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Section 21-2040.01: Interested Director Transactions and Considerations of Fairness

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Section 21-2040.01: Interested Director Transactions and Considerations of Fairness

I. INTRODUCTION

The separation of ownership and control in a corporation leaves the shareholder vulnerable to unfair treatment by management.¹ Transactions between the corporation and an interested director present such an opportunity for abuse of shareholder interests.² Nevertheless, it has been suggested that conflicts of interest involving management may be effectively controlled in three ways.³ First, shareholders can carry out the management functions themselves. Secondly, market incentives can be utilized whereby a director's best interests will be served by maximizing shareholder interests. Finally, legal rules and sanctions may be used to deter unwanted self-dealing.⁴ This note will discuss the third type of control, specifically, Nebraska's statutory response to the problem of the interested director.⁵

Section 21-2040.01 was added to the Business Corporation Act in 1972,⁶ but has yet to be interpreted by the Nebraska Supreme Court. The statute is modeled after Section 41 of the Model Business Corporation Act,⁷ and establishes a means whereby directors may contract or transact with their corporation if statutory tests are satisfied.⁸ Section 41 of the Model Act was patterned after the

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1. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1933).
 2. See Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME LAW. 201 (1977). The law finally came to view the "interested director" as a necessary evil, a recurring problem which had to be dealt with realistically.
 3. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738 (1978).
 4. *Id.* at 777.
 5. NEB. REV. STAT. § 21-2040.01 (Reissue 1974). For the entire Nebraska Business Corporation Act, see *id.* §§ 21-2001 to -20,134 (Reissue 1977).
 6. L.B. 1182, 1972 Neb. Laws.
 7. 1 AMERICAN BAR FOUNDATION, *MODEL BUSINESS CORPORATION ACT ANNOTATED* § 41 (2d ed. 1971) [hereinafter cited as MODEL ACT ANN.].
 8. NEB. REV. STAT. § 21-2040.01 (Reissue 1974):

interested director statutes of California, New York, Delaware, and New Jersey.⁹ Therefore, to understand section 21-2040.01 and predict how the Nebraska courts will construe it, a review of judicial interpretations of other "interested director" statutes with similar provisions¹⁰ is required.

II. THE SCOPE OF SECTION 21-2040.01

A. Background

The common law developed its own standards in resolving director conflicts of interest, initially declaring all interested transactions voidable at the option of the corporation.¹¹ This rigid position

No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors or officers are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose if:

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

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

(3) The contract or transaction is fair and reasonable to the corporation. Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

9. The following state statutes were in existence at the time section 41 of the Model Act was drafted: CAL. CORP. LAW § 820 (West 1955); DEL. CODE tit. 8, § 144 (1974); N.J. STAT. ANN. § 14A:6-8 (West 1969); N.Y. BUS. CORP. LAW § 713 (McKinney 1963) (amended 1971). The California statute has been replaced by a more liberal statute. See CAL. CORP. CODE § 310 (West 1977). Basically the new statute provides more definite validation procedures and removes the fairness requirement in certain situations. References in this article to the California statute are to section 820 after which the Nebraska Statute was patterned. New York's statute was revised in 1971; reference to section 713 as amended will only be in the context of those provisions which are applicable to section 21-2040.01.
10. Although "interested director" statutes vary somewhat from state to state, their basic pattern is the same—that contracts with the corporation are permissible if (1) approved by the board or shareholders, or (2) if the transaction is found to be fair to the corporation.
11. For analyses of the common law principles which laid the foundation for "interested director" statutes, see Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966); Note, "Interested Director's" Contracts—Section 713 of the New York Business Corporation Law and the Fairness Test, 41 FORDHAM L. REV. 639 (1973).

against interested director transactions subsequently eroded. By 1960 the general rule could be stated thus:

[N]o transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but . . . the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.¹²

This principle became the cornerstone of the interested director statute around which the procedural provisions were built. Unfortunately, the certainty these statutes were to bring to interested director transactions never materialized. Judicial construction and application of the statutory provisions has varied. As one commentator noted: "These provisions received mixed reviews from the legal community. While most authorities favored the statute's approach, it was generally conceded that it raised as many questions as it resolved."¹³

B. Purposes of Statute

The drafters of the Model Act stated that the purpose of section 41 was

to establish statutory guidelines for determining the validity of transactions between a corporation and one or more of its directors, or between corporations having common directors, or between a corporation and another entity in which a director of the corporation is financially interested. It validates if the prescribed tests are satisfied, transactions with interested directors which common law rules often make voidable, if not void.¹⁴

The section, in addition to applying to interested director transactions,¹⁵ also permits transactions between corporations with interlocking boards. In Nebraska, officers of the corporation are *not* within the scope of section 21-2040.01 in contrast to many states which expressly include officers with directors in their statutes.¹⁶

12. Marsh, *supra* note 11, at 43.

13. Note, *supra* note 11, at 647-48 (footnotes omitted).

14. 1 MODEL ACT ANN. § 41, ¶ 2., at 842 (Comment). This statement should apply equally to section 21-2040.01, as it is patterned directly after section 41.

15. In 1962, the New York Stock Exchange listed the most common conflicts of interests which involve directors: (1) the direct or indirect ownership of property leased to the company; (2) sales or purchases of goods or services to or from organizations the director has an interest in; and (3) ownership by directors of the parent company of a portion of the minority equity in subsidiaries. Nolan, *Today's Director*, 20 N.Y.L.F. 313, 337 (1974). The use of the word "transaction" enables the statute to apply to many situations which would not be reachable under the term "contract." Therefore it is possible that director involvement in situations such as dissolution, usurpation of corporate opportunity, and dividend policies would be under the purview of the statute. See Bulbulia & Pinto, *supra* note 2, at 205 n.33.

16. See, e.g., DEL. CODE tit. 8, § 144 (1974).

Since Nebraska does not do so, it would seem that self-dealing officers in Nebraska would be subject to common law principles governing such conduct which were developed prior to the passage of section 21-2040.01.

The enactment of these statutes represented a backlash against the harsh stance taken against interested director transactions at common law. However, compliance with the statute's procedural provisions does not validate the contract or transaction for all purposes. Validation under section 21-2040.01 merely serves to remove the taint associated with the director's involvement in the transaction. The comment to the Model Act conscientiously indicates this point:

The function of section 41 is not to provide a basis for validating for all purposes a contract or transaction between an interested director and his corporation, but simply to establish that such contract or transaction is not automatically void or voidable solely by reason of the director's interest.¹⁷

This view was also expressed in a case involving the New York statute,¹⁸ the court holding that "[d]espite the validity of the resolution under section 713, the interested directors may in any event be liable for having participated in a transaction from which they may derive an indirect personal benefit."¹⁹ Much of this inquiry can be subsumed in the fairness requirement. Depending upon the latitude given to the concept of fairness, the fairness test of section 21-2040.01(3) should be sufficient to protect shareholder interests in most situations involving an interested director.

III. INTERPRETATION AND APPLICATION

Section 21-2040.01 provides that a transaction with an interested director is valid if approved by either a disinterested board or fully informed shareholders, *or* if the transaction is fair and reasonable to the corporation.²⁰ The use of the disjunctive "or" suggests that the statute permits enforcement of a transaction which is unjust or unreasonable to the corporation as long as it is approved by a disinterested board or informed shareholders. Such an interpretation would be a major departure from the common law rule requiring

17. 1 MODEL ACT ANN. § 41, ¶ 2, at 844 (Comment).

18. *Rapoport v. Schneider*, 29 N.Y.2d 396, 278 N.E.2d 642, 328 N.Y.S.2d 431 (1972).

19. *Id.* at 402, 278 N.E.2d at 646, 328 N.Y.S.2d at 437. This principle is somewhat subsumed in the fairness test of the statute assuming the gloss applied by *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (1952), is incorporated into the statute. See notes 22-35 & accompanying text *infra*. However, it is conceivable that a transaction may be fair to the corporation yet constitute a breach of the director's duty to the corporation.

20. See NEB. REV. STAT. § 21-2040.01 (Reissue 1974). For text of statute, see note 8 *supra*.

that interested director transactions be fair to the corporation.²¹

The first case to deal with this structural problem was *Remillard Brick Co. v. Remillard-Dandini Co.*²² Two directors of the manufacturing companies, the Remillard-Dandini Co. and its affiliate, in an effort to separate manufacturing and sales functions, formed a sales corporation in which they owned the entire stock interest. They then entered into sales contracts with the manufacturing companies which were ratified by the board of directors of Remillard-Dandini. Although this ratification would not have satisfied the requirement of board ratification under California's interested director statute,²³ a written consent to the sales contracts was submitted by the majority shareholder of record.²⁴ On appeal of the shareholders' derivative suit the court found that the sales contracts were profitable to the manufacturing companies²⁵ and that there was literal compliance with California's interested director statute, as it then existed, by reason of the majority shareholder's approval of the sales contracts.²⁶ Nevertheless, the court found the contracts unfair to the manufacturing companies and accordingly voided them. In rejecting defendants' contention that compliance with the statute's approval procedures precluded judicial review of the transaction's fairness, the court held that "[e]ven though the requirements of section 820 are technically met, transactions that are unfair and unreasonable to the corporation may be avoided."²⁷

The importance of the *Remillard* holding is that it places a judicial gloss upon the statute, requiring interested director transactions to always meet the test of fairness despite the statutory language indicating otherwise. One writer has cynically observed, "the entire statute could as well have been compressed into the final clause,"²⁸ which requires fairness and reasonableness. How-

21. Bulbulia & Pinto, *supra* note 2, at 207.

22. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

23. Since the votes of the two interested directors did not count toward ratification, there was only one director's vote in favor of ratifying the contracts while two directors voted against ratification. See CAL. CORP. LAW § 820(a) (West 1955) (*superseded by* CAL. CORP. CODE § 310 (West 1977)) (requiring ratification by a vote sufficient for the purpose without counting the votes of the interested directors). Section 21-2040.01(1) contains the same requirement.

24. This satisfied the requirements of shareholder ratification under Section 820(b).

25. 109 Cal. App. 2d 405, 416, 241 P.2d 66, 72 (1952).

26. *Id.* at 418, 241 P.2d at 73-74. See CAL. CORP. LAW. § 820(a) (West 1955) (*superseded by* CAL. CORP. CODE § 310 (West 1977)).

27. 109 Cal. App. at 418, 241 P.2d at 74. The *Remillard* interpretation was reaffirmed in *Kenneron v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953).

28. Marsh, *supra* note 11, at 47.

ever other commentators have concluded that the *Remillard* approach is wholly consistent with the intent of the drafters of section 820.²⁹

The *Remillard* approach has been followed by most jurisdictions which have interpreted their respective interested director statutes.³⁰ In 1976, the Delaware Supreme Court, interpreting its statute which is similar in form and substance to section 21-2040.01, adopted the *Remillard* approach in *Fliegler v. Lawrence*.³¹ The court held that directors must prove the fairness of their transactions with the corporation notwithstanding shareholder ratification:³² "[The statute] merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute . . . removes the transaction from judicial scrutiny."³³ It has also been concluded that the *Remillard* gloss was impliedly adopted by the New York legislature when it enacted section 713,³⁴ since the drafters patterned the statute after the California model and were totally aware of the *Remillard* interpretation.³⁵ This same argument can be made in construing section 21-2040.01. Nebraska's adherence to the disjunctive form contained in California's statute seems to indicate an intent to accept that jurisdiction's judicial interpretations arising from use of the disjunctive.³⁶ In addition, adoption of the *Remillard* approach

29. Bulbulia & Pinto, *supra* note 2, at 209:

The drafters of the statute did not intend to affect the voidability of transactions which were unfair, but to overcome the problems created by the "involvement" of interested directors in the approval or ratification process. Thus the statute . . . was aimed at curing procedural problems, not at assuring substantive fairness.

30. Bulbulia & Pinto, *id.* at 227.

31. 361 A.2d 218 (Del. 1976).

32. At issue was whether the shareholder ratification was effective for the purpose of relieving defendants of the burden of proving fairness when two-thirds of the shareholders voting were also interested in the transaction. This operated to taint the ratification and prevented the burden of proof from shifting to the plaintiff. *Id.* at 221. See notes 51-71 & accompanying text *infra* (discussion of burden of proof principles).

33. 361 A.2d at 222. Delaware's acceptance of the *Remillard* approach should indicate that more conservative jurisdictions would follow suit. However, the language of section 144(a) (3) is more conducive to a *Remillard* interpretation than is that of section 21-2040.01.

34. N.Y. BUS. CORP. LAW § 713 (McKinney 1963) (amended 1971).

35. Note, *The Status of the Fairness Test Under Section 713 of the New York Business Corporation Law*, 76 COLUM. L. REV. 1156, 1167-74 (1976).

36. The California statute served as the prototype for Section 41 of the Model Act from which section 21-2040.01 was derived. Nebraska case law sets forth a rule of construction that when construing a statute borrowed from a foreign state, there is a presumption that the legislature adopted it with approval of all interpretations given it by the courts of that state in the absence of indicia

by pro-management Delaware should weigh heavily in bringing about general acceptance of the *Remillard* gloss in those jurisdictions which have patterned their statutes after the California model.

The disjunctive structure of the Nebraska statute can be construed as establishing the fairness test as a separate ground for affirming an interested director transaction. This interpretation was followed in an Illinois case³⁷ in which the validity of a contract under Delaware's interested director statute³⁸ was at issue. The executors of the estate of Rumsfield, who was a director of Joanna-Western Mills, sought to enforce a stock redemption agreement entered into by the decedent and defendant corporation. The court found there had been no effective ratification of the agreement but held that the agreement would still be enforceable if it complied with the statute's fairness test.³⁹ Oregon, whose statute⁴⁰ is identical to section 41 of the Model Act, has also construed the fairness test as a separate ground for affirming interested director contracts.⁴¹ Considering the similarity between section 21-

of contrary intention on the part of the legislature. *In Re Estate of Thompson*, 169 Neb. 311, 99 N.W.2d 245 (1959). The court held in *Thompson* that the decisions followed as statutory interpretation precedent need not come exclusively from the highest courts of the other state, "that reported decisions of trial and intermediate appellate courts are to be considered for whatever persuasive merit they deserve." *Id.* at 317, 99 N.W.2d at 251.

This principle of statutory construction was followed in *Larson v. State*, 161 Neb. 339, 73 N.W.2d 388 (1955), in which the court stated: "The Criminal Code of Nebraska was adopted from Ohio and the decisions of the Supreme Court of that state construing its criminal code are persuasive whenever a like problem is considered by this court." *Id.* at 342, 73 N.W.2d at 391. This method of statutory interpretation should weigh heavily in favor of reading a *Remillard* gloss into section 21-2040.01. Since the statute was adopted from the Model Act which in turn was derived from the California statute, a presumption should exist that the legislature adopted the *Remillard* interpretation in its enactment of section 21-2040.01.

37. *Harris Trust & Sav. Bank v. Joanna-Western Mills*, 53 Ill. App. 3d 542, 368 N.E.2d 629 (1977).

38. DEL. CODE tit. 8, § 144 (1974).

39. "In our view 144(a)(3) [the fairness test] is meant to be effective in those instances where the agreement is known, but the individual director's interest in that agreement is not disclosed." 53 Ill. App. at 554, 368 N.E.2d at 638. The court also held "[t]he burden of proof rests on the interested parties when 'fairness' alone can sustain the transaction." *Id.* at 548, 368 N.E.2d at 634.

40. OR. REV. STAT. § 57.265 (1975).

41. *American Timber & Trading Co. v. Niedermeyer*, 276 Or. 1135, 1146, 558 P.2d 1211, 1218-19 (1976): "This change would allow the enforcement of contracts between a corporation and its directors even when it has not been approved by a disinterested board or ratified by the stockholders, so long as 'the contract or transaction is fair and reasonable to the corporation.'"

2040.01 and the statutes of Oregon and Delaware, it is probable that the Nebraska courts would also adopt this position.

Ernest Folk, a leading authority on Delaware corporate law, has maintained that the *Remillard* gloss is not applicable in Delaware. It is his view that the purpose and effect of Delaware's statute is to validate a contract between a corporation and its directors if "any one of three statutory tests is met."⁴² Therefore, authorization by a fully informed and disinterested board precludes any judicial scrutiny of the transaction's fairness. Folk reasons that the Delaware statute is essentially a codification of the business judgment rule as applied to interested director transactions.⁴³ Yet, it would seem that *Fliegler v. Lawrence*⁴⁴ has rejected Folk's view.⁴⁵ However, one commentator suggests the decision may be restricted to situations in which the transaction is approved by interested shareholders.⁴⁶

The Folk interpretation has been followed in a Tennessee lower court decision.⁴⁷ The case involved a derivative suit brought against the defendants as directors and majority shareholders. Defendants had incorporated for the purpose of owning transport trucks which were in turn leased to the plaintiff corporation. Although the issue before the court was the fairness of the lease agreement, the court, without citing any outside authority, stated: "It should be noted that the way the statute reads the transaction . . . is not voidable if any of the three subsections apply."⁴⁸ Whether the Supreme Court of Tennessee will adhere to this interpretation and preclude any inquiry into a transaction's fairness when there has been compliance with the statutory approval procedures is at this time pure conjecture.

The federal district court of New Jersey has construed that state's interested director statute as requiring compliance with *each* statutory test in order to validate a particular transaction.⁴⁹ If the opinion is read literally, it would require a transaction to be authorized by a disinterested board *and* ratified by the shareholders *and* be found fair and reasonable to the corporation.

42. See E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75 (1972).

43. *Id.* at 75-81.

44. 361 A.2d 218 (Del. 1976).

45. See notes 31-33 & accompanying text *supra*.

46. Bulbulia & Pinto, *supra* note 2, at 25. However, the court did not seem constrained by the fact situation when it held that "[n]othing in the statute . . . removes the transaction from judicial scrutiny." 361 A.2d 218, 222 (Del. 1976).

47. Tennessee Dressed Beef Co. v. Hall, 519 S.W.2d 805 (Tenn. Ct. App. 1974).

48. *Id.* at 808. This interpretation of Tennessee's interested director statute was criticized in Recent Developments, *Corporations—Duty of Loyalty and Corporate Opportunity—Transactions Between Corporations With Common Directors*, 43 TENN. L. REV. 155 (1975).

49. Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974).

It is doubtful that such an interpretation would be followed today by the New Jersey state courts.⁵⁰ However, the holding could be construed as a rejection of the fairness test as a separate and independent ground for affirming such transactions.

IV. FAIRNESS

A. The Burden of Proving Fairness

At common law, the burden of proving a transaction's fairness was placed upon the interested director.⁵¹ If a *Remillard* gloss requiring judicial scrutiny of a transaction's fairness in all circumstances is adopted by the Nebraska courts, then what effect does compliance with the provisions of section 21-2040.01 have in determining the transaction's validity? Authorization by a disinterested board or by fully informed shareholders should logically affect the burden of proving fairness. Otherwise the statutory tests would be mere surplusage and, as noted earlier, the "entire statute could just as well have been compressed into the final clause."⁵² If this construction is to be avoided, the key to section 21-2040.01 is its allocation of the burden of proof.⁵³ Allocation of the burden is crucial; because of the conceptual problems posed by the fairness test, the burden of proof would many times determine the controversy's outcome.⁵⁴ Jurisdictions which have addressed this question have supplied differing answers.

Clearly the burden of proof is upon the director when there has been no board or shareholder approval.⁵⁵ However, some jurisdic-

50. The federal court's interpretation has been labeled absurd. See *Bulbulia & Pinto*, *supra* note 2, at 211 n.72. They believe that the holding could be rationalized as viewing the statutory fairness test as procedural, thus a director showing board and shareholder approval and procedural fairness would have a less stringent test to prove substantive fairness. *Id.*

51. The leading case which promulgated this principle was *Pepper v. Litton*, 308 U.S. 295 (1939). It held that when a director's transaction with the corporation is challenged, the burden is on the director to "show its inherent fairness from the viewpoint of the corporation and those interested therein." *Id.* at 306. See also *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 280-81, 166 N.E.2d 793, 800 (1960).

52. *Marsh*, *supra* note 11, at 47. See notes 22-29 & accompanying text *supra*.

53. The late Carlos Israels viewed burden of proof as the crucial issue to understanding the implications of interested director statutes. See *Israels, The Corporate Triangle—Some Comparative Aspects of the New Jersey, New York, and Delaware Statutes*, 23 *RUTGERS L. REV.* 615 (1969).

54. *Bulbulia & Pinto*, *supra* note 2, at 225-26. See notes 71-90 & accompanying text *infra* (discussion of the conceptual problems associated with the fairness test).

55. "The burden of proof rests on the interested parties when 'fairness' alone can sustain the transaction." *Harris Trust & Sav. Bank v. Joanna-Western Mills*, 53 Ill. App. 3d 542, 548, 368 N.E.2d 629, 634 (1977).

tions maintain the burden of proving fairness is on the interested director even though there is compliance with the statutory procedures. Iowa adopted this position in *Holi-Rest, Inc. v. Treloar*:⁵⁶ "Nor does [the interested director statute⁵⁷] modify our common law requiring a corporation-controlling director, challenged in a self-dealing situation, to carry the burden to establish his good faith, honesty and fairness."⁵⁸ California courts also seem to place the burden of proof upon the challenged director, notwithstanding statutory compliance.⁵⁹ Adherence to this view essentially interprets the statute as merely a codification of the common law principles.⁶⁰ Compliance with the statute's approval procedures could only serve as evidence of the transaction's fairness and reasonableness to the corporation. This position has been justified on the ground that shifting the burden of proof to those challenging the fairness of the transaction would be contrary to the approach established by *Remillard*.⁶¹ Therefore, compliance with the statutory tests should only have the effect of removing the presumption of unfairness and merely shifts the burden of going forward to the plaintiffs.⁶²

In *Scott v. Multi-amp Corp.*,⁶³ the court interpreted New Jersey's statute as not relieving the directors of the burden of proving fairness. Rather, the statute establishes a less stringent standard for the requisite proof if the interested directors comply with its provisions. This conclusion was reached through an interpretation of the Commissioners' Comment accompanying the statute.⁶⁴ The comment stated that the statute was meant to overrule case law which had required clear and convincing proof of the transaction's fairness, allowing the courts to deal with such matters under their general equitable powers. The court held that the statute substitutes "the 'preponderance of the evidence' test for the 'clear and convincing' requirement."⁶⁵

56. 217 N.W.2d 517 (Iowa 1974).

57. IOWA CODE ANN. § 496A.34 (West 1978). The Iowa statute is identical in substance to section 41 of the Model Act.

58. 217 N.W.2d at 525.

59. Although the question of the statute's effect on the burden of proof has not been directly confronted, the court has reiterated the principles of *Pepper v. Litton* when issues predicated on section 820 have been before the court. See *Mueller v. MacBan*, 62 Cal. App. 3d 258, 132 Cal. Rptr. 222 (1976); *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953).

60. See note 11 & accompanying text *supra*.

61. *Bulbulia & Pinto*, *supra* note 2, at 211.

62. *Id.*

63. 386 F. Supp. 44 (D.N.J. 1974).

64. N.J. STAT. ANN. § 14A:6-8 (West 1969).

65. The portion of the Commissioners' Comment on which the court based its reasoning read:

Nebraska case law prior to the current act also required the interested director to establish the transaction's fairness by clear and convincing proof.⁶⁶ It could thus be argued that section 21-2040.01 does not affect the burden of proof established by common law, but only serves to set a less rigid standard in proving fairness. Unfortunately section 21-2040.01 was not supplemented with the clear expression of legislative intent that accompanied the New Jersey statute.

The final view taken is that compliance with the statute's approval procedures fully shifts the burden of proving unfairness to those challenging the transaction. After an extensive analysis of legislative intent behind the passage of New York's interested director statute, one author concluded that it shifts the "burden of proof to the complaining corporation when there is full and fair disclosure and approval by a vote of disinterested directors or shareholders."⁶⁷

This approach was taken by a federal court applying New York law to an interested director transaction in *Cohen v. Ayers*.⁶⁸ Referring to the scope of review under the statute, the court stated: "If either shareholder or director approval was obtained, it is unnecessary to require the defendants to 'affirmatively establish that

Subsections 14A:6-8(1) and 14A:6-8(2) of this section have been adapted from section 820 of the California Act and have no counterpart in Title 14. Substantially similar provisions are contained in the New York and Delaware Acts. The rule presently in effect in New Jersey is that any contract or other transaction between a corporation and one or more of its directors is voidable at the election of the corporation unless the party seeking to enforce the contract or transaction demonstrates by clear and convincing proof that it is honest, fair and reasonable. . . . The Commission believed that this rule operates harshly in many cases, and that the rule stated in this section would eliminate the inequities and uncertainties caused by the present rule, leaving undisturbed the power of the courts to deal with such matters under general equitable principles.

Id.

66. See *Price v. Fraser*, 119 Neb. 806, 231 N.W. 18 (1930). In *Price*, the court held: "[T]ransactions between corporations having common officers and directors are presumptively fraudulent, and the burden is on the defendants to sustain the transaction by clear and convincing evidence that it was fair." *Id.* at 817, 231 N.W. at 23. This rule was also followed in *Rittinger v. Pierpont*, 145 Neb. 161, 15 N.W.2d 393 (1944). Although it was stated in terms of common directorates, arguably the rule would apply to other "interested director" transactions. In *Gorder v. Plattsmouth Canning Co.*, 36 Neb. 548, 54 N.W. 830 (1893), the court held that contracts between a corporation and its directors are not necessarily void if it is "clear" that the transaction was made in good faith and beneficial to the corporation. *Id.* at 556, 54 N.W. at 833.
67. Note, *supra* note 35, at 1186. See also C. ISRAELS, CORPORATE PRACTICE § 9.19 (1974) (expressing the same conclusions respecting section 713).
68. 449 F. Supp. 298 (N.D. Ill. 1978).

the . . . transaction was fair and reasonable' when made."⁶⁹ If the director is relieved of this burden, the undeniable implication is that in any challenge to a transaction approved by the board or shareholders, the plaintiff must bear the burden of proving that the transaction was unfair to the corporation.⁷⁰ This position was also implied in a case construing Delaware's statute when the court found that "[t]he burden of proof rests on the interested parties when 'fairness' alone can sustain the transaction."⁷¹

Placing the burden of proving fairness upon the interested director is desirable if protection of shareholder interests is the essential motive of the statute. However, the goal of certainty and predictability regarding a transaction's validity suffers under that view. Nebraska courts should be aware that there exists such an inverse relationship between protection of shareholder interests and certainty in director transactions when eventually called upon to construe section 21-2040.01. Resolution of this trade-off will depend on policy decisions. The focus of this policy debate will be whether the state, in this area, should pursue a pro-management or pro-shareholder stance.

B. The Fairness Test

The cornerstone of section 21-2040.01 is the requirement that the transaction be "fair and reasonable" to the corporation. *Remillard* mandates that fairness be the focus in evaluating transactions between directors and their corporation. The concept of fairness is elusive; there is no precise test or formula setting forth its parameters. Fairness in any one case is purely a function of the facts of that case.⁷² Ironically, the weakness of the fairness test, in terms of predictability, gives rise to its greatest strength; it allows courts the flexibility necessary to protect shareholders from a myriad of potentially harmful transactions.⁷³

69. *Id.* at 310.

70. *Cohen* was decided under the current version of section 713, enacted in 1971. The language of the new provisions can be read as providing a strong intent that compliance with the statute's approval procedures will validate even an unfair transaction. However it seems that the New York courts will still apply a *Remillard* gloss to section 713. A review of case law construing section 713 since 1971 revealed that the dicta in these cases indicates "a presumption on the part of the New York courts that compliance with the section does not abrogate the fairness doctrine." Note, *supra* note 35, at 1185.

71. *Harris Trust & Sav. Bank v. Joanna-Western Mills*, 53 Ill. App. 3d 542, 548, 368 N.E.2d 629, 634 (1977).

72. *See id.* at 555, 368 N.E.2d at 639 ("In our view, the fairness of the agreement is a question of fact . . . [T]hat fairness must be determined as of the date of ratification, not the date of execution.") *See also* 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 919 (perm. ed. 1975).

73. *See generally* Bulbulia & Pinto, *supra* note 2, at 223-27.

The law has fashioned various standards in focusing the inquiry upon a transaction's fairness. The most pervasive test is that expressed by the Supreme Court in *Pepper v. Litton*.⁷⁴

[T]he burden is on the director . . . 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.⁷⁵

This "arm's length bargain" test is applied by the California courts under their statute.⁷⁶

A variation of the standard is used by Delaware—"whether the proposition submitted would have commended itself to a wholly independent board of directors."⁷⁷ New York, according to one commentator, has adhered to a variety of tests, weaving in and out between the "arm's length bargain" test and a good faith test.⁷⁸ In one instance a new test of fairness was formulated in *Case v. New York Central Railroad*.⁷⁹ Assessing the fairness of a transaction between a parent corporation and its subsidiary, the court approached fairness with the view that the parties to the transaction should simply receive what they bargained for.⁸⁰ This approach to fairness has been severely criticized, particularly its deficiency in protecting minority shareholder interests.⁸¹ Another factor in determining fairness is whether there has been full disclosure of the director's interests.⁸² Regardless of which test is adopted by the Nebraska courts, however, they have in common the effect of granting wide discretion to the court, thus enabling the fairness test to envelop a wide number of fact situations.

A corporation's contract with its director should be viewed from two perspectives. Courts will generally review not only the fairness of the bargain but also whether the bargain is in the best interests of the corporation. These principles were demonstrated in

74. 308 U.S. 295 (1939).

75. *Id.* at 306 (footnote omitted).

76. See *Mueller v. MacBan*, 62 Cal. App. 3d 258, 277, 132 Cal. Rptr. 222, 232 (1976); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 851, 47 Cal. Rptr. 392, 407 (1965); *Kenneron v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 172, 260 P.2d 823, 832 (1953).

77. E. FOLK, *supra* note 42, at 86. This standard has been applied in *Johnston v. Greene*, 35 Del. Ch. 479, 490, 121 A.2d 919, 925 (Super. Ct. 1956); *Harris Trust & Sav. Bank v. Joanna-Western Mills*, 53 Ill. App. 3d 542, 555, 368 N.E.2d 629, 639 (1977).

78. Note, *supra* note 11, at 663.

79. 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

80. "[T]he agreement must be looked at with the knowledge which those who entered into it had when it was executed." *Id.* at 158, 204 N.E.2d at 647, 256 N.Y.S.2d at 612.

81. Note, *supra* note 11, at 663.

82. *Voss Oil Co. v. Voss*, 367 P.2d 977 (Wyo. 1962).

*Fill Buildings, Inc. v. Alexander Hamilton Life*⁸³ in which the court set forth what has been called the "two-tiered standard" of fairness.⁸⁴ In this instance, defendant corporation challenged the validity of an assumed lease entered into with Fill Buildings, a corporation owned by a director of the original tenant-corporation. The tenant-corporation, which subsequently went bankrupt, had been warned against overexpansion by the state insurance department just prior to the execution of the lease. Defendant had assumed the leasehold when it took over the operations of the original tenant. The court found that the price of the leasehold agreement was fair but that the interested director could not sustain the burden of proving that the transaction was in the best interests of the corporation.⁸⁵ There was offered no legitimate business reason why the corporation would enter into such a lease while in financial trouble.

Given an instance of alleged director enrichment at corporate expense such as in this case, the burden to establish fairness resting on the director requires not only a showing of "fair price" but also a showing of the fairness of the bargain to the interests of the corporation. Only when a convincing showing is made in both respects can "fairness" under the statute be said to have been established.⁸⁶

The court agreed with defense counsel's observation that the sale of widgets by a director to the corporation would not be "fair" even though the price was fair, if there was no corporate purpose furthered by the acquisition of widgets.⁸⁷

Remillard also illustrates that the inquiry into fairness extends further than an income statement analysis. The year before the manufacturing companies entered into sales contracts with their directors' sales corporation, they had profits of approximately \$45,000. The profits received from the sales corporation alone under the 1948 and 1949 contracts were \$78,198 and \$47,199 respectively. Despite this financial gain, the court ruled the contracts "unfair" to the corporation.

It is no answer to say that the manufacturing companies made a profit on the deal, or that [the directors] did a good job. The point is that those large profits that should have gone to the manufacturing companies were diverted to the sales corporation. The good job done by [the directors] should and could have been done for the manufacturing companies.⁸⁸

83. 396 Mich. 453, 241 N.W.2d 466 (1976).

84. Simpson & Burnett, *Business Organizations*, 23 WAYNE L. REV. 349, 363 (1977).

85. The burden of proof was expressly placed on the director under the Michigan statute in force at that time. This case exemplifies the importance of which party bears the burden of proving fairness; in this instance it was outcome determinative.

86. 396 Mich. at 461, 241 N.W.2d at 469 (footnote omitted).

87. *Id.* n.7.

88. 109 Cal. App. 2d at 419, 241 P.2d at 74. The inquiry taken by the court is analogous to that taken under the doctrine of usurpation of corporate opportunity.

The final aspect of the fairness test involves the time at which the fairness of the transaction is to be judged. This determination may be critical. A slight change in circumstances may render a transaction which is fair today unfair tomorrow. The statutes of California, New Jersey, New York, and Delaware assert that fairness is to be judged at the time the transaction is approved or ratified.⁸⁹ Theoretically, a transaction which was fair when approved could not later be overturned if circumstances change and the corporation is left with the bad end of a bargain. This possibility has led to the conclusion that these statutes are concerned with procedural, not substantive fairness.⁹⁰

Section 21-2040.01 leaves this question open, only requiring that the transaction be fair and reasonable to the corporation. As a result, Nebraska courts would be free to view the substantive fairness of the transaction at dates subsequent to its approval. It could be argued that it is unfair for a director to reap a greater than expected profit at the corporation's expense due to a change in circumstances—that a transaction between a corporation and its director must always be a continuing symbiotic relationship. Much will depend upon which standard the court will use in assessing fairness. For example, if the "arm's length bargain" test is adopted, it would necessitate that fairness be judged at the time the transaction was approved. However, courts should be free to assess the fairness of a continuing transaction at any point in the life of the transaction due to the lack of constraint in the statute.

V. CONCLUSION

The enactment of section 21-2040.01 has not eliminated the uncertainty associated with interested director transactions. Absent judicial interpretation, the statute raises as many questions as it resolves. This uncertainty is intensified by the divergent interpretations given to those statutes after which section 21-2040.01 was patterned.

It is probable that the Nebraska courts will adopt the approach expressed in *Remillard*, requiring director transactions to be fair and reasonable to the corporation. With such a gloss placed on the statute, the real key to section 21-2040.01 will be procedural.

The same fact situation may state a cause of action under both interested director and corporate opportunity legal theories. See *Tennessee Dressed Beef Co. v. Hall*, 519 S.W.2d 805 (Tenn. Ct. App. 1974). This similarity between the two doctrines is analyzed in E. FOLK, *supra* note 42, at 89-93.

89. CAL. CORP. LAW. § 820 (West 1955) (*superseded by* CAL. CORP. CODE § 310 (West 1977); DEL. CODE tit. 8, § 144 (1974); N.J. STAT. ANN. § 14A:6-8 (West 1969); N.Y. BUS. CORP. LAW § 713 (McKinney 1963) (amended 1971).

90. Bulbulia & Pinto, *supra* note 2, at 219.

The dilemma in providing a degree of certainty in interested director transactions while retaining the maximum amount of shareholder protection can best be reconciled by viewing section 21-2040.01 as a procedural tool, the burden of proving the fairness or unfairness of the transaction being dependent upon whether there was compliance with the statutory guidelines for board or shareholder approval.

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