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THE CORPORATE DIRECTOR’S FIDUCIARY DUTY OF LOYALTY: UNDERSTANDING THE SELF-INTERESTED DIRECTOR TRANSACTION

Norwood P. Beveridge, Jr.*

INTRODUCTION

For some years there has been a debate about whether the corporation, as a matter of freedom of contract, should be substantially liberated from mandatory requirements with respect to the relations between shareholders and management, including the board of directors.¹ As a practical matter, what is being proposed is no less than the abolishment of the corporate director’s fiduciary duty of loyalty.²

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² See Douglas M. Branson, Assault on Another Citadel: Attempts To Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors, 57 FORDHAM L. REV. 375 (1988). In fact, the abolition of the fiduciary duty of loyalty is being proposed on the partnership level, too. See Larry E. Ribstein, A Mid-Term Assessment of the Project To Revise the Uniform Partnership Act, 46 BUS. LAW. 111, 138 (1990). Professor Ribstein states that mandatory fiduciary duties recently were abolished for limited partnerships in Delaware. Id. at 138 n.99. However, the new Delaware statute stops short of actually allowing abolishment. The Delaware Revised Uniform Limited Partnership Act provides in relevant part as follows:

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner, (1) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner’s good faith reliance on the provisions of such partnership agreement, and (2) the partner’s duties and
The use of the term "fiduciary" itself is being avoided. The American Bar Association Committee on Corporate Laws in its 1984 revision of the Model Business Corporation Act stated that the term "fiduciary" should not be used in the statute to refer to a director. The American Law Institute has just published its massive Principles of Corporate Governance: Analysis and Recommendations, the culmination of years of effort since 1978, which also excludes the use of the word "fiduciary" to refer to a corporate director in its black letter rules. Yet, there is no doubt that a corporate director is a fiduciary.

With respect to the corporate director's fiduciary duty of loyalty, this is also beyond question and in fact is all that is signified by the term "fiduciary." While it is also said that a corporate director has a fiduciary duty of care, there is nothing uniquely fiduciary about a director's duty of care.

It does not help matters that the American Law Institute itself has also stopped using the term "duty of loyalty" to describe a director's obligation to refrain from self-dealing. The use of the new term "duty of fair dealing" is unfortunate because nonfiduciaries also have a duty of good faith and fair dealing, but not a fiduciary duty of loyalty, and it only confuses the situation to use the same term to describe two completely different obligations. The liabilities may be expanded or restricted by provisions in a partnership agreement.

3. MODEL BUSINESS CORP. ACT § 8.30(a) cmt. at 222 (1984). "Section 8.30 does not use the term 'fiduciary' in the standard for directors' conduct, because that term could be confused with the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation." Id.


5. J.C. SHEPHERD, THE LAW OF FIDUCIARIES 355 (1981) ("The fiduciary relationship between director and corporation is unquestioned. It is the cornerstone of the directors' office, and as such has become trite law.").

6. Id. at 48 ("The duty of loyalty is, of course, the essence of the fiduciary relationship . . . . There is no causal relationship between the duty of loyalty and the fiduciary relationship—they are one and the same thing.").

7. Id. at 49 ("[T]he duty of care has absolutely no necessary connection with fiduciary relationships."); see Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 DUKE L.J. 879, 915 (stating that the duty of care is not distinctively fiduciary).

8. This decision was announced in PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS at xi n. (A.L.I. Tentative Draft No. 7, 1987). The title of Part V has accordingly been changed from "Duty of Loyalty" to "Duty of Fair Dealing." See PRINCIPLES, supra note 4, at 259.


10. For a dramatic illustration of the difference, see Rajala v. Allied Corp., 919 F.2d 610 (10th Cir. 1990), cert. denied, 111 S. Ct. 1685 (1991). In Rajala, the purchaser, under an agreement to develop and supply high-molecular-weight resins, saw its breach-of-contract claims dismissed by directed verdict but persuaded a jury to grant $70 million in compensatory and punitive damages for breach of fiduciary duty. On appeal, the judgment for plaintiff was reversed on the grounds that under applicable state law no fiduciary duty existed. Id. at 625.
explanation offered is that courts have used the term "duty of loyalty" to refer to situations other than pecuniary interest self-dealing, and it is desirable to use a different term to isolate that situation from the others.\footnote{11}

It can certainly be agreed that the corporate director's fiduciary duty of loyalty pervades the law of corporations. In fact, if it were possible to abolish the duty of loyalty, there would be no law of corporations so far as the relations among the shareholders, the board of directors, and management are concerned.\footnote{12} It is readily apparent that among our largest corporations conflict-of-interest transactions are prevalent, and these transactions have always been resolved by duty-of-loyalty analysis.\footnote{13}

It is the purpose of this Article to make the case for the continued use of loyalty:

11. PRINCIPLES, supra note 4, at 260 (introductory note to Part V).
12. Professor Ruder has given the following list of substantive areas covered by the duty of loyalty:

self-dealing, dealings by a corporate parent with its subsidiaries, majority shareholder injury to minority shareholders in corporate acquisition and reorganization transactions, excessive compensation, use of corporate funds to perpetuate control, sale of control at a premium, insider trading, corporate opportunities, competition by corporate officers and directors with their corporation, and fiduciary obligations in bankruptcy.

David S. Ruder, Duty of Loyalty—A Law Professor's Status Report, 40 BUS. LAW. 1383, 1386-87 (1985). To this list could be added (at least) demand on directors and shareholders in shareholder derivative actions, use of special litigation committees, indemnification of officers and directors, resistance to hostile takeovers, composition of the board of directors, settlement of derivative actions, characterizations of claims as direct or derivative, the director's duty of good faith, and the availability of the attorney-client privilege in derivative litigation.

\footnote{13}

TABLE 1

<table>
<thead>
<tr>
<th>1989 Fortune 25 Largest U.S. Industrials</th>
<th>1\textsuperscript{a}</th>
<th>2\textsuperscript{a}</th>
<th>3\textsuperscript{a}</th>
<th>4\textsuperscript{a}</th>
<th>5\textsuperscript{a}</th>
<th>6\textsuperscript{a}</th>
<th>7\textsuperscript{a}</th>
<th>8\textsuperscript{a}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name &amp; State of Incorporation</td>
<td>1838</td>
<td>1386-87</td>
<td>(introductory note to Part V).</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Motors (DE)</td>
<td>20(14/6)</td>
<td>*</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Ford Motor (DE)</td>
<td>17(9/8)</td>
<td>*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exxon (NJ)</td>
<td>15(10/5)</td>
<td>*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>IBM (NY)</td>
<td>18(15/3)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Electric (NY)</td>
<td>19(16/3)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mobil (DE)</td>
<td>14(7/7)</td>
<td>*</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philip Morris (VA)</td>
<td>21(15/6)</td>
<td>*</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chrysler (DE)</td>
<td>20(15/5)</td>
<td>2%</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E.I. DuPont (DE)</td>
<td>18(6/12)</td>
<td>28%</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Texaco (DE)</td>
<td>15(12/3)</td>
<td>*</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Chevron (DE)</td>
<td>12(7/5)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amoco (IN)</td>
<td>14(7/7)</td>
<td>*</td>
<td></td>
<td></td>
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</tbody>
</table>

continued...
fiduciary duty of loyalty analysis in corporation law. There is no point at this late date to continue to ask whether a corporate director is a trustee.\textsuperscript{14} It has already been explained that it is un instructive to analogize a director to a trustee, because the courts that make this analogy do not explain why some similarities between directors and trustees are relevant and others are not.\textsuperscript{16} A director is not a trustee, he is a fiduciary, and he does have a duty of loyalty.

The basic duty of loyalty analysis arises with the self-interested contract in which the director or controlling stockholder enters into a transaction with the corporation. The rules in the area of interested director contracts are poorly understood and are in need of clarification. This Article will analyze the self-interested contract by examining in order (1) the validity of such contracts at common law; (2) the impact of the interested director statutes on the validity of such contracts; (3) the issues of fairness and the burden of proof; (4) qualifications for the disinterested director; (5) proposals of the American Law Institute; (6) fairness and the business judgment rule compared; and finally (7) the application of these principles to the freezeout merger.

It will be seen that the application of fiduciary principles by the courts in

<table>
<thead>
<tr>
<th>Company</th>
<th>Total # of Directors</th>
<th>Director Stockholdings</th>
<th>Director Transactions</th>
<th>More than 5% Stockholders</th>
<th>Stockholder Suits Pending</th>
<th>Staggered Board</th>
<th>Golden Parachutes</th>
<th>Poison Pill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shell Oil (DE)</td>
<td>12(6/6)</td>
<td>100%</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proctor &amp; Gamble (OH)</td>
<td>19(11/8)</td>
<td>*</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boeing (DE)</td>
<td>11(9/2)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Occidental Petroleum (DE)</td>
<td>17(8/9)</td>
<td>2%</td>
<td>x x</td>
<td>SLC</td>
<td>x x x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Technologies (DE)</td>
<td>12(11/1)</td>
<td>2%</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eastman Kodak (NJ)</td>
<td>14(9/5)</td>
<td>*</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USX (DE)</td>
<td>15(10/5)</td>
<td>*</td>
<td>x x</td>
<td>x x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dow Chemical (DE)</td>
<td>17(4/13)</td>
<td>*</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Xerox (NY)</td>
<td>12(8/4)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Atlanta Richfield (DE)</td>
<td>15(9/6)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pepsico (NC)</td>
<td>14(9/5)</td>
<td>*</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RJR Nabisco Holdings</td>
<td>11(3/8)</td>
<td>97%</td>
<td>x x</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>McDonnell Douglas (MD)</td>
<td>13(9/4)</td>
<td>15%</td>
<td>x x</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

(1) Total Number of Directors (outside/inside). Inside directors include retired officers and controlling shareholders
(2) Director and Officer Stockholdings (to next highest integer) (* Less than 1%)
(3) Director transactions with the corporation
(4) More than 5% stockholders exist
(5) Stockholder suits pending (Special Litigation Committee)
(6) Staggered Board
(7) Golden Parachutes
(8) Poison Pill

14. See A.A. Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365 (1932); E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932).
FIDUCIARY DUTY OF LOYALTY

this area has led not at all towards categorical prohibition but towards the upholding of such contracts where there has been adequate disclosure and approval by disinterested corporate authority.

I. ORIGINS OF THE PROBLEM: VALIDITY OF CONTRACTS BETWEEN A CORPORATION AND ITS DIRECTORS

All current thinking on the corporate director's duty of loyalty appears to start with the proposition, which seems now to be universally accepted, that transactions between a director and his corporation at common law were generally voidable without regard to fairness. It is submitted that this proposition is completely erroneous.

Professor Marsh appears to have been the first to make the claim that self-interested contracts were voidable regardless of the fairness of the transactions. Twenty-six years ago, he stated in a much-cited article:

In 1880 it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction. . . . Under this rule it mattered not the slightest that there was a majority of so-called disinterested directors who approved the contract . . . . This rule applied not only to individual contracts with directors, but also to the situation of interlocking directorates where even a minority of the boards were common to the two contracting corporations.

However, the general rule in 1880 was actually the opposite of that described. Interested director contracts were not always voidable. One of the leading treatises stated:

But the weight of authority and of reason appears to indicate that such a contract would be valid. . . . There is no necessary impropriety in a contract between a director and the corporation, if the latter is represented by other agents. On the contrary, such contracts are, in many instances, the natural result of circumstances, and are justified by the approved usages of business men.

An earlier treatise of the time held to the same effect: "The managers or di-

16. See, e.g., PRINCIPLES, supra note 4, § 5.01 reporter's note at 270; EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS § 3.01, at ch.3, p.1 (1984); ROBERT C. CLARK, CORPORATE LAW § 5.1 (1986).
17. Harold Marsh, Jr., Are Directors Trustees?, 22 Bus. Law. 35, 36-37 (1966). Because excerpts from this article are published in the leading text on corporate law, it is fair to say that many lawyers begin their thinking on this subject here. See WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 556-59 (6th ed. unabr. 1988).
18. 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 527, at 494-95 (2d ed. 1886); see also SEWARD BRICE, A TREATISE ON THE DOCTRINE OF ULTRA VIRES 477-87 (2d Amer. ed. 1880); JAMES H. PURDY, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 741 (1905); Correspondence, Directors' Contracts with Themselves, 16 Am. L. Rev. 917 (1882).
rectors of a corporation are not trustees of its property in such a sense, as to
disenable them from purchasing the property or stock belonging to it, with the
same effect as though they were not managers or directors."

In a much-cited decision of this era, Twin-Lick Oil v. Marbury, the
United States Supreme Court declined to consider whether a transaction be-
tween the corporation and a director could be set aside, holding that the plain-
tiff shareholder had waited too long to bring suit. However, the Supreme
Court stated clearly that interested director contracts were not necessarily
suspect:

While it is true that the defendant, as a director of the corporation, was
bound by all those rules of conscientious fairness which courts of equity
have imposed as the guides for dealing in such cases, it cannot be main-
tained that any rule forbids one director among several from loaning money
to the corporation when the money is needed, and the transaction is open,
and otherwise free from blame. No adjudged case has gone so far as this.
Such a doctrine, while it would afford little protection to the corporation
against actual fraud or oppression, would deprive it of the aid of those most
interested in giving aid judiciously, and best qualified to judge of the neces-
sity of that aid, and of the extent to which it may safely be given.

In another case, while setting aside a related sale of corporate property, the
Supreme Court of Illinois upheld a loan to the corporation by one of its direc-
tors and the accompanying pledge of corporate assets, explaining: "We have
never known it questioned that a director or stockholder may trade with, bor-
row from or loan money to the company of which he is a member, on the same
terms and in like manner as other persons."

Once we accept the fact that, according to the great weight of authority,
interested director transactions were never thought to be voidable without re-
gard to fairness, we are freed from the necessity of answering Professor
Marsh's perplexing question of why there was an unexplained change in legal
philosophy. If we review the early cases in light of agency and trust law
principles, we can also stop wondering why corporate law, as some critics

tions Aggregate 214 (2d ed. 1843).
20. 91 U.S. 587 (1875).
21. Id. at 593-94.
22. Id. at 589.
23. Harts v. Brown, 77 Ill. 226, 230-31 (1875); accord Combination Trust Co. v. Weed, 2 F.
24, 24 (C.C.E.D. Pa. 1880) (contract with president); Duncomb v. New York, Housatonic, & N.
R.R., 88 N.Y. 1, 7 (1882) (same).
24. Marsh, supra note 17, at 40 ("One searches in vain in the decided cases for a reasoned
defense of this change."). The early twentieth-century authorities were clear on the general rule of
validity and did not note any change in the law on this subject. See Henry W. Ballantine,
Ballantine on Corporations § 123, at 388-89 (1927); 4 William M. Fletcher, Cyclopaedia
of the Law of Private Corporations § 2347, at 3599-3600 (1918); 13 Am. Jur. Corporations
§ 10005 (1938).
would have it, does not follow the strict prohibitions of trust and agency law.\textsuperscript{25}

In fact, the nineteenth-century cases did make the analogy to trust and agency law, but there never was, and there is not now, any doctrine in either agency\textsuperscript{26} or trust\textsuperscript{27} law that categorically prohibits transactions between the fiduciary and the person represented; it is a matter of prohibiting the fiduciary from standing on both sides of the transaction. The fiduciary cannot represent both himself and his principal or beneficiary. Validation of the transaction then requires (1) a full disclosure by the fiduciary of his conflict of interest and any material information he may have about the transaction, and (2) informed consent by or on behalf of the principal or beneficiary.\textsuperscript{28}

The question of consent did not pose much of a problem in agency law, since the principal was always the person in control of the activity by definition.\textsuperscript{29} In trust law, however, the trustee was the person in control, and the beneficiaries assumed a presumptively subservient position, which complicated the matter; also there arose questions not present in agency law, such as whether consent might be given in advance in the deed of trust (the answer was generally yes),\textsuperscript{30} whether consent might be given to one trustee by his fellow trustees (no),\textsuperscript{31} whether the consent of the beneficiaries had to be unanimous (yes),\textsuperscript{32} and whether the chancery court itself might validate the transaction (yes).\textsuperscript{33}

As applied to the corporation, the question of consent initially turned on whether the consent of the board was sufficient or whether the consent of all or some of the shareholders would be required. There was some conflict in the early cases, but the general answer was that the consent of an informed board would suffice. This raised the additional questions of what should be done if a majority of the directors were interested, so that a disinterested quorum could not be assembled, and what should be done if the interested director participated in the giving of consent by the board, whether or not his vote was

\textsuperscript{25} See Brudney, \textit{supra} note 1, at 1434 (noting that relaxation of rules from trust and agency law has been without explanation or justification); David M. Phillips, \textit{Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine}, 32 \textit{RUTGERS L. REV.} 184, 189 (1979) ("Case law has never satisfactorily explained the reasons for the divorce of corporate law from trust principles.").

\textsuperscript{26} See \textit{Restatement (Second) of Agency} §§ 389-390 (1958); \textit{Annotation, Rights and Remedies of Principal Where Agent Professes To Sell Principal’s Property Without Disclosing that He Is the Purchaser}, 62 A.L.R. 63 (1929).

\textsuperscript{27} See \textit{Restatement (Second) of Trusts} §§ 170, 205-206, 216 (1959); Austin W. Scott, \textit{The Trustee’s Duty of Loyalty}, 49 \textit{HARV. L. REV.} 521, 565 (1936) (noting that validation requires disclosure, consent, and fairness).

\textsuperscript{28} \textit{Shepherd}, \textit{supra} note 5 at 168-70; see Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) ("The key to upholding an interested transaction is the approval of some neutral decision-making body.").

\textsuperscript{29} See \textit{Restatement (Second) of Agency} § 1 (1958).

\textsuperscript{30} Scott, \textit{supra} note 27, at 524.

\textsuperscript{31} \textit{Id.} at 536.

\textsuperscript{32} \textit{Id.} at 524.

\textsuperscript{33} \textit{Id.} at 533.
needed or his presence was needed to constitute a quorum.

If we examine the cases cited by Professor Marsh in support of his assertion that interested director contracts were voidable in spite of fairness, we will see that the cases were actually concerned with transactions in which the interested director was active in representing both sides of the deal. Three of the cases involved the activities of the same man, Allen M. Sherman, a director, member of the executive committee, and financial agent of the Cumberland Coal and Iron Company. In one of these three cases, a New York Supreme Court stated that an interested director transaction is voidable without regard to fairness unless ratified by all of the stockholders, not the disinterested directors. This case is cited by two of the leading authorities earlier in this century as illustrative of a minority view, along with a New Jersey case also cited by Professor Marsh.

II. Statutory Intervention into Interested Director Contracts

Some of the early American cases refer to the English statute on interested director contracts, sections 85 through 87 of the Companies Clauses

34. Wardell v. Railroad Co., 103 U.S. 651, 655 (1880) (directors authorizing unfair contract were to profit personally from it); O'Connor Mining & Mfg. Co. v. Coosa Furnace Co., 10 So. 290, 292 (Ala. 1891) (transactions between corporations under common control were not voidable by creditors in absence of fraud); Memphis & C. R. Co. v. Wood, 7 So. 108, 109 (Ala. 1889) (voiding transactions by controlled subsidiary with its parent); Nedry v. Vaile, 160 S.W. 880, 882 (Ark. 1913) (transactions between corporation and its president and principal stockholder were not voidable by creditor in absence of fraud); New Blue Point Mining Co. v. Weissbein, 244 P. 325, 328 (Cal. 1926) (transaction authorized by two interested directors not subject to corporate disaffirmance due to long delay in objection); Davis v. Rock Creek L. F. & M. Co., 55 Cal. 359, 364 (1880) (stating that the law does not permit a transaction where president and director executed notes and mortgage in favor of a firm of which president was a member); Mallory v. Mallory-Wheeler Co., 23 A. 708, 709 (Conn. 1891) (declining to enforce contract where majority of board authorized contracts with themselves); European & N. Am. Ry. v. Poor, 59 Me. 277, 278-79 (1871) (analyzing legality of a construction contract signed by the president and the director in which president was personally interested); Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., 16 Md. 456, 474 (1860) (unfair contract was set aside where purchasing director actively represented corporation in the sale); Pearson v. Concord R.R., 62 N.H. 537, 539 (1883) (enjoining execution of transactions between controlled subsidiary and parent corporation); Munson v. Syracuse, G. & C. Ry., 8 N.E. 355, 355 (N.Y. 1886) (declining to determine the legality of participation by selling director in corporation's approval of purchase contract).


36. See Ballantine, supra note 24, § 123, at 388-89 (discussing minority view); 4 Fletcher, supra note 24, § 2346, at 3596-99 (same).

37. Stewart v. Lehigh Valley R.R., 38 N.J.L. 505 (1875). The third Sherman case involved a mortgage given by the Cumberland company to Mr. Sherman. There the Maryland Court of Appeals held that Mr. Sherman had failed to show that he had given any consideration for the mortgage, which therefore could not be enforced against the company. Cumberland Coal & Iron Co. v. Parish, 42 Md. 598, 613 (1875).

Consolidation Act. The English statute provided that no director was to be interested in a contract with his corporation and that if he was so interested, his office as director would become vacant. Apart from the statute, a contract authorized by an interested director could not be enforced against the corporation by the director. This early statute apparently did not serve as a model for American legislatures.

A nineteenth-century West Virginia statute provided in relevant part:

No member of the board shall vote on a question in which he is interested otherwise than as a stockholder, or be present at the board while the same is being considered; but if his retiring from the board in such case reduce the number present below a quorum, the question may nevertheless be decided by those who remain.

According to the Supreme Court of West Virginia, this statute modified the rule that directors could not authorize a contract with a codirector, only the shareholders. However, the court held that the effect of the statute was not to insulate the contract from any attack but to leave open the right of creditors to set aside the transaction for unfairness. The court noted that the obvi-

39. Companies Clauses Consolidation Act, 1845, 8 & 9 Vict., ch. 16 (Eng.). The statute provided in relevant part:

LXXXV. No Person shall be capable of being a Director unless he be a Shareholder, nor unless he be possessed of the prescribed Number, if any, of Shares; and no Person holding an Office or Place of Trust or Profit under the Company, or interested in any Contract with the Company, shall be capable of being a Director; and no Director shall be capable of accepting any other Office or Place of Trust or Profit under the Company, or of being interested in any Contract with the Company, during the Time he shall be a Director.

LXXXVI. If any of the Directors at any Time subsequently to his Election accept or continue to hold any other Office or Place of Trust or Profit under the Company, or be either directly or indirectly concerned in any Contract with the Company, or participate in any Manner in the Profits of any Work to be done for the Company, or if such Director at any Time cease to be a Holder of the prescribed Number of Shares in the Company, then and in any of the Cases aforesaid the Office of such Director shall become vacant, and thenceforth he shall cease from voting or acting as a Director.

LXXXVII. Provided always, that no Person being a Shareholder or Member of any incorporated Joint Stock Company shall be disqualified or prevented from acting as Director by reason of any Contract entered into between such Joint Stock Company and the Company incorporated by the special Act; but no such Director, being a Shareholder or Member of such Joint Stock Company, shall vote on any Question as to any Contract with such Joint Stock Company.

Id.


43. Id. at 807.

44. Id.

45. Id.
ous purpose of the statute was to allow a disinterested minority of the board to act. 46

A 1920 Rhode Island statute provided that an interested director contract that was approved by disinterested directors could be set aside only for reasons that would void a contract with a stranger. 47

However, the best known of the statutes, and the one that served as a model for modern statutes, 48 was the 1931 California version. 49 The new statute was

46. Id.

47. The text of the statute was as follows:

Validity of Contract by Corporation in Case of Interested or Interlocking Directors.

Sec. 21.—Any corporation may contract for any lawful purpose with one or more of its directors or with any corporation having with it a common director or directors, if the contract is entered into in good faith and is approved or ratified by a majority vote at any meeting of its board of directors: Provided, that the contracting or common director or directors shall not vote on the question and shall not be counted in ascertaining whether or not a quorum is present for this purpose at the meeting. A contract made in compliance with the foregoing provisions shall be voidable by the corporation complying with said provisions only in case it would be voidable if made with a stranger.


820. 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 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.

intended to allow the interested director to be counted towards a quorum and
even to vote in favor of the transaction, as long as (1) there were sufficient
disinterested directors voting to authorize the transaction without his vote, or
(2) a majority of the informed shareholders approved the transaction, or (3)
the transaction was just and reasonable.60 Professor Ballantine said it was the
view of a majority of the committee on corporations that interested director
contracts should be voidable only for unfairness and not because the interested
director was counted towards a quorum or had voted to approve the
transaction.61

The California statute introduced two new elements not present in the
Rhode Island or West Virginia statutes: (1) ratification by a committee of the
board, and (2) ratification by the shareholders. Committees of the board were
known to the law of corporations as authorized by statute, the corporate char-
ter or bylaws, or by implied authority, although it was not believed that the
board could delegate its entire authority to a committee.62 With respect to
ratification by shareholders, the rule was, at common law, different from the
rule for directors: Shareholders who were interested in the transaction were
entitled to have their votes counted towards ratification although necessary to
the result.63 However, it was said to be the "better rule" that a majority share-
holder could not ratify his own contracts.64 At the same time, dummy direc-
tors who were dominated and controlled by an interested director were not
considered disinterested for the purpose of disinterested director ratification,
but the fact that a director had been nominated and elected by a majority
shareholder did not as such disqualify him from being disinterested.65

A question left unanswered by the California statute was whether a transac-
tion could be validated by the vote of an interested shareholder under section
820(b) if the transaction was not just and reasonable. This question was an-
swered in the negative by a California appellate court in the well-known case

51. Henry W. Ballantine, Questions of Policy in Drafting a Modern Corporation Law, 19 CAL.
L. REV. 465, 475-76 (1931). For a discussion of the state of the law in California on this subject
at the time, see Robert E. Carp, Comment, Corporations: Effect of Directors' Adverse Interest or
Conflicting Duties to Invalidate Contracts: California Civil Code Section 311, 29 CAL. L. REV.
480 (1941); Owen B. Marron, Comment, Corporations: Effect upon Contracts of Adverse Interest
of Directors: Interlocking Directorates, 19 CAL. L. REV. 304 (1931); Recent Decisions, Corpora-
tions: Contracts: Effect upon Contracts of Adverse Interest of Directors, 21 CAL. L. REV. 64
(1932).
52. 3 FLETCHER, supra note 24, §§ 1951-1960, at 3144-53 (1917).
53. 4 id. § 2187, at 3393-94.
54. 4 id. § 2398, at 3650. In the case of Klein v. Independent Brewing Ass'n, 83 N.E. 434 (Ill.
1907), the court stated that if it were a question of whether the majority shareholders had exer-
cised good judgment, a different rule might apply, but, in the case before the court, the corpo-
ration had purchased property from interested directors for a price much in excess of its value. Id.
at 441. This, said the court, was a fraud on the shareholders, which the majority could not ratify.
Id.
55. 4 FLETCHER, supra note 24, § 2355, at 3611 (citing Cowell v. McMillin, 177 F. 25, 43 (9th
Cir. 1910)).
of Remillard Brick Co. v. Remillard-Dandini Co. In Remillard, two individuals owning sixty percent of the voting stock of one corporation caused the corporation and its wholly owned subsidiary to enter into contracts with a third corporation of which the two individuals owned all of the stock. Under the contracts, the third corporation enjoyed substantial profits. The majority shareholders argued that since they had approved the contracts in their capacity as shareholders, section 820 was satisfied and it did not matter that the contracts were unfair to the controlled corporation. The minority forty-percent shareholder sued the majority shareholders. The court set aside the contracts, pointing out that the statute included language that "[d]irectors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation." Therefore, it could not have been the intent of the statute to allow a majority of the directors to mulct the minority stockholders.

The Remillard case is illustrative of a problem created by statutory intervention into the interested director transaction. The common law solution had been to allow interested director contracts if disinterested board approval had been obtained after full disclosure, although there was an early minority view that only the shareholders could validate such a transaction. The purpose of the statutes had been to facilitate interested director transactions by overturning the minority decisions and making it clear that the board could act, but also to allow a disinterested minority of the board to act if a quorum could not be obtained, or to allow an interested majority of the board to act if the transaction was otherwise fair.

However, the result has been a lack of understanding in the cases as the courts have had to decide whether the statute provides the exclusive method of validating such contracts, whether compliance with the statute validates the transaction, or whether the court must still find fairness to the corporation. The remainder of this section will discuss some of the leading cases in this area.

Delaware adopted a statutory provision in 1967 based on the California model, but which introduced some new elements. In addition to the transac-

57. Id. at 68-69.
58. Id.
59. Id. at 73.
60. Id. at 72-73.
61. Id. (quoting CAL. CORP. CODE § 820 (West 1947)).
62. Id. at 75.
63. DEL. CODE ANN. tit. 8, § 144 (1991). The statute in its present form reads as follows: § 144. Interested directors; quorum.
(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
tion not being void or voidable because of participation or voting by the interested director, the Delaware version provided that it would not be void or voidable because of the interest of the director itself. The statute also borrowed from the West Virginia version by allowing the transaction to be approved by a majority of the disinterested directors, even though the disinterested directors are less than a quorum.

The same question as to the effect of approval by interested shareholders under the statute was answered by the Delaware Supreme Court in the well-known case of Fliegler v. Lawrence. There, the defendant directors and officers of Agau Mines, Inc., acquired, through a separate corporation that they controlled, certain mining properties that they optioned to Agau Mines. Subsequently, Agau exercised the option to acquire the properties in exchange for Agau stock, and this decision was approved by the Agau board and by a majority of the Agau stockholders. However, a majority of the approving shareholder votes were cast by the defendants, and the Delaware Supreme Court held that this interested shareholder approval did not relieve the defendants of the burden of proving that the transaction was intrinsically fair to Agau. There was one disinterested director on the board, and the defendants argued that his approval at the board level validated the transaction, but the court did not accept that argument since this director did not participate at the board meeting where the decision to exercise the option was made.

The Delaware law on this subject received a very strange interpretation by the United States Court of Appeals for the Tenth Circuit in Robert A. Wach-
sler, Inc. v. Florafax International, Inc.,71 where a consulting agreement between Florafax and a corporation owned by one of its five directors and his wife was set aside; this even though the contract was found to be substantively fair to the corporation.72 The contract had not been approved by the board of Florafax; it had been signed, on behalf of Florafax, by its president and chief executive officer with the approval of its chairman of the board and principal shareholder.73 The statute therefore was inapplicable, but the court quite properly held that the statute was not intended as the exclusive method for validating interested director contracts.74 However, in a poorly reasoned opinion the court then went on to hold that (1) acceptance of benefits under the contract by Florafax would not be a sufficient ratification, although the Delaware courts would apparently so hold;75 and (2) the contract could not be ratified by the board but only by a majority of the Florafax shareholders.76 This latter holding is a complete misinterpretation of the law on this subject and ignores the pre-statute majority rule that the interested director contract can be approved by disinterested directors.

In fact, there was no need for any ratification of the contract since it had been signed by the president and chief executive officer with the chairman’s approval. There is no requirement that every interested director transaction be approved by the board if made in the ordinary course of business or if the board has delegated authority to the president to make such contracts.77 The question is whether the corporation is represented by parties with adequate authority other than the interested director, and that was clearly the case in Wachsler. This decision is particularly offensive since the only reason the corporation repudiated the contract was that the principal shareholder sold his stock to a third party, who appointed a new board that disaffirmed the contract.78

71. 778 F.2d 547 (10th Cir. 1985).
72. Id. at 551.
73. Id. at 548.
74. Id. at 551.
75. Id. at 552.
76. Id. at 552-53.
77. See Tenzer v. Superscope, Inc., 702 P.2d 212, 214 (Cal. 1985) (president and chairman agreed to pay outside director $1.6 million finder’s fee); PRINCIPLES, supra note 4, § 5.09, at 406-07, § 5.09 cmt. at 407-18. The evidence in Wachsler showed that other Florafax directors were receiving fees from the corporation under agreements that did not have board approval. Wachsler, 778 F.2d at 548.
78. Wachsler, 778 F.2d at 549. The old president was a member of the new board, and it would have been appropriate if he had been held personally liable for breach of his warranty of authority, but this question was not presented to the court. See Husky Indus. v. Craig Indus., 618 S.W.2d 458, 461 (Mo. Ct. App. 1981) (holding that agent may be personally liable where he erroneously represents that he has authority to bind the principal). This sale of control stock brings into play the considerations that underlay the United States Supreme Court’s holding in Bangor Punta Operations v. Bangor & Aroostook Railroad, 417 U.S. 703 (1974). There the Court held that a corporation could not sue its former parent corporation for improper self-dealing where almost all of its stock was now held by a shareholder who was not a shareholder at the time of the acts relevant. Id. at 710-11.
In the subsequent case of *Marciano v. Nakash*, the Delaware Supreme Court clarified the law by holding that, indeed, the statute is not the exclusive method of validating interested director transactions. In *Marciano*, one of two fifty-percent shareholders had made loans totaling $2.5 million to the corporation without board or shareholder approval, the board and the shareholders having been evenly divided. Because the statute was not applicable, the court held that the shareholder making the loans had the burden of proving that the transaction was intrinsically fair to the corporation, which it found to have been met. The court noted in dicta that the effect of the statute where the transaction is approved by disinterested directors or disinterested shareholders who are in either case fully informed is to shift the burden of proof to the plaintiff to prove gift or waste of corporate assets. On the other hand, if the approval is not fully informed, the burden remains on the defendant to prove intrinsic fairness.

Another curious exercise in statutory interpretation is met in *Scott v. Multi-Amp Corp.*, which concerns the New Jersey statute dealing with validation of interested director contracts. The New Jersey statute was adopted first in 1968 and is based substantially on the California statute. In *Scott*, the court was faced with a challenge to a proposal by directors and controlling shareholders, owning over twenty percent of the outstanding stock in Multi-Amp Corporation, to sell all the assets and business of Multi-Amp to a second corporation of which they owned all the stock. A contract for the sale had been approved by the Multi-Amp board, subject to the approval of the sale by Multi-Amp shareholders. Citing an article by Carlos L. Israels of the New York Bar, the court held that, despite the use of the disjunctive "or" in the statute, an interested director transaction must pass muster under each of the three subdivisions of the New Jersey statute: (1) approval by disinterested directors, (2) approval by shareholders, and (3) fairness. This indefensible interpretation of the statute was rejected by the New Jersey legislature in 1988 but the accompanying Commissioners’ Comment makes it clear that the statute is not intended to provide a procedure to validate interested director contracts but to reverse the former common law rule of voidability solely

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79. 535 A.2d 400 (Del. 1987).
80. Id. at 403.
81. Id. at 401.
82. Id. at 407.
83. Id. at 405 n.3.
84. Id.
87. Scott, 386 F. Supp. at 52.
88. Id.
on account of the conflict. The court in Scott also held that compliance with the statute did not relieve the interested director from the burden of proving the fairness of the contract to the corporation.

In summary, the treatment of the statutes by the courts has been uneven. There is agreement only on the principal questions: (1) that approval of the shareholders is not required for validation of the transaction; (2) that the contract is not voidable without regard to fairness if the statutory procedure is followed; and (3) that if approval at the board or shareholder level has validated the contract only by vote of interested parties, the court must still find fairness in the transaction. The two issues of what is meant by fairness in the interested director context and who has the burden of proof for showing fairness require further understanding.

III. FAIRNESS AND THE BURDEN OF PROOF IN INTERESTED DIRECTOR CONTRACTS

In agency law, an agent who is charged with a breach of the duty of loyalty, as by having an undisclosed conflict of interest, has the burden of proving that he did not have a conflict; if the agent is charged with a breach of the duty of care, the plaintiff has the burden to prove the breach. An agent who acts as an adverse party with the knowledge of the principal also has a duty to deal fairly with the principal and to disclose all material facts to the principal; the agent also has the burden of proof as to compliance with these duties. On the issue of fair dealing, this at a minimum includes the agent's duty of disclosure and not driving a hard bargain through the use of his position. If the principal is independent and self-reliant, the fact that the agent has got the better of the deal will not be a breach of duty so long as there is full disclosure. However, if the principal is in a dependent position and not well advised by other competent persons, or relies on the agent for guidance, the agent may have to prove substantive fairness of the transaction as well as full disclosure.

Similarly, in trust law, a trustee who is charged with a breach of the duty of loyalty—as in a self-dealing transaction—has the burden of proving that his actions were not a breach of trust. In dealing with the beneficiary on the

91. Id. (Commissioners' Comment, 1988 Amendments). New Jersey did follow the minority rule at one time. See Stewart v. Lehigh Valley R.R., 38 N.J.L. 505 (1875). The Stewart court actually upheld the challenged contract as valid against third parties such as the plaintiff, so this discussion was really dictum. Id. at 524.

92. Scott, 386 F. Supp. at 68 ("[A] fiduciary who engages in self-dealing must endure the burden of proving that a challenged transaction is fair and equitable.").

93. Lindland v. United Business Invs., 693 P.2d 20, 25 (Or. 1984) ("The party claiming a breach of fiduciary duty must plead and prove the breach, and must show that the breach caused an identifiable loss or resulted in injury to the party."); Restatement (Second) of Agency § 389 cmt. e (1958) ("[T]he burden of proof is upon the agent to show that he has satisfied the duties required by the rules stated in this section.").

94. Restatement (Second) of Agency § 390 & cmt. g (1958).

95. Id. § 390 & cmt. c.

trustee's own account, the trustee must deal fairly and communicate all material facts about the transaction of which the trustee is aware.\textsuperscript{97} Even where the beneficiary has consented to the adverse interest of the trustee, the transaction may be avoided if it is not "fair and reasonable."\textsuperscript{98} However, where the beneficiary is independent and represented by other advisers, this does not mean that the transaction will be set aside just because the trustee got the better of the bargain.\textsuperscript{99}

In the corporation cases before the advent of the modern interested director statutes, these general fiduciary principles were applied to self-dealing transactions where the corporation was represented by disinterested officers. Thus, in the case of interested director contracts or contracts between corporations with common directors, the burden of proof was generally on the defendant to prove that the transaction was fair and reasonable and that appropriate disclosure had been made.\textsuperscript{100} Unfairness would exist where there was gross inadequacy of price; however, if disinterested representatives acted for the corporation, mere inadequacy of price would not establish unfairness where appropriate disclosure was made.\textsuperscript{101}

Nonetheless, there has been a divergence of views on the question of burden of proof. Writing in 1946, Professor Ballantine stated that some jurisdictions placed the burden on the plaintiff minority shareholder.\textsuperscript{102} The effect of the interested director statutes has not been dispositive where the burden of proof is not settled in the statute itself. Professor Ballantine stated that the California statute in 1931 did not address the question of the burden of proof,\textsuperscript{103} and the California courts held, without discussion, that it remained with the interested director.\textsuperscript{104}

The California statute was amended in 1977 to distinguish between material financially interested director transactions and transactions between companies with common directors where no director material financial interest is present. The burden of proof that the transaction is just and reasonable is placed on the interested director only in the situation where the financial interest transaction is not approved by disinterested shareholders or disinterested directors. However, in the case of transactions approved by disinterested directors, the transaction still must be just and reasonable, but the burden is on the plaintiff to prove that it is not.\textsuperscript{105}

\textsuperscript{97} Restatement (Second) of Trusts § 170 (1959).
\textsuperscript{98} Id. § 216(3).
\textsuperscript{99} Shepherd, supra note 5, at 169.
\textsuperscript{100} 4 Fletcher, supra note 24, § 2337, at 3586-87, § 2389, at 3643.
\textsuperscript{101} 4 id. § 2335, at 3583-86.
\textsuperscript{102} Henry W. Ballantine, Ballantine On Corporations, § 70 (rev. ed. 1946); see also 3 Fletcher, supra note 24, § 921, at 513-20 (perm. ed. 1986).
\textsuperscript{103} Ballantine, supra note 51, at 476.
\textsuperscript{105} Cal. Corp. Code § 310 (West 1990); see Tenzer v. Superscope, Inc., 702 P.2d 212, 220 (Cal. 1985) (president and chairman of the board agreed to pay outside director $1.6 million
Before the New York statute was amended in 1971 to place the burden of proof on the interested director in cases where the contract was not approved by disinterested directors or the shareholders after full disclosure, it was unclear whether the statute was intended to change the common law rule that the burden of proof was on the interested director.\textsuperscript{106}

Delaware courts began to place the burden on the plaintiff to prove that the transaction amounted to corporate waste where there had been approval of the transaction by disinterested directors or shareholders even before the Delaware statute.\textsuperscript{107} Now it appears clear that in Delaware the burden to prove intrinsic fairness is on the controlling stockholder where there is no disinterested director or stockholder approval,\textsuperscript{108} but the burden is on the plaintiff to prove waste where there is such approval.\textsuperscript{109}

As used by the Delaware Supreme Court, the terms “entire fairness,” “inherent fairness,” and “intrinsic fairness” have the same meaning: that under all the circumstances the transaction would have recommended itself to an independent board of directors that was acting in good faith and had the best interests of the corporation in mind.\textsuperscript{110} By contrast, the term “corporate waste,” when applied to actions by directors or shareholders, refers to decisions that fall outside the business judgment rule\textsuperscript{111} and that are of such na-


\textsuperscript{107} Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (holding that the business judgment rule is applicable to decision by disinterested directors to buy properties from 46% controlling shareholder); accord Weiss v. Kay Jewelry Stores, Inc., 470 F.2d 1259, 1272 (D.C. Cir. 1972) (holding that plaintiff had the burden of proving bad faith or abuse of discretion amounting to legal waste where no interested director had voted on the relevant transaction).


\textsuperscript{110} Summa, 540 A.2d at 407; Fliegler v. Lawrence, 361 A.2d 218, 224-25 (Del. 1976); Kenann v. Eshleman, 2 A.2d 904, 908 (Del. 1938); see also Sterling, 93 A.2d at 110. The same test has been applied by the United States Supreme Court. See Pepper v. Litton, 308 U.S. 295, 306-07 (1939) ("[T]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921) (requiring full adequacy of consideration).

\textsuperscript{111} Aronson v. Lewis, 473 A.2d 805, 815-17 (Del. 1984). The American Law Institute seems to have come around to this point of view. See Discussion of Principles of Corporate Governance, 67 A.L.I. PROC. 178 (1990) [hereinafter ALI Discussion].
ture that no person of ordinarily sound business judgment would view them as a fair exchange.\textsuperscript{112}

IV. Qualifications for the Disinterested and Independent Director

Since approval of interested director transactions by disinterested directors substantially affects both the burden of proof and the standard of review, it is important to understand what is meant by a disinterested director.

It has been the contention of many commentators that truly disinterested directors do not exist in publicly held companies because all directors are selected by and owe their position and perquisites of office to the controlling shareholder or chief executive officer. Thus, Professor Marsh's conclusion was that current rules do little or nothing to inhibit conflicts of interest, and the Securities Exchange Act of 1934 should be amended to prohibit affiliated-person transactions subject to exemptions to be granted by the Securities and Exchange Commission.\textsuperscript{113} This proposal was more recently echoed by Dean Clark.\textsuperscript{114} Such calls for categorical prohibition\textsuperscript{115} are not likely to be heeded by the legislatures and have been largely ignored by the courts.

However, the outside or independent director has been much in vogue for publicly held companies at least since the 1970s and is required for registered investment companies by federal statute\textsuperscript{116} and for other publicly held corporations by rules of the national securities exchanges and the National Association of Securities Dealers.\textsuperscript{117} This development was called for not only by academicians\textsuperscript{118} but also by groups such as the Business Roundtable.\textsuperscript{119}

With the increasing activism of institutional investors, who collectively hold a majority of stock in the large publicly held corporations, the trend towards a


\textsuperscript{113} Marsh, supra note 17, at 73-75.


\textsuperscript{115} Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 622-28 (1982).


The majority of independent directors on the board is accelerating. The Securities and Exchange Commission staff has refused to opine that shareholder proposals to amend company bylaws to require a majority of independent directors may properly be excluded from management’s proxy statement, and the Dow Chemical Company, for example, included such a proposal in the proxy material for its 1991 annual meeting of stockholders. Bills were introduced in both houses of Congress on June 4, 1991, to amend the Securities Exchange Act of 1934 to allow holders of not less than three percent or $1 million in market value of the voting equity securities of an issuer to nominate in management’s proxy statement persons for election to the board.

The argument that, because of structural bias, actions by disinterested directors in interested director transactions should be ignored as being of no legal consequence has not been accepted by the courts. Dismissing a charge that directors were not disinterested because they were nominated and elected at the behest of the interested forty-seven percent controlling shareholder, the Delaware Supreme Court said simply: "That is the usual way a person becomes a corporate director." In that case, the transaction under attack was a board-approved consulting agreement with the controlling shareholder, a seventy-five-year-old executive who was allegedly required to perform little or no services for his substantial salary, bonus, and interest-free loans. As to
what would make the other directors interested for purposes of excusing a demand on the board in this derivative shareholder’s action, the court held that director interest requires either a conflict of interest or a personal financial benefit from the transaction. On remand, the plaintiff amended his complaint, and the court of chancery held that new allegations excused demand on the board. The new allegations were that the consulting agreement was for a grossly inadequate consideration and really intended to compensate the controlling shareholder for losses under an unrelated agreement with another corporation, of which seven of the board members were also directors, thereby creating both a conflict of interest and sufficient allegations of waste.

It has been questioned whether the business judgment rule can ever be applied to transactions between a majority shareholder and the corporation. To be sure, the courts have applied the intrinsic fairness test to such transactions where there was no disinterested director or shareholder approval. However, the business judgment rule has been applied to these transactions where the terms of the transaction were not set by the majority shareholder.

There is a difference between approval of the transaction by the interested shareholder and approval by disinterested directors of the controlled corporation. Of course, if the directors are in fact dominated by the majority shareholder, they are not disinterested. However, it has been held that allegations that the interested party dominated and controlled the board through his ownership of a majority of the voting stock were insufficient to impugn the integrity and independence of the directors. The reason for this was expressed very simply: “Directors may be elected by the holder of a majority of the stock of a corporation and yet be free agents and honest men.”

127. Id. at 812; accord Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (divided loyalties or personal financial benefit).
130. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.9, at 4-215 to 4-216 (2d ed. 1990); Andrew G.T. Moore, The “Interested” Director or Officer Transaction, 4 DEL. J. CORP. L. 674, 675 (1979).
131. Fliegler v. Lawrence, 361 A.2d 218, 223-24 (Del. 1976) (selling developed corporate opportunity to the corporation); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971) (breach of contract to purchase oil).
132. Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970) (corporate parent’s duty to share oil import allocation with subsidiary); see Sinclair, 280 A.2d at 720 (discussing Getty); cf. Case v. N.Y. Cent. R.R., 204 N.E.2d 643 (N.Y. 1965) (holding that the allocation of tax benefits under consolidated returns should not be interfered with, absent an abuse of power).
134. Blish v. Thompson Automatic Arms Corp., 64 A.2d 581, 605-06 (Del. 1948); see Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984) (holding that majority stock ownership does not destroy the presumption of director independence and good faith in demand-on-board context).
The Corporate Governance Project has been an ambitious and controversial undertaking since its beginning in 1978, and it is not yet completed. The current draft of the ALI Principles is over 750 pages long. As the title indicates, it is not a restatement of existing law in the traditional ALI format, nor is it really an analysis of the combined statutory and common law of corporations as it has developed and currently exists. It is rather a series of recommendations of a largely legislative nature that the Institute proposes for adoption mostly through judicial action to replace the system we now have. As such, it should be welcomed for the insight it brings to difficult areas of the law of corporations. However, it also should be treated with caution since it represents the product of neither judicial nor legislative reaction to specific problems arising from real-world fact patterns.

Like every other modern authority, the treatment of director self-dealing seemingly rests at every point on Professor Marsh's conclusion that such activity was prohibited at common law, without regard to any concepts of fairness or unfairness. It simply colors the whole treatment of the problem to take that erroneous view as a point of beginning, as if it represented an Edenic situation from which we have inexplicably strayed and to which we should return, if only we could. It is proposed, therefore, that we should take as our corrected point of beginning the proposition that interested director transactions are now and always were proper and lawful if structured so that independent and disinterested informed approval is combined with good faith behavior of the interested director. This will allow us to focus on the real problem of ensuring in each case the proper disclosure and informed consent.

Part V of the ALI Principles is now entitled "Duty of Fair Dealing" (formerly "Duty of Loyalty"), and in the space of 240 pages it deals with some specific applications of the duty of loyalty of corporate directors, officers, and controlling shareholders: (1) transactions with the corporation; (2) compensation; (3) use of corporate property, position, or information; (4) taking of corporate opportunity; (5) competition with the corporation; and (6) sale of control. The subjects of tender offers and freezeout mergers are treated elsewhere.

The definitions in Part I of the ALI Principles always must be kept in mind. For instance, the definition of "Disinterested Directors" introduces a discordant note at the outset by refusing to give any effect to approval by a single
disinterested director even if there is only one on the board. This approach ignores existing case law and statutory law and has been rejected by at least one court. The structure of Part V of Principles discloses that a series of very debatable value judgments has been made by the drafters that betrays the ambivalence that has always prevailed in this area. Thus, on the most basic question of what standard will be applied to an interested director transaction where there has been informed and disinterested director approval, Principles refuses to give business judgment rule protection to the decision. Instead, a new and judicially untested "could reasonably have concluded" standard is created which is more rigorous than the business judgment rule but not so rigorous as the intrinsic fairness rule (retitled as a simple fairness standard). Then it is made clear that the new "could reasonably have concluded" standard is available only if the disinterested director approval is given in advance of the transaction, another value judgment unsupported by authority. Finally, the new standard is only applied to interested director transactions involving something other than compensation, corporate opportunities, competition with the corporation and other subjects dealt with separately.

The reporter's note to section 5.02 offers as a defense to the new standard the fact that the Delaware courts have only "indicated in dictum" that the business judgment rule applies where disinterested director approval has been obtained. This is not so. The Delaware Court of Chancery in the leading case of Puma v. Marriott specifically held some time ago that the business judgment rule and not the fairness rule is applicable to the decision of disinterested directors in an interested director/controlling shareholder transaction. The

139. See, e.g., Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 379 (6th Cir. 1984); Lewis v. Fuqua, 502 A.2d 962, 971 (Del. Ch. 1985) (holding that conclusions of a one-person special litigation committee would be acceptable if the committee is independent, acts in good faith, and shows a reasonable basis for its conclusions), appeal denied sub nom. Fuqua Indus. v. Lewis, 504 A.2d 571 (Del. 1986).

140. See, e.g., DEL. CODE ANN. tit. 8, § 141 (1991) (requiring only one member for board of directors or committee).

141. Houle v. Low, 556 N.E.2d 51, 58-59 (Mass. 1990) (holding that one director on special litigation committee is sufficient, but number of directors will be considered in determining independence).

142. PRINCIPLES, supra note 4, § 5.02(a)(2)(B), at 273 ("[D]isinterested directors . . . could reasonably have concluded that the transaction was fair to the corporation at the time of such authorization.").

143. Id. § 5.02 cmt. at 275 (new in its articulation).

144. Id. § 5.02(a)(2) cmt. at 283.

145. Id. § 5.02(a)(2)(A) & cmt. at 288; see id. § 5.02(a)(2)(A) cmt. at 284 (asserting that "intrinsic," "inherent," or "entire" fairness as a standard offers insufficient analytical guidance).

146. Id. § 5.02 cmt. at 276 (distinguishing "based on principle and policy rather than on existing statutes or decisions").

147. Id. § 5.02 reporter's note at 302.

148. 283 A.2d 693 (Del. Ch. 1971).

149. Id. at 696. The court was clearly referring to the independent director action. Although the transaction also was approved by the Marriott shareholders, the defendants owned 46% of the
Delaware Supreme Court cited *Puma* with approval in the leading case of *Aronson v. Lewis* in holding that the business judgment rule would come into play in an interested director/controlling shareholder transaction (there compensation) both in resolving demand futility and as a defense to the merits of the suit. Finally, in the more recent case of *Grobow v. Perot*, involving the $745 million buyback by General Motors of the stock of director H. Ross Perot, the Delaware Supreme Court made it clear that the directors' decision there was protected by the business judgment rule.

The new "could reasonably have concluded" standard is related to another very questionable conclusion reached earlier in Principles that the business judgment rule gives protection to all "rational" business decisions, not just to "reasonable" business decisions and that this distinction is supported by the cases and gives much greater protection to the board. The earliest case cited by Principles for the "rational" judgment terminology is *Sinclair Oil Corp. v. Levien*, but, in applying this test to the question at hand, the court there also said the plaintiff must prove the decision was not "reasonable." Finally, in the same case, the Delaware Supreme Court also said that conduct falling outside the business judgment rule must amount to "waste." Principles is thus seen to use rational, reasonable, and waste as three distinct tests in Part V when the fact is that they are all the same standard. The Institute has recently acknowledged that the "waste" and "business judgment rule" standards are the same, and it plans to revise Principles to reflect stock.


151. *Id*.

152. 539 A.2d 180 (Del. 1988).

153. *Id.* at 189-91 ("The law of Delaware is well established that, in the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock at a premium over market from a dissident shareholder is entitled to the protection of the business judgment rule."); *see also* Levine v. Smith, 591 A.2d 194, 206 (Del. 1991) ("[A] plaintiff in a demand futility case must plead particularized facts creating a reasonable doubt as to the 'soundness' of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction.").

154. PRINCIPLES, supra note 4, § 4.01(c)(3) & cmt. at 181 (noting that a director's good faith business judgments are protected if "he rationally believes that his business judgment is in the best interests of the corporation").

155. *See id.* § 4.01(c) cmt. at 232 (stating that "decisions will not be disturbed if they can be attributed to any 'rational business purpose' ") (quoting Sinclair Oil Co. v. Levien, 280 A.2d 717, 720 (Del. 1971))).

156. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971) (plaintiff must "meet his burden of proving that a dividend cannot be grounded on any reasonable business objective").

157. *Id.* at 722 (finding motives immaterial "unless the plaintiff can show that the dividend payments resulted from improper motives and amounted to waste").

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this fact.\textsuperscript{159}

It should be emphasized that Part V is deliberately structured to deal only with pecuniary interest self-dealing and not other director conflicts of interest, and it does not use the term "duty of loyalty" to refer to director pecuniary interest self-dealing.\textsuperscript{160} The standard of conduct for the disinterested director acting in a conflict situation is provided only by Part IV (Duty of Care and Business Judgment Rule) and not Part V.\textsuperscript{161}

The basic, self-interested director transaction, then, is governed by a complex formula. The transaction is upheld if (1) conflict disclosure is made, and (2) (A) the transaction is fair, or (B) it is authorized in advance by disinterested directors and they could reasonably have concluded it was fair, or (C) it is authorized or ratified by disinterested shareholders and does not constitute waste. The burden of proof is on the person challenging the transaction only where there is informed approval by disinterested shareholders or prior informed approval by disinterested directors.\textsuperscript{162}

This formula is not applied to compensation decisions. In the case of compensation of directors who are also senior executives, the transaction is upheld if the compensation is (1) fair, or (2) authorized or ratified by disinterested directors and the business judgment rule is satisfied, or (3) authorized or ratified by disinterested shareholders and does not constitute waste. The burden of proof is on the person challenging the transaction unless there was no disinterested director or shareholder approval.\textsuperscript{163} This standard is specifically applicable to the controversial area of golden parachute compensation arrangements under which lucrative severance payments are made to corporate executives following voluntary or involuntary separation from employment after a takeover.\textsuperscript{164} At the present time, the issues of management compensation in general\textsuperscript{165} and golden parachutes in particular\textsuperscript{166} are as controversial as any subject in corporate governance. In any event, whether one finds multimillion dollar golden parachutes more or less offensive than, say, the $90 million museum built by Occidental Petroleum Corporation to house the art collection of its chief executive officer, Armand Hammer,\textsuperscript{167} may be a matter of personal taste. Under existing law, the business judgment rule applies to the decisions

\textsuperscript{159} \textit{ALL} Discussion, supra note 111, at 178.
\textsuperscript{160} \textit{PRINCIPLES}, supra note 4, at 260 (introductory note to Part V).
\textsuperscript{161} \textit{Id.} at 259 (introductory note to Part V).
\textsuperscript{162} \textit{Id.} § 5.02, at 273-74.
\textsuperscript{163} \textit{Id.} § 5.03, at 312-13.
\textsuperscript{164} \textit{Id.} § 5.03 cmt. at 317, § 6.02 cmt. at 554.
of independent directors in the golden parachute case as well as in the museum situation.\footnote{168}

Yet another formula is applied to corporate opportunity transactions, which are business activity opportunities that as between corporate directors and officers and the corporation rightfully belong to the corporation.\footnote{170} These transactions by directors who are also senior executives are upheld if (1) the opportunity is first offered to the corporation and conflict disclosure is made \textit{and} the opportunity is rejected by the corporation \textit{and} the rejection (A) is fair, or (B) is authorized in advance by disinterested directors \textit{and} the business judgment rule is satisfied, or (C) is authorized or ratified by disinterested shareholders \textit{and} does not constitute waste.\footnote{171} As in section 5.02, the burden of proof is on the person challenging the transaction only where there is informed approval by disinterested shareholders or prior informed approval by disinterested directors.

Here is a trap for the unwary, again unsupported by any authority. If the opportunity is not first offered to the corporation, the director cannot later defend on the grounds that his failure to offer was fair.\footnote{172} He cannot, for instance, argue that he believed in good faith that the opportunity was not a corporate opportunity or that the corporation was not in a position to take the opportunity.\footnote{173} It is inappropriate for the reporter to cite the recent case of \textit{Klinicki v. Lundgren}\footnote{174} as authority for this last proposition, because that case cited the then-current draft of Principles of Corporate Governance as authority for its decision.\footnote{175} The only recourse for the director in this situation is to procure rejection of the opportunity after the fact, which may not be feasible once the matter is in litigation.\footnote{176}

\section*{VI. THE BUSINESS JUDGMENT AND ENTIRE FAIRNESS STANDARDS COMPARED}

The two standards that have been used in the self-dealing cases are the business judgment standard and the entire fairness standard. At the outset, it


\footnote{170} PRINCIPLES, supra note 4, § 5.05, at 363-65; see Annotation, \textit{Fairness to Corporation Where "Corporate Opportunity" Is Allegedly Usurped by Officer or Director}, 17 A.L.R.4TH 479 (1982).

\footnote{171} PRINCIPLES, supra note 4, § 5.05, at 363-65.

\footnote{172} Id. § 5.05(a) cmt. at 369, § 5.05(c) cmt. at 378-79.

\footnote{173} Id. § 5.05 reporter's note at 384.

\footnote{174} Id. § 5.05 reporter's note at 384 (citing Klinicki \textit{v. Lundgren}, 695 P.2d 906 (Or. 1985)).

\footnote{175} Klinicki \textit{v. Lundgren}, 695 P.2d 906, 919-20 (Or. 1985).

\footnote{176} PRINCIPLES, supra note 4, § 5.05(e), at 365.
should be said again that there is no difference between the "fairness" standard, the "intrinsic" fairness standard, the "entire" fairness standard, and the "inherent" fairness standard. They are all the same standard: fairness.

The Delaware Court of Chancery said recently that the significant difference between the fairness and business judgment tests is who has the burden of proof. To be sure, at least in Delaware the burden is on the interested director or controlling shareholder to prove entire fairness where that test is used, and the burden is on the minority shareholder challenging the transaction to prove waste where disinterested and informed approval has been made, but the standard of review has not otherwise been assumed to be the same. The business judgment rule has been defined to exclude only decisions involving waste, that is, transactions that no person of ordinarily sound business judgment would believe were fair. The entire fairness test has been held to require the fiduciary to prove that the outcome of the transaction, had it been approved by an independent board of directors, would have been the same.

The Delaware Supreme Court has compared the two standards using the following language:

Where the directors have represented both themselves and the corporation, and where there was no ratification by stockholders, and the action is thereupon duly challenged, the court will usually have no choice but to employ its own judgment in deciding the perhaps very close and troublesome questions as to whether the evidence shows that the directors in fact used the utmost good faith and the most scrupulous fairness. Where there was stockholder ratification, however, the court will look into the transaction only far enough to see whether the terms are so unequal as to amount to waste, or whether, on the other hand, the question is such a close one as to call for the exercise of what is commonly called "business judgment." In the former case the court will reverse the decision of the stockholders; in the latter it will not.

The business judgment rule is intentionally tolerant of errors of judgment;

179. Summa, 540 A.2d at 406; Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938) (citing Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921)).
182. See supra notes 107-12 and accompanying text.
183. Gottlieb, 91 A.2d at 58.
185. Gottlieb, 91 A.2d at 58.
in fact that is its original and primary purpose. It might be said, then, that the business judgment rule requires only a showing that a reasonably prudent director could have made such a judgment (a possibility), while the entire fairness rule requires a showing that a reasonably prudent director would have made the challenged judgment (a probability). However, in holding recently that the entire fairness test had not been met, the Delaware Supreme Court said that no independent board of directors could have taken such action in good faith and in the honest belief that it was in the best interests of the corporation, citing a leading business judgment rule decision. It is doubtful that the entire fairness test is really intended to be broad enough to include a range of errors of judgment the way the business judgment test is. While it obviously intends a range of reasonable decisions, that range usually is believed to be narrower than the range encompassed by the business judgment rule.

It is suggested that the reason why the business judgment and fairness standards are so much alike is that they aim at the same norm, although for different reasons. Both standards compare the challenged transaction with a transaction that could properly be approved by a hypothetical reasonable board of directors acting in good faith and uninfluenced by negligence or incompetence on the one hand, and bias or self-interest on the other. Thus, in deciding that a challenged transaction had met the fairness test, the Delaware Supreme Court said that if an independent board of directors had approved the transaction, a reviewing court would not think of disturbing its judgment upon the matter, a business judgment rule standard once again.

It is worth noting that the Delaware Supreme Court also uses the intrinsic fairness test as the standard to be applied by the court of chancery in approving the settlement of a shareholders derivative action. In Neponsit Investment Co. v. Abramson, the court held that the chancellor must make more than a cursory scrutiny of the issues and after weighing and considering the claims and defenses determine the intrinsic fairness of the settlement in the exercise of the court's sound business judgment.

VII. THE PROPER STANDARD FOR FREEZEOUT MERGER SELF-DEALING

It might be expected that the field of freezeout mergers would be an espe-
cially fertile one for application of fiduciary duty doctrines, and indeed it has been. In a freezeout merger, a majority shareholder merges the controlled corporation with another corporation wholly owned by him and eliminates the minority shareholders in the first corporation by paying them in cash for their shares. This technique was not available until the advent of the modern business corporation statutes in the 1960s, which allowed the payment of cash as consideration in mergers as well as securities. If the majority shareholder controls the requisite majority of shares, the minority shareholders cannot block the merger by voting against it. They have the right to demand a statutory appraisal of the fair value of the shares, but the question is whether or not they have any other rights. In the landmark case of *Singer v. Magnavox Co.*, the Delaware Supreme Court decided that they do, applying the entire fairness standard as well as the rule that compliance with corporate statutory provisions does not necessarily make corporate action valid in law.

In the *Singer* case, the court held that the burden was on the majority shareholder to establish the entire fairness of the merger to the minority shareholders and in particular to establish that there was a business purpose for the merger other than the elimination of the minority. As a bill of rights for minority shareholders, the *Singer* doctrine was to be short-lived. Almost at once, the court severely weakened the holding by ruling in *Tanzer v. International General Industries* that the business purpose for the merger could be a business purpose solely of the parent corporation and that a business purpose of the controlled corporation did not have to be shown. A few years later, with *Singer* and *Tanzer* author Justice Duffy gone from the court and the court membership expanded from three to five due to an intervening constitutional amendment, the holdings of *Singer* and *Tanzer* that a business purpose of any kind was necessary for a freezeout merger were overruled by a unanimous court in the famous case of *Weinberger v. UOP, Inc.* For good measure, the *Weinberger* decision also overruled two other recent decisions.


194. *Id.* at 980.

195. *Id.* at 975 (citing Schnell v. Chris-Craft Industries, 285 A.2d 437, 439 (Del. 1971) to the effect that “inequitable action does not become permissible simply because it is legally possible”).

196. *Id.* at 976.

197. *Id.* at 980.


199. *Id.* at 1124.


201. 457 A.2d 701, 715 (Del. 1983).

and established new guidelines for freezeout mergers:

1. no independent business purpose is required for a freezeout merger;\(^{203}\)
2. the statutory appraisal remedy is the exclusive remedy for minority shareholders in a freezeout merger, except where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable over-reaching are involved;\(^{204}\)
3. proof of value of the minority shares in an appraisal or other stock valuation proceeding may be made by any techniques or methods generally considered acceptable in the financial community and otherwise admissible in court, except any element of value arising from the accomplishment or expectation of the merger;\(^{205}\)
4. the plaintiff in a suit challenging a freezeout merger must allege specific acts of fraud, misrepresentation, or other items of misconduct to demonstrate the unfairness of the merger terms to the minority;\(^{206}\)
5. the initial burden is on the plaintiff attacking the merger to demonstrate some basis for invoking the fairness obligation;\(^{207}\)
6. the ultimate burden of proof is on the majority shareholder to show by a preponderance of the evidence that the transaction is fair to the minority shareholders;\(^{208}\)
7. however, where the merger has been approved by an informed vote of a majority of the minority shareholders, the burden of proof entirely shifts to the plaintiff to show that the transaction was unfair to the minority;\(^{209}\)
8. before the burden shifts to the plaintiff, the majority shareholder has the burden of proof that all material facts relevant to the transaction were disclosed to the minority shareholders voting on the merger;\(^{210}\)
9. proof of fairness might be shown by establishing an independent negotiating committee of the outside directors of the controlled corporation to negotiate the terms of the merger with the majority shareholder.\(^{211}\)

The *Weinberger* court clearly applied the entire fairness standard to the merger and found it wanting in fairness since, among other things, the controlling shareholder had used members of the controlled corporation’s board of

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\(^{203}\) *Weinberger*, 457 A.2d at 715.

\(^{204}\) *Id.* at 714-15.

\(^{205}\) *Id.* at 713.

\(^{206}\) *Id.* at 703.

\(^{207}\) *Id.*

\(^{208}\) *Id.*

\(^{209}\) *Id.*

\(^{210}\) *Id.*

\(^{211}\) *Id.* at 709 n.7. See generally Scott V. Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988) (advocating the use of special committees of outside directors to evaluate interested director transactions).
directors in formulating its bid, and they, having a conflict of interest, did not share their findings with their fellow directors.\textsuperscript{218} For purposes of the present discussion, however, the interesting question is what standard, business judgment or entire fairness, is to be applied to the merger where the independent negotiating committee technique, the majority of the minority shareholder approval technique, or both are used? Two recent Delaware Court of Chancery decisions have given opposite answers to this question.

In \textit{Citron v. E.I. DuPont de Nemours & Co.},\textsuperscript{218} the chancery court had before it a merger of Remington Arms Company into its parent and majority shareholder, DuPont. The merger was negotiated by an independent committee of Remington directors and was expressly contingent upon the affirmative vote of a majority of the Remington shares not owned by DuPont. Recognizing that under \textit{Weinberger} the affirmative vote of a majority of the minority shareholders shifted the burden of proving the merger was unfair to the plaintiff, the \textit{Citron} court held that while the burden had shifted, the standard of review had not.\textsuperscript{214} The court therefore applied the entire fairness standard, not the business judgment standard, in holding that the merger was fair.\textsuperscript{216} In doing so, the chancellor noted that another court of chancery decision was to the contrary\textsuperscript{216} and that, in \textit{Weinberger} itself, the Delaware Supreme Court had cited a business-judgment waste-standard case in stating that the plaintiff would have to prove the merger was unfair.\textsuperscript{217}

Before the 1970s, which was the era of the "going private" wars, no one seemed to pay much attention to what the minority shareholders thought of interested transactions with a majority shareholder.\textsuperscript{218} However, the device became popular as a means of showing that the majority shareholder had not controlled the transaction. Under the new California Corporations Code of 1977, interested director transactions might be validated by a vote of a major-

\begin{footnotes}
\textsuperscript{212.} \textit{Weinberger}, 457 A.2d at 709-10.
\textsuperscript{213.} 584 A.2d 490 (Del. Ch. 1990).
\textsuperscript{214.} \textit{Id.} at 500-02.
\textsuperscript{215.} \textit{Id.} at 505, 510.
\end{footnotes}
ity of the minority shareholders, even if less than a quorum. The controversial new “going private” regulations of the Securities and Exchange Commission, finally adopted in 1979, also required the issuer in a going private transaction to state whether the transaction was structured so that approval of at least a majority of unaffiliated security holders was required.

When the question of what effect to give to a majority of the minority shareholders approval, where the merger was expressly conditioned on such approval, was raised in the Weinberger case at the chancery court level, the chancellor said it was a question of first impression. He decided to dismiss that complaint for failure to state a cause of action, but with leave to amend. When the plaintiff went to trial on an amended complaint, the chancellor held that conditioning the freezeout merger on majority approval by the minority shareholders did not relieve the majority shareholder of the burden to prove the entire fairness of the merger. He then held that the defendant had satisfied that burden, and as to that point he was reversed by the Delaware Supreme Court. The supreme court also held that the defendant had not made full disclosure to the minority shareholders in soliciting their approval, thereby removing the question of burden shifting from the case, while noting that if full disclosure had been made, the burden would have been on the plaintiff to prove unfairness. Since, as already mentioned, the supreme court cited a waste standard decision at that point, this should have indicated that the plaintiff would face a business judgment standard, but the chancellor in Citron held that an intervening decision pointed in another direction.

The intervening decision was Rosenblatt v. Getty Oil Co., and as the chancellor stated, that case held that where, “as here,” a freezeout merger is approved by a majority of the minority shareholders, the burden is on the plaintiff to prove unfairness, but the Rosenblatt court then seemed to apply an entire fairness standard. Although a majority of the minority shareholders

219. CAL. CORP. CODE § 310(a)(1) (West 1990). Although the reference is to approval by the shareholders under section 153, with interested shares not entitled to vote, and section 153 requires a majority of a quorum, under section 112 shares not entitled to vote are not counted in determining a quorum or required vote. See HAROLD MARSH & R. ROY FINKLE, MARSH’S CALIFORNIA CORPORATION LAW § 11.10 (3d ed. 1990).


223. Id. at 1363.


228. See Rosenblatt, 493 A.2d at 937.
in *Rosenblatt* had approved the merger, the merger was not conditioned on receiving such approval, and the chancellor therefore held that he would assume without deciding that the defendant majority shareholder still had the burden to prove intrinsic fairness. The *Rosenblatt* decision is confusing and is cited in the ALI Principles both as establishing a waste standard and as establishing an unfairness standard.

There does not seem to be any good reason to shift the burden of proof to the plaintiff where the merger was not conditioned on receiving a majority of the minority shareholders’ approval, even if such approval was obtained. If the minority does not have the power to veto the merger, its opinion is advisory. The Delaware Court of Chancery recently held that the burden does not shift in this situation, and that holding was affirmed by the Delaware Supreme Court.

As to the standard to be applied, the waste standard is the one applied by the Delaware courts where self-dealing transactions have been approved after full disclosure by corporate authority having the power to do so, and it should be applied in the freezeout merger case, too.

With respect to the independent board committee, the *Weinberger* court did not say that use of such a committee would shift the burden of proof, and it is hard to understand why it would. Neither the committee nor the full board itself has the authority to approve such a merger, which must be submitted to the shareholders unless a short-form merger is involved. However, the approval of an independent committee should be strong evidence for the majority shareholder since the entire fairness standard, as has been discussed, merely requires him to prove that the transaction would recommend itself to an independent company.

**Conclusion**

The purpose of this Article is to clarify the analytical framework for application of the corporate director’s fiduciary duty of loyalty. First of all, we should stop avoiding the use of the word “fiduciary.” Because all agents are fiduciaries, everyone working for the corporation is a fiduciary, although most will have little occasion to exercise any fiduciary power. If a corporate director...
does not want to be a fiduciary, he will have to rid himself of the power to manage other people's property, and that he cannot do.

We should continue to use the term "duty of loyalty." It is the essence of the fiduciary that he has a duty of loyalty, which has been defined to mean avoidance of conflict of interest. Simply put, no man can serve two masters. We have been led astray in the application of this principle to the corporate director cases due in large part to Professor Marsh's assurance that interested director transactions were voidable without regard to fairness at common law. They were not, and it would perhaps put our minds at ease if we were to rephrase the definition as follows: No man can serve two masters without disclosure and informed consent.

The statutes on interested director contracts were designed to simplify the problem, not complicate it as we have allowed them to do. They were intended to facilitate such contracts by allowing a minority of the board to act and even by allowing the interested director to act so long as the transaction is fair. The director is a businessperson, not a member of some holy order, and this area of the law should be rid of the mystical cant that has surrounded it. If no court ever again refers to the punctilio of an honor the most sensitive, our analysis will be greatly aided. If an interested director transaction has been approved by independent, informed corporate authority, it should only be reviewed under the business judgment rule.

The meanings of the terms in this area need to be better understood: disinterested director, interested director, fairness, business judgment, burden of proof, and good faith. There is no reason to continue to tolerate the confusion that has been engendered by lack of definition. With respect to the Principles of Corporate Governance, it is submitted that the Institute is in error in substituting mechanical rules for fiduciary analysis. If mechanical rules are to be imposed, they should be imposed by the legislature.