Washington Law Review

Volume 69
Number 1 *Dedicated to Marjorie Dick Rombauer*

1-1-1994

Director Conflict of Interest under the Model Business Corporation Act: A Model for All States?

Peter E. Kay

DIRECTOR CONFLICTS OF INTEREST UNDER THE MODEL BUSINESS CORPORATION ACT: A MODEL FOR ALL STATES?

Peter E. Kay

Abstract: The American Bar Association has adopted a new model director conflict of interest statute based on bright-line definitions and a rigid preclusion of judicial review. This Comment examines the statute and provides revisions that are necessary for the statute to operate as the drafters intended. The Comment also challenges the merits of the statute by arguing that its reliance on disinterested director approval procedures is an inadequate safeguard for shareholders and its emphasis on large corporations renders the statute unsuitable for the majority of corporations.

In 1988, the American Bar Association adopted a new director conflict of interest statute in an effort to eliminate uncertainty in the conflict of interest field. The drafters felt that businesses could not operate effectively under the constant threat of court scrutiny that was present under previous Model Business Corporation Act provisions. The resulting statute, subchapter F, sections 8.60 to 8.63, emphasizes the use of disinterested director approval to prevent director conflicts of interest from arising. It is questionable, however, whether the statute is suitable for the majority of corporations, and its attempts to reduce court scrutiny ironically may result in an increase in litigation.

This Comment focuses on the desirability of the statute's bright-line standard, and on the degree to which the statute accomplishes its stated goals of predictability and practical administration. Part I gives a brief overview of the history of director conflict of interest law. Part II provides a description of the statute. First, it analyzes the statute's requirements for a "transaction," without which a director conflict of interest cannot occur. Second, part II examines the elements necessary to place a transaction within the statute's judicial review preclusion framework. Third, it considers the provision's judicial review preclusion. Fourth, part II analyzes the provisions for insulating transactions from judicial review through director and shareholder approval. Part III examines the degree to which the statute accomplishes its stated goals and discusses possible revisions. Finally, part IV considers the implications and effects of adopting this statute, arguing that the statute's reliance on disinterested director approval is misguided and that the provisions are ill-suited for most corporations.

I. DIRECTOR CONFLICT OF INTEREST LAW FROM PAST TO PRESENT

Corporate director conflicts of interest arise when directors' personal or financial interests conflict with their fiduciary responsibilities to the corporation and its shareholders.[1] To raise the issue of a conflict of interest, shareholders must bring derivative actions in the name of the corporation against the interested directors.[2] These shareholders seek a recovery on behalf of the corporation for the alleged harm caused by the interested directors' breach of fiduciary duty.[3] The law governing these corporate director conflicts of interest has developed over this century from a common law approach into a statutory approach. The drafters of the Model Business Corporation Act (MBCA) adopted a bright-line statute approach that was intended to overcome some of the uncertainties that existed under prior common and statutory conflict of interest law.

A. Conflicts of Interest at Common Law and the Development of Statutes

At common law, the courts subjected director and officer conflict of interest law to constant reinterpretation. Under the earliest analysis, conflict of interest transactions between a corporate officer or director and the corporation were voidable at the corporation's option.[4] Gradually, courts departed from this original rule and began to accept conflict of interest transactions that had received disinterested shareholder or director approval, provided that the director could prove that such transactions were substantively fair to the corporation.[5] This

---

1. *Black's Law Dictionary* 299 (6th ed. 1990). The most common director conflicts of interest are (1) direct or indirect ownership of property leased to the corporation, (2) sales to or purchases from organizations in which the director has an interest, and (3) ownership of a portion of the minority equity in a subsidiary. William Nolan, *Today's Director,* 20 N.Y.L.F. 313, 337 (1974).

2. Harry Henn and John Alexander, *Laws of Corporations* 1037 (3d ed. 1983).

3. *Id.*

4. Harold Marsh, *Are Directors Trustees? Conflicts of Interest and Corporate Morality,* 22 Bus. Law. 35, 36 (1966); *see* Wardell v. Union Pac. R.R. Co., 103 U.S. 651, 656 (1881).

5. Marsh, *supra* note 4, at 40; Holcomb v. Forsythe, 113 So. 516, 520 (Ala. 1927). Substantive fairness is determined by evaluating the terms of the transaction. Some courts have held that fairness is determined by whether or not the transaction resembles the results of normal arm's length business negotiations. Pepper v. Litton, 308 U.S. 295, 306–07 (1939).

doctrinal shift originally occurred in cases of interlocking directorships, in which two corporations had common directors.[6] The reasons for this shift have not yet been satisfactorily explained.[7]

Permitting the approval of conflict of interest transactions by disinterested directors or shareholders, however, created great uncertainty as new issues arose. These issues included whether or not the interested director could be counted for purposes of a quorum at the board meeting, the criteria necessary for being a disinterested director or shareholder, and who held the burden of proof on transaction fairness.[8]

As the common law doctrine evolved, states began to enact statutes specifically addressing officer and director conflict of interest transactions, with California enacting the first such law in 1931.[9] This California statute served as a basis for the MBCA section 41, adopted by the ABA in 1969.[10] Although approximately 35 states adopted these statutory provisions,[11] the lack of term definitions caused confusion as to what exactly constituted a conflict of interest.[12]

Furthermore, the courts were uncertain of the requirements necessary to preclude judicial review of transactions under these statutes. In California, the court in *Remillard Brick Co. v. Remillard-Dandini Co.*[13] rejected the interpretation that an interested director's compliance with the state's conflict of interest approval procedures precluded judicial review of transaction fairness. The court held that, even though the approval of a transaction technically met the statute's requirements, a

6. Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 Notre Dame L. Rev. 201, 203 (1977).

7. Marsh, *supra* note 4, at 40–41.

8. Lizabeth A. Moody, *Statutory Solutions to Conflicts of Interest in Close Corporations*, 35 Clev. St. L. Rev. 95, 100 (1987).

9. Cal. Civ. Code § 311 (1931) *amended and retitled* Cal. Corp. Code § 820 (1947).

10. Model Business Corp. Act Ann. § 41 (2d ed. 1971). The section declares that transactions between a corporation and a director or entity in which a director is financially interested are not voidable if (1) after disclosure, the board approves the transaction without the interested director's vote; (2) after disclosure, shareholders entitled to vote approve the transaction; or (3) the transaction is fair and reasonable to the corporation. *Id.* Compliance with the statute's procedural provisions, however, does not entirely validate a transaction, but simply establishes that it was not automatically void or voidable by reason of the director's interest.

11. See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 312 (Proposed Final Draft 1992) for a listing of states that have adopted MBCA § 41 and other statutes [hereinafter ALI].

12. *See* Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Directors' Conflicting Interest Transactions*, 44 Bus. Law. 1307, 1308 (1989) [hereinafter Committee Report].

13. 241 P.2d 66 (Cal. App. 1952).

corporation may still void transactions containing unfair and unreasonable terms.[14] The court thus interpreted the statute to require both procedural and substantive fairness. These conflict of interest statutes, therefore, did not resolve all the ambiguities present in the field of conflict of interest law.

B. *The Drafters' Objectives in MBCA Sections 8.60–8.63*

The confusion over the scope of statutory coverage prompted the drafters of the MBCA, the ABA Committee on Corporate Laws, to take a fresh look at director conflict of interest law.[15] The committee argued that businesses cannot function effectively in an environment where courts can review possible conflict of interest transactions years later.[16] The twin objectives of this statutory revision effort were, therefore, to increase predictability and to enhance the practical administration of director conflict of interest transactions.[17] To accomplish these twin objectives, the drafters proposed a precise director conflict of interest definition. In addition, the drafters created a more exacting set of safe harbor procedures than those found in prior statutes, in order to better insulate director conflict of interest transactions from court review.[18] The resulting statute, however, specifically excludes non-director officer and employee conflicts of interest from its coverage. Instead, the drafters state that the law of agency prescribing loyalty of an agent to a principal, as well as internal rules and personnel procedures of a corporation, can adequately govern such situations.[19]

A conflict of interest transaction, however, must be within the bright lines established by the statute in order to qualify for safe harbor protection. The drafters recognized that, as with any bright-line, situations falling just outside the lines would bear a close resemblance to those covered by the statute. Nonetheless, because of the need for predictability in the conflict of interest field, the drafters accepted such tradeoffs.[20] The committee also argued that conflict of interest

---

14. *Id.* at 74.
15. Committee Report, *supra* note 12, at 1308.
16. *Id.* at 1309.
17. *Id.* at 1308.
18. *Id.*
19. *Id.* at 1310.
20. *Id.* at 1309.

transactions are not crimes, torts, or necessarily injurious to others.[21] Courts should, therefore, accord strong countervailing weight under conflict of interest law to "social" values, such as economic efficiency, predictability, and business finality.[22] Furthermore, as the courts can still attack events that fall outside a statutory definition on other legal grounds,[23] a bright-line approach appeared to best accomplish the desired objectives.

After more than three and a half years of work, the ABA adopted these director conflict of interest provisions as subchapter F of the MBCA in December 1988.[24] These provisions, however, have not received widespread acceptance. As of July 1, 1993, only four states, Georgia,[25] Mississippi,[26] Montana,[27] and Washington,[28] had adopted the statute.

II. OVERVIEW OF SUBCHAPTER F: MBCA §§ 8.60–8.63

The statute consists of four sections: 1) Definitions, 2) Preclusion of judicial review, 3) Director transaction approval provisions, and 4) Shareholder approval provisions.[29] For these provisions to apply, the statute requires the presence of a transaction that meets the drafters' criteria. Once the presence of a transaction is established, the statute places possible conflict of interest transactions into one of two categories, depending on the director's relationship to the transaction. Under section 8.60(1)(i), the first category, a director possesses a conflicting interest in a transaction if the director knows at the time of

---

21. *Id.* Commentators have challenged this conclusion by arguing that unfaithfulness is a serious moral failure by individuals charged with responsibility for the affairs of others. *See* Douglas Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 Fordham L. Rev. 375, 388 (1988).

22. Committee Report, *supra* note 12, at 1309. These values, however, are all economic in nature, not social.

23. *Id.* at 1308; *see* Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985) (seizing a corporate opportunity); Donahue v. Rodd Electrotype Co., 328 N.E. 2d 505 (Mass. 1975) (breaching a fiduciary duty to minority shareholders).

24. Committee Report, *supra* note 12, at 1307.

25. Ga. Code Ann. §§ 14-2-860 to -863 (Michie 1990). Georgia has also extend the statutory coverage to include corporate officers. *Id.* § 14-2-864.

26. Miss. Code Ann. §§ 379-4-860 to -863 (Supp. 1992).

27. Mont. Code Ann. §§ 35-1-461 to -464 (1991).

28. Wash. Rev. Code. §§ 23B.08.700–.730 (1993). The Washington Legislature also adopted the commentary to subchapter F as official state legislative history. 1989 Wash. Senate Journal 3057–73.

29. Model Business Corp. Act Ann. §§ 8.60–8.63 (Supp. 1992), *reprinted in* Committee Report, *supra* note 12, at 1313–31.

commitment[30] that the director or a "related person" is 1) a party to the transaction, or 2) has such a significant "beneficial financial interest" in or so closely linked to the transaction that it would influence the director in an approval vote.[31]

In the second category, section 8.60(1)(ii), a conflict of interest exists if, in a transaction of such significance that it is or would normally be brought before the board, the director knows at the time of commitment that certain entities with which the director has a significant relationship are either 1) parties, or 2) have such a significant "beneficial financial interest" in or so closely linked to the transaction that it would influence the director in an approval vote.[32]

The preclusion of judicial review, section 8.61, declares that courts may not review, on grounds of a director conflict of interest, transactions that do not meet the statutory definitions.[33] This section also denies courts the power to attack, enjoin, or award damages for transactions that meet the statutory definitions if either 1) disinterested directors approved the transaction, 2) shareholders approved the transaction, or 3) the transaction is fair to the corporation when the transaction is entered into.[34] To preclude judicial review of transactions, the director approval section requires an affirmative vote by a majority of the corporation's "qualified directors," after the interested director has provided the required disclosure.[35] For shareholder approval to be effective in precluding court review, an affirmative vote by a majority of the corporation's "qualified shares" is necessary, once the required disclosure has occurred.

A. *The Requirements for a Transaction*

Under subchapter F, an event must possess two elements before it is considered to be a "transaction" in which a conflict of interest may occur. First, the provisions require that the corporation actually take action or be a party to the event, either directly or through a controlled

30. *Id.* § 8.60(5). Time of commitment means the time when a transaction is consummated or when unilateral withdrawal would entail significant loss. *Id.*

31. *Id.* § 8.60(1)(i).

32. *Id.* § 8.60(1)(ii).

33. *Id.* § 8.61(a).

34. *Id.* § 8.61(b). The interested director has the burden of proof in determining the transaction's fairness. *See* Committee Report, *supra* note 12, at 1324.

35. Model Business Corp. Act Ann. § 8.62.

entity.[36] If a corporation refrains from acting, a shareholder may not challenge, on conflict of interest grounds, any benefits that accrue to a director from the event, because a transaction is not present under subchapter F.[37] The statute also does not consider unilateral actions by a director, such as seizing a corporate opportunity or entering into competition with the corporation, to be transactions. These events are excluded from coverage because any possible bilateral exchanges present do not involve the corporation as a party.[38] Shareholders, however, may still attack these director actions under common law theories based upon the director's duty of loyalty.[39]

Second, the comments declare that the term "transaction" connotes a negotiation or consensual bilateral arrangement between the corporation and another party that concerns the economic rights and interests of the respective parties.[40] A transaction under subchapter F is, therefore, a "deal" and not simply a unilateral action conducted by the corporation or the director.[41] For example, if the directors commit the corporation to a "crown jewel" option[42] with a third party, a transaction exists under the statute.[43] Such action involves a negotiated deal with other parties concerning their respective economic rights and interests. On the other hand, the drafters do not consider a decision to distribute "poison pill" rights[44] to be a transaction.[45] In these situations, only unilateral action by the corporation is present and, therefore, no transaction is present.

---

36. Committee Report, *supra* note 12, at 1317–18.

37. *Id.* at 1317.

38. *Id.*

39. *Id.* at 1308; *see, e.g.*, Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985) (holding that a director who seizes a corporate opportunity is in violation of the duty of loyalty); Lincoln Stores, Inc. v. Grant, 34 N.E.2d. 704 (Mass. 1941) (finding that a director's entrance into competition with the corporation is a violation of the duty of loyalty).

40. Committee Report, *supra* note 12, at 1310.

41. *Id.*

42. A crown jewel is the granting of purchase options on desirable assets to a friendly party in an attempt to discourage hostile takeovers. Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1286 n.37 (Del. 1989).

43. Committee Report, *supra* note 12, at 1317.

44. Poison pill rights provide shareholders with the right to be bought out by the corporation at a substantial premium upon the occurrence of a stated triggering event. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986).

45. Committee Report, *supra* note 12, at 1317.

B. *Conflicting Interest Transactions*

Even if an event is within the statute's restrictive transaction definition, it still may not be challenged by shareholders under conflict of interest rules if the transaction fails to present a conflict of interest under either section 8.60(1)(i) or (1)(ii). These sections establish the two subchapter F conflict of interest categories that include common required elements as well as ones specific to each category.

1. *Section 8.60(1)(i) Transactions: Directors and Related Persons*

The entities covered under this first category, section 8.60(1)(i), consist of the director and persons related to the director.[46] The related person term encompasses two specific and exclusive subclasses. The first subclass encompasses family members and their spouses,[47] individuals in the director's household, and trusts and estates of which these individuals are significant beneficiaries.[48] The second subclass consists of trusts, estates, incompetents, and minors of which the director is a fiduciary.[49]

---

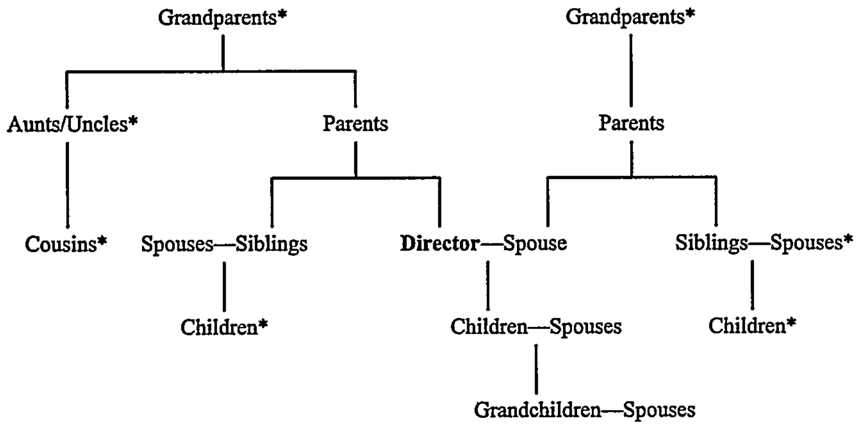
46. Model Business Corp. Act Ann. § 8.60(1)(i).

47. *Id.* § 8.60(3). A related person of the director includes "the spouse (or a parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director." *Id.* This definition of a related person has also been adopted by the ALI. *See* ALI, *supra* note 11, § 1.03(a).

48. Model Business Corp. Act Ann. § 8.60(3)(i).

49. *Id.* § 8.60(3)(ii). The statute already covers some of these situations under the first subclass.

The exclusive set of family members covered by the statute is best illustrated by a diagram:



* These individuals are not considered related persons and, therefore, transactions with them are not considered conflicts of interest under subchapter F.

In addition to these family members, the term related persons also includes non-family individuals sharing the same home as the director.[50] Because the statute's use of the term spouse is intended to include common law spouses and unrelated cohabitants,[51] the "same home" provision was presumably designed to include half- and step-relatives, roommates, and live-in servants. Finally, trusts and estates of which these relatives and individuals are significant beneficiaries are within the scope of the statute. Directors are thereby prevented from indirectly benefiting otherwise covered individuals through trusts established for their benefit.

2. *Section 8.60(1)(ii) Transactions: Entities with Economic Ties to the Director*

Section 8.60(1)(ii), the second category of covered transactions, requires the presence of two elements in order for a conflict of interest to arise. First, it examines transactions involving specified entities with which the director possesses certain ties. Second, the section includes only those transactions that are significant enough to the corporation to warrant a decision at the board level.

50. *Id.* § 8.60(3)(i).

51. Committee Report, *supra* note 12, at 1320.

This section establishes three sets of covered entities that encompass the professional and employment associates of a director. The first set consists of those entities, other than the corporation, of which the director is a general partner, employee, director or agent.[52] The second set encompasses those individuals who control any entity in the first set or entities controlled by or under common control of an entity in the first set. This extension of statutory coverage to these economically linked entities is consistent with the drafters' notion that the statute's applicability should not depend on formalistic ownership distinctions.[53] The statute, however, is not intended to apply to transactions between a parent corporation and a partially owned subsidiary.[54] Instead, the courts must address these transactions under the developing common law of a controlling shareholder's fiduciary duty.[55] Finally, the third set includes individuals who are general partners, principals, or employers of the director.[56]

Section 8.60(1)(ii) also limits conflicts of interest to those transactions significant enough to warrant attention by the acting corporation's board of directors. For a conflict of interest to arise, the section requires that the transaction either have been actually brought before the board, or be of such character and significance that, in the normal course of business, it would be brought before the board.[57] There is no precise bright line, however, that determines when board approval is required. Furthermore, subchapter F does not provide any guidance in resolving this issue. The modern rule states that a board must approve extraordinary corporate actions, but not ordinary actions.[58] The difficulty, however, lies in determining what is ordinary and what is extraordinary; the issue is highly dependent on the context in which it is raised.[59]

Section 8.60(1)(ii) contains this extra threshold requirement because the drafters viewed the linkage between directors and business associates

---

52. Model Business Corp. Act Ann. § 8.60(1)(ii)(A).

53. Committee Report, *supra* note 12, at 1318.

54. *Id.* at 1319.

55. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (self-dealing present when a parent receives benefit from a subsidiary to the detriment of the subsidiary's minority shareholders).

56. Model Business Corp. Act Ann. § 8.60(1)(ii)(C).

57. *Id.* § 8.60(1)(ii).

58. Lee v. Jenkins Bros., 268 F.2d 357 (2d Cir.), *cert. denied* 361 U.S. 913 (1959); *see* ALI, *supra* note 11, § 3.02 (listing the functions of the board of directors).

59. ALI, *supra* note 11, § 3.02 commentary at 110. The ALI defines extraordinary actions as situations that affect the control or the structure of the corporation. *Id.* at 111.

to be more distant than the one between directors and related persons.[60] This viewpoint is consistent with the common law distinction that developed between cases involving direct conflicts of interest, and those involving interlocking directors.[61] The comments state that sufficient reason does not exist to subject routine business dealings to court challenge because the terms of these dealings are determined by competitive market forces.[62] Furthermore, since most of these transactions are conducted at personnel levels far below the board,[63] only transactions that merit board approval are considered conflicts of interest under subchapter F. Case law has demonstrated, however, that lower level employees can be influenced by a director,[64] and, therefore, such transactions are not necessarily determined by market forces.

3. *Party to the Transaction and Interest in the Transaction Elements*

Directors possess a conflict of interest under subchapter F if a covered entity[65] either 1) is a party to the transaction, or 2) has a significant beneficial financial interest in or so closely linked to the transaction that this relationship would reasonably be expected to influence the director in an approval vote. Under the party category of section 8.60(1)(i) and (ii) transactions, the mere presence of a covered entity in a transaction is sufficient to invoke statutory coverage. This coverage may encompass situations in which a director or a related person is a nominal party in transactions with the corporation. Examples include serving as a registered agent or escrow agent.

A conflict of interest may also arise under subchapter F when a covered entity possesses certain beneficial financial interests. The beneficial financial interest, in the case of a director, must be separate from any interest the director possesses as a result of being a director or shareholder of the corporation.[66] For example, a director's interest in a transaction based on its possible impact on the corporation's stock price or profits is not considered to give rise to a conflict of interest. On the other hand, directors possessing sufficiently large ownership interests in

60. Committee Report, *supra* note 12, at 1318.

61. *See supra* notes 6–7 and accompanying text.

62. Committee Report, *supra* note 12, at 1318.

63. *Id.* at 1318–19.

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

65. This term refers to the respective entities under Model Business Corp. Act Ann. § 8.60(1)(i)–(ii). *See supra* notes 46–56 and accompanying text.

66. Committee Report, *supra* note 12, at 1315.

entities that conduct business with the corporation or directors who are significant creditors of the corporation are considered to have a beneficial financial interest under the statute.[67]

According to the drafters, this beneficial financial interest must not be based on a contingent or remote gain.[68] The "in or so closely linked" element requires that the economic gain of the covered entity hinge directly on the transaction.[69] Future reductions in the director's local taxes, or future increases in services owned by the director that are unrelated to the corporation, are examples of interests too remote to constitute a conflict of interest under the statute.[70] On the other hand, an example of a "so closely linked" interest would be a director owning land near one of several possible corporate expansion sites. The director may not have an interest in the land actually selected by the corporation, but the director's property will greatly appreciate in value if the board selects the particular location near the director's land.

Finally, the statute requires that the interest be of such financial significance to the director or related person that it would reasonably be expected to exert an influence on the director's voting decision.[71] The court, in reviewing a conflict of interest accusation, inquires as to whether the covered entity's interest is of such financial significance that an outside observer would reasonably expect it to influence the director's judgment. This objective standard does not require the existence of an actual influence upon the director, but only that one may be reasonably expected.[72]

C. *Preclusion of Judicial Review*

Under subchapter F, a transaction must comply precisely with the statutory requirements in order for a conflict of interest to arise. If a particular requirement is lacking, the preclusion of judicial review provision prevents a court from setting aside or enjoining a transaction, or awarding damages on the grounds of a director conflict of interest.[73] The statute preempts the conflict of interest field and forbids courts from

67. *Id.* at 1316.

68. *Id.* at 1315.

69. *Id.*

70. *Id.* at 1315–17.

71. Model Business Corp. Act Ann. § 8.60(1)(i)–(ii).

72. Committee Report, *supra* note 12, at 1315.

73. Model Business Corp. Act Ann. § 8.61(a).

finding such an interest present in situations that lie outside the statute's bright lines.[74] Subchapter F, however, does not prevent courts from examining such transactions under other expanded notions of a director's duty of loyalty.[75]

In transactions that satisfy the conflict of interest requirements, neither the interested director nor the transaction itself is vulnerable to legal attack on conflict of interest grounds if either the disinterested director or shareholder approval procedures have been complied with.[76] Both the interested director and the transaction are also immune from legal attack if a court determines the transaction was fair to the corporation.[77]

D. *The Director Approval Safe Harbor Provision*

To establish safe harbor protection for director conflict of interest transactions, most corporations will utilize the provisions authorizing an approval vote by a majority of the corporation's qualified directors.[78] This approval vote requires at least two qualified directors voting for approval and may occur at any time either before or after the actual transaction.[79] Before the vote occurs, the interested director must make a required disclosure to the other members of the board.[80] The disclosure should reveal the existence and nature of the conflicting interest, as well as all facts known to the director that an ordinarily prudent person would believe to be material.[81]

To be considered a qualified director under the statute, individuals must meet two criteria.[82] First, the director may not have a conflicting interest in the transaction.[83] This requirement excludes those directors interested in the transaction as defined by section 8.60. Second, the

---

74. Committee Report, *supra* note 12, at 1322. For example, if a conflict of interest is claimed as a result of a transaction with a director's cousin, the court must declare that, since a cousin is not a related party under § 8.60(3), a conflict of interest is not present. *Id.*

75. *See* Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985) (seizing a corporate opportunity); Cole Real Estate Corp. v. Peoples Bank & Trust Co., 310 N.E.2d 275 (Ind. App. 1977) (misuse of corporate property).

76. Model Business Corp. Act Ann. § 8.61(b)(1)–(2).

77. *Id.* § 8.61(b)(3).

78. Committee Report, *supra* note 12, at 1328.

79. Model Business Corp. Act Ann. § 8.62.

80. *Id.* § 8.62(a).

81. *Id.* § 8.60(4).

82. *Id.* § 8.62(d).

83. *Id.*

director may not have a familial, financial, professional, or employment relationship with the interested director that would reasonably be expected to exert an influence on the first director.[84] The comments declare that the determination of whether or not such a relationship exists should be based on each individual situation rather than on formalistic rules.[85] The drafters, however, do not provide any examples of what relationships are considered sufficient. This section, with its more open-ended, case-by-case determination of a director's status, stands in sharp contrast to the statutory bright-line approach utilized in other provisions.[86]

E. The Shareholder Approval Safe Harbor Provisions

A conflict of interest transaction may also achieve safe harbor protection through shareholder approval.[87] The statute requires a majority vote of all qualified shares in order to protect a transaction from court review.[88] Before this vote occurs, notice must be provided to all shareholders that describes the conflict of interest, the interested director must inform the corporation's vote tabulator of all shares that the director knows are not qualified, and the required disclosure[89] must be provided to the voting shareholders.[90]

Qualified shares consist of all corporate shares except those that the secretary or other authorized vote tabulator knows are either owned by or the voting rights are controlled by the director or a related party.[91] This definition disqualifies those shares that the vote tabulator knows of independently, as well as those indicated by the interested director before the approval vote occurs. Shares owned by entities that possess certain economic ties with the director under section 8.60(1)(ii), however, are considered qualified. The drafters state that no reason exists to strip these entities of their voting rights because they will vote in accordance with their own economic interests, rather than those of the interested

84. *Id.*

85. Committee Report, *supra* note 12, at 1330.

86. *See, e.g.*, Model Business Corp. Act Ann. § 8.60(3).

87. *Id.* § 8.63.

88. *Id.*

89. *Id.* § 8.60(4); *see supra* note 81 and accompanying text.

90. Model Business Corp. Act Ann. § 8.63(a). The section, however, does not delineate who is responsible for providing the notice to the shareholders or who bears the expense of a proxy solicitation.

91. *Id.* § 8.63(b).

director.[92] Furthermore, it is doubtful whether a director will ever know if these entities actually own shares of the corporation.[93]

III. NECESSARY REVISIONS TO SUBCHAPTER F

Although subchapter F partially accomplishes the drafters' intended goals, amendments are required for the statute to function effectively. Five needed modifications concern extending statutory coverage to officers, the requirements for a transaction, the related person definition, the types of parties to a transaction, and the preclusion of judicial review provisions. States that have adopted subchapter F, or are considering such adoption, should enact these amendments to resolve some of the ambiguities and inconsistencies that are present in the current statute.

A. Extending Subchapter F Coverage to Corporate Officers

The coverage of Subchapter F should be extended to include corporate officers, as the drafters' rationale for excluding such individuals is unconvincing. The drafters state that officer conflicts of interest are covered by the general laws of agency and are, therefore, excluded from subchapter F.[94] Additionally, the drafters appear to maintain that, because most large corporations have internal regulations governing officer conduct,[95] including officer conflicts within the statute would be redundant. Both courts and conflict of interest statutes, however, historically have addressed officer and director conflicts of interest under the same doctrine.[96] Furthermore, state corporate statutes must be responsive to the needs of all corporations, not just large ones. These smaller corporations may not have, nor be able to afford, the elaborate internal personnel regulations found in larger companies. States adopting subchapter F should, therefore, amend the statute to include coverage of officer conflicts, as Georgia has done.[97]

---

92. Committee Report, *supra* note 12, at 1332.

93. *Id.*

94. *Id.* at 1310.

95. *Id.*

96. *See supra* notes 4–9 and accompanying text.

97. Ga. Code Ann. § 14-2-864 (Michie 1990).

B. The Restrictive Transaction Requirements of Subchapter F

Second, the exclusion of many events from conflict of interest review, as a result of the restrictive transaction requirements of subchapter F, will produce different legal outcomes in factual situations that previously have been analyzed under the same legal doctrines. These differing outcomes are difficult to reconcile under the statute's practical administration objective. For example, courts previously analyzed poison pill plans and crown jewel options[98] under the same enhanced business judgment rules.[99] These two actions are merely different defenses against hostile takeover attempts. Under the statute's restrictive multiple party "deal" requirement, crown jewel options are characterized as transactions and, therefore, eligible to receive safe harbor protection from judicial scrutiny.[100] Poison pills on the other hand, are not considered to be transactions under subchapter F, and now lie outside the scope of conflict of interest law. Instead, these excluded takeover defenses are subjected to greater scrutiny under the developing law that governs takeovers. In creating this takeover defense coverage dichotomy, however, the drafters do not offer any sound policy reasons for the distinctions they draw.

The multiple party "deal" requirement also excludes the vast category of unilateral corporate actions that impact the economic rights of other parties. Examples of these actions include forgiving a director's debt to the corporation and guaranteeing a director's obligation to a third party. A conflict of interest would appear to be present but, because these actions do not involve a consensual bilateral arrangement between two parties, they are not considered conflicts of interest under the statute. States that enact subchapter F, therefore, should not adopt these restrictive requirements and instead interpret the transaction element broadly.

98. *See supra* notes 42–45 and accompanying text.

99. *Compare* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (finding that decisions regarding poison pill plans are subject to the business judgment rule) *with* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1988) (finding that decisions regarding crown jewels are subject to the business judgment rule). *See supra* notes 42–45 and accompanying text.

100. Committee Report, *supra* note 12, at 1317.

C. *The Related Party Definition: Predictability over Fairness*

A third necessary revision concerns the related person bright-line definition set forth in section 8.60(3). By overemphasizing predictability, subchapter F creates unwarranted complexity and arbitrariness in an area of conflict of interest law that courts are more able to equitably judge. The related person definition should instead provide for a more open-ended set of relationships and the consideration of actual family circumstances.

Traditional American family relationships have undergone drastic change in recent years through the increase in divorce, remarriage, adoption, single parents, and same and opposite sex couples living together.[101] The drafters of subchapter F have attempted to classify these relationships within a bright-line statute. The resulting definition is a complex and awkwardly worded attempt to encompass a vast yet exclusive set of relationships.[102] Subchapter F also finds the mere existence of a covered relationship sufficient to invoke its provisions.

Courts, however, have addressed conflicts of interest on a case-by-case basis, rather than by automatic presumptions.[103] Courts also will not hesitate to reach out and include more distantly related individuals when the facts warrant action.[104] The ability to examine a wide range of relationships on a case-by-case basis enables a court to make more realistic determinations on specific facts.[105] For example, suppose a corporation engages in a transaction with an estranged in-law of a director. Although the director and the relative may not be on speaking terms, subchapter F presumes a conflict of interest based on family status alone. On the other hand, a director could have a close relationship with

---

101. *See generally* William R. Beer, *Relative Strangers: Studies of Stepfamily Processes* 14 (1988) (documenting the increased rates of single parents and remarriages); Barry D. Adams, *The Rise of the Gay and Lesbian Movement* 121–60 (1987) (documenting the rise of the gay rights movement); James M. Henslin ed., *Marriage and Family in a Changing Society* 76, 576 (3d ed. 1989) (documenting increased divorce rates and numbers of unmarried couples living together).

102. *See supra* notes 46–51 and accompanying text.

103. *See e.g.*, Imberman v. Alexander, 184 N.Y.S.2d 801, 805 (N.Y. Supp. 1959) ("[t]he father-son relationship does not of itself create a liability").

104. Knox Glass Bottle Co. v. Underwood, 89 So. 2d 799 (Miss. 1956) (conflict of interest present in transactions with grandchildren's trusts), *cert. denied*, 353 U.S. 977 (1957).

105. One court has already considered the effects of family friction on family relationship statutory provisions in the context of tax attribution of share redemptions under 26 U.S.C. § 302(b)(1) (1988). Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975); *contra*, Metzger Trust v. Commissioner, 693 F.2d 459 (5th Cir. 1982) *cert. denied*, 463 U.S. 1207 (1983).

a cousin, but any possible conflict of interest is excluded by the statute's definition.[106]

Subchapter F already provides for an open-ended court inquiry on relationship status in the context of qualified directors, through its use of the term "familial relationship," rather than related person.[107] The statute should, therefore, incorporate a similar open-ended determination of covered relationships and consider the actual family circumstances present. This would avoid the unwarranted complexity and arbitrariness currently present in such determinations.

D. *The Need to Exclude* De Minimis *Parties: Consistent with the Statutory Objectives*

The current statute is flawed in a fourth area, the scope of parties covered. The inclusion of parties within statutory coverage that do not possess a financial interest in the transaction runs contrary to the drafters' notions of a conflict of interest. Instead, the party category should include a financial *de minimis* requirement to screen out transactions of negligible financial value and nominal party involvement. The official commentary declares that, for a conflict of interest to exist, there first must be a transaction in which the director has a financial interest.[108] Furthermore, the drafters explain that limiting a conflict of interest inquiry to the financial interests of the director, immediate family members, and associates is the only practical course available in regulating conflict of interest transactions under subchapter F.[109] In nominal party transactions, however, the entity does not possess a financial interest in the transaction, yet is still within the statutory scope. Because a financial *de minimis* requirement appears to be more consistent with the drafters' intent, either legislatures should amend the provisions or courts should interpret them to exclude nominal party transactions.

---

106. If a shareholder charges that a conflict of interest occurred as a result of a transaction with a director's cousin, the court must declare that since a cousin is not a related party under § 8.60(3), a conflict of interest is not present. Committee Report, *supra* note 12, at 1322; *see supra* notes 46–51 and accompanying text.

107. Model Business Corp. Act Ann. § 8.62(d); *see supra* notes 84–86 and accompanying text.

108. Committee Report, *supra* note 12, at 1316.

109. *Id.* at 1310.

E. Drafting Inconsistency in the Preclusion of Judicial Review

A fifth inconsistency in the statute concerns a drafting error in the judicial preclusion section. This error raises questions about the statute's effectiveness in protecting corporations that utilize the statute's safe harbor provisions. Under sections 8.60(1)(i) and (ii), the definition of a conflicting interest includes an "interest in *or so closely linked* to the transaction."[110] The italicized language, however, does not appear in the judicial preclusion provisions, as this section is limited to "interests in the transaction."[111] The language difference may indicate that a category of interests so closely linked to a transaction constitutes a conflict of interest, but is not within the judicial preclusion provisions.[112] The predictability objective of the statute, however, does not appear to support such an interpretation. Although the "so closely linked" language could already be incorporated in the defined conflict of interest term under sections 8.60(1)(i) and (ii), it is probably a drafting error.

Although courts will likely interpret the term "interest" broadly to include closely linked situations, they could also interpret the statute to require substantive fairness for these closely linked interests, regardless of the presence of director or shareholder approval.[113] As the safe harbor provisions were intended to avoid such a judicial result, states that have adopted subchapter F should amend their laws to close this loophole antithetical to the statute's predictability objectives.

IV. FUNDAMENTAL FLAWS IN THE APPROACH OF SUBCHAPTER F

Redrafting can eliminate the statutory problems concerning officer coverage, transactions, related persons, *de minimis* parties, and the preclusion of judicial review. Fundamental flaws concerning the statute's over reliance on disinterested director approval and its unsuitability for most corporations, however, raise serious doubts as to whether subchapter F is indeed a model that states should adopt.

---

110. Model Business Corp. Act Ann. § 8.60(1)(i)–(ii) (emphasis added).

111. *Id.* § 8.61(b).

112. John Steel, *Directors' Conflicting Interest Transactions*, in *The 1990 Business Law Section Midyear Meeting and Seminar*, 6–1, 6–17 (Washington State Bar Ass'n ed., 1990).

113. *See* Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. App. 1952); *see supra* notes 13–14 and accompanying text.

A. Over Reliance on Disinterested Director Approval

The statute's reliance on disinterested director approval, the safe harbor provision more likely to be utilized by corporations, is inappropriate for three reasons. First, its overemphasis on the use of disinterested director approval can lead to less substantive scrutiny of transactions. Second, subchapter F's complete reliance on director approval procedures, without any substantive fairness safeguards, is misguided in light of group dynamics research that questions whether directors can ever be truly disinterested. Finally, the statute's proposed protection against improper director action is seriously weakened by the business judgment rule and inadequate when compared with the protections contained in other state statutes.

1. Overemphasis on Director Approval Results in Less Scrutiny of Transactions

Subchapter F's overemphasis on the precautionary use of director approval will lead to inadequate transaction scrutiny, as unnecessary approval votes will clutter already crowded corporate board agendas. Although the statute emphasizes bright lines, the extent of coverage is unclear in some sections, particularly the beneficial financial interest provisions. The official comments acknowledge the vague scope of this section and recommend that individuals subject any questionable transaction to the statutory safe harbor provisions.[114] The drafters claim that corporations will suffer only nuisance harm if a court ultimately determines that a conflict of interest was not present.[115] For most transactions, disinterested director approval will be utilized to secure safe harbor protection.

These precautionary director approval votes, however, will cause significantly greater harm to shareholders' interests. The routine use of precautionary approval votes will lull directors into a false sense of security and inhibit the adequate scrutiny of actual conflict of interest transactions. Because of this constant need to approve possible conflict of interest transactions, director approval will become little more than a

114. Committee Report, *supra* note 12, at 1323.

115. *Id.*

rubber stamp that does not adequately protect the interests of shareholders.[116]

The overemphasis on approval votes will also adversely impact corporate productivity. The board of directors in many large corporations meets a few days each year for only a couple of hours.[117] Because of time constraints, conflict of interest approval votes must fight for space on an agenda that is already crowded with such items as business policy decisions, dividend declarations, and corporate records that must be audited.[118] The increased need for director approval votes under subchapter F will, therefore, result in a flood of unnecessary approval resolutions swamping board meetings. The sheer number of these resolutions will divert directors' attention away from both important business decisions and actual conflicts of interest.

2. *Are Disinterested Directors Really Disinterested?*

Although the statute's overemphasis on disinterested director approval is cause for concern, the reliance on disinterested director approval without substantive fairness safeguards raises even greater doubts about the statute's ability to protect adequately the interests of shareholders. Social research on group dynamics has raised the issue of a structural bias concerning whether disinterested directors are in fact truly disinterested, and demonstrates the need for substantive safeguards in the conflict of interest field.

Structural bias is the institutional symbiosis that exists when directors pass judgment upon their fellow directors.[119] Although the recent debate concerning this structural bias has focused on its effects in the context of special litigation committees,[120] the problem exists irrespective of

116. *See* Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 Wash. L. Rev. 79, 102 (1993) (judicial oversight necessary as breach of trust is not a risk for which shareholders bargain); *cf.* Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 278–80 (1977) (market forces do not protect shareholders from one shot raids by management on assets).

117. Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 Bus. Law. 1477, 1481 (1984).

118. Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 Wake Forest L. Rev. 5, 12–15 (1989).

119. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, Law & Contemp. Probs., Summer 1985, at 83, 85.

120. *See* Murdock, *supra* note 116, at 102–20 (structural bias is a function of group dynamics); *contra*, Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation:*

whether the issue is duty of care or duty of loyalty.[121] Indeed, the presence of structural bias in director conflicts of interest appears to have been recognized by the courts at common law.[122] The corporate bar, however, views the idea of a structural bias as "a relatively silly, but harmless academic argument."[123] It characterizes the argument as requiring one to accept the belief that directors are more willing to risk their reputations and future income than the social embarrassment of challenging their colleagues.[124]

This position, however, misconstrues the nature of structural bias as a conscious decision-making process, rather than as an unconscious element of individual decision-making. Social research has concluded that people arbitrarily segregate themselves into groups and develop loyalties toward other group members.[125] Feelings of group loyalty are even stronger when the group is relatively homogenous in belief and membership within the group is desirable.[126] These factors are present within the context of corporate boards, as most are composed of a very homogenous group of directors[127] who owe their positions on the board

---

Delaware Law and the Current ALI Proposals Compared, 44 Bus. Law. 503, 534–38 (1989) (structural bias is unconvincing and mischievous on policy grounds).

121. Murdock, *supra* note 116, at 102. The duty of care concerns the lack of diligence and skill in managing a corporation. *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors approved the sale of a company in a two hour meeting without viewing documents or reports). The duty of loyalty focuses on personal opportunistic conduct such as conflicts of interest. *See, e.g.,* Talbot v. James, 190 S.E.2d 759 (S.C. 1972) (corporate majority shareholder/officer hired self as a building contractor for corporate real estate project).

Some commentators have found a lack of distinction between the two duties. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis,* 71 Cornell L. Rev. 261, 290–91 (1986) (distinction between duty of care and loyalty not clear). Others have emphasized the differences between the two duties. *See* Branson, *supra* note 21, at 382–85.

122. Cumberland Coal & Iron Co. v. Parish, 42 Md. 598 (1875). The court stated, "the remaining directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of one of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation." *Id.* at 606.

123. Dooley & Veasey, *supra* note 120, at 535–36.

124. *Id.* at 535.

125. Rolf Holtz & Norman Miller, *Assumed Similarity and Opinion Certainty,* 48 J. Personality & Soc. Psychol. 890, 890 (1985).

126. *Id.*

127. More than 90 percent of all directors are white males, Heidrick & Struggles, *The Changing Board* 12, 3 (1988), aged at least 50, *id.* at 12, and have graduated college, Heidrick & Struggles, *Director Data* 8 (1982).

to friendships and recommendations.[128] Service on these boards is a great honor, with the desire for membership being overwhelmingly motivated by the resulting status, rather than by the monetary rewards.[129]

The feelings of group loyalty that develop from the privilege of board membership have an influence on the directors' decision-making processes. Greater weight is accorded to fellow directors' perceptions and explanations than to the opinions of outsiders challenging transactions.[130] This structural bias within the board membership demonstrates the need for substantive fairness safeguards in conflict of interest statutes and the inadequate protection provided by subchapter F's sole reliance on procedural fairness.

3. *State Substantive Fairness Protections and the Inadequate Protection of the Business Judgment Rule*

The drafters attempt to offer protection against director bias by stating that the director actions must comply with the duty of care provisions of section 8.30 in order for the board approval to receive protective effect.[131] Any protection provided by the duty of care, however, is severely restricted by the business judgment rule.[132] This rule prevents courts from examining the merits of business decisions in situations in which conflicts of interest are not present.[133] The rule is, therefore, applicable to decisions by disinterested directors who, by definition, do

128. *Executive Pay: Salary Scales: View From the Top: Three Former or Current CEOs Ponder Pay at the Highest Levels,* Wall St. J., Apr. 18, 1990, at R11.

129. Heidrick & Struggles, *The Changing Board* 10 (1983).

130. Cox & Munsinger, *supra* note 119, at 103–04; Victor Bradley, *The Independent Director—Heavenly City or Potemkin Village?,* 95 Harv. L. Rev. 597, 611 (1982) (unless a director is appointed solely to monitor other members, the director's effectiveness is tempered by the need to interact with board members on other matters).

131. Model Business Corp. Act Ann. § 8.30 (Supp. 1993). The duty of care requires that directors discharge their duties in good faith, with the care of an ordinarily prudent person and in a manner the director believes to be in the best interests of the corporation. *Id.* For a listing of state duty of care statutes, see *id.* comment at 934–36.

132. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (finding that there is a presumption in making business decisions that the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company). The MBCA does not codify the business judgment rule and instead leaves its development to the courts. Model Business Corp. Act Ann. § 8.30, commentary at 928 (Supp. 1993). For a court to examine the substance of a decision, the plaintiff must prove that an element is lacking and, therefore, the rule is not applicable.

133. *See Aronson,* 473 A.2d at 812 (stating that the business judgment rule is applicable when a conflict of interest does not exist).

not possess a conflict of interest.[134] A major precondition for invoking the business judgment rule is that the directors must have acted on an informed basis.[135] If the required disclosure has been provided to these directors under subchapter F,[136] a plaintiff will have a difficult burden in overcoming the business judgment rule and challenging any director impropriety or collusion.

The complete reliance on procedural considerations in subchapter F contrasts sharply with the various substantive fairness standards found in other conflict of interest statutes. A majority of states have adopted the original MBCA section 41 provisions[137] that did not contain the rigid court review preclusions of subchapter F.[138] Courts were thereby permitted to more closely examine conflict of interest transactions for substantive fairness.[139] States with other statutes counteract the effects of structural bias by having director approval merely shift the burden of proof on transaction fairness to the plaintiff in conflict of interest litigation,[140] or by expressly requiring some form of fairness.[141] Even the American Law Institute's *Principles of Corporate Governance,* which has been criticized by commentators for weakening the director's duty of loyalty,[142] contains a substantive fairness safeguard for director approval.[143] Subchapter F, however, has gone too far in eliminating these

134. *See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (noting that the business judgment rule applies to disinterested director and shareholder approvals).

135. *See supra* note 132; *cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors approved sale of company in a two hour meeting without viewing documents or reports).

136. Model Business Corp. Act Ann. § 8.60(4).

137. *See* ALI, *supra* note 11, at 312–13.

138. *See supra* notes 72–77.

139. The purpose of section 41 was not to validate a transaction between an interested director and a corporation for all purposes, but rather to establish that a transaction was not void or voidable solely by reasons of the director's interest. Model Business Corp. Act Ann. § 41 comment at 844 (2d ed. 1971). For example, the court stated that the Iowa version of section 41 did not modify the common law requirement that a corporation-controlling director has the burden of establishing good faith, honesty, and fairness, when challenged on a conflict of interest transaction. Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517, 525 (Iowa 1974) (interpreting Iowa Code § 496A.34 (1973)).

140. *See* Ill. Ann. Stat. ch. 5 para. 8.60 (Smith-Hurd 1992).

141. *See* Cal. Corp. Code § 310 (West 1990) (requiring the transaction to be just and reasonable).

142. *See* Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project,* 55 Geo. Wash. L. Rev. 325, 369–70 (1987).

143. *See* ALI, *supra* note 11, § 5.02(a)(2)(B) (requiring that the director could have reasonably concluded that transaction was fair to corporation).

substantive safeguards,[144] and states considering the revision of their conflict of interest statutes should seriously consider alternative choices.

B. *Statutory Objectives Achieved at the Expense of Small Corporations*

The second major flaw in subchapter F is its unsuitability for most corporations. The drafters have created a statute that provides predictability in the conflict of interest field for their large corporate clients. The provisions, however, are ill-suited for the vastly more numerous small and closely held corporations in which conflicts of interest more frequently arise.[145] By catering to the needs of large corporations, the statute will force these more typical corporations to defend transactions in court more frequently. Serious consideration should, therefore, be given to a conflict of interest statute that differentiates the approval requirements for smaller and larger corporations.

The ABA committee that drafted subchapter F is dominated numerically by attorneys with large corporate clients.[146] Subchapter F's emphasis on disinterested director approval is well-suited for the needs of their clients. Outside directors comprise the majority of most large corporate boards, and these individuals typically have little to do with the corporation's daily business.[147] As such, sufficient disinterested directors' votes may easily be obtained for approval votes under subchapter F. The statutory bright lines also allow corporations with astute counsel to structure transactions so as to avoid the provisions or ensure proper safe harbor approval has occurred.

Corporate statutes, however, should be responsive to the needs of most corporations, not just the elite giants. The overwhelming majority of corporations are not Fortune 500 companies, nor publicly held

---

144. *See* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence,* 67 Tex. L. Rev. 1351, 1411 (1989).

145. Robert W. Hamilton, *Reflections of a Reporter,* 63 Tex. L. Rev. 1455, 1466 (1985).

146. *Id.* at 1459. Of the 24 members of the Business Law Section in 1988, 18 were either attorneys from large firms that represent large corporations or officers of large corporations. 44 Bus. Law. i, x–xi (1988). This same committee also drafted the 1989 amendments to the model derivative proceeding provisions that made derivative actions harder for shareholders to bring and easier for management to dismiss. Model Business Corp. Act Ann. §§ 7.40–7.47 (Supp. 1992).

147. Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors,* 24 Wake Forest L. Rev. 5, 6–9 (1989).

companies, but rather are small, closely held companies.[148] Because the requirement for a board of directors is often either ignored or observed only as a mere formality in many of these corporations,[149] or alternatively is composed of family members,[150] disinterested director approval provisions are ill-suited for most typical corporations.[151]

Subchapter F not only ignores the circumstances of small corporations, but its emphasis on bright lines and precise approval provisions will create court challenges for small corporations, rather than eliminate them. Consider two examples of situations confronting typical small corporations. First, the sole owner/director of a corporation transfers property to the business in exchange for debt. The corporation later goes bankrupt. A trustee in the subsequent bankruptcy proceedings can now allege a conflict of interest and seek to set aside the transfer because it did not receive, nor was it capable of receiving, safe harbor protection. The owner/director now has the difficult burden of proving the transaction's fairness where few objective guidelines exist in the closely held corporation setting.[152]

In the second example, another typical closely held corporation that has two shareholders, seventy percent and thirty percent respectively, and a board composed of the two shareholders as well as the majority shareholder's spouse, attempts to engage in a similar transfer. Under subchapter F, the transaction is dependent on the approval of the minority shareholder, who possesses tremendous leverage. If the majority shareholder does not agree to the demands of the minority shareholder, and instead approves the transfer by either a board or shareholder vote, the minority owner can challenge the transaction as a conflict of interest. The majority shareholder will be faced with the

148. It has been estimated that 95 percent of all corporations have fewer than ten shareholders. Alfred F. Conard, *The Corporate Census: A Preliminary Exploration,* 63 Calif. L. Rev. 440, 458–59 (1975).

149. Robert E. Ginsberg, *The Need for Special Close Corporation Legislation in Illinois,* 25 DePaul L. Rev. 1, 23 (1975). One commentator has stated that a board of directors in a close corporation is about as appropriate as Robert's Rules of Order for a two person get-together. E.R. Latty, *The Close Corporation and the New North Carolina Business Corporation Act,* 34 N.C. L. Rev. 432, 433 (1956). Closely held corporations are those corporations that contain a small number of stockholders, no ready market for the corporate stock, and substantial majority stockholder participation in the management, direction, and operations of the corporation. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (1975).

150. F. Hodge O'Neil & Robert B. Thompson, *O'Neil's Close Corporations* 14 (3d ed. 1992).

151. Moody, *supra* note 8, at 119 (conflict of interest provisions that focus on disinterested director approval do not serve closely held corporations well).

152. *Id.*

difficult burden of proving the transaction's fairness.[153] The bright lines of subchapter F cause these and other situations typically encountered in small corporations to be subjected to burdensome court litigation. The only predictable result for states that adopt subchapter F appears to be a rise in court cases involving small corporations forced to prove the fairness of prior transactions.

V. CONCLUSION

Subchapter F requires a few modifications in order to function as intended by the drafters. It is designed to reduce the incidence of conflicts of interest and to increase corporate efficiency. In the rush to accomplish these goals, the drafters, however, have neglected the needs of most typical corporations by focusing on the elite giants of the corporate world. Furthermore, the interests of shareholders in ensuring transaction fairness are sacrificed in the name of reduced litigation and greater efficiency. The harmful effects that will result for the majority of corporations under subchapter F greatly outweigh the benefits accruing to the few. States should, therefore, seriously consider alternative conflict of interest provisions.

153. *Id.*