuqua* case, a (one-man) special litigation committee reviewed a derivative action and recommended the dismissal of that action. Lewis v. Fuqua, 502 A.2d 962, 965-66 (Del. Ch. 1985). Among other things, the court noted: "In regard to th[e] interested director issue, the Committee recognized three separate tests of liability," including the first one—"a test based on Section 144 of the Delaware General Corporation Law." *Id.* at 970. Of course, as discussed several times above, section 144 is not a test of liability.

Clarification of section 144 may help in other ways as well. For example, in *Pfeffer v. Redstone*, the court dismissed a count in a plaintiff's complaint seeking to void a transaction as an interested transaction under section 144. Pfeffer v. Redstone, No. 2317-VCL, 2008 Del. Ch. LEXIS 12, at *45-47 (Del. Ch. Feb. 1, 2008). Section 144 did not apply at all—the directors were not on both sides. *Id.* at *46. The count also complained of a breach of fiduciary duty—such claims are for the common law, not for section 144. *Cf. id.* at *45.

voidable *solely* as a result of the offending interest.[129] That is, section 144 determines whether a covered transaction will be scrutinized under the common law of breach of fiduciary duty alone or under both the common law of breach of fiduciary duty *and* the common law of voidability.

Practitioners are cautioned not to construe section 144 to provide more protection than it does. Reliance on the cases suggesting that compliance with the statute, standing alone, results in business-judgment protection could, depending on the circumstances, result in their clients' receiving inaccurate advice with respect to the level of scrutiny that a Delaware court will apply to an interested transaction. Moreover, reliance on the plain text of the statute itself is at practitioners' peril because section 144's invocation in common-law contexts may have resulted in judicial glosses on section 144 that do not match the text.[130]

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[129]Some might wonder, therefore, whether section 144 serves any valuable purpose at all. But repeal of section 144 would revert scrutiny of interested transactions back to the pre-1967 common law, in which interested directors did not count toward a quorum. *See supra* text accompanying notes 13-20. Without a compensating change in the common law, section 144 plays a small but crucial role and should be retained, albeit in its original, limited application. Nevertheless, a possible statutory revision could mitigate the confusion that has arisen over the proper role and application of section 144: section 144 could be amended by deleting from section 144(a) the text following the phrase "counted for such purpose," and replacing it with "provided, however, that nothing in this section shall limit the authority of a court to review the contract or transaction under equitable principles." That is, the three tests in (a)(1), (a)(2), and (a)(3) would be eliminated from the statute. Such an amendment would retain the principal function of the statute—the reversal of the common law regarding voidability of interested transactions—but allow Delaware courts to invalidate or enjoin those transactions under the principles of equity. *Cf.* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

[130]*See, e.g.*, discussion *supra* note 102.