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Corporate Disloyalty—
A Wyoming Case and the ALI Project

Harvey Gelb*

The Wyoming Supreme Court recently had the opportunity to resolve a number of issues relating to corporate fiduciary standards. In the process, the court construed Wyoming’s Business Corporation Act, which is patterned after the Model Business Corporation Act. Using this case as a backdrop, the author reviews proposals by the American Law Institute regarding the duty of loyalty that directors owe to their corporation in conflict of interest transactions. The author argues that the proposals unduly dilute the duty of directors. The author concludes that the trend away from imposing a high duty of loyalty on directors in conflict of interest transactions unfairly leaves minority shareholders and creditors without protection.

Wyoming, unlike Delaware and a number of other jurisdictions, is not a prolific breeder of corporate caselaw. When a case is decided like Lynch v. Patterson,¹ (Lynch) which deals with a multitude of corporate issues, including the duties of loyalty and care, contracts with interested directors, executive and director compensation, competition by a former director, and direct recovery in a derivative suit, it is an exciting event. This article considers and evaluates all of these aspects of Lynch, but goes somewhat further. As will be seen, this was a case which inter alia held certain directors liable for breach of fiduciary duty. In the process, the court considered certain provisions of the Wyoming Business Corporation Act,² including section 17-1-136.1, which pertains to director conflicts of interest, that is, contracts or transactions between a corporation and

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I would like to acknowledge the assistance of Darlene Reiter and Richard Schneebeck in the preparation of this article.

1. 701 P.2d 1126 (Wyo. 1985)
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. This article, however, considers the application of breach of fiduciary duty principles where certain procedures not involved in *Lynch*, but contained in section 17-1-136.1, that is, disinterested director votes or shareholder votes, are used to sanction conflict of interest contracts or transactions.

In the midst of reflection on such matters, almost irresistibly, a disturbing question keeps coming to the fore—whether contracts or transactions which engender conflict of interest problems are so beneficial or necessary to corporate life and to social well-being that the path to their consummation should be an easy one. Surely even the phrase "conflict of interest" has negative connotations which have not subsided with the passage of time. The law, however, has undergone considerable transformation in its willingness to permit contracts and transactions between directors and their corporations. Further, as will be seen, some courts and others continue to attempt to make conflict of interest contracts or transactions more likely to succeed where they are sanctioned by such devices as so-called disinterested director or shareholder votes. This author has too healthy a fear of such contracts or transactions and too little regard for the efficacy of such devices to be convinced of the wisdom of such efforts.

Coincidentally, this is a time in which the American Law Institute (ALI) is engaged in the process of formulating principles of corporate governance, a project which *inter alia* has included the preparation of a tentative draft encompassing the "duty of loyalty." This draft receives considerable attention in this article. While judicial decisions which go too far in watering down loyalty requirements in conflict of interest situations on the basis of so-called disinterested votes of directors or shareholders are disturbing, the degree of acceptance which such dilution has found in Tentative Draft No. 3 of the ALI is appalling. Although there may be decisions which improvidently reduce loyalty requirements, it is, to say the least, premature for the ALI to magnify and sanctify such positions. It is not yet clear that dilution of loyalty trends have evolved into firm national judicial positions deserving of great respect in the

4. *American Law Institute, Principles of Corporate Governance: Analysis and Recommendations* (Tent. Draft No. 3, 1984) [hereinafter *Tentative Draft No. 3*]. Tentative Draft No. 3 includes proposals relating to the duty of loyalty. For some background on the American Law Institute Corporate Governance Project, see Eisenberg, *An Introduction to the American Law Institute's Corporate Governance Project*, 52 Geo. Wash. L. Rev. 495 (1984). At the time of this writing, Tentative Draft No. 3 has not been submitted to the American Law Institute membership for approval. Revisions of Tentative Draft No. 3 are to be submitted to the Council of the American Law Institute, and a revised draft may be submitted to the membership in May, 1986. Telephone interview with Marshall L. Small, American Law Institute reportorial staff (August, 1985).
5. See *infra* notes 74 and 79 for examples of such cases.
6. See *infra* note 7 for further discussion.
7. Presently there are duty of loyalty statutes (sometimes referred to as “safe harbor statutes”) in many states. See infra text accompanying notes 42-44. Tentative Draft No. 3 admits that “there is considerable confusion in the cases as to the scope of judicial review to be employed when testing the validity of a transaction between a director or senior executive and the corporation,” and indicates that there is not yet a substantial body of caselaw construing the statutes. TENTATIVE DRAFT NO. 3 infra note 4, at 111, 131. For further discussion regarding the existing state of the law see E. BRODSKY & M.P. ADAMS, LAW OF CORPORATE OFFICERS AND DIRECTORS §§ 3:05 - 3:07 (1984) and F.H. O'NEAL & R.B. THOMPSON, O'NEAL'S OPPOSITION OF MINORITY SHAREHOLDERS § 3.15, at 134-36 (2d ed. 1985). This article presents various arguments against unduly watering down loyalty requirements in conflict of interest cases because of disinterested director or shareholder votes. For example, see the persuasive judicial arguments from older cases which could be contrasted sharply with the positions embraced in Tentative Draft No. 3 which rely on the protective quality of disinterested director votes as a reason for diluting or impairing loyalty requirements. See, e.g., infra note 81.


Those who recall Tentative Draft No. 1 will note that the subtitle of the project has been changed from “Restatement and Recommendations” to “Analysis and Recommendations.” The change was made to allay the fear that courts might be misled by the traditional word “Restatement” in the title to view the entire document as purporting to restate existing law, ignoring the detailed explanation in the Comments of how far that was and how far it was not the case.

The present form “Analysis and Recommendations” makes clear, it is believed, that all statements concerned with law should be regarded as recommendations of the Institute, with the context and the explanation in the Comment making clear how far a recommendation is believed to be consistent with prevailing law and how far legal change is contemplated, and, if the latter, whether by decision or by legislation.

9. Id. at ix-x states in the foreword:

The fiery rhetoric aroused by Tentative Draft No. 1 included the assertion that the Institute departed from its own tradition in going beyond restatement of existing law and making proposals as to what the law should be. Those who put forward this critique are obviously misinformed as to the mission of the Institute and its work product during more than half a century. The Restatements, important as they are, never have been viewed as the exclusive means for pursuit of our objectives: “the clarification and simplification of the law and its better adaptation to social needs.”
While Lynch did not involve the impact of disinterested director or shareholder votes, it will leave a bittersweet taste in the mouths of those who favor strong deterrence against fiduciary misfeasance. Although in some respects it speaks strongly in favor of fiduciary responsibility, in other ways it undermines such responsibility.

Finally the Revised Model Business Corporation Act which was recently completed includes a section dealing with conflict of interest transactions. In light of the extensive analysis in this article of the corresponding Wyoming statutory section involving interested director transactions, and the likelihood of eventual legislative consideration of amendments based on the Revised Model Business Corporation Act, this article will comment on the revised section.

The Lynch Case (Facts)

In Lynch, a stockholder’s derivative action was brought by Patterson, a minority stockholder of Lynch Consulting Services, Inc. (LCS), a Wyoming corporation in the oil field consulting business, to recover damages allegedly resulting from actions taken by its three directors in violation of their fiduciary duties to the corporation. A counterclaim was filed by the directors and LCS against Patterson alleging that he committed a breach of fiduciary duties as a former director by entering into competition with LCS.

Patterson, a thirty percent owner of the voting stock of LCS, resigned as director and officer of LCS on February 28, 1981, and formed his own consulting company the next month. Two of the three defendant directors were Birl Lynch and R.C. Lynch (the Lynches) who each owned thirty-five percent of the voting stock of LCS. The third defendant director was Eunice Lynch (Eunice), the wife of one of the Lynches, and the mother of the other. At a meeting of the board of directors of LCS, consisting of the Lynches and Eunice, held on February 28, 1981, the compensation of each of the Lynches was doubled to $8,000 per month. For the period March 1, 1981 through December 1981, the Lynches received not only the increased salaries, but also bonuses amounting to over $7,400 each. At a meeting in January 1982, the directors voted to discontinue such salaries and to hire Lynch Management Services (LMS), a partnership composed of the Lynches, to manage LCS. The directors also agreed to convene regularly and to pay the Lynches monthly director fees of $1,300 each.

In accordance with their management agreement, LCS paid LMS $17,000 per month in management fees. LMS disbursed $16,000 of this money in monthly salaries to the Lynches. While receiving these fees, LMS sought business for itself as an oil-field consultant.

12. Id.
In its first complete fiscal year under the management of LCS ending April 30, 1983, LCS operated at a net loss of over $300,000 compared to over $90,000 net earnings from operations during the previous fiscal year. Further, by April 30, 1983, the liabilities of LCS exceeded its assets by over $105,000 while one year earlier its net assets had amounted to over $360,000. LCS, on the other hand, posted net earnings of over $150,000 during its first year (January 1, 1982-December 31, 1982), and its net assets increased from the partners' original contribution of $969 to over $11,000.

At board meetings in February and March, 1982, the directors of LCS agreed to purchase property for which the corporation paid $85,000. Four months later by unanimous vote of the directors, the property was sold to the Lynches for $75,000.13

The district judge concluded that the Lynches, as directors of LCS, were fiduciaries to Patterson. The Lynches were found to have engaged in self-serving transactions with LCS and to have failed to establish the fairness of their dealings.14 Further, the director fees, increased officer salaries, management fees paid to LCS, and the benefit to the Lynches from the sale of real property were found to constitute improper corporate expenditures in the total amount of $266,000.15 The court held the Lynches directly liable to Patterson for his pro rata share of such expenditures, which the court calculated to be in the amount of $79,800, based on Patterson's thirty percent interest in the corporation.16 The district court dismissed Patterson's claim against Eunice and the defendants' counterclaim against Patterson.17

**Duty of Loyalty to the Corporation**

In challenging the findings of the trial court that the Lynches had failed to establish the fairness to the corporation of management fees paid to LCS and that the Lynches had not carried their burden of proof with respect to the conveyance of the real estate to themselves at a loss to the corporation of $10,000, the Lynches contended that a complaining stockholder must establish fraud or unreasonableness in order to recover damages from a director who enters into contracts with a corporation or approves his own compensation.18 The Lynches evidently wanted section 17-1-136.1(a)(iii) of the Wyoming Business Corporation Act19 interpreted in such a way as to require the plaintiff to establish the unreasonableness of a challenged transaction.20 Section 17-1-136.1(a) reads as follows:

13. *Id.* at 1128-29. All relevant facts are stated on these pages except for the fact that Eunice Lynch was the mother of one of the directors, which appears on page 1137.
14. *Id.* at 1129.
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 1131.
(a) No contract or other transaction between a corporation and one (1) or more of its directors or any other corporation, firm, association or entity in which one (1) or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of the relationship or interest or because the director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies the contract or transaction or because his or their votes are counted for the purpose, if:

(i) The fact of the relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of the interested directors; or

(ii) The fact of the relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify the contract or transaction by vote or written consent; or

(iii) The contract or transaction is fair and reasonable to the corporation.22

The Lynches did not argue that the transaction at issue here was validated by virtue of subsections (a)(i) or (ii) but relied instead on subsection (iii) and the argument that the plaintiff had the burden of proof under that subsection to establish the unreasonableness of the challenged transaction.23 The Wyoming Supreme Court rejected the contention of the Lynches, holding that under subsection 17-1-136.1(a)(iii) "an interested director, unable to rely on subparts (i) or (ii), bears the burden of proving by clear and convincing evidence that a challenged transaction was fair and reasonable to the corporation."24 In reaching its conclusion the court referred to prior cases from Wyoming and elsewhere25 (which require a challenged, interested director to prove that he acted in good faith and that the contested transactions were fair to the corporation) and concluded that the Wyoming Business Corporation Act does not dictate a contrary result.26 The court buttressed its conclusion by referring to the principle that "the fiduciary obligation of a director is a fundamental component of the corporate structure,"27 which "is embodied in § 17-1-133(b), W.S.1977, 1984 Cum.Supp., which imposes upon directors the affirmative duties of good faith, loyalty and care."28 The court took the position that "the very nature of these fiduciary standards of conduct demands that a challenged director bear the burden of establishing that a contract under which he benefits also serves the best interests of the corporation."29

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23. Lynch, 701 P.2d at 1132.
24. Id.
25. Id. at 1131. The cases referred to are those cited infra notes 30, 41.
27. Id. at 1132.
28. Id.
29. Id.
court described the fiduciary obligations of corporate directors and majority shareholders as follows:

[their] dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. . . . The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside."

Applying the rule that the interested director bears the burden of proving by clear and convincing evidence that a challenged transaction was fair and reasonable to the corporation under section 17-1-136.1(a)(iii), the Lynch court concluded that the evidence supported the factual findings of the trial court regarding the management fees and the transfer of real estate.

The position of the Supreme Court of Wyoming regarding burden of proof is correct. It is quite appropriate to interpret section 17-1-136.1, which involves director conflict of interest transactions, with the historic and important fiduciary duty of loyalty in mind. The principle that the director has fiduciary duties to the corporation including the duty of loyalty in conflict of interest situations is well established:

Corporate managerial powers, being powers in trust, must be exercised honestly and in good faith. The director or officer "owes loyalty and allegiance to the corporation—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment. In the discharge of his duties a director must, of course, act honestly and in good faith. . . ."

30. Id. at 1131 (citing Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).
32. Id.
33. This article is written from the perspective of analyzing the liability of interested directors in conflict of interest transactions because the Lynch case is written from that perspective and because Section 17-1-136.1 is written in terms of such transactions. It is recognized that theories of corporate loyalty pertinent to corporate officers and majority shareholders, as such, may also be worthy of exploration in connection with Lynch and certain other cases involving conflict of interest transactions. Tentative Draft No. 3, supra note 4, § 5.08, which is discussed in this article from the director perspective, also specifically deals with certain corporate officers, and Section 5.14 deals with dominating shareholder transactions with the corporation.
The significance of the duty of loyalty in discerning legislative intent under section 136.1 is increased because such a duty is also imposed by the legislature in Section 133(b), a section which, as indicated, did not go unnoticed by the Wyoming Supreme Court.35

The Requirement of Fairness to the Corporation

There was a time when the general common law rule was that any transaction or contract between a corporation and a director was voidable by the corporation.36 Such a rule deters disloyalty effectively by the extreme device of rendering self-dealing transactions or contracts completely vulnerable. There is, of course, good reason for courts to be concerned about such transactions or contracts since they may be used by those in power to take advantage of those out of power, such as minority shareholders or corporate creditors.37 It came to be recognized, however, that such transactions or contracts may be beneficial to corporations and should not be automatically voidable.38 The modern rule which has developed would render them voidable "on the basis of the conflicting interest plus the additional factor of unfairness to the corporation"39 with the burden of proving their fairness on those who would sustain them. Fairness is tested on the basis of whether an independent fiduciary would bind the corporation to such a transaction in an arm's length bargain.40

35. Lynch v. Patterson, 701 P.2d 1126, 1132 (Wyo. 1985). The phrase "best interests of the corporation" appears in section 133(b) as well as in the Model Business Corporation Act Section 35. The Corporate Director's Guidebook refers to the phrase "best interests of the corporation" as "that component of the duty of loyalty involving the corporate director's primary allegiance. As the shareholders' designee, the corporate director is in a position of stewardship for the owners of the enterprise, whose interests are interchangeably merged with the interests of the corporate entity." American Bar Association, Section of Corporation, Banking and Business Law, Committee on Corporate Laws, Corporate Director's Guidebook, 33 Bus. L. 1591, 1601 (1978) [hereinafter Corporate Director's Guidebook].


37. See Marsh, supra note 36, at 35-39 (a collection of judicial comments on the dangers and disadvantages to the corporation which arise from conflict of interest transactions). Some of these comments are quoted infra note 81.

38. E. Brodsky & M.P. Adamski, supra note 7, § 3:01, at 2, state:

In recognition of the prevalence of interlocking directorates, and because of the belief that certain transactions between the corporation and its directors, or between the corporation and another corporation in which one or more of its directors had an interest, might be beneficial to the corporation, the rule of strict voidability was gradually repudiated.

The merits of the abolition of strict voidability are debatable. See infra note 81: Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597 (1982).

39. H. Hens & J. Alexander, supra note 34, § 238, at 639, in discussing conflict of interest transactions, state:

There is a three-way split of authority as to whether such a transaction is voidable on the basis of the conflicting interest alone, on the basis of the conflicting interest plus the additional element of fraud or bad faith, or on the basis of the conflicting interest plus the additional factor of unfairness to the corporation. The more modern cases tend to apply the "fairness" test: Would an independent corporate fiduciary in an arm's length bargain bind the corporation to such a transaction?

40. Id. at 639-40.
As indicated above, earlier Wyoming cases placed the burden of showing fairness on the interested director.41

Furthermore, a number of states including Wyoming enacted statutory provisions like section 136.142 which have been referred to as safe harbor statutes43 and provide that no contract or transaction between a corporation and one or more of its directors shall be either void or voidable because of the relationship or interest of the director if one of several conditions is met.44 In enacting such a statutory provision, Wyoming was following the approach of Model Business Corporation Act section 4145 which states its limited objective as: "contracts or transactions involving an interested director will not be void or voidable solely because of the director's interest if certain conditions are met. In all other respects equitable principles will continue to be applicable."46

It is one thing to adopt a statute which eliminates or codifies the elimination of a rigid voidability rule. It is quite another matter to broadly construe such a statute beyond its limited objective so as to weaken the position of shareholders or creditors by implying that the statute changes the burden of proof which a court would normally apply in a case alleging fiduciary misconduct and testing the fairness and reasonableness of a contract or transaction. In light of the very real dangers posed by a conflict of interest,47 directors on both sides of a transaction such as those in the Lynch case should have the burden of proving its fairness. Moreover, the interested director is generally more knowledgeable about the corporate transaction in which he is involved than would be the minority shareholder or creditor who must be protected. Placing the burden on the interested director is, therefore, sensible. The historic and continuing recognition in cases and other statutory sections that directors, as fiduciaries, owe a duty of loyalty to the corporation,48 along with the practical policy considerations calling for adequate protection of the corporation, its minority shareholders, and creditors suggest that it would be improper to construe statutory sections like section 136.1 to undermine the recognized fiduciary duty of loyalty beyond what their limited objective and express language mandate. Indeed, a proper regard for the duty of

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43. Tentative Draft No. 3, supra note 4, § 5.08, reporter's note at 129.
44. Id. at 129-32. For example, the Iowa and Nebraska statutory sections cited supra note 42 set forth the same conditions as those in Wyoming section 17-1-136.1(a). See supra text accompanying note 22.
46. Model Act supra note 45, § 41 comment 2, at 842.
47. See Marsh, supra note 36, at 35-39. See also infra note 81.
loyalty and for the policy considerations also justifies a court decision to place the burdens of production and persuasion regarding the fairness issue on the interested director in a case like *Lynch*.

Section 136.1 and similar safe harbor statutes of other states\(^{49}\) raise various questions of interpretation which the Wyoming court did not have to reach. It may be argued that, literally, section 136.1 validates a contract without regard to fairness or that it places the burden of proving unfairness on a complaining party if either of the other statutory conditions, that is, those referring to disinterested director approval\(^ {50}\) or shareholder approval,\(^ {49}\) are satisfied. Arguments, however, which attribute such significance to section 136.1 are not very persuasive. The factors discussed above which call for a narrow reading of section 136.1, along with a reading which does not unduly undermine the fiduciary duty of loyalty, militate against construing that section to eliminate judicial scrutiny of the fairness issue or to affect the burden of proof regarding that issue. A reading which attributes too much significance to subsections (i) and (ii) would be unfortunate and unreasonable. This is illustrated vividly by the impact such a construction would confer on interested shareholder votes of approval.

**Shareholder Approval**

Suppose there was shareholder approval in *Lynch* because the Lynches as majority shareholders voted in favor of the transactions in which they had an interest. There is nothing in the language of subsection (ii) which indicates that the majority vote must be disinterested. Indeed, in light of the contrast in language between subsection (ii) and subsection (i), which specifically refers to a vote by disinterested directors, it could be argued that subsection (ii) contemplates a vote by interested shareholders. A vote by interested shareholders such as the Lynches should not immunize a transaction from scrutiny as to fairness or be the reason for relieving the defendant of the burden of proving the fairness of a contract or transaction. It seems absurd to say that the legislature intended to preclude the court from examining the fairness of a contract or transaction or to relieve interested parties of their burden of proof in a conflict of interest situation simply because interested shareholders cast enough shareholder votes to approve the contract or transaction. The corporation and its minority shareholders and creditors would be left without protection against unfairness by a statutory interpretation which precludes judicial inquiry into that question. A complaining party would be relegated to attacks on a transaction based on theories much more difficult to sustain, such as waste,\(^ {52}\) to the extent that such other theories would be deemed viable.

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49. See *Tentative Draft* No. 3, *supra* note 4, § 5.08, reporter's note at 129-30, 134-37. For a list of states with safe harbor statutes see also *supra* note 42.


51. Id. § 17-1-136.1(a)(ii).

52. See *infra* text accompanying note 66 for the meaning and a discussion of the term "waste" as used here.
in the face of an expansive interpretation of the immunity afforded by the language of section 136.1.\textsuperscript{53}

In addition, even if fairness itself is subject to judicial scrutiny, protection to the complaining party would be greatly and irrationally reduced by a statutory interpretation placing the burden of proving unfairness on him simply because of an interested shareholder vote which affords him no added protection. In a Delaware decision cited by the Wyoming Supreme Court in Lynch,\textsuperscript{54} the court narrowly interpreted a similar statutory provision involving ratification by the shareholders of an interested transaction. The court concluded that the statute did not provide broad immunity for defendants but merely removed an "interested director" cloud when its terms were met. The statute provided against invalidation of an agreement "solely" because such a director or officer is involved.\textsuperscript{55} The Delaware Court pointed out that "[n]othing in the statute sanctions unfairness to [the corporation] or removes the transaction from judicial scrutiny."\textsuperscript{56} Moreover, the Delaware court rejected the argument that the defendants had been relieved of the burden of proving fairness by reason of the shareholder ratification because the ratification was not given by a majority of independent or disinterested shareholders.\textsuperscript{57}

Interpretation of the statute as precluding a judicial inquiry regarding fairness or affecting the burden of proof on that question even where a contract or transaction is approved by a disinterested shareholder vote would be unreasonable because the statutory language does not differentiate between an interested and disinterested shareholder vote. Nor does subsection (i) of section 136.1(a) mandate any approach as to judicial consideration of the fairness of a transaction or burden of proof where a disinterested director vote approving the transaction has been obtained since, in view of the language of section 136.1(a), it would be difficult to give greater effect to subsection (i) than to subsection (ii).

Even if not compelled to do so by statute, however, a court must face the question of whether, as a matter of judicial lawmaking, a disinterested shareholder or disinterested director vote of approval shifts the burden of proof on the fairness issue, eliminates the need for a judicial inquiry regarding fairness, or reduces the level of judicial scrutiny to be applied to a transaction. Tentative Draft No. 3\textsuperscript{58} takes the position that in the

\textsuperscript{53} One could take the very extreme position that satisfying any of the conditions of section 136.1 would validate a transaction against any or almost any legal attack. Such a position seems untenable. For example, it seems inconceivable that a court would automatically sustain a transaction under that section if fraud were used to obtain a vote of approval by the disinterested directors or shareholders or if corporate waste was involved.

\textsuperscript{54} Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976). While the Delaware statutory section involved in Fliegler differs in some respects from Wyoming Section 136.1, the perspective of the Delaware court, as explained in the text accompanying this note and note 55, infra, may reasonably be applied to the Wyoming section. A similar perspective is found in Remillard Brick Co. v. Remillard-Dandini, 109 Cal.2d 401, 241 P.2d 66 (Cal. 1952).

\textsuperscript{55} Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976).

\textsuperscript{56} Id.

\textsuperscript{57} Id. at 221.

\textsuperscript{58} Tentative Draft No. 3, supra note 4, § 5.08 (a)(2).
absence of a disinterested shareholder or disinterested director vote, or a corporate standard (adopted by disinterested directors or disinterested shareholders) permitting a transaction,\(^5^9\) a director violates the duty of loyalty owed to the corporation if the transaction was not fair to it.\(^6^0\) Further, the burden of proving fairness in such cases is on the director.\(^6^1\) The Draft explains:

In determining whether to enter into a transaction, the corporate decisionmaker who approves the transaction should consider not only whether the transaction will be “fair” to the corporation as measured by comparison with an arm’s-length transaction with an unrelated party, but whether the transaction affirmatively will be in the corporation’s best interest, as in a transaction with an unrelated party.\(^6^2\)

The Draft further indicates that the burden will be on the director to prove the transaction is in fact fair, rather than whether a corporate decisionmaker could reasonably have believed it to be fair.\(^6^3\)

The Draft calls for a completely different approach if a transaction was authorized or ratified by a disinterested shareholder vote following proper disclosure to the shareholders, however. In such a case the interested director will violate his duty of loyalty to the corporation only if the transaction constitutes a waste of corporate assets,\(^6^4\) and the burden of proving such waste is on the challenging party.\(^6^5\) The Draft essentially adopts the position that “to prove waste of corporate assets, a party must show that no person of ordinary sound business judgment would say that the consideration received by the corporation was a fair exchange for what was given by the corporation.”\(^6^6\) Of course, disclosure by the director in connection with authorization or ratification is important, and he owes a duty to the corporation not only to avoid misleading it by misstatements or omissions, but to disclose affirmatively the material facts concerning a transaction in which he has a personal interest.\(^6^7\)

Admittedly, there is judicial authority which favors a shift in burden of proof to the complaining party or a dilution of the fairness standard

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59. Tentative Draft No. 2, supra note 8, § 1.27, defines the term “corporate standard” as follows: “Standard of the Corporation’ means a valid certificate or by-law provision, or board or shareholder resolution, regulating corporate governance.” Tentative Draft No. 3, supra note 4, § 5.08 (a)(2)(C) indicates that the corporate standard must be adopted in accordance with section 5.06, which calls for disinterested director or shareholder action.

60. Tentative Draft No. 3, supra note 4, § 5.08 (a)(2).
61. Id. § 5.08(b).
62. Id. § 5.08(a)(2)(C) comment at 123-24.
63. Id. at 123.
64. Id. § 5.08(a)(2)(B).
65. Id. § 5.08(b).
66. Id. § 5.08(a)(2)(B) comment at 122. Waste is defined in Tentative Draft No. 2 as follows: “A waste of corporate assets’ means a transaction whose terms are such that no person of ordinary sound business judgment would say that the consideration received by the corporation was a fair exchange for what was given by the corporation.” Tentative Draft No. 2, supra note 8, § 1.30.
67. Tentative Draft No. 3, supra note 4, § 5.08(a)(2)(B) comment at 115.
based on disinterested shareholder approval.\textsuperscript{68} A majority vote of disinterested shareholders would arguably give some protection to those who need it. It may be said that disinterested shareholder approval furnishes at least some objectivity in the consideration and approval of a transaction or contract. The protection may be illusory, however, because the protective impact of a disinterested shareholder vote depends on various factors such as the extent of information readily available to such shareholders, the degree of diligence which they could be expected to apply to the rendering of a wise decision based on such information,\textsuperscript{69} and the use of a reasonable test and procedure for classifying shareholders as interested or disinterested.\textsuperscript{70} Moreover, the shareholder vote does not substitute for the protection afforded by a bargaining process leading to a true arms length agreement—a process which would be present in the usual non-conflict of interest situation.\textsuperscript{71} Since the degree of protection afforded by a so-called disinterested shareholder vote may under the circumstances be uncertain or debatable, shifting the burden of proof regarding fairness should not be automatic or lightly sanctioned. Rather, it should depend on the development and application of adequate judicial safeguards regarding the sufficiency of the protective quality of the vote.\textit{A fortiori} withdrawing the fairness issue from judicial scrutiny, or reducing the level of that scrutiny because of a so-called disinterested shareholder vote is even more questionable.

It is true that it would be desirable on some occasions to encourage the submission of conflict of interest transactions to a shareholder vote even where corporate statutory law does not require such a procedure.\textsuperscript{72}

\textsuperscript{68} See, e.g., Michelson v. Duncan, 407 A.2d 211 (Del. 1979).

\textsuperscript{69} In a large public corporation, it seems unrealistic to expect the kind of consideration of proposals made through the proxy solicitation process which will be protective of the corporation's minority shareholders and creditors.\textit{Tentative Draft No. 2, supra} note 8, at 54, states: "Direct review by the body of shareholders, however, while perhaps effective in close corporations, is seldom efficacious in publicly held corporations, because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues." One wonders why the statement from Tentative Draft No. 2 did not influence the drafters of Tentative Draft No. 3, who placed so much reliance on disinterested shareholder approval.

\textsuperscript{70} \textit{Tentative Draft No. 2, supra} note 8, § 1.15 defines interested shareholder as follows: "(2) A shareholder is interested in a transaction if either the shareholder or, to his knowledge, an associate of the shareholder, is a party to the transaction." An associate is defined in Tentative Draft No. 3,\textit{ supra} note 4, § 5.01 as:

1. A spouse, child, parent, or sibling of a director [§ 1.08] or of a senior executive [§ 1.25] or of a shareholder, or

2. Any person [§ 1.20] for whom a director, senior executive, or shareholder has financial responsibility, or with whom he has a business relationship that is sufficiently substantial that it would reasonably be expected to affect his judgment with respect to the transaction in question in a manner adverse to the corporation.

This definition may not be broad enough to insure the objectivity of the voter which is required to make the vote of approval protective. In any event, the question of interest and a procedure for determination of interest where there are large numbers of shareholders may be vexing indeed. See \textit{Tentative Draft No. 2, supra} note 8, § 1.15 comment at 7-9.

\textsuperscript{71} Marsh,\textit{ supra} note 36, at 49.

\textsuperscript{72} Express statutory provisions recognize that certain transactions such as mergers must be approved by shareholder vote. See, e.g., Wyo. Stat. § 17-1-403 (Supp. 1985)
While one may quite properly be skeptical about the adequacy of the consideration which the shareholders would give to the proposed transaction, the resultant disclosure would at least be healthy and encourage fair play. Conceivably, statutes could be revised to require all conflict of interest transactions to have shareholder approval, but that would prove to be too cumbersome and expensive in some situations. Short of such a blanket requirement, the disinterested shareholder approval process could be encouraged by giving interested directors some advantage as against potential complaining parties, provided that material disclosures have been properly made in obtaining shareholder approval. A shift in the burden of proof to the complaining party would confer such an advantage on the interested director. But to go further and eliminate or modify the fairness requirement regarding the contract or transaction because of a disinterested shareholder vote means saddling a corporation with a transaction or contract with an interested director which a complaining party can prove to be unfair.

The position, therefore, of the Draft\textsuperscript{73} and some courts\textsuperscript{74} which supports the dilution of fiduciary responsibility by lowering or eliminating the fairness requirement and using instead a waste requirement in the presence of a disinterested shareholder vote furnishes a fiduciary with more of an advantage vis-à-vis his corporation than is appropriate. Such a fiduciary should not win a case in which a complaining party is able to meet the burden of proving that the fiduciary has engaged in a transaction which is unfair to the corporation. Public policy simply should not favor such a result. When a director considers entering into a conflict of interest transaction, he should fix his attention on the question of its fairness in a most sober way. The Corporate Director's Guidebook suggests:

When conflicting interests are present, the corporate director must be concerned that fairness obligations are recognized and satisfied. If a transaction by a director with the corporation involves a possible conflict of interest, its fairness to the corporation should be a primary concern for both the interested director and those disinterested directors entertaining a request for favorable action.\textsuperscript{75}

Director concern about fairness should not be relieved because of an upcoming shareholder vote. The prospect of a shareholder vote should not lead to director complacency regarding the fairness of a transaction.

Arguably, a middle ground may be appropriate: in those cases in which a court finds a disinterested shareholder vote exceptionally protective of the corporate interest, then, in addition to a shift in burden of proof to the complaining party, the shareholder vote should be considered as

\begin{footnotes}
\item 73. Tentative Draft No. 3, supra note 4, § 5.08 (a)(2)(B).
\item 74. See, e.g., Michelson v. Duncan, 407 A.2d 211 (Del. 1979).
\item 75. Corporate Director's Guidebook, supra note 35, at 1599.
\end{footnotes}
evidence of fairness. In the usual situation where there is appropriate disclosure to disinterested shareholders but no special reason to assign unusual protective significance to the vote, the burden of proof may be placed on the complaining party but the fairness of the transaction should remain at issue and be unaffected by the disinterested shareholder vote. The problem with such a middle ground is that it may at times get a court involved with complex hairsplitting decisions (as to whether a shareholder vote is unusually protective) in order to increase the burden on a complaining party to show unfairness, a burden which is difficult enough as it is.

Finally, it may be argued that in the presence of a properly informed unanimous shareholder ratification, a conflict of interest transaction should be unassailable on grounds of fairness, waste, or otherwise. One problem with such a position is that it fails to adequately protect corporate creditors. Moreover, even a unanimous shareholder vote may in some contexts furnish little actual protection to those who have voted to approve because of their ignorance or inattention.

Disinterested Director Approval

Whether or to what extent a disinterested director vote should alter in any way the judicial inquiry into fairness raises a number of issues. Tentative Draft No. 3 takes the position that in a case involving an alleged violation of the director's duty of loyalty, if a transaction was authorized in advance by disinterested directors following appropriate disclosure, the challenging party will have the burden of proving that the disinterested directors could not reasonably have believed the transaction to be fair to the corporation. The Draft explains that this represents a level of judicial scrutiny more intense than that used under the business judgment rule but less intense than that required if there had been no disinterested director or shareholder approval. Admittedly, there is judicial authority which favors a shift in the burden of proof to the complaining party and a dilution of the fairness standard or even elimination

76. Perhaps in the close corporation context a favorable disinterested shareholder vote would have a better chance of being viewed as exceptionally protective because the shareholders may be closer to the situation than they would be in the public corporation context. See supra note 69.
77. Tentative Draft No. 3, supra note 4, § 5.08 (a)(2)(A).
78. Id. comment at 119. That comment states:
   If a transaction has been authorized in advance by disinterested directors, the burden of proof will be on the party challenging the transaction under § 5.02(a)(2)(A), but a somewhat more intense level of judicial scrutiny than the rational basis test required under the business judgment rule (and a somewhat less intense level of scrutiny than that required if there has been no disinterested director or shareholder approval) is to be applied—namely, whether the directors who approved the transaction could not reasonably have believed the transaction to be fair.
   See generally American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (Tent. Draft No. 4, 1985) for a discussion of the duty of care and the business judgment rule.
of that standard based on disinterested director approval. The disinterested director vote would arguably give some protection to those who need it. As in the case of the disinterested shareholder vote, such a vote may furnish a measure of objectivity in the consideration and approval of a transaction or contract. It may or may not render the bargaining process relative to the transaction or contract close to or the same as that which would obtain in an arms length situation.

As in the case of a disinterested shareholder vote, though, the degree of protection provided by a disinterested director vote is questionable and will vary with each case. Defining what is disinterested, and overcoming problems of favoritism present formidable difficulties. To counter the evils of self-dealing, the independent director must assume an adversarial role in the particular transaction. Several factors often undermine such a role, however, such as psychological and social pressures, limited incentives to perform such a role and weak sanctions for failure to rightly perform. In addition, variations in the extent of disclosure to directors

80. Tentative Draft No. 2, supra note 8, § 1.15, defines “interested director” as follows:
   (1) A director [§ 1.08] or officer [§ 1.19] is “interested” in a transaction if:
      (a) the director or officer is a party to the transaction, or
      (b) the director or officer or an associate [§ 5.01] of the director has a pecuniary interest in the transaction, or the director or officer has a financial or familial relationship to a party to the transaction, that is sufficiently substantial that it would reasonably be expected to affect the director’s or officer’s judgment with respect to the transaction in a manner adverse to the corporation.
   For the definition of the term “associate” see supra, note 70.
81. Marsh, supra note 36, at 37 summarizes judicial views regarding problems, including favoritism, in relying on so-called disinterested director approval as follows:
   The courts stated that the corporation was entitled to the unprejudiced judgment and advice of all of its directors and therefore it did no good to say that the interested director did not participate in the making of the contract on behalf of the corporation. “... the very words in which he asserts his right declare his wrong; he ought to have participated....” Furthermore, the courts said that it was impossible to measure the influence which one director might have over his associates, even though ostensibly abstaining from participation in the discussion or vote. “... a corporation, in order to defeat a contract entered into by directors, in which one or more of them had a private interest, is not bound to show that the influence of the director or directors having the private interest determined the action of the board. The law cannot accurately measure the influence of a trustee with his associates, nor will it enter into the inquiry....”
   Perhaps the strongest reason for this inflexibility of the law was given by the Maryland Supreme Court which stated that, when a contract is made with even one of the directors, “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.” Or, as Justice Davies of the New York Supreme Court expressed the same thought: “The moment the directors permit one or more of their number to deal with the property of the stockholders, they surrender their own independence and self control.” (citations omitted).
82. Brudney, supra note 38, at 610.
83. Id. at 610-13.
84. Id. at 613-14.
85. Id. at 614-16.
and in the effort expended by them to consider a matter render their protective role somewhat uncertain.\(^6\)

The weakness of reliance on directors for protection is illustrated by the lack of effort shown in the recent case of *Smith v. Van Gorkom*.\(^7\) In that case, the Delaware Supreme Court held that a group of sophisticated directors had breached their fiduciary duty by failing to ascertain readily available valuation information which was relevant to their decision to recommend a merger. The court found that the board acted without information adequate to reach an informed business judgment as to the fairness of a $55 per share selling price of the corporation.\(^8\) Casting further doubt on the reliability of independent directors, one commentator, who examined the experience that those directors have had in the role of enforcing fairness standards concluded: "To be sure, the available evidence does not demonstrate systematic malfunction by the independent director. On the other hand, no evidence thus far available reveals effective functioning in this role."\(^9\)

Serious questions, therefore, must be raised about watering down a requirement of fairness and shifting the burden of proof of fairness simply because so-called disinterested directors have approved a transaction. It is true that it would be desirable at times to encourage the submission of a conflict of interest transaction to a disinterested director vote. This may lead to healthy disclosure and bargaining. In light of the potential for abuse or inadequate protection even with the approval of the disinterested directors, however, it is not too much to place the burden of proof on the interested director unless the court, operating from a perspective of healthy skepticism, is satisfied that the disinterested director vote reflects at least a considerable measure of objectivity and genuine protection of the corporate interest.\(^10\) Moreover, as a general rule, a director simply should not be able to sustain the validity of a contract which is unfair to his corporation even where his co-directors have approved it. Perhaps, if the court can conclude that the disinterested director vote has afforded as much protection as arms length bargaining, the vote should be considered as evidence of fairness. Even in cases in which a court would shift the burden of proof to a complaining party, however, the latter should be able to prevail by proving the unfairness of the transaction with the interested director.

\(^6\) See *id.* at 609. Profess Brudney states:
Since the governing rules validate the independent director's approval of self-dealing or self-aggrandizing transactions only if the relevant information is disclosed to, or known by the director, there should be little difficulty for the independent director in obtaining information about the transaction. However, for the many judgments that turn on comparative data, the task is likely to require time and effort. Presumably, staff assistance would aid the directors. Even with that assistance, however, the demands of such monitoring are not insignificant, especially for directors who, for the most part, appear to be engaged principally in other activities. (footnotes omitted)
\(^7\) 488 A.2d 858 (Del. 1986).
\(^8\) *Id.* at 874.
\(^9\) Brudney, * supra* note 38, at 616.
\(^10\) See *supra* text accompanying notes 68-72 for a similar approach in cases where there is a disinterested shareholder vote.
Analysis of Lynch v. Patterson

On the facts of Lynch, where there was no claim of disinterested approval by shareholders or directors, the Wyoming court was correct not only in placing the burden of proof on the interested directors, but also in insisting that this burden be met with clear and convincing evidence that the challenged transaction was fair and reasonable to the corporation.91 The clear and convincing standard was explained in language quoted from earlier cases:

When the evidence is such that the mind readily reaches a satisfactory conclusion as to the existence or nonexistence of a fact in dispute, then the evidence is, of necessity, clear and satisfactory...92

We further had said that clear and convincing evidence is "that kind of proof which would persuade a trier of fact that the truth of the contention is highly probable."93

The court pointed to the evidence that the Lynches hired their own partnership, LMS, to manage the corporation,94 the partnership drew $17,000 per month in management fees95 and took consulting jobs for itself which otherwise would have gone to the corporation,96 and, finally, that the corporation operated at a loss under this arrangement while the management company showed a profit.97 The court stated that the only justification presented at trial for this agreement was that it provided advantages for cash flow and tax planning.98 In the face of this evidence, the court held that the factual finding of the trial court that the Lynches had failed to establish the fairness to the corporation of management fees in excess of $9,000 per month was adequately supported by the evidence.99 The court also sustained the trial court’s conclusion that the Lynches failed to prove by clear and convincing evidence the fairness of the conveyance of property to themselves at a loss to the corporation of $10,000.100

Conclusion

In the case of self-dealing where little or no protection for the corporation, minority shareholders, or creditors exists in the checks and balances of the corporate governmental structure, it is appropriate to lay a heavy burden of proof on interested parties with regard to the issue of fairness. It is true that at times this approach may yield too much of a strategic edge to a minority shareholder who is being unreasonable or spiteful, or is improperly using a particular transaction as a wedge to obtain some

91. Lynch v. Patterson, 701 P.2d 1126, 1132.
94. Lynch, 701 P.2d at 1132-33.
95. Id.
96. Id.
97. Id.
98. Id.
99. Id.
100. Id.
concession. It may even result in the loss to the corporation of the benefits of a transaction because of apprehension of the interested directors about potential litigation. Where, however, the potential for taking unfair advantage of a corporation, its minority shareholders and its creditors is great, as in Lynch, placement of the burden of showing fairness by clear and convincing evidence on the interested parties is appropriate.

**Executive Compensation and Director's Fees**

*The Lynch Case*

*Lynch* dealt with the question of executive compensation and director fees separately from that of the other interested transactions. The court alluded to the judicial reluctance to inquire into the reasonableness of executive compensation fixed by a disinterested board. It noted the existence of a stricter standard when a recipient sets his own compensation, however, and pointed to the burden which falls on the director to prove the reasonableness of challenged compensation which he has set. The court listed several factors which have been established in considering whether a defendant has met his burden with respect to the reasonableness of his fee or salary as follows:

These criteria include the recipient's ability, services and time devoted to the company, the size and complexities of the business, success achieved, corporate earnings and profits, increase in volume or quality of business, the prevailing general economic conditions, a comparison of salaries with distributions to stockholders, compensation for comparable positions in comparable concerns, and the amount previously received as salary.

The court concluded that for both director and executive salaries the evidence supported the trial court's conclusion that the defendants had failed to establish the reasonableness of the compensation.

While the court placed the burden on the interested directors to prove the reasonableness of the compensation, it refrained from analyzing the problem in terms of section 136.1, using the word "fairness," or referring to the "clear and convincing" standard utilized in connection with the other interested transactions. Whether such omissions are significant or

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101. Thus, in a close corporation setting, one can envision certain minority shareholders withholding approval of an interested transaction because of base motives of their own.
102. Oberhelman v. Barnes Inv. Corp., 236 Kan. 355, 690 P.2d 1343 (1984) (citing Newton v. Hornblower, Inc., 224 Kan. 506, 582 P.2d 1136, Syl. para. 9 (1978)). That court stated: "Where the fairness of a fiduciary transaction is challenged, the burden of proof is upon the fiduciary to prove by clear and satisfactory evidence that such transaction was fair and done in good faith."
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.* at 1133-35.
inadvertent is unclear. Perhaps the court sought to place some distance between the analysis of compensation issues and other interested transaction issues. Nor is it clear whether any significance was intended by the court in considering compensation in terms of “reasonableableness” alone rather than in terms of fairness and reasonableness. It may be that a fairness test requires a higher standard of fiduciary behavior than a reasonableness test. Perhaps the omission of any reference to the “clear and convincing” standard indicates a reluctance by the court to decide if that standard must be used in a compensation case where, because of the facts, the liability of a director may be determined without employing such a strict standard.

Arguably, the judicial scrutiny of compensation arrangements should be less intense or the burden of proof less onerous than that required in most other interested transactions, since the latter can be avoided while compensation arrangements with directors as such and as officers or employees are often necessary. Because of the difficulties courts encounter in determining the reasonableness of compensation, the frequency of such interested director transactions, and the potentially disruptive effects of litigation on corporate and judicial operations, courts may want to avoid a flood of cases casting them in the role of super boards of directors to check on the reasonableness of corporate compensation. They may not want to encourage such litigation by making it too easy for plaintiffs to win such cases. While the burden of proof should be placed on the interested parties who set the compensation, piling the clear and convincing standard on top of that may be just a little too much. In any event, it would be well for parties in a close corporation, through prior planning,

109. TENTATIVE DRAFT NO. 3, supra note 4, § 5.09 comment c, at 143 states “... unlike most other self-interested transactions—which may be foregone, since the corporation usually need not deal with the director or senior executive—compensation arrangements with directors and senior executives are necessary in all cases.”


Yes, the Court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are inestimable, the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—It would be the precise antithesis of justice; it would be a farce.

If comparisons are to be made, with whose compensation are they to be made—executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Manifestly, the material at hand is not of adequate plasticity for fashioning into a pattern or standard. Many instances of positive underpayment will come to mind, just as instances of apparent rank overpayment abound. . . .

Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province. (emphasis in original)
to set up protective mechanisms regarding salaries. In the public corporation context, various devices which enhance prospects for achieving objectivity in setting salaries should be adopted. When such devices or mechanisms are effectively used, corporate compensation arrangements should be harder to successfully challenge.

The Proposed Approach of the ALI

Under ALI Tentative Draft No. 3, compensation payments to directors violate the duty of loyalty owed to the corporation in the absence of disinterested director or disinterested shareholder approval or permission by the terms of a standard of the corporation, if the interested director cannot meet the burden of proving that the transactions were fair to the corporation. The Draft, however, takes the position that, in the case of a transaction authorized by disinterested directors following appropriate disclosure, the duty of loyalty is violated by the interested director only if the directors who authorized the payment did not act in a manner that meets the standards of the business judgment rule. In the case of a transaction that was authorized or ratified by disinterested shareholders following appropriate disclosure, the Draft takes the position that the interested director violates the duty of loyalty only if the transaction constitutes a waste of corporate assets. If there has been disinterested shareholder approval or disinterested director approval or if the transaction is permitted by the terms of a standard of the corporation, then the Draft would put the burden of proof on the challenging party.

The authors of the Draft state that section 5.09 is intended to give disinterested directors wide discretion in fashioning compensation programs, thereby reflecting the deference shown by many courts when reviewing compensation arrangements. The Draft also points out that the action of directors in fixing their own fees for attendance at board and committee meetings, or fixing a yearly retainer, is a transaction for

111. See e.g., F.H. O'Neal & R.B. Thompson, 2 O’Neal’s Oppression of Minority Shareholders (2d ed. 1985). Chapter 9 discusses arrangements to avoid oppression.
112. Tentative Draft No. 3 supra note 4, comment c at 143-44 refers to “institutionalized procedures for disinterested decision-making which are now widely practiced by large corporations, as reflected in § 3.07, [which] make it less likely that corporations will be disadvantaged by unfair compensation arrangements with senior executives.” Comment c at 144 further states: “In many cases the senior executive will not participate in fixing his own compensation where compensation arrangements are made by a compensation committee composed of disinterested directors who have no significant relationship with senior executives.” Tentative Draft No. 2, supra note 8, § 3.07, at 104 recommends that certain large corporations should have a compensation committee composed of directors who are not officers or employees of the corporation, and a majority of whom have no significant relationship with the corporation’s senior executives.
113. See supra note 59 for a discussion of permission by the terms of a standard of the corporation.
114. Tentative Draft No. 3, supra note 4, §§ 5.09 (b), 5.09(a)(2)(C).
115. Id. § 5.09(a)(2)(A).
116. Id. § 5.09(a)(2)(B).
117. Id. § 5.09(b).
118. Id. § 5.09 reporter’s note, at 149.
which by its very nature disinterested board approval is not available.\textsuperscript{119} Further, so-called “back scratching” arrangements pursuant to which directors vote to approve each other’s compensation as officers or employees would not constitute disinterested director action.\textsuperscript{120}

\textit{Analysis}

Notwithstanding these barriers to obtaining disinterested director approval, the Draft dilutes the responsibility of interested directors too much by substituting for the fairness requirement the business judgment or waste tests in cases involving compensation where there has been so-called disinterested director or disinterested shareholder approval. Just as with other interested transactions, the protective impact of so-called disinterested director or disinterested shareholder votes is often questionable.\textsuperscript{121} It is no easier to justify the legality of compensation arrangements which a complaining party can prove to be unfair than it is to justify other interested transactions which are proven to be unfair. In addition, as with other interested transactions, the burden of proof should not be shifted from the interested director unless the court is satisfied that the disinterested vote reflects a considerable degree of objectivity and protection for the corporate interest.\textsuperscript{122} Although courts may be justifiably apprehensive about deciding the fairness of compensation, they have not been able to avoid similar issues in other contexts, such as taxation,\textsuperscript{123} and the Equal Pay Act.\textsuperscript{124} Further, since loyalty in the corporate setting must be assured, courts should be willing to do what is required. If the burden on the judicial system is too great, or perhaps just as a matter of sound policy, alternative ways of resolving disputes over compensation should be considered. The matter of compensation for directors should not be resolved, however, by undue reliance on devices which may leave investors without adequate protection.

\textbf{Direct Recovery by Shareholders}

Although \textit{Lynch} was a stockholder’s derivative suit, in which as a general rule recovery would go to the corporation, the court permitted recovery by the individual shareholder Patterson. It reasoned that “courts sometimes permit pro-rata recovery by individual shareholders to prevent an award from reverting to the wrongdoers who remain in control of the corporation.”\textsuperscript{125} The court refused “to order payment into the corporate treasury in this case and risk necessitating a subsequent suit by Patterson to compel the directors to declare a dividend or apply the funds to legitimate corporate purposes.”\textsuperscript{126}

\begin{itemize}
\item \textsuperscript{119} \textit{Id.} § 5.09 comment f, at 146.
\item \textsuperscript{120} \textit{Id.}
\item \textsuperscript{121} \textit{See supra} text accompanying notes 69-71 and 80-89.
\item \textsuperscript{122} \textit{See supra} text accompanying notes 71 and 90.
\item \textsuperscript{123} \textit{See 4 A. J. Merten's Law of Federal Income Taxation}, § 25.80 (discussion of litigation over the deductibility of corporate compensation for federal tax purposes).
\item \textsuperscript{124} \textit{Weeks, Equal Pay: The Emerging Terrain}, 12 J. College & University L. 41, 44 (1985).
\item \textsuperscript{125} \textit{Lynch}, 701 P.2d at 1130.
\item \textsuperscript{126} \textit{Id.} at 1130-31.
\end{itemize}
While the Wyoming court’s position may seem entirely sensible, the reasons it gives are not generally used to justify an individual recovery by a shareholder.\textsuperscript{127} Allowing a direct recovery in a derivative suit, though unusual, could often be justified by the reasons given in Lynch,\textsuperscript{128} but the analysis did not go far enough. The court failed to determine whether creditors would be prejudiced by such an award, although it is mentioned in the opinion that the liabilities of the corporation exceeded its assets by a significant sum.\textsuperscript{129} The problem is that the corporation receives nothing by virtue of this suit for the benefit of creditors, and one shareholder has been preferred. It may be that the court had a reason for being unconcerned over creditors in the present case. In any event, a court should make a finding that creditors or other shareholders are not being unfairly prejudiced before it allows pro rata recovery.\textsuperscript{130}

**DISMISSAL OF THE CLAIM AGAINST THE THIRD DIRECTOR**

Justice Rooney authored Part 2 of the majority opinion in Lynch since Justice Rose, who wrote Part 1, disagreed with Part 2. Part 2, supported by three of the five members of the court, excused Eunice Lynch, a third corporate director, from liability not because she committed no breach of fiduciary duty (a question with which the opinion did not really deal), but because she received no funds and, therefore, should not have to reduce amounts due from the wrongdoers. The court stated: "If equity allows direct payment to Patterson so as to prevent the award ‘from reverting to the wrongdoers’ and to avoid the ‘risk [of] necessitating a subsequent suit’. . . then equity should cause the funds to be repaid by those who received them.\textsuperscript{131}" The court pointed out that the director fees, officer salaries, management fees and benefit from the sale of the real property did not go to Eunice,\textsuperscript{132} that the funds were properly returnable by the Lynches rather than Eunice,\textsuperscript{133} and that Eunice would not benefit from the return.\textsuperscript{134} The court said that this was not a case in which the improper decision of the board resulted in a loss to the corporation without such loss going to the directors. Further, the court felt that when the loss results in a gain to some directors but not all, those receiving the gain should ultimately bear the responsibility of repaying the loss.\textsuperscript{135}

\textsuperscript{127} W. Cary & M. Eisenberg, Cases and Materials on Corporations 94 (5th Ed. Unab. 1980).
\textsuperscript{128} Id.
\textsuperscript{129} Lynch v. Patterson, 701 P.2d 1126, 1129 (Wyo. 1985).
\textsuperscript{130} Principles of Corporate Governance: Analysis and Recommendations (Discussion Draft No. 1, 1985) § 7.16 provides:

\((e)\) The court having jurisdiction over a derivative action may direct that all or a portion of the damages be paid directly to individual shareholders, on a pro-rata basis, when adequate provision has been made for the creditors of the corporation and such a recovery is equitable under the circumstances.

\textsuperscript{131} Lynch, 701 P.2d at 1136 (emphasis and brackets in original).
\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} Id.
This part of the decision raises a number of problems. First, the court offered no satisfactory explanation for its assumption that a director with such intimate family connections to the interested directors and who voted for the transactions found to be improper should be placed in a different category and relieved of liability simply because she did not directly receive the benefits.\textsuperscript{136} Second, the opinion does not state whether the defendants held liable had sufficient assets to pay the judgment. Although the opinion in unclear on this matter, it could be construed to leave the third director in the clear even if that result would leave creditors and minority shareholders with unpaid judgments. Perhaps the court should take into account the extent of wrongdoing among the three directors and allocate the financial responsibilities to them accordingly, but Eunice should not be entirely relieved of potential liability until innocent parties have received satisfaction. Finally, the principle on which Eunice is exonerated from liability defeats the important policy of deterrence in cases involving breach of the fiduciary duties of care or loyalty.

The dissent would have held that Eunice breached the duty of care owed to the corporation and was jointly and severally liable with the other directors for damages.\textsuperscript{137} The dissenting opinion seems much more persuasive than the majority. In that opinion, Justice Rose, joined by Chief Justice Thomas, points out:

As a voting member of the board of directors, she approved a series of transactions which destroyed the corporation while enhancing the value of a competing partnership composed of her husband and son. Conduct this egregious violates the duty of care imposed upon all directors by the Wyoming Business Corporation Act . . . regardless of whether she personally benefited from her actions.

The fact that she voted to funnel corporate funds to directors other than herself cannot, as the majority hold, release her from liability where the duty and breach are clearly established.\textsuperscript{138}

The dissent cited section 17-1-133(b) and pointed out that "[c]ourts will step in . . . where the directors have wasted the corporate assets and no rational business purpose justifies such conduct."\textsuperscript{139} The dissent went on to state that, while any one of certain actions might not be sufficient to hold a director liable, the complete pattern of conduct in this case evidenced a program of corporate destruction and violated the duty of care imposed by Section 133(b). Such behavior, the dissent argued, "cannot be attributed to errors in judgment or calculated business risks."\textsuperscript{140}

\textsuperscript{136} See infra note 141 and accompanying text. \\
\textsuperscript{137} Lynch, 701 P.2d at 1139 (Rose, J., dissenting). \\
\textsuperscript{138} Id. at 1137. \\
\textsuperscript{139} Id. \\
\textsuperscript{140} Id. at 1138. The dissent quite properly cited Francis v. United Jersey Bank, 162 N.J. Super. 355, 392 A.2d 1233 (1978) (director held liable for negligent performance of duties where corporation unlawfully paid substantial sums to members of her family) and Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (which held that directors who attempt to exercise their business judgment without obtaining adequate information violate their duty of care to the corporation).
In the circumstances of this case it would appear that the dissent could have expressly presented the duty of loyalty as a theory on which to predicate liability. The argument would be that Eunice, because of her close family relationship to the other directors, was in reality an interested director herself and subject to the same liability as the others.\(^{\text{141}}\) The theory upon which liability is predicated may be important in the ultimate allocation of damages among wrongdoers. Since a director guilty of an intentional breach may be held not to be in pari delicto with directors who negligently permit his conduct, the negligent directors may be entitled to recover their share of the liability from the director who intentionally breached his duties.\(^{\text{142}}\)

Finally, the dissent quite properly explained that "[d]irect recovery by Patterson is consistent with a finding of liability on the part of Eunice Lynch, since she participated as a director in the dissipation of his thirty percent share in the corporation. Prorata recovery simply prevents the complaining stockholder's award from reverting to the control of the three directors who misused the corporate funds. . . ."\(^{\text{143}}\)

**Competition with the Corporation by Former Directors**

The Lynches, in a counterclaim against Patterson, contended that by forming an oil-field consulting business in competition with LCS, he breached his fiduciary duties as a former director of the corporation.\(^{\text{144}}\) The Wyoming Supreme Court cited the principle that a director or officer who terminates his position has a right to open his own business and compete for former clients in the absence of an agreement to the contrary, and held that Patterson breached no duty to LCS shareholders by accepting consulting jobs offered by clients of the corporation after he had established his own business.\(^{\text{145}}\)

As a general proposition, the court's position seems consistent with established law.\(^{\text{146}}\) However, the Lynches also contended that Patterson took one exploration job (the Sunmark exploration job) generated by LCS with corporate funds while Patterson served as director and officer of the corporation.\(^{\text{147}}\) Citing testimony by Patterson that the Sunmark job called for his expertise, that Sunmark officials wanted him on the job, and that without him the corporation would not have received the work, the court

\(^{\text{141}}\) Tentative Draft No. 3, supra note 4, § 5.08 reporter's note at 132 states that "[c]ourts have recognized that a transaction between the spouse of a director or senior executive and the corporation will be treated in the same manner as when the director or senior executive is the contracting party."


\(^{\text{143}}\) Lynch, 701 P.2d at 1139.

\(^{\text{144}}\) Id. at 1135.

\(^{\text{145}}\) Id.


\(^{\text{147}}\) Lynch, 701 P.2d at 1135.
held that Patterson breached no duty of loyalty by resigning from LCS and subsequently performing work that was directed to him personally rather than to the corporation. The failure of the court to state with clarity the facts on which it based its position limits any meaningful analysis of this decision. From the language of the court, it is not completely clear whether the Sunmark job had already been awarded to LCS at the time Patterson resigned. Further, there is no indication whether LCS could have arranged to handle the work without Patterson.

If the Sunmark job could be considered to belong to LCS before Patterson left, a point which is not completely clear from the opinion of the court, then the court would have to face the question of whether a former employee should be able to take away business which the corporation already has. As a matter of policy, one could conceive of a hardline position flatly precluding such a diversion of business. This would close the door of temptation to former corporate officials who are willing to try to take away existing corporate business when they leave. On the other hand one could conceive of the hardline position with some limited exceptions, such as situations where the company could no longer handle the business anyway. Moreover, it would appear that if the corporation already had the business in hand when the corporate official left, the departed official should have the burden of proof in justifying the transfer of business to himself. If the facts justifying the diversion of the Sunmark job were as unclear as they seemed from the court’s opinion, perhaps the loser in the case should have been the party with the burden of proof.

The Revised Model Business Corporation Act

It was noted earlier that the Wyoming Business Corporation Act section 136.1 dealing with director conflicts of interest follows the same approach as that of the Model Business Corporation Act section 41. Indeed, the sections are almost identical. There is now a Revised Model Business Corporation Act which contains section 8.31 dealing with director conflicts of interest. Since this article has given considerable attention to section 136.1, it seems to be a good vehicle for discussing section 8.31, particularly since the latter section is likely to be under legislative scrutiny in Wyoming and elsewhere.

According to the official comment, “the sole purpose of section 8.31 is to sharply limit the common law principle of automatic voidability and in this respect section 8.31 follows earlier versions of the Model Act and the statutes of many states dealing with conflict of interest transactions.” Section 8.31(a) provides as follows:

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or

148. Id. at 1135-36.
149. See supra note 45 and accompanying text.
150. Revised Model Act, supra note 10, at § 8.31.
151. Id. comment 1, at 228.
indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director’s interest in the transaction if any one of the following is true:

(1) the material facts of the transaction and the director’s interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;

(2) the material facts of the transaction and the director’s interest were disclosed or known to shareholders entitled to vote and they authorized, approved, or ratified the transaction; or

(3) the transaction was fair to the corporation.\(^{153}\)

It should be noted that there are additional subsections which provide: that the director vote under (a)(1) must be disinterested and must consist of at least two director votes; that shares owned by or voted under the control of a director who has a direct or indirect interest in the transaction may not be counted in a vote of shareholders to determine whether the transaction should be authorized;\(^{153}\) and that a director has an indirect interest in a transaction if another entity in which he has a material financial interest or in which he is a general partner, is a party to the transaction, or another entity of which he is a director, officer, or trustee, is a party to the transaction, and the transaction is or should be considered by the board of directors of the corporation.\(^{154}\)

The language of section 8.31 represents an improvement over section 41 in a number of ways. First, use of the word “solely” makes the limited purpose of the section more clear. Second, section 41 does not call for disclosure of the material facts of the transaction to the board or to the shareholders while section 8.31 does. While a court may well require such disclosure in order to have an effective validating vote by either the board or the shareholders for purposes of section 41, it is good that the statute specifically makes such disclosure mandatory. Third, the word “reasonable” is dropped from the section which relieves the transaction of automatic voidability if it is fair. This may be an improvement if the word “reasonable” is considered a less demanding requirement than (and encompassed within the meaning of) the word “fair” or as potentially confusing surplusage.\(^{155}\) Finally, the clear rejection of interested shareholder votes to sanction conflict of interest transactions is wise.

In considering section 8.31, it is important to emphasize that it is aimed at making an automatic rule of voidability inapplicable to transactions that are fair or have been approved in the manner provided by the section. The official comment indicates a number of important points in this connection:

\(^{152}\) Id. § 8.31(a).

\(^{153}\) Id. § 8.31(c).

\(^{154}\) Id. § 8.31(b).

\(^{155}\) 2 Model Business Corporation Act Annotated § 8.31 annot. 2, at 966 (3rd ed. 1985) states that “[i]t is believed that the words ‘and reasonable’ added nothing of substance to the test of fairness.”
The approval mechanisms set forth in section 8.31(c) and (d) relate only to the elimination of this automatic rule of voidability and do not address the manner in which the transactions must be approved under other sections of this Act. . . .

The elimination of the automatic rule of voidability does not mean that all transactions that meet one or more of the tests set forth in section 8.31(a) are automatically valid. These transactions may be subject to attack on a variety of grounds independent of section 8.31—for example, that the transaction constituted waste, that it was not authorized by the appropriate corporate body, that it violated other sections of the Model Business Corporation Act, or that it was unenforceable under other common law business principles.156

Thus, section 8.31 leaves to the courts many of the questions which have been discussed in this article. Its limited role of eliminating the automatic rule of voidability leaves to the courts the question of what grounds independent of section 8.31 would justify attacks on interested transactions as well as questions of burden of proof in such proceedings. It has been a contention of this article that section 41 of the Model Act and its offspring should be interpreted in the same way and this contention is amply supported by the official comment to section 8.31 of the Revised Model Business Corporation Act.157

Finally, it should be noted that the Revised Model Act does not attempt to define precisely when a director should be viewed as "interested" but does define one aspect of this concept, the indirect interest.158 The official comment takes the position that a director should be viewed as interested in a transaction if he or the immediate members of his family have a financial interest in the transaction or a relationship with the other parties to the transaction such that the relationship might reasonably be expected to affect his judgment in the particular matter in a manner adverse to the corporation.159 That the problem of ascertaining "interest" can be a difficult one was referred to earlier in this article. The Revised Model Act authors are wise to leave it largely uncodified by statute so that the courts are relatively free to wrestle with it.

Conclusion

After the law moved from a rule which made conflict of interest transactions voidable by the corporation to one which tolerated them if they were fair, one might reasonably have expected the law to vigorously protect minority shareholders and creditors against the evils of conflict of interest in cases in which fairness was at issue. Instead, we have reached a point where an ALI tentative draft dealing with the duty of loyalty pro-

156. Revised Model Act, supra note 10, § 8.31 comment 1, at 228.
157. See supra text accompanying note 151.
158. Revised Model Act, supra note 10, § 8.31 comment 5, at 231.
159. Id.
vides, not without judicial support, that a complaining party such as a minority shareholder would lose a case in which he was able to prove that a contract with the director is unfair simply because of a so-called disinterested director or disinterested shareholder vote approving the contract. As has been indicated, this constitutes overreliance on dubious weapons. It is hoped that the ALI will ultimately use its influence in the development of the law regarding conflict of interest in a way that is more protective of minority investors.

One could look to the states to beef up their corporation statutes to protect investors against conflict of interest transactions, but competition among the states to entice local incorporation, which has been characterized as a "race to the bottom," would seemingly make them poor candidates for the job of rescuing the unprotected from management chicanery or impropriety. One suspects that the Revised Model Business Corporation Act would have little chance for adoption in many states to the extent that its sections alienate corporate management. Assuming that the rule against automatic voidability of conflict of interest transactions is here to stay, the approach taken in the Revised Model Act may be wise since it at least leaves to the courts a fairly untrammeled opportunity to develop the law dealing with conflict of interest transactions. It may well be, however, that the most effective way to deal with conflict of interest transactions would be through federal legislation which imposes uniform corporate fiduciary standards since the federal government would be able to be more strict than the states in dealing with such transactions. Those interested in the proper development of the law, including the ALI, should carefully consider calling for federal legislation to deal with conflict of interest transactions.

"Probably the best example of "the race for the bottom" appears in the Report of the Corporation Law Revision Commission of New Jersey in 1968, which stated: "It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts... Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions. (citation omitted)."

161. Id. at 702. Cary speaks of a proposed federal statute, applying to some but not all corporations, which would allow companies to incorporate in the jurisdiction of their choice, but would subject them to certain general standards. Among the provisions which a federal statute might include are "federal fiduciary standards with respect to directors and officers and controlling shareholders... and an 'interested directors' provision prescribing fairness as a prerequisite to any transaction..."