7

NORMAL GOVERNANCE: THE DUTY OF CARE

7.1 Introduction to the Duty of Care

The shareholders' right to elect directors is not the law's only strategy for corporate governance. Fiduciary standards also play a role in normal governance, just as they do in agency and partnership law.[1] The duties of a fiduciary are essentially three. The first and most basic, sometimes called the "duty of obedience." This duty plays a significant role in agency law but is not prominent in corporate law. Corporate directors' fiduciary duties generally fall into two principle categories. These are the judicially created duties of loyalty and care (or attention). The duty of loyalty (which we address in Chapter 8) requires that corporate fiduciaries exercise their authority in a good-faith attempt to advance corporate purposes. In particular, it bars corporate officers and directors from competing with the corporation (without informed consent); from misappropriating its property, information, or business opportunities; and especially from transacting business with it on unfair terms. These requirements account for much of the mandatory content of U.S. corporate law.

By contrast, the duty of care reaches every aspect of an officer's or director's conduct, since, in its classic formulation, it requires these parties to act with "the care of an ordinarily prudent person in the same or similar circumstances." Despite its sweeping scope, however, the duty of care is litigated much less than the duty of loyalty, primarily because the law insulates officers and directors from liability based on negligence (as opposed to knowing

1. As we noted in Chapter 1, examples of fiduciary relationships in the law include the relationship between a trustee and *cestui que trust* (i.e., the beneficiary), between a guardian and her ward, and between an executor and the estate. These relationships may be regarded as classical or pure fiduciary relationships because they involve both the exercise of legal power by one over property that he or she does not equitably own and relationships of dependency. For example, the settlor of a trust may well be dead and the beneficiary may be not legally of age or may be incompetent when the opportunity to misbehave presents itself to the trustee. In the case of a decedent's estate, those legally entitled to succeed to the decedent's property may not even know they are beneficiaries of a will. Another class of relationships that have traditionally been treated as fiduciary in character may not have the same degree of dependency, but they still present the same condition of trust. These relationships include the agent's relationship with his principal, the relationship between partners, and the relationship between directors and the corporation.

misconduct) in order to avoid inducing risk-averse management of the firm. In this Chapter, we address both the duty of care and the insulating law that mitigates its effects on directors and officers. First, however, we offer a brief excursus on the evolution of fiduciary duties at common law.

7.2 The Duty of Care and the Need to Mitigate Director Risk Aversion

From the beginnings of Anglo-American corporate law, courts have maintained that a corporate director must do more than pursue the corporation's interests in good faith; a director also has the duty to act as a reasonable person would in overseeing the company's operations.

An English Court of Chancery case decided in 1742 evidences the foundational nature of the duty of care. The report relates that the King chartered the Charitable Company in the early eighteenth century as a stock company, "to assist poor persons with sums of money by way of loans, and to prevent their falling into the hands of pawnbrokers, *&c.*"[2] It appears that the chief administrative officer of the corporation, with two confederates, soon began to defraud the company by "lending [] more money upon old pledges, without calling in the first sum lent." "The loss which ensued from this mismanagement [was] prodigious . . . not less than 350,000 [pounds]." The liability of those actively engaged in the fraud was easily established by the Lord Chancellor. The more subtle question concerned the possible liability of the "committee-men" (directors), who had not participated in the wrongs, but whose inattention had permitted them to occur. As to them, the Lord Chancellor held that "by accepting of a trust of this sort a person is obligated to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it. . . ."[3] Although we do not know if the directors were forced to pay damages, we do know that the Chancellor appointed a master to determine whether they had acted with reasonable diligence. This much establishes that a director's duty of "reasonable diligence" has been a feature of corporate law for a long time.[4]

How does the law currently express this basic obligation? According to the American Law Institute's (ALI's) Principles of Corporate Governance, a corporate director or officer is required to perform his or her functions (1) in good faith, (2) in a manner that he or she reasonably believes to be in the best interests of the corporation, and (3) with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and

2. *The Charitable Company v. Sutton*, 2 Atk. 400, 406 (Ch. 1742), 26 Eng. Reps. 642 (1742).

3. Id., 26 Eng. Reps. at 645.

4. See, e.g., *Godbold v. Branch Bank*, 11 Ala. 191 (1847); *Hodges v. New England Screw Co.*, 1 R.I. 312 (1850); *Bates v. Dresser*, 251 U.S. 524 (1920) (Holmes, J.). It is notable that *Sutton* is not a case in which a loss resulted from a board decision; rather, it was a neglect of attention case. The cases of inattention, rather than poor judgment, are the cases in which one would traditionally find directors liable for breach of care.

under similar circumstances.[5] The core of this standard is the level of care that we expect would be exercised by an ordinarily prudent person.[6] This formulation appears to make the duty of care into a negligence rule like any other negligence rule in tort law. However, the duty of care is not just another negligence rule. As we discuss below, there is an important policy reason why a business loss cannot be analogized to a traffic accident or a slip on a banana peel. The reason, bluntly stated, is that corporate directors and officers invest other people's money. They bear the full costs of any personal liability, but they receive only a small fraction of the gains from a risky decision. Liability under a negligence standard therefore would predictably discourage officers and directors from undertaking valuable but risky projects.

Consider the following excerpt from a Delaware Court of Chancery opinion.

GAGLIARDI v. TRIFOODS INTERNATIONAL, INC.

683 A.2d 1049 (Del. Ch. 1996)

ALLEN, C.:

Currently before the Court is a motion to dismiss a shareholders action against the directors of TriFoods International, Inc. . . . In broadest terms the motion raises the question, what must a shareholder plead in order to state a derivative claim to recover corporate losses allegedly sustain[ed] by reason of "mismanagement" unaffected by directly conflicting financial interests? . . .

I start with what I take to be an elementary precept of corporation law: in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith. There is a theoretical exception to this general statement that holds that some decisions may be so "egregious" that liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction. . . .

The rule could rationally be no different. Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first. Shareholders don't want (or shouldn't rationally want) directors to be risk averse. . . .

5. See ALI, Principles of Corporate Governance §4.01 (1994). See also RMBCA §8.30.

6. As of 2005, forty jurisdictions required that a corporate director discharge the duties of that office in good faith and with a stated standard of care, usually phrased in terms of the care that an ordinarily prudent person would exercise under similar circumstances. Thirty-five of these jurisdictions also expressly required that a director perform these duties in a manner that she reasonably believes to be in the best interests of the corporation. See RMBCA. §8.30, at 8-178 (2005).

[But] directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky! — you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, . . . only a very small probability of director liability based on "negligence," "inattention," "waste," etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.

The law protects shareholder investment interests against the uneconomic consequences that the presence of such second-guessing risk would have on director action and shareholder wealth in a number of ways. It authorizes corporations to pay for director and officer liability insurance and authorizes corporate indemnification in a broad range of cases, for example. But the first protection against a threat of sub-optimal risk acceptance is the so-called business judgment rule. That "rule" in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty. . . ."

As *Gagliardi* states, the law protects corporate officers and directors from liability for breach of the duty of care in many ways, some statutory and some judicial. First, the statutory law authorizes corporations to *indemnify the expenses* (including in some cases the judgment costs) incurred by officers or directors who are sued by reason of their corporate activities. See, e.g., DGCL §145. Second, the statutory law authorizes corporations to purchase liability insurance for their directors and officers, which may even cover some risks that are not subject to indemnification. Third, courts have long evolved the protection of the so-called business judgment rule, as we discuss below. And last, when in 1985 it was seen that the protection of the business judgment rule was not as far reaching as had been thought,[7] legislatures across the country followed Delaware's lead by specifically authorizing companies to waive director (and sometimes officer) liability for acts of negligence or gross negligence. We discuss these statutes, such as DGCL §102(b)(7), below.

7. The case of *Smith v. Van Gorkom*, discussed below, was the occasion for this realization.

These provisions pose an interesting question: Why do corporations purchase insurance for directors and officers rather than raising salaries and board fees and then allowing directors and officers to take the money and purchase insurance on their own accounts? We suppose, as in many aspects of this field, the answer lies in the transaction costs of contracting and in other institutional details of the environment in which this contracting occurs. While we do not claim to know the answer, we offer here some possibilities. First, D&O (directors and officers) insurance might be cheaper if the company acts as a central bargaining agent for all of its officers and directors. Second, and related, uniformity may have value in that it standardizes directors' individual risk profiles in decision making, and avoids potentially negative signaling that would arise from directors having different levels of coverage. Third, tax law may favor firm-wide insurance coverage, since D&O insurance is a deductible expense for corporations. Or fourth, directors may under-invest in D&O insurance if left to themselves, because shareholders also benefit from D&O insurance. In early 2005, directors of WorldCom and Enron made headlines by paying out of their own pockets to settle shareholder lawsuits arising under federal securities laws. At WorldCom, the independent directors agreed to pay \$18 million (20 percent of their collective net worth) toward a \$54 million settlement for their role in WorldCom's \$11 billion accounting fraud. At Enron, ten directors agreed to pay \$13 million toward a \$168 million settlement for their role in Enron's fraudulent accounting practices (but had collectively made \$250 million (pre-tax) on the sale of their Enron shares). The natural question arises: Where was the D&O insurance? Most academic commentators and practitioners agree that out-of-pocket liability arose in these two cases due to a "perfect storm" set of facts: Both companies were bankrupt and so could not indemnify the directors; both companies had well-documented paper trails of director inattention and inaction; activist pension funds such as the New York State retirement fund were intent on making examples out of these two companies, which were the largest (WorldCom) and second-largest (Enron) bankruptcies in U.S. history; and the enormous potential liabilities in both cases could have easily exceeded the companies' D&O policies. Consistent with this "perfect storm" conclusion, Professors Black, Chefffins, and Klausner report only one other case (*Van Gorkom*) in which directors actually paid out-of-pocket for either damages or legal expenses under U.S. securities law or corporate law;[9] and even this case is not really an example of out-of-pocket liability, for reasons described below.

7.4 Judicial Protection: The Business Judgment Rule

Long before legislatures acted to protect directors and officers from liability arising from breach of the duty of care, courts fashioned their own protection.

9. Bernard S. Black, Brian R. Cheffins & Michael D. Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055 (2006).

Over roughly the past 150 years, U.S. courts have evolved the so-called business judgment rule.[10] Because corporate law is state law, there is no canonical statement of the "business judgment rule." The core idea, however, is universal: Courts should not second-guess good-faith decisions made by independent and disinterested directors. Put differently, the business judgment rule means that courts will not decide (or allow a jury to decide) whether the decisions of corporate boards are either substantively reasonable by the "reasonable prudent person" test or sufficiently well informed by the same test. In the following case, the shareholder plaintiffs had a pretty good argument that the board's decision was not "reasonably prudent." Nevertheless, the court refused to inquire whether an ordinarily prudent person would have made this same decision.

KAMIN v. AMERICAN EXPRESS CO.

54 A.D.2d 654 (N.Y. 1976)

GREENFIELD, J.:

In this stockholders' derivative action, the individual defendants, who are the directors of the American Express Company, move for an order dismissing the complaint for failure to state a cause of action . . . and alternatively, for summary judgment. . . . The complaint is brought derivatively by two minority stockholders of the American Express Company, asking for a declaration that a certain dividend in kind is a waste of corporate assets, directing the defendants not to proceed with the distribution, or, in the alternative, for monetary damages. . . . It is the defendants' contention that, conceding everything in the complaint, no viable cause of action is made out.

[T]he complaint alleges that in 1972 American Express acquired for investment 1,954,418 shares of common stock of Donaldson, Lufken and Jenrette, Inc. (hereafter DLJ), a publicly traded corporation, at a cost of $29.9 million. It is further alleged that the current market value of those shares is approximately $4.0 million. On July 28, 1975, it is alleged, the Board of Directors of American Express declared a special dividend to all stockholders of record pursuant to which the shares of DLJ would be distributed in kind. Plaintiffs contend further that if American Express were to sell the DLJ shares on the market, it would sustain a capital loss of $25 million, which could be offset against taxable capital gains on other investments. Such a sale, they allege, would result in tax savings to the company of approximately $8 million, which would not be available in the case of the distribution of DLJ shares to stockholders. . . .

It is apparent that all the previously-mentioned allegations of the complaint go to the question of the exercise by the Board of Directors of business judgment in deciding how to deal with the DLJ shares. The crucial allegation which must be scrutinized to determine the legal sufficiency of the complaint is paragraph 19, which alleges:

10. See generally S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93 (1979).

> All of the defendant Directors engaged in or acquiesced in or negligently permitted the declaration and payment of the Dividend in violation of the fiduciary duty owed by them to Amex to care for and preserve Amex's assets in the same manner as a man of average prudence would care for his own property. . . .

[T]here is no claim of fraud or self-dealing, and no contention that there was any bad faith or oppressive conduct. The law is quite clear as to what is necessary to ground a claim for actionable wrongdoing. In actions by stockholders, which assail the acts of their directors or trustees, courts will not interfere unless the powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of the stockholders. Mere errors of judgment are not sufficient as grounds for equity interference, for the powers of those entrusted with corporate management are largely discretionary. . . .

More specifically, the question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the Board of Directors.

. . . Courts will not interfere with such discretion unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose. It is for the directors to say . . . when and to what extent dividends shall be declared. . . . The statute confers upon the directors this power, and the minority stockholders are not in a position to question this right, so long as the directors are acting in good faith. . . .

Thus, a complaint must be dismissed if all that is presented is a decision to pay dividends rather than pursuing some other course of conduct . . . . Courts have more than enough to do in adjudicating legal rights and devising remedies for wrongs. The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages. . . .

It is not enough to allege, as plaintiffs do here, that the directors made an imprudent decision, which did not capitalize on the possibility of using a potential capital loss to offset capital gains. More than imprudence or mistaken judgment must be shown.

Nor does this appear to be a case in which a potentially valid cause of action is inartfully stated. . . . The affidavits of the defendants and the exhibits annexed thereto demonstrate that the objections raised by the plaintiffs to the proposed dividend action were carefully considered and unanimously rejected by the Board at a special meeting called precisely for that purpose at the plaintiffs' request. The minutes of the special meeting indicate that the defendants were fully aware that a sale rather than a distribution of the DLJ shares might result in the realization of a substantial income tax saving. Nevertheless, they concluded that there were countervailing considerations primarily with respect to the adverse effect such a sale, realizing a loss of $25 million, would have on the net income figures in the American Express financial statement. Such a reduction of net income would have a serious effect on the market value of the publicly traded

American Express stock. This was not a situation in which the defendant directors totally overlooked facts called to their attention. They gave them consideration, and attempted to view the total picture in arriving at their decision. While plaintiffs contend that according to their accounting consultants the loss on the DLJ stock would still have to be charged against current earnings even if the stock were distributed, the defendants' accounting experts assert that the loss would be a charge against earnings only in the event of a sale, whereas in the event of distribution of the stock as a dividend, the proper accounting treatment would be to charge the loss only against surplus. While the chief accountant for the SEC raised some question as to the appropriate accounting treatment of this transaction, there was no basis for any action to be taken by the SEC with respect to the American Express financial statement.

The only hint of self-interest which is raised . . . is that four of the twenty directors were officers and employees of American Express and members of its Executive Incentive Compensation Plan. Hence, it is suggested, by virtue of the action taken earnings may have been overstated and their compensation affected thereby. Such a claim . . . standing alone can hardly be regarded as sufficient to support an inference of self-dealing. There is no claim or showing that the four company directors dominated and controlled the sixteen outside members of the Board. Certainly, every action taken by the Board has some impact on earnings and may therefore affect the compensation of those whose earnings are keyed to profits. That does not disqualify the inside directors, nor does it put every policy adopted by the Board in question. All directors have an obligation, using sound business judgment, to maximize income for the benefit of all persons having a stake in the welfare of the corporate entity. . . . The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others presents no basis for the super-imposition of judicial judgment, so long as it appears that the directors have been acting in good faith. The question of to what extent a dividend shall be declared and the manner in which it shall be paid is ordinarily subject only to the qualification that the dividend be paid out of surplus (Business Corporation Law Section 510, subd. b). The Court will not interfere unless a clear case is made out of fraud, oppression, arbitrary action, or breach of trust.

. . . Accordingly, the motion by the defendants for summary judgment and dismissal of the complaint is granted. . . .

QUESTIONS

1. Assuming the board acted in good faith in *Kamin*, what is the board's view about the efficiency of the capital markets? If the capital markets are very highly efficient in fact, what does the *Kamin* transaction imply about the wealth-creating impact of this action?

2. The empirical literature in finance suggests that alternative accounting characterizations do not affect share price if they are made publicly and are well understood. Corporate directors and managers typically care a great deal about accounting changes that might lower reported earnings or revenues. If the studies are correct and the market sees through accounting treatments, why might business people act in this way?

3. Would *Kamin* have been decided differently under §4.01(c) of the American Law Institute's Principles of Corporate Governance?

7.4.1 Understanding the Business Judgment Rule

Upon reflection, the so-called business judgment rule comes to seem a bit more mysterious than it first appears. More precisely, there are three mysteries. The first mystery is this: What exactly *is* this "rule"?

There is, as we have said, no single canonical statement of the business judgment rule. The closest one can come may be the formulation contained in the American Bar Association's *Corporate Director's Guidebook*, where it is said that a *decision* constitutes a valid business judgment (and gives rise to no liability for ensuing loss) when it (1) is made by *financially disinterested directors* or officers (2) who have become *duly informed* before exercising judgment and (3) who exercise judgment in a *good-faith* effort to advance corporate interests.[11] Since the law cannot order directors to make correct decisions by fiat, it follows, in our view, that disinterested directors who act deliberately and in good faith should never be liable for a resulting loss, no matter how stupid their decisions may seem ex post.

The mystery associated with the business judgment rule is why it is necessary at all. After all, if a director has no conflicting interest, is reasonably informed, and makes a good-faith judgment (by which we mean an honest judgment seeking to advance the corporation's interests), what possible basis for liability exists? The answer, we think, is that there is none — not because the business judgment rule exists but because there is no breach of directorial duty. So why have a special "business judgment rule" in the first place?

There are two reasons, we believe. The first is procedural. When courts invoke the business judgment rule, they are, in effect, converting what would otherwise be a question of fact — whether the financially disinterested directors who authorized this money-losing transaction exercised the same care as would a reasonable person in similar circumstances — into a question of law for the court to decide. Recall that courts decide questions of law, while juries ordinarily decide questions of fact. So the business judgment rule insulates disinterested directors from jury trials, which encourages the dismissal of some claims before trial and allows judicial resolution of the remaining case-based claims that go to trial.

11. See American Bar Assn., Corporate Director's Guidebook (2d ed. 1994); see also American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §4.01(c) (1994); RMBCA §8.30.

In addition to this procedural reason, a second reason for the business judgment rule is to convert the question "Was the standard of care breached?" into the related, but different questions of whether the directors were truly disinterested and independent and whether their actions were not so extreme, unconsidered, or inexplicable as not to be an exercise of good-faith judgment. In most circumstances, courts are extremely reluctant to infer that directors lack good faith based on the outcome of board decisions.[12]

Thus, there are two ways in which the business judgment rule can be said to insulate directors from duty-of-care liability, one procedural and the other substantive. But why *should* the law have evolved to provide this additional insulation that is not available to other classes of defendants in negligence cases? Here we fall back on the analysis of directorial incentives that was introduced above in the *Gagliardi* case.

Directors who risk liability for making "unreasonable" decisions — or even for failing to become reasonably informed or engaging in appropriate deliberation before acting — are likely to behave in a risk-averse manner that harms shareholders. This is the reason why, once a court concludes that the case before it involves fully disinterested directors, the business judgment rule will be said to apply, and the case will be dismissed unless there is some very unusual feature that suggests possible suspect motivation.

This account of the practical effect of the business judgment rule leads to the final mystery associated with the rule: Why bother with the duty of care at all? Why *announce* a legal duty to behave as a reasonable director would behave but *apply* a rule that *no good-faith decision* gives rise to liability as long as no financial conflict of interest is involved?

The answer must be that there is social value to announcing a standard ("you must act as a reasonable person would act") that is not enforced with a liability rule. But how? We suggest that when corporate lawyers charge directors with their legal duty of care, most board members will decide how to act based on several considerations, not on their risk of personal liability alone. Nonlegal sanctions such as personal reputation may affect some directors, but many more, we suspect, will be motivated by a simple desire to do the right thing whether or not personal liability is at risk. For such people, articulating the standard of care has the pedagogic function of informing them just what "doing the right thing" means under the circumstances.

7.4.2 The Duty of Care in Takeover Cases: A Note on *Smith v. Van Gorkom*

One of the most interesting features of corporation law over the period 1985-2000 has been the evolution of the law of directors' and officers' duties in the context of hostile takeover attempts. This story is told in Chapter 12 but will be prefaced here. It begins with an unusual 3-2 Delaware Supreme Court

12. There is an exception in cases involving a change in corporate control, where directors may have an "entrenchment interest."

hostile takeovers later in detail), in the end if a sufficient number of the investors want to cash out, this form itself will not stop that.

A recent case in the Court of Chancery, *eBay Holdings, Inc. v. Newmark* demonstrates the utility of this new statute. Craigslist, Inc. operates its free website by the same name with great success. But the company earned revenue only from a small part of its website (apartment rental ads in NYC and some job ads). It was viewed by its founders and controllers as a community service, making just enough money to operate with a small (34-person) staff. But its special character — a reflection of the personalities of its two founders — was not set forth in its charter. Uoops! Thus when eBay acquired a minority interest and agitated for profit maximization, the board, dominated by the founders, took defensive action designed to preserve their conception of the company as a community benefit into the indefinite future by preventing any takeover of Craigslist. This seems precisely the sort of firm that would now incorporate as a B Corp. But in the event the court struck down the defensive actions, holding that since the company had another substantial (28 percent) shareholder who was interested in monetizing the business, the directors had an obligation to attempt to earn profits. Had Craiglist been formed as a B Corp, the result would have been otherwise. See *eBay Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010).

8.2 Self-Dealing Transactions

We return now to the traditional model of business corporations in which investors are presumed to be seeking and directors are obliged to seek only long-term financial gain. Sometimes directors or controlling shareholders purport to advance shareholder interests by themselves engaging in transactions with the corporation. These "related-party" transactions offer the paradigmatic circumstance in which courts are required to assess compliance with the duty of loyalty. These cases show that, even if the legal primacy of shareholder interests over those of other constituencies remains uncertain in some cases, it is quite clear that directors and corporate officers may not benefit financially at the expense of the corporation in these self-dealing transactions. The danger in such transaction is apparent, but how should the law deal with it? It might simply prohibit all (direct or indirect) transactions between directors or officers and the corporation. This would eliminate the opportunity for insider opportunism, but it would do so at the cost of preventing some mutually beneficial transactions, as when directors are more confident about a corporation's prospects than are banks or outside investors. A more nuanced if operationally more difficult approach would be to permit interested transactions that are "fair" to the corporation but to proscribe those that are not.

In rationally choosing between these possible legal rules one should also consider the costs of administering the rule chosen. Ideally, the legal regime should be simple (like the preclusion alternative) but discriminating (like the screening alternative), and it should operate without requiring (or inviting) litigation in every such transaction. The evolution of fiduciary law of director self-dealing can be seen as an attempt to somehow balance these three interests.

8.2.1 The Disclosure Requirement

The law has tended to adopt some version of the screening alternative. That is, boards of directors may approve transactions between the corporation and one or more of directors or officers. But they may only approve such transactions as are fair to the corporation. What then more particularly are the requirements of a related-party transaction and a process that will be validated if challenged in court as unfair? The first requirement of valid authorization of a conflicted transaction is that the interested director makes full disclosure of all material facts of which she is aware at the time of authorization. But how far does this disclosure obligation reach?

STATE EX REL. HAYES OYSTER CO. v.
KEYPOINT OYSTER CO.
391 P.2d 979 (Wash. 1964)

DENNEY, J.:

Verne Hayes was CEO, director, and 23 percent shareholder of Coast Oyster Co., a public company that owned several large oyster beds. Verne's employment contract barred him from taking part in any business that would compete with Coast except for his activities in Hayes Oyster Co., a family corporation in which he owned 25 percent of the shares and his brother, Sam, owned 75 percent. In the spring of 1960, when Coast was badly in need of cash to satisfy creditors, Hayes suggested that Coast sell its Allyn and Poulsbo oyster beds. Hayes then discussed with Engman, a Coast employee, how Hayes Oyster might help Engman finance the purchase.

On August 11, 1960, Coast's board approved Hayes's plan to sell the Allyn and Poulsbo beds to Keypoint Oyster Co., a corporation to be formed by Engman, for $250,000, payable $25,000 per year, with 5 percent interest, thus improving Coast's cash position and relieving it of the expenses of harvesting the oysters in those beds. On September 1, 1960, Hayes and Engman agreed that Keypoint's shares would be owned half by Engman and half by Hayes Oyster. At a Coast shareholders' meeting on October 21, 1960, the shareholders approved the sale to Keypoint — Hayes voting his Coast shares and others for which he held proxies (in total constituting a majority) in favor. At none of these times did any person connected with Coast (other than Hayes and Engman) know of Hayes's or Hayes Oyster's interest in Keypoint.

In 1961 and 1962, Hayes sold his Coast shares and executed a settlement agreement with respect to his Coast employment contract. Shortly thereafter, Coast's new managers brought suit against Verne and Sam Hayes for their Keypoint shares and all profits obtained by Hayes as a result of the transaction. The trial court absolved Hayes of any breach of duty to Coast.

Coast does not seek a rescission of the contract with Keypoint, nor does it question the adequacy of the consideration which Keypoint agreed to pay for the purchase of Allyn and Poulsbo, nor does Coast claim that it suffered any loss in the transaction. It does assert that Hayes, Coast's president, manager and director, acquired a secret profit and personal advantage to himself in the acquisition of the Keypoint stock by Hayes or Hayes Oyster in the side deal with Engman; and that such was in violation of his duty to Coast, and that, therefore, Hayes or Hayes Oyster should disgorge such secret profit to Coast.

Certain basic concepts have long been recognized by courts throughout the land on the status of corporate officers and directors. They occupy a fiduciary relation to a private corporation and the shareholders thereof akin to that of a trustee, and owe undivided loyalty, and a standard of behavior above that of the workaday world. . . .

Directors and other officers of a private corporation cannot directly or indirectly acquire a profit for themselves or acquire any other personal advantage in dealings with others on behalf of the corporation. . . .

Respondent [Hayes] is correct in his contention that this court has abolished the mechanical rule whereby any transaction involving corporate property in which a director has an interest is voidable at the option of the corporation. Such a contract cannot be voided if the director or officer can show that the transaction was fair to the corporation. However, nondisclosure by an interested director or officer is, in itself, unfair. This wholesome rule can be applied automatically without any of the unsatisfactory results which flowed from a rigid bar against any self-dealing. . . .

The trial court found that any negotiations between Hayes and Engman up to . . . September 1, 1960, resulted in no binding agreement that Hayes would have any personal interest for himself or as a stockholder in Hayes Oyster in the sale of Allyn and Poulsbo. The undisputed evidence, however, shows that Hayes knew he might have some interest in the sale. It would have been appropriate for Hayes to have disclosed his possible interest at the informal meeting in Long Beach on August 4, 1960, and particularly at the meeting of Coast's board of directors on August 11, 1960. It is not necessary, however, for us to decide this case on a consideration of Hayes' obligation to Coast under the circumstances obtaining at that time.

Subsequent to the agreement with Engman, Hayes attended the meeting of Coast stockholders on October 21, 1960, recommended the sale, and voted a majority of the stock, including his own, in favor of the sale to Keypoint. On the same day, . . . he signed the contract which, among other things, required Keypoint to pay 10 monthly payments amounting to $25,000 per year, to pay interest on [a] deferred balance at 5 percent, to make payments on an option agreement which Coast had with one Smith, to plant sufficient seed to produce 45,000 gallons of oysters per year, inform Coast of plantings, furnish annual reports to Coast, operate the oysterlands in good workmanlike manner, keep improvements in repair, pay taxes, refrain directly or indirectly from engaging in growing, processing or marketing dehydrated oysters or oyster stew, give Coast first refusal on purchase of Keypoint oysters of 10,000 gallons per year or one-fourth of Keypoint's production. Title was reserved in Coast until payment in full of the purchase price of $250,000. . . .

At this juncture, Hayes was required to divulge his interest in Keypoint. His obligation to do so [arose] from the possibility, even probability, that some controversy might arise between Coast and Keypoint relative to the numerous provisions of the executory contract. Coast shareholders and directors had the right to know of Hayes' interest in Keypoint in order to intelligently determine the advisability of retaining Hayes as president and manager under the circumstances, and to determine whether or not it was wise to enter into the contract at all, in view of Hayes' conduct. In all fairness, they were entitled to know that their president and director might be placed in a position where he must choose between the interest of Coast and Keypoint in conducting Coast's business with Keypoint.

Furthermore, after receipt of the Keypoint stock, Hayes instructed the treasurer of Coast to make a payment on the Smith lease-option agreement which Keypoint was required to pay under the provisions of the contract. This action by Hayes grew out of a promise which Hayes made to Engman during their negotiations before the sale to reduce the sale price because of mortality of oysters on Allyn and Poulsbo. There was a clear conflict of interest.

The cases relied upon by respondent are not opposed to the rule condemning secrecy when an officer or director of a corporation may profit in the sale of corporate assets. In *Leppaluoto v. Eggleston*, 57 Wash. 2d 393, 357 P.2d 725, Eggleston secretly chartered his own equipment to a corporation in which he had one-half interest, for $25,000, without the knowledge of the owner of the remaining stock. We held that Eggleston was not required to return the $25,000 to the corporation because there was no proof that the charter arrangement was unfair or unreasonable and no proof that Eggleston made any profit on the transaction and that, absent proof of loss to the corporation or profit to Eggleston, no recovery could be had. In the case before us, profit to Hayes or Hayes Oyster in acquiring 50 percent of Keypoint stock is clear and undisputed. . . .

It is true that Hayes hypothecated his stock in Coast to one of Coast's creditors in early August, 1960. Undoubtedly, this aided Coast in placating its creditors at that time and showed absence of an intent to defraud Coast. It is not necessary, however, that an officer or director of a corporation have an intent to defraud or that any injury result to the corporation for an officer or director to violate his fiduciary obligation in secretly acquiring an interest in corporate property. . . .

Actual injury is not the principle upon which the law proceeds in condemning such contracts. Fidelity in the agent is what is aimed at, and as a means of securing it, the law will not permit the agent to place himself in a situation in which he may be tempted by his own private interest to disregard that of his principal. . . .

Respondent asserts that action by Coast shareholders was not necessary to bind Coast to the sale because it had already been approved by Coast's board of directors. Assuming this to be true, Hayes' fiduciary status with Coast did not change. He could not place himself in an adverse position to Coast by acquiring an interest in the executory contract before the terms of said contract had been performed by Keypoint. Coast had the option to affirm the contract or seek rescission. It chose the former and can successfully invoke the principle that whatever a director or officer acquires by virtue of his fiduciary relation, except in open dealings with the company, belongs not to such director or officer, but to the company. . . .

This rule appears to have universal application. . . . The trial court's finding that Hayes acted on behalf of Hayes Oyster in all of his negotiations with Engman subsequent to July, 1960, does not alter the situation. Sam Hayes knew that Verne Hayes was president and manager of Coast and owed complete devotion to the interests of Coast at the time Verne Hayes first approached him on the subject of sharing with Engman in the purchase of Allyn and Poulsbo. Sam Hayes knew and agreed that any interest of Verne Hayes or Hayes Oyster in Keypoint was to be kept secret and revealed to no one, including Coast. Sam Hayes authorized Verne Hayes to proceed with the deal on behalf of Hayes Oyster on this basis. Verne Hayes became the agent of Hayes Oyster in negotiating with Engman.

. . . Every sound consideration of equity affects Hayes Oyster as well as Verne Hayes. Neither can profit by the dereliction of Verne Hayes. . . .

The decree and judgment of the trial court. . . is reversed with direction to order Keypoint Oyster Company to issue a new certificate for 250 shares of its stock to Coast Oyster Company and cancel the certificates heretofore standing in the name of or assigned to Hayes Oyster Company. . . .

QUESTIONS ON STATE EX REL. HAYES OYSTER CO. v. KEYPOINT OYSTER CO.

Why do courts consider nondisclosure per se unfair? Why shouldn't Hayes be granted the opportunity to show that the consideration received for the oyster beds was completely fair? After all, Hayes Oyster is not attempting to rescind the sale.

MELVIN EISENBERG, SELF-INTERESTED TRANSACTIONS IN CORPORATE LAW

13 J. Corp. L. 997, 997-1008 (1988)

[W]hy isn't fairness of price enough without full disclosure? . . .

[A] rule that fairness of price was enough without full disclosure would in effect remove decision making from the corporation's hands and place it in the hands of the court. Many or most self-interested transactions involve differentiated commodities. . . . In the case of commodities that are differentiated, . . . prices are invariably negotiated. The market may set outside limits on the price—at some point, the price the seller demands is so high that the buyer would prefer a market substitute, or the price the buyer insists upon is so low that the seller would prefer to market his commodity to someone else — but within those limits the price will be indeterminable prior to negotiation. Therefore, if by a "fair price" we mean the price that would have been arrived at by a buyer and a seller dealing at arm's length, in the case of a self-interested transaction involving a differentiated commodity, a court attempting to determine whether the price was fair can do no more than to say that the price was or was not within the range at which parties dealing at arm's length would have concluded a deal . . .

NOTES ON DISCLOSURE OF CONFLICTED TRANSACTIONS

Requiring a corporate fiduciary to disclose his or her interest in a proposed transaction with the corporation is only the first step. The difficult question is just what must be disclosed beyond the simple fact of self-interest. For example, if a director (call him Jones) offers to buy 50 acres of the corporation's land at a price that he regards as fair, must he disclose his intended use of the property? What if Jones's cousin is a developer who has informed him of his plan for a large residential development in the neighborhood, which will make the property more valuable? Should Jones have to disclose his cousin's plans? Does Jones have to disclose the highest price that he is willing to pay? What principle answers these questions?

The fiduciary's role in negotiating a conflicted transaction with his corporation is not an easy one. Recall the singing phrases of Judge Cardozo in *Meinhard v. Salmon*: Some forms of behavior open to traders in the market are not available to fiduciaries. Among these forms is a range of disingenuous actions that fall short of fraud. The Delaware court's legal standard for disclosure by a conflicted fiduciary is that a director or controlling shareholder must disclose *all* material information relevant to the transaction.[9] In our example, a literal application of this language would require Jones to disclose both what he learned from his cousin and the highest price he would pay. But such a requirement, since it would tend to remove the prospects of any benefit to the fiduciary, might radically reduce the number of mutually beneficial transactions offered. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (en banc) later in this Chapter.[10] So, courts would most likely not treat a fiduciary's reservation price as a "fact" that must be disclosed.

Finally, note that federal securities laws may also regulate disclosure of self-dealing transactions in public corporations. Given that Coast Oyster is a public company, would Verne be compelled to disclose his interest in the oyster bed sale under Regulation S-K, Item 404(a) (in your statutory supplement) if he were to undertake the same transaction with Engman today?[11]

9. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1978).

10. See generally Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 Vand. L. Rev. 1087 (1996).

11. Note that the disclosure required of the issuer for "related party" transactions must be made in the Form 10-K Annual Report (filed with the SEC) and the annual statement that public companies must distribute to shareholders.

8.3 The Effect of Approval by a Disinterested Party

A student reading thus far might conclude that litigation about conflicted transactions would focus solely on the adequacy of disclosure or, if the insider actions were fully disclosed, on the intrinsic fairness of their terms. That, however, is not usually the case. The procedural aspects of how such transactions are considered and approved tend in fact to play a central role. We noted earlier that approval of self-dealing transactions by disinterested directors or shareholders began to play a key role in the defense of these transactions at least by the early twentieth century. This role was codified in the so-called safe harbor statutes, adopted by states from the mid-twentieth century, and was further developed by the courts since. The principal legal questions raised by disinterested review mechanisms concern (1) the question whether the disinterested approval has sufficient integrity to be accorded some affect by reviewing courts and (2) the standard of judicial review to be employed *after* disinterested review and approval. For example, is it cursory review under the business judgment standard? Or is it more searching review under some sort of "fairness-lite" standard? And should it matter whether directors or shareholders approve the transaction? (A related issue is, What if the transaction is only disclosed *after* the fact but is then ratified by disinterested directors?)

We explore these issues beyond full disclosure below, beginning with the effects of safe harbor statutes.

8.3.1 Early Regulation of Fiduciary Self-Dealing

Understanding safe harbor statutes requires understanding a bit of corporate law history. In the late eighteenth and early nineteenth centuries, American and English courts looked to the law of trusts for guidance in adjudicating disputes over the duties of corporate directors.[12] The trust's division of ownership into legal ownership (with control) and beneficial interest (without control) provided an obvious analogue for the division of ownership powers between the board and shareholders in the widely held corporation.

Early trust law flatly prohibited a trustee from dealing either with trust property on his own account or with the trust beneficiary respecting trust property.[13] Such transactions could be set aside at the insistence of any interested party, without regard to how fair they may have seemed. But with time, the law recognized that a trustee could deal with a beneficiary with respect to trust property,[14] *if* the beneficiary was competent, consented after full disclosure, *and* the transaction was fair.[15] If any of these conditions was not met, however, the transaction between a beneficiary and a trustee was voidable.

12. *Ex parte Holmes*, 5 Cow. 426 (N.Y. Sup. Ct. 1826); Lawrence E. Mitchell, *Fairness in Trust in Corporate Law*, 43 Duke L.J. 425 (1993).

13. *Ex parte Holmes*, 5 Cow. 426.

14. *Smith v. Lancing*, 22 N.Y. 520 (1860).

15. *U.S. Rolling Stock Co. v. The Atlantic and Great Western Railroad Co.*, 34 Ohio St. 450 (1878).

Thus, transactions with trust beneficiaries were not flatly prohibited, as were transactions between the trustee and the trust itself.[16]

Some commentators argue that, by 1880, the trust rule (prohibition or void) as opposed to the trust beneficiary rule (voidable), had become the general rule of corporation law; conflicted director transactions were simply void.[17] Other commentators dispute this claim.[18] All agree, however, that, beginning in the early twentieth century, courts would uphold as valid a contract between a director and the corporation if it was (1) on fair terms (2) had been approved by a board comprised of a majority of disinterested directors after (3) full disclosure. A contract that did not meet *all aspects* of this test was voidable, meaning that it would be set aside on the application of any party with an interest in the contract.

The practical problem in this approach laid in the requirement that transactions be approved by a majority of disinterested directors. Under early twentieth-century law, an interested director's attendance at a board meeting could not be counted toward a quorum on a question in which he was interested.[19] This rule meant that a corporation could not act to authorize a contract in which a majority of the board was personally interested. No quorum could be had. Of course, corporate officers could authorize minor contracts within the scope of their authority, but a major contract requiring board approval simply could not be authorized if a majority of directors were financially interested in it.

There was, however, good reason to make some of these contracts binding; knowledgeable directors might sometimes offer the company better terms than anyone else. One solution was for shareholders to put into the corporation's charter a provision allowing an interested director to be counted toward a quorum. In that event, a meeting could be held, and the contract approved. Courts upheld the validity of these provisions, and this innovation thus permitted interested transactions involving a majority of the board to be accomplished.[20] Nevertheless, courts continued to require directors to prove that such transactions were fair — that is, these transactions remained voidable following "interested" approval, but only if they were unfair or inadequately disclosed. This was essentially the nineteenth-century trust beneficiary rule, applied to the corporation.

16. See, e.g., *In re Gleeson*, 124 N.E.2d 624 (Ill.App. 1954).

17. See Harold Marsh Jr., *Are Directors Trustees?*, 22 Bus. Law. 35 (1966). Professor Marsh's interpretation has been widely accepted. See, e.g., 2 Model Business Corp. Act Annot. §8.60, at 8-406 (3d ed. 1994). ("[A]s late as the end of the nineteenth century the rule appeared settled that the corporation had the power to avoid all such transactions without regard to the fairness of the transaction or the manner in which it was originally approved by the corporation.")

18. Professor Norwood Brevenridge urges that, at times in the nineteenth century, judges were willing to permit interested director transactions to stand if they found them fair in all respects. See Norwood P. Brevenridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DePaul L. Rev. 655 (1992) (Professor Marsh was completely wrong; the rule was opposite of that which he asserts: If an interested contract was fair, it was sustained (citing the leading treatise, 1 V. Morowitz, The Law of Public Corporations 214 (2d ed. 1843)).

19. See *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 602 (Del. 1948).

20. E.g., *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 117 (Del. 1952).

The next stage in the development of the law of director conflict occurred in the mid-twentieth century, with the movement to enact legislative provisions governing director conflict transactions.[21] These provisions were, in effect, a statutory embodiment of earlier charter provisions that sought to ensure that interested transactions would *not be void per se*. That is they were a statutory effort to give all corporations of the jurisdiction the benefit of a charter provision that allowed a quorum to exist and to vote to authorize a transaction between the corporation and one or more directors. These "safe harbor" statutes are discussed below.

8.3.2 Judicial Review of Self-Dealing Today: The Limited Role of Safe Harbor Statutes

As we indicated, the safe harbor statutes initially sought to permit boards to authorize transactions in which a majority of directors had an interest. Most U.S. jurisdictions now have such statutes. Almost all of these statutes provide that a director's self-dealing transaction is not voidable simply because it is interested, or in the language of the Delaware version, such a transaction is not voidable "solely" because it is interested, so long as it is adequately disclosed and approved by a majority of disinterested directors or shareholders, or it is fair. See, e.g., DGCL §144; NYBCL §713; Cal. Corp. Code §310. However, these statutes might also be interpreted to mean that a conflict transaction is *never* voidable if it is fully disclosed and authorized or approved by the board and shareholders in good faith *or* if it is fair to the corporation at the time it is authorized. However, courts have resisted such a broad reading. Consider the following case.

COOKIES FOOD PRODUCTS v. LAKES WAREHOUSE

430 N.W.2d 447 (Iowa 1988)

NEUMAN, Justice.

This is a shareholders' derivative suit brought by the minority shareholders of a closely held Iowa corporation specializing in barbecue sauce, Cookies Food Products, Inc. (Cookies). The target of the lawsuit is the majority shareholder, Duane "Speed" Herrig and two of his family-owned corporations, Lakes Warehouse Distributing, Inc. (Lakes) and Speed's Automotive Co., Inc. (Speed's). Plaintiffs alleged that Herrig, by acquiring control of Cookies and executing self-dealing contracts, breached his fiduciary duty to the company and fraudulently misappropriated and converted corporate funds. Plaintiffs sought actual and punitive damages. Trial to the court resulted in a verdict for the defendants, the district court finding that Herrig's actions benefited, rather than harmed, Cookies. We affirm. . . .

21. See, e.g., Cal. Corp. Code §310; DGCL §144; NYBCL §713; RMBCA §8.60.

L. D. Cook of Storm Lake, Iowa, founded Cookies in 1975 to produce and distribute his original barbeque sauce. Searching for a plant site in a community that would provide financial backing, Cook met with business leaders in seventeen Iowa communities, outlining his plans to build a growth-oriented company. He selected Wall Lake, Iowa, persuading thirty-five members of that community, including Herrig and the plaintiffs, to purchase Cookies stock. All of the investors hoped Cookies would improve the local job market and tax base. The record reveals that it has done just that.

Early sales of the product, however, were dismal. After the first year's operation, Cookies was in dire financial straits. At that time, Herrig was one of thirty-five shareholders and held only two hundred shares. He was also the owner of an auto parts business, Speed's Automotive, and Lakes Warehouse Distributing, Inc., a company that distributed auto parts from Speed's. Cookies' board of directors approached Herrig with the idea of distributing the company's products. It authorized Herrig to purchase Cookies' sauce for twenty percent under wholesale price, which he could then resell at full wholesale price. Under this arrangement, Herrig began to market and distribute the sauce to his auto parts customers and to grocery outlets from Lakes' trucks as they traversed the regular delivery route for Speed's Automotive.

In May 1977, Cookies formalized this arrangement by executing an exclusive distribution agreement with Lakes. Pursuant to this agreement, Cookies was responsible only for preparing the product; Lakes, for its part, assumed all costs of warehousing, marketing, sales, delivery, promotion, and advertising. Cookies retained the right to fix the sales price of its products and agreed to pay Lakes thirty percent of its gross sales for these services.

Cookies' sales have soared under the exclusive distributorship contract with Lakes. Gross sales in 1976, the year prior to the agreement, totaled only \$20,000, less than half of Cookies' expenses that year. In 1977, however, sales jumped five-fold, then doubled in 1978, and have continued to show phenomenal growth every year thereafter. By 1985, when this suit was commenced, annual sales reached \$2,400,000.

As sales increased, Cookies' board of directors amended and extended the original distributorship agreement. In 1979, the board amended the original agreement to give Lakes an additional two percent of gross sales to cover freight costs for the ever expanding market for Cookies' sauce. In 1980, the board extended the amended agreement through 1984 to allow Herrig to make long-term advertising commitments. Recognizing the role that Herrig's personal strengths played in the success of the joint endeavor, the board also amended the agreement that year to allow Cookies to cancel the agreement with Lakes if Herrig died or disposed of the corporation's stock.

In 1981, L. D. Cook, the majority shareholder up to this time, decided to sell his interest in Cookies. He first offered the directors an opportunity to buy his stock, but the board declined to purchase any of his 8100 shares. Herrig then offered Cook and all other shareholders \$10 per share for their stock, which was twice the original price. Because of the overwhelming response to these offers, Herrig had purchased enough Cookies stock by January 1982 to become the majority shareholder. His investment of \$140,000 represented fifty-three percent of the [outstanding shares]. . . .

Shortly after Herrig acquired majority control he replaced four of the five members of the Cookies' board with members he selected. . . . Subsequent changes made in the corporation under Herrig's leadership formed the basis for this lawsuit.

First, under Herrig's leadership, Cookies' board has extended the term of the exclusive distributorship agreement with Lakes and expanded the scope of services for which it compensates Herrig and his companies. In April 1982, when a sales increase of twenty-five percent over the previous year required Cookies to seek additional short-term storage for the peak summer season, the board accepted Herrig's proposal to compensate Lakes at the "going rate" for use of its nearby storage facilities. . . .

Second, Herrig moved from his role as director and distributor to take on an additional role in product development. This created a dispute over a royalty Herrig began to receive. . . . Herrig developed a recipe [for taco sauce] because he recognized that taco sauce, while requiring many of the same ingredients needed in barbeque sauce, is less expensive to produce. . . . In August 1982, Cookies' board approved a royalty fee to be paid to Herrig for this taco sauce recipe. This royalty plan was similar to royalties the board paid to L.D. Cook for the barbeque sauce recipe. That plan gives Cook three percent of the gross sales of barbeque sauce; Herrig receives a flat rate per case. Although Herrig's rate is equivalent to a sales percentage slightly higher than what Cook receives, it yields greater profit to Cookies because this new product line is cheaper to produce.

Third, since 1982 Cookies' board has twice approved additional compensation for Herrig. In January 1983, the board authorized payment of a $1000 per month "consultant fee" in lieu of salary, because accelerated sales required Herrig to spend extra time managing the company. Averaging eighty-hour work weeks, Herrig devoted approximately fifteen percent of his time to Cookies' and eighty percent to Lakes' business. In August, 1983, the board authorized another increase in Herrig's compensation. Further, at the suggestion of a Cookies director who also served as an accountant for Cookies, Lakes, and Speed's, the Cookies board amended the exclusive distributorship agreement to allow Lakes an additional two percent of gross sales as a promotion allowance to expand the market for Cookies products outside of Iowa. As a direct result of this action, by 1986 Cookies regularly shipped products to several states throughout the country.

As we have previously noted, however, Cookies' growth and success has not pleased all its shareholders. The discontent is motivated by two factors that have effectively precluded shareholders from sharing in Cookies' financial success: the fact that Cookies is a closely held corporation, and the fact that it has not paid dividends. Because Cookies' stock is not publicly traded, shareholders have no ready access to buyers for their stock at current values that reflect the company's success. Without dividends, the shareholders have no ready method of realizing a return on their investment in the company. This is not to say that Cookies has improperly refused to pay dividends. The evidence reveals that Cookies would have violated the terms of its loan with the Small Business Administration had it declared dividends before repaying that debt. That SBA loan was not repaid until the month before the plaintiffs filed this action.

Unsatisfied with the status quo, a group of minority shareholders commenced this equitable action in 1985. Based on the facts we have detailed, the plaintiffs claimed that the sums paid Herrig and his companies have grossly exceeded the value of the services rendered, thereby substantially reducing corporate profits and shareholder equity. Through the exclusive distributorship agreements, taco sauce royalty, warehousing fees, and consultant fee, plaintiffs claimed that Herrig breached his fiduciary duties to the corporation and its shareholders because he allegedly negotiated for these arrangements without fully disclosing the benefit he would gain. The plaintiffs sought recovery for lost profits, an accounting to determine the full extent of the damage, attorneys' fees, punitive damages, appointment of a receiver to manage the company properly, removal of Herrig from control, and sale of the company in order to generate an appropriate return on their investment.

Having heard the evidence presented on these claims at trial, the district court filed a lengthy ruling that reflected careful attention to the testimony of the twenty-two witnesses and myriad of exhibits admitted. The court concluded that Herrig had breached no duties owed to Cookies or to its minority shareholders. . . .

II. FIDUCIARY DUTIES

Herrig, as an officer and director of Cookies, owes a fiduciary duty to the company and its shareholders. . . . Herrig concedes that Iowa law imposed the same fiduciary responsibilities based on his status as majority stockholder. . . . Conversely, before acquiring majority control in February 1982, Herrig owed no fiduciary duty to Cookies or plaintiffs. . . . Therefore, Herrig's conduct is subject to scrutiny only from the time he began to exercise control of Cookies. . . .

[T]he legislature enacted section 496A.34, . . . that establishes three sets of circumstances under which a director may engage in self-dealing without clearly violating the duty of loyalty:

> No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest . . . if any of the following occur:
>
> 1. The fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves, or ratifies the contract or transaction . . . without counting the votes . . . of such interested director.
> 2. The fact of such relationship or interest is disclosed or known to the shareholders entitled to vote [on the transaction] and they authorize . . . such contract or transaction by vote or written consent.
> 3. The contract or transaction is fair and reasonable to the corporation.

Some commentators have supported the view that satisfaction of any *one* of the foregoing statutory alternatives in and of itself, would prove that a director has fully met the duty of loyalty. . . . We are obliged, however, to interpret statutes in conformity with the common law wherever statutory language does not directly negate it. . . . Because the common law and section 496A.34 require directors to show "good faith, honesty, and fairness" in self-dealing, we are persuaded that satisfaction of any one of these three alternatives under the statute would merely preclude us from rendering the transaction void or voidable *outright* solely on the basis "of such [director's] relationship or interest.". . . We thus require directors who engage in self-dealing to establish the additional element that they have acted in good faith, honesty, and fairness. . . .

. . . The crux of appellants' claim is that the [trial] court should have focused on the fair market value of Herrig's services to Cookies rather than on the success Cookies achieved as a result of Herrig's actions.

We agree with appellants' contention that corporate profitability should not be the sole criteria by which to test the fairness and reasonableness of Herrig's fees. . . .

Given an instance of alleged director enrichment at corporate expense . . . the burden to establish fairness resting on the director requires not only a showing of "fair price" but also a showing of the fairness of the bargain to the interests of the corporation. . . . Applying such reasoning to the record before us, however, we cannot agree with appellants' assertion that Herrig's services were either unfairly priced or inconsistent with Cookies corporate interest.

There can be no serious dispute that the four agreements in issue — for exclusive distributorship, taco sauce royalty, warehousing, and consulting fees — have all benefited Cookies, as demonstrated by its financial success. Even if we assume Cookies could have procured similar services from other vendors at lower costs, we are not convinced that Herrig's fees were therefore unreasonable or exorbitant. Like the district court, we are not persuaded by appellants' expert testimony that Cookies' sales and profits would have been the same under agreements with other vendors. As Cookies' board noted prior to Herrig's takeover, he was the driving force in the corporation's success. Even plaintiffs' expert acknowledged that Herrig has done the work of at least five people — production supervisor, advertising specialist, warehouseman, broker, and salesman. While eschewing the lack of internal control, for accounting purposes, that such centralized authority may produce, the expert conceded that Herrig may in fact be underpaid for all he has accomplished. We believe the board properly considered this source of Cookies' success when it entered these transactions, as did the district court when it reviewed them. . . .

[T]he record before us aptly demonstrates that all members of Cookies' board were well aware of Herrig's dual ownership in Lakes and Speed's. We are unaware of any authority supporting plaintiffs' contention that Herrig was obligated to disclose to Cookies' board or shareholders the extent of his profits resulting from these distribution and warehousing agreements; nevertheless, the exclusive distribution agreement with Lakes authorized the board to ascertain that information had it so desired. Appellants cannot reasonably claim that Herrig owed Cookies a duty to render such services at no profit to himself or his companies. Having found that the compensation he received from these agreements was fair and reasonable, we are convinced that Herrig furnished sufficient pertinent information to Cookies' board to enable it to make prudent decisions concerning the contracts. . . .

AFFIRMED.

SCHULTZ, J. (dissenting). . . .

Much of Herrig's evidence concerned the tremendous success of the company. I believe that the trial court and the majority opinion have been so enthralled by the success of the company that they have failed to examine whether these matters of self-dealing were fair to the stockholders. While much credit is due to Herrig for the success of the company, this does not mean that these transactions were fair to the company.

I believe that Herrig failed on his burden of proof by what he did not show. He did not produce evidence of the local going rate for distribution contracts or storage fees outside of a very limited amount of self-serving testimony. He simply did not show the fair market value of his services or expense for freight, advertising and storage cost. He did not show that his taco sauce royalty was fair. This was his burden. He cannot succeed on it by merely showing the success of the company.

The shareholders, on the other hand, . . . have put forth convincing testimony that Herrig has been grossly overcompensated for his services based on their fair market value. . . .

QUESTION

Should the limited effect of the safe harbor statute be given if the directors who approved the transaction were under the influence or control of a majority shareholder (as presumably was the case in *Cookies*)? Should it matter that the shareholders who authorize or ratify an interested transaction include the votes of the interested shareholder?

8.3.3 Judicial Review When Transaction Has Been Approved by a Disinterested Majority of the Board

As we noted, under the conventional interpretation of the safe harbor statutes, the approval of an interested transaction by a fully informed board has the effect only of authorizing the transaction, not of foreclosing judicial review for fairness.[22]

That interpretation of the safe harbor statutes leaves open the critical question: What standard of judicial review should courts employ when

22. See, e.g., *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976); *Kahn v. Lynch Communications Systems*, 638 A.2d 1110 (Del. 1994); *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702, 208 Cal. App. 3d 1250 (Ct.App. 1989); *Cohen v. Ayers*, 596 F.2d 733 (7th Cir. 1979).