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Statutory Solutions to Conflicts of Interest in Close Corporations

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STATUTORY SOLUTIONS TO CONFLICTS OF INTEREST IN CLOSE CORPORATIONS

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I. INTRODUCTION

The close corporation operates in a continual atmosphere of conflict and self-dealing. Typical close corporation transactions between directors and the corporation, such as the purchase and sale of assets between the corporation and the director-shareholders, the compensation of director-shareholders, or loans from the corporation to the director-shareholders produce conflicts which, more often than not, evolve from frustration to friction, from friction to disaffection and, ultimately, from disaffection to litigation. Problems caused by transactions between a corporation and one or more of its directors have constituted a pervasive theme of corporate law for the last half century. Statutory solutions for such problems were first attempted in the 1930's. Projects of the American Bar Association and the American

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1 There are many definitions of the term “close corporation.” See 1 F. O'NEAL, CLOSE CORPORATIONS § 1.02 (2d ed. 1971). For the purposes of this article, the close corporation will be defined as a corporation which has few shareholders all of whom are active in the management and conduct of the business.
2 MODEL BUSINESS CORP. ACT ANN. § 8.31 (3d ed. 1985).
4 The project began in 1980 and the Revised Model Business Corporation Act was
Law Institute\(^5\) have again focused attention on statutory provisions relating to conflicts of interests. In recent years the central piece for discussion of statutory approaches to dealings between a corporation and its directors has concerned the public corporation, particularly defensive measures in connection with tender offers and the dismissal of the derivative action.\(^6\)

The revisers have paid little attention to the application of such provisions to close corporations.\(^7\) The focus for close corporations, instead, has been on careful planning by the shareholders permitted by the statutory provisions relating to close corporations.\(^8\) These provisions provide sufficient flexibility to make it possible to reduce the business bargain to writing at the outset of the venture by anticipating that conflicts will arise and structuring the corporation's governance in such a way as to avoid many of the outcomes which frequently erupt into bad feelings and law suits.\(^9\)

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\(^6\) My most serious criticism of the Committee consensus is that, even though the Act will be applicable primarily to corporations not registered under the federal securities acts, the Committee tended to overemphasize the potential effects of Model Act provisions on publicly held corporations. Most Model Act states, of course, have both publicly held and closely held corporations; consequently, it is important that provisions be workable for publicly held corporations as well as equitable in the closely held corporation. In a number of instances, however, Committee members seemed to draw illustrations exclusively from publicly held corporations even when the issues under discussion, such as conflict-of-interest transactions between a director and the corporation, were more likely to arise, or to pose more serious problems, in closely held corporations. See also Folk, Conflicts of Interest Under State Law, 3 INST. ON SEC. REG. 179 (1972) (application of statutes to the close corporation is not discussed).

\(^7\) See 1 F. O'NEAL, supra note 1, at §§ 3.01- 3.39.

\(^8\) In order to attempt to overcome the presumption of invalidity or to introduce certainty of result into self-dealing transactions, corporate counsel at an early time began to insert provisions into the charter and/or bylaws of corporations which purported to permit interested directors to contract with the corporation. The effect of such clauses remain
Advanced planning is not always possible. The problem which arises may never have been anticipated. It is very likely that the participants in uncertain. Interpreting these clauses, courts have held that they permit the directors to be part of the quorum and reverse the rule of voidability or negate the rule which requires the interested director to carry the burden of proving fairness, placing the burden of proving unfairness on the persons attacking the transaction. Some courts have afforded them no efficacy whatsoever.

O'Neal gives examples of two such charter clauses:

Transactions in Which Directors are Interested

A director of this Corporation shall not be disqualified by his office from dealing or contracting with this Corporation either as a vendor, purchaser or otherwise, nor shall any transaction or contract of this Corporation be void or voidable by reason of the fact that any director or any firm of which any director is a member or any corporation of which any director is a shareholder, office or director, is in any way interested in such transaction or contract, provided that, after such interest shall have been disclosed, such transaction or contract is or shall be authorized, ratified or approved either (1) by a vote of a majority of a quorum of the Board of Directors or of the Executive Committee, without counting in such majority or quorum any director so interested or any director who is a member of a firm so interested, or a shareholder, officer or director of a corporation so interested, or

(2) by the written consent, or by a vote at a stockholders' meeting, of the holders of record of a majority of all the outstanding shares of stock of this Corporation entitled to vote; nor shall any director be liable to account to this Corporation for any profits realized by or from or through any such transaction or contract of this Corporation authorized, ratified or approved as aforesaid by reason of the fact that he, or any firm of which he is a member or any corporation of which he is a shareholder, officer or director was interested in such transaction or contract. Nothing herein contained shall create liability in the events above described or prevent the authorization, ratification or approval of such contracts in any other manner provided by law.

* * *

Interested Directors

(a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or are financially interested, shall be either void or voidable for this reason alone or by reason alone that such director or directors are present at the meeting of the board, as of a committee thereof, which approves such contract or transaction, or that his or their votes are counted for such purpose;

(1) If the facts of such common directorship, officership or financial interest is disclosed or known to the board or committee, and the board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote or votes of such interested director or directors;

(2) If such common directorship, officership or financial interest is disclosed or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of the shareholders; or

(3) If the contract or transaction is fair and reasonable as to the corporation at the time it is approved by the board, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board or of a committee which approves such contract or transaction.
the enterprise will not concentrate on eventualities which they feel will never come to fruition. In the sacharin environment which surrounds the birth of most close corporations, even the most expert lawyer finds it difficult to focus the clients' attention on original sin. Less experienced counsel never bother. Too many close corporations are formed using self help and, even when assisted by a lawyer mid-wife, trace their beginnings to the stationery store rather than to informed planning.

A major function of general corporation statutes, in addition to enabling the formation of entities with limited liability, is to supply gap-filling standard form provisions which make rules for a given contingency where the participants have failed to do so. Many corporation laws, for example, supply a fairly complete set of bylaws for a corporation when the corporation's shareholders either do not adopt bylaws or fail to cover a certain matter in the bylaws adopted.

It is the purpose of this article to consider state statutory provisions governing conflicts of interest and their application to close corporations to determine whether or not such provisions provide useful rules for the unanticipated conflict which arises during corporate operations.

(e) The board shall have authority to fix the compensation of directors for services in any capacity.

Id. at § 10.20.

10 Laws relating to intestacy are perhaps the best example of such provisions where in effect the statute supplies a will for those who fail to write their own. See Uniform Probate Code §§ 2-101 to 2-114, 2-301, 2-302 (6th ed. 1983). In the Comment to 2-101 it is stated:

The Code attempts to reflect the normal desire of the owner of wealth as to disposition of his property at death and for this purpose the prevailing patterns in wills are useful in determining what the owner who fails to execute a will would probably want.

A principle purpose of this Article and Article III of the Code is to provide suitable rules and provisions for persons of modest means who rely on the estate plan provided by law.

While the prescribed patterns may serve the same as rules of law which may in some cases defeat the interest of a decedent, this is true of any statute of this type. In assessing the changes it must therefore be borne in mind that the decedent may always choose a difficult rule by executing a will.

Id. at 24-25. See also Ribsteen, An Analysis of Georgia's New Partnership Laws, 36 Mercer L. Rev. 443, 445 (1985). The author there, in discussing the Uniform Partnership Act, points out that statutes which function to provide parties to business associations a standard form agreement governing their relationship are economically efficient in that the parties (1) save the costs of a "custom-made agreement;" (2) are informed of their rights reducing the need for litigation; and (3) usually obtain what they would have arrived at through negotiation although they initially failed to think through the legal consequence of their dealings.

II. THE COMMON LAW DOCTRINES

The common law doctrine governing transactions between a director and the corporation evolved from a rule of absolute voidability to a rule of fairness.\textsuperscript{12} Early cases held that any contract between a director and the corporation was voidable at the instance of the corporation, without regard to any other factor such as fairness or unfairness.\textsuperscript{13} The rationale for the rule was that the director's duty of loyalty was inevitably compromised by a transaction in which the director stood on both sides. The early cases not only assumed that the director would act in his own interest \textit{vis-a-vis} the corporation but also assumed that co-directors would be sufficiently influenced by their colleague so as to become interested as well.\textsuperscript{14}

Cases applying the rule of voidability gradually gave way to a rule based on the trust principle that a trustee can deal with the trust if there is full disclosure and the beneficiary of the trust consents to the transaction; thus the rule developed that a contract between a director and the corporation is valid if it is approved by a disinterested majority of the directors and a court finds that it is neither unfair nor fraudulent.\textsuperscript{15}

\textsuperscript{12} See Marsh, \textit{Are Directors Trustees? Conflicts of Interest and Corporate Morality}, 22 Bus. Law. 35 (1966). This work is a classic analysis of the development of common law doctrines concerning director conflicts of interest. \textit{See also A.L.I., Principles of Corporate Governance} § 5.02 (Tent. Draft No. 5 1986) (Comment); \textit{Model Business Corp. Act Ann.} § 8.31 (3d ed. 1985) (Annotation).


\textsuperscript{14} Cumberland Coal and Iron. Co. v. Parish, 42 Md. 598 (Ct. App. 1875). The court there stated: "[T]he 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." \textit{Id.} at 606.

\textsuperscript{15} See Marsh, \textit{supra} note 12 at 39-43. \textit{See also R. Clark, Corporate Law} § 5.1 (1986), where the author suggests that the change in case outcomes respecting self-dealing were due to the increase in the number of such cases relating to close corporations which has become greater in number than those relating to public corporations. The analogous trust principle is discussed in A. Scott, \textit{Abridgment Of The Law Of Trusts}, § 170 (1960), as follows:

As to the duty of loyalty owed by a trustee to the beneficiaries of the trust, it is important to distinguish the situation where the trustee in dealing with trust property on his own account acts without the consent of the beneficiaries from the situation where he so acts with their consent. Where the beneficiaries do not consent, the transaction is voidable by them even though the trustee acted in good faith and the transaction was in all other respects fair and reasonable. On the other hand, where the beneficiaries consent to the transaction, it is not always voidable by them; it is voidable if, but only if, the trustee failed to disclose to the beneficiaries the material facts which he knew or should have known, or if he used the influence of his position to induce the consent, or if the transaction was not in all respects fair and reasonable.
The newer and more flexible rule was justified on the basis of the exigencies of modern business and the desirability of giving a reviewing court the aid of the opinions of those most closely associated with the corporation. 16

The concept of approval by a majority of disinterested directors produced an additional set of issues. These included: (1) whether or not the interested director could be counted for purposes of a quorum; 17 (2) the nature of the interest which would disqualify a director from participating in the decision to approve a transaction; 18 (3) the nature of the disclosure required with respect to the interest of the director; 19 and (4) the burden of proof in connection with the fairness or unfairness of the transaction. 20

Later cases held that the sole test of validity is whether or not the transaction is fair to the corporation and that the interested director bears the burden of proving the inherent fairness of the transaction. 21 As one commentator has pointed out: "The common law has moved from a predictable standard which rendered transactions with interested directors voidable at the option of the corporation to a more flexible but uncertain standard, under which the transactions are valid only if they are found to be fair." 22

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16 R. Clark, supra note 15, at § 4.1; Marsh, supra note 12, at 39-42.
18 Id.
19 See Marsh, supra note 12 at 40-41.
20 Id. at 44 nn. 32-33.
21 Id at 43, n. 12.
22 Bulbulia & Pinto, supra note 3, at 204. See also R. Clark, supra note 15, at § 55.1.

Professor Clark suggests that a new stage began with the adoption of the 1975 California Corporation Code. He stated:

In sum, the law seems to have evolved through three or four rules:

(1) a flat prohibition against basic self-dealing;
(2) a rule allowing basic self-dealing that is approved by a majority of disinterested directors and is fair;
(3) a rule allowing basic self-dealing that is fair, as found by a court; and
(4) in some states, perhaps, a rule allowing basic self-dealing that is fair or that is approved by a majority of properly informed shareholders.

One naturally wonders about the meaning of these changes. What, if anything, explains these historical shifts? Are the rules that have survived this evolutionary process justified? Are they optimal? These questions deserve the greatest attention by those trying to understand the forces that shape corporate law.

Id.
III. Statutory Provisions Governing Conflicts Of Interest

Legislative attempts to deal with typical and frequently troublesome conflicts of interest took a number of approaches.\(^{23}\) For the most part, the statutes were enabling,\(^{24}\) saving such transactions, if the statutory tests were met, from the common law doctrine of voidability, either with respect to self-dealing transactions generally\(^{25}\) or with respect to certain transactions such as executive compensation.\(^{26}\) Some statutes prohibited categories of activities;\(^{27}\) e.g., loans to directors. Others required approval by shareholders in order to validate a specified transaction.\(^{28}\)

The first statute designed to apply to self-dealing transactions generally was adopted by California in 1931.\(^{29}\) It was to serve as the basic model for subsequent statutes which would be widely adopted throughout the country, in the search for a statutory solution for self-dealing. In effect, the California statute codified the case law as it had developed in the early part of the twentieth century. It declared that a transaction

\(^{23}\) See Bulbulia & Pinto, supra note 3, at 204. See also 3 W. Fletcher, Cyclopedia of the Law of Private Corporations § 915 (rev. perm. ed. 1986).

\(^{24}\) See E. Folk, The Delaware General Corporation Law § 144 (1972).


\(^{26}\) See, e.g., Ohio Rev. Code Ann. § 1701.60 (Baldwin, 1970).


\(^{29}\) Cal. Corp. Code § 310 (West 1986). The text of the statute provides:

Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation. No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm, or association in which one or more of its directors, or between a corporation and any corporation, firm, or association in which one or more of its directors are directors or are financially interested, is either void or voidable because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes or approves the contract or transaction, or because his or their votes are counted for such purpose, if the circumstances specified in any of the following subdivisions exist:

(a) The fact of the common directorship or financial interest is disclosed or known to the board of directors or committee and noted in the minutes, and the board or committee authorizes, approves, or ratifies the contract or transaction in good faith by a vote sufficient for the purpose without counting the vote or votes of such director or directors.

(b) The fact of the common directorship or financial interest is disclosed or known to the shareholders, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of shareholders entitled to vote.

(c) The contract or transaction is just and reasonable as to the corporation at the time it is authorized or approved.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves, or ratifies a contract or transaction.
between a director and the corporation was neither void nor voidable because the director was present or because his votes are counted for the purpose of approving the transaction if there was disclosure of the financial interest of the director and if it was (1) approved by the disinterested directors; (2) approved by a majority of shareholders; or (3) the transaction was "just and reasonable" to the corporation at the time it was approved. 30

"Safe harbor" statutes of the California type have been adopted in thirty-nine jurisdictions. 31 The great impetus for their inclusion in general corporation statutes came with the insertion of such a provision into Delaware law 32 in the general revision of 1967 and the addition of a similar provision to the Model Business Corporation Act in 1969. 33 According to the Reporter for the Delaware revision, the section was not to provide a basis for validating a transaction between a director and the corporation but to enable such transactions by overturning the rule of automatic voidability. 34

In addition to "safe harbor" provisions applicable to self dealing between a corporate director and the corporation, generally, many states also adopted, in the wake of the movement for corporate revision which took place in the 1950's and 1960's, discrete provisions directed to typical, and frequently troublesome, conflict of interest transactions. Many states followed a Wisconsin law allowing directors, by an affirmative vote of a majority of those in office, and irrespective of any personal interest of any of them, to have the authority to establish reasonable compensation including pension and death benefits, for services to the corporation by

30 Id.

34 See E. Folk, supra note 24, at 82.
directors. Such a provision was targeted to the close corporation where compensation arrangements could not be otherwise authorized.

Many states also regulated certain financial dealings between the corporation and its directors. Some prohibited loans to directors. Some prohibited the guarantee of director obligations. Others restricted credit transactions between the director and the corporation unless approved by the shareholders.

IV. Application of Interested Director Statutes to Close Corporations

Inherent in the "safe harbor" statutes were the same interpretive problems of the later common law approach outlined above. Unresolved questions in many jurisdictions were: whether or not the statute in question only acts to enable a transaction between the corporation and a director rather than to validate it; whether or not the statute precludes judicial inquiry into the fairness of a transaction if it is approved by disinterested directors or by shareholders; whether or not the disclosure

36 Without such a statute, the practice of in seriatim voting was necessary where the directors were also the officers of the corporation.
39 See Model Business Corp. Act Ann. (3d ed. 1985) (Comment 1). See also, E. Folk supra note 24, at 82, where the author states:

Effect of the statute. Section 144(a) is negative in effect. A contract or transaction covered by the statute is not void or voidable solely because those approving a transaction have a conflict of interest, or solely because his vote is counted for that purpose. The validating effect does not go beyond removing the spectre of voidability which might otherwise arise from the presence of any one or more of these three elements.


Many states have 'safe harbor' statutes relating to transactions between directors and the corporation. These statutes have generally approached conflict-of-interest transactions in terms of the voidability of transactions and the effect of approval by disinterested directors or shareholders, rather than imposing an affirmative duty of loyalty. This may reflect the evolution of the law in this area from a rule that originally permitted all transactions with directors to be set aside without regard to fairness, and a tendency to leave the development of affirmative duties of loyalty to the case law. All but four of these statutes may literally be read to preclude judicial inquiry into the fairness of a transaction that has been
requirements attach to the fact of the conflict or the material facts of the transaction;\textsuperscript{41} and whether or not there is a distinction between shareholder approval and director approval as to the requirement of disinterest.\textsuperscript{42} In addition the definition of disinterested and the effect of the statute on the burden of proof as to the issue of fairness was generally left to the courts.\textsuperscript{43} All of these issues posed particular problems for the close corporation, where there were directors who were likely to be nominees of a particular shareholder.\textsuperscript{44}

There are surprisingly few reported cases interpreting the Delaware\textsuperscript{45} and MBCA\textsuperscript{46} statutes and their clones\textsuperscript{47} in the context of the close corporation. The recent cases generally concern the fallout from hostile takeovers and fears of hostile takeovers.\textsuperscript{48} Gries Sports Enterprises v. Cleveland Browns Football Co.,\textsuperscript{49} a case recently decided by the Supreme Court of Ohio, applying Delaware law, does present an archetypical fact situation. The myriad of opinions growing out of the case serve to demonstrate the difficulty, if not impossibility, of the useful application of a safe harbor statute in the context of a close corporation. The case involved a transaction between the Cleveland Browns Football Co. (hereinafter the Corporation), the owner of the Cleveland Browns football team, and Arthur Modell, a director and majority shareholder. The Corporation acquired from Modell all of the outstanding shares of another corporation, the Cleveland Stadium Corporation, for \$6,000,000. The transaction was approved by the board of directors of the Corporation. At the time of the transaction, March 16, 1982, the Corporation had two major shareholders, Modell\textsuperscript{50} and Robert Gries.\textsuperscript{51} The board of directors consisted of Modell; Modell's wife, Patricia Modell; James Bailey, general counsel to the corporation and a full time employee; James Berick, outside legal counsel to the corporation; Richard Cole; Nate Wallak, also a full time employee of the corporation, and Robert

\textsuperscript{41} See A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 5.02 (Tent. Draft No. 5 1986) (Reporter's Note and Comment).

\textsuperscript{42} See Bulbulia & Pinto supra note 3, at 81-83.

\textsuperscript{43} Id. at 210 n. 69.

\textsuperscript{44} Glebe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378 (1918).

\textsuperscript{45} DEL. CODE ANN. tit. 8 § 144 (1985).

\textsuperscript{46} MODEL BUSINESS CORP. ACT § 41 (rev. ed. 1969).

\textsuperscript{47} See A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 5.01 (Tent. Draft No. 5 1986) (Reporter's Note 1).

\textsuperscript{48} See MODEL BUSINESS CORP. ACT ANN. § 4.

\textsuperscript{49} 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986).

\textsuperscript{50} Arthur Modell owned fifty-three percent of the corporation's stock. 26 Ohio St. 3d at 15, 496 N.E.2d at 960.

\textsuperscript{51} Robert Gries owned 43% of the corporation's stock. Id.
Gries. All the directors of the corporation other than Gries, were nominees of Modell although they had been elected with Gries' approval. All directors attended the meeting at which the purchase was approved by a 4-1 vote.\textsuperscript{52}

On the day following the date of the approval of the transaction, Gries filed a shareholders' derivative action seeking rescission of the acquisition. The basis of the complaint was that the shares of Cleveland Stadium Corporation were overvalued and therefore the transaction was unfair to the Corporation. Plaintiff's theory was that the directors who had approved the transaction were "interested" and thus the defendant Modell had the burden of proving "intrinsic fairness" in order to sustain the validity of the transaction. Defendants contended that the acquisition was approved by a majority of the disinterested directors in accordance with the conflict of interest provision in the Delaware Corporation Law\textsuperscript{53} and that the decision was thus protected by the business judgment rule preventing any judicial inquiry as to the fairness of the transaction.\textsuperscript{54}

After a four week trial in 1984, the trial judge concluded that the approving directors were "interested"\textsuperscript{55} and that the defendants had not established that the transaction was intrinsically fair to the corporation.\textsuperscript{56} The finding of "interest" was apparently based on a transaction which preceded the transaction in question in which directors Bailey, Berick and Cole had redeemed shares in the acquired corporation at a high value.\textsuperscript{57} In addition the court held

\textsuperscript{52} Gries voted "no". The Modells abstained from voting. \textit{Id.}

\textsuperscript{53} Del. Code Ann. tit. 8 § 144 (1986).

\textsuperscript{54} 26 Ohio. St. 3d at 20-22, 496 N.E.2d at 963-66.


\textsuperscript{56} \textit{Id.} (Conclusions of Law, ¶ 7), \textit{reprinted in} Appellant's Brief at app. 94, \textit{Gries}, 15 Ohio St. 3d 15, 496 N.E.2d 959 (1986).

\textsuperscript{57} \textit{Id.} In Conclusions of Law, paragraph 8, the Court concluded:

Even if the intrinsic fairness test were not applicable here, directors Cole, Bailey and Berick still could not claim the protection of the 'business judgment' rule, since that rule does not apply to actions taken by directors with respect to a transaction which confers personal financial benefits upon the directors. \textit{Gottleib v. Heyden Chemical Corp.}, 90 A.2d 650 (1952). Directors Cole, Bailey and Berick all derived personal financial benefits from the subject transaction. Accordingly, the transaction was not approved by a majority consisting of disinterested directors. \textit{Aronson v. Lewis}, 473 A.2d 805, 812 (Del. 1984).

\textit{Id.} at app. 94-95.

Prior to the transaction in question, twenty percent of the Cleveland Stadium Corporation had been owned by persons other than Modell including Berick, Bailey, Wallack, Cole and Gries. On March 2, 1982 these shareholders had redeemed all of their shares for $120.00 per share. Each had previously had an option to sell the shares back to the
that they were further interested in that they were beholden to Modell.\textsuperscript{58}

The defendants appealed to an intermediate appellate court. Almost a year elapsed. On April 25, 1985, the appellate court in a 2-1 decision reversed the judgment of the trial court.\textsuperscript{59} The majority of the appellate panel held that neither the interest of the directors in the prior acquisition nor the status as Modell's nominees rendered them "interested" within the meaning of the Delaware statute.\textsuperscript{60} Nor did the fact that one was either a full time employee or outside counsel by itself constitute enough to disqualify.\textsuperscript{61} The court cited with approval the following language from \textit{Aronson v. Lewis:}\textsuperscript{62}

Thus it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method

\textsuperscript{58} In Findings of Fact, paragraph 23, the court also found:

As of March 16, 1982, directors Berick, Bailey and Wallach [sic] were clearly beholden to defendant Modell, in that the continuation of their employment (as outside counsel in the case of Mr. Berick, and as full-time employees of the Browns in the case of Mr. Bailey and Mr. Wallack) was entirely dependent upon their retaining the goodwill of Mr. Modell, who, as Chief Executive Officer of the Browns, had the power to discharge them. Director Cole, the former brother-in-law of plaintiff Robert D. Gries, was similarly beholden to defendant Modell, for on January 13, 1982, Modell and Cole had entered into a written agreement wherein Modell agreed:

\begin{enumerate}
\item To cause the Browns to buy Cole's stock in the Browns for $665,000;
\item to personally purchase Cole's shares in CSC for $192,000, if such shares were not redeemed by CSC, at that price, by March 1, 1982;
\item to support Cole's "re-election as a Director so long as we mutually agree that it is in our joint best interests and in the best interest of all the shareholders of CBFC."
\item to continue Cole's salary and Blue Cross coverage as a Vice President of the Browns for a period of five years. In addition, prior to the March 16, 1982 Board meeting, director Cole had obtained employment with a travel agency, 50% of which was owned by the Browns. The Board of Directors of the Browns was therefore dominated by ABM.
\end{enumerate}


\textsuperscript{60} \textit{Id.} at 14-15.

\textsuperscript{61} \textit{Id.}

of election, that generally touches on independence (citation omitted). Additionally the mere fact that a director is an employee of the corporation does not mean that he or she is dominated by a majority shareholder. 63

On the facts, the appellate court then found that, of the four directors who had approved the transaction, one was "interested;" 64 one probably "interested;" 65 and two "disinterested." 66 Since, in the appellate court's opinion the transaction had thus been approved (2-1) by disinterested directors, the trial court should not have considered the question of fairness. 67 In a dissenting opinion, the third appellate judge concluded that the financial interest in the prior redemption was in itself sufficient to supply an "interest" as was the fact that one director was the Corporation's outside counsel. 68

The plaintiff then appealed to the Ohio Supreme Court. Another year elapsed. On August 20, 1986, the Supreme Court reversed the judgment of the Court of Appeals and reinstated the judgment of the trial court by a vote of 4-3. 69 Five opinions were written. 70 The opinion of the Court concluded that all of the directors who voted in favor of the acquisition

63 Id. at 815.
64 Gries, slip op. at 17 (Ct. App. 8th Dist. Ohio Apr. 25, 1985) (Cole).
65 Id. at 19 (Bailey).
66 Id. at 15-18.
67 Id. at 23.
68 The dissenting judge stated:
   The record reveals that the March 2, 1982 stock redemption was an integral part of the March 16, 1982 CSC acquisition. There would not have been a redemption, but for the impending acquisition of CSC. On March 2, 1982, Modell caused CSC to redeem the remaining 20 percent of its outstanding stock that was owned by persons or entities other than Modell for $120 per share. When the redemption was completed, Modell owned 100 percent of the stock in CSC. The total cost to CSC for this stock redemption was $1,200,000, all of which was borrowed from Central National Bank (CNB) as evidenced by a promissory note from CSC to CNB, dated March 2, 1982. Under the plan for the Browns to purchase Modell's 100 percent interest in CSC, the Browns would borrow $6,000,000 from CNB. CNB would then disburse $4,800,000 to Modell for his stock of CSC and disburse $1,200,000 to itself, to be treated as the Browns' contribution of such amount to the capital of CSC and CSC's repayment of the March 2, 1983 loan. This disbursement was completed by 7:45 a.m. on March 17, 1982.
   Moreover, the record demonstrates that the transaction was originally structured as a single transaction. However, it was changed to two transactions for tax purposes. Id. at 8-9 (Jackson, J., dissenting).
69 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986).
70 Judge Wise of the Fifth Appellate District sitting for Justice Locher wrote the opinion of the Court. Justice Brown wrote a concurring opinion. Justices Holmes, Douglas and Wright each wrote dissenting opinions. Id.
were "interested." They interest resided in dual positions with the acquiring and the acquired corporations, either as shareholders or employees, their involvement in the legal structuring of the acquisition transaction as counsel, their having sold their shares in the acquired corporations in the redemption transaction which took place prior to the acquisition, and Berick's position as outside counsel to the corporation. A concurring justice based his finding of interest on the prior redemption transaction which he characterized as a special financial benefit from the acquisition but rejected the idea that a director is automatically dominated by the corporation's chief executive officer because he serves as outside counsel for the corporation. Three dissenting justices found three of the four directors who voted in favor of the acquisition to be "disinterested" and only one to be sufficiently dominated by Modell through "intense financial dependence" to be "interested". The following chart tabulates the conclusions of the eleven judges who considered this case as to the question of interest (or disinterest). The chart indicates whether or not the respective directors who voted in favor of the acquisition were found by the judge to be disqualified by reason of interest.

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71 The Ohio Supreme Court applied the following test to the issue of interest:

Under Delaware law, (A) a director is interested if (1) he appears on both sides of a transaction or (2) he has or expects to derive personal financial benefit not equally received by the stockholders; (B) a director is independent if his decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences; a director is not independent when he is dominated by or beholden to another person through personal or other relationships, and (C) a director is informed if he makes a reasonable effort to become familiar with the relevant and reasonably available facts prior to making a business judgment.

Id. at 22, 496 N.E.2d at 965.

72 Id. at 22-23.

73 Id.

74 Id.

75 Id.

76 Id.

77 Id. at 28-29, 496 N.E.2d at 970.

78 Id. at 21, 496 N.E.2d at 970. Justice Brown states in his concurring opinion:

I wish to emphasize that I reject the idea that a director is automatically "dominated" by the corporation's chief executive officer merely because that director is outside counsel for the corporation. I say this because a strained construction of Part I B of the majority opinion might raise this unwarranted implication in the minds of some readers.

79 26 Ohio St. 3d at 41-46, 496 N.E.2d at 979-83. (Cole was the director found to be sufficiently dominated by Modell).

80 Id.
Five of the judges involved concluded that the directors were not “disinterested” by virtue of the director’s participation in a stock redemption which was completed at the time of the transaction in question but found to be a prelude thereto. \(^81\) Five of the judges concluded that directors were not “disinterested” because they were dominated by the majority shareholder who nominated them for their offices. \(^82\) Four of the judges concluded that involvement as an employee of both corporations was sufficient to render a director “disinterested.” \(^83\) Five of the judges concluded that service as outside counsel to the corporation rendered a director not “disinterested.” \(^84\) All of the judges found intense financial involvement in other transactions between the director and the majority shareholder disqualifying for purposes of the statute. \(^85\)

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\(^{81}\) Corrigan, Parrino, Douglas, Wayne and Holmes.

\(^{82}\) Angelotta, Wise, Celebrezze, Sweeney and Brown.

\(^{83}\) Angelotta, Wise, Celebrezze and Sweeney.

\(^{84}\) Wise, Celebrezze and Sweeney.

\(^{85}\) This related only to Richard Cole.
The *Gries* case also serves an example of the difficulties encountered in applying the third leg of the safe harbor statute to close corporation cases. The Delaware statute, in pertinent part, provides:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose if:

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(3) The contract or transaction is fair as of the time it is authorized approved or ratified, by the board of directors, a committee or the shareholders.86

The presumed effect of this part of the statute is to subject corporate decision making to judicial review. What it does in reality is to defer the corporate decision to the judge who acts more or less as the beneficent dictator, substituting his business judgment based on his business experience (if any) and personal values for that of the corporate participants. Although voluminous testimony was produced at trial with respect to the valuation of the acquired corporation, in order to make a determination as to “fairness” the trial judge disregarded the expert testimony in its entirety.87 He, in effect, constituted himself the “ideal” director. He describes the process by which he came to the conclusion that the transaction was unfair in a letter announcing his decision.88 He stated:

86 DEL. CORP. CODE tit. 8 § 144 (1986).
87 Conclusion of Law paragraph 31 states:
   After carefully considering and evaluating the testimony and credibility of the various expert witnesses who testified at trial as to the value of CSC's lease of the Stadium and CSC's right to manage and operate the Stadium until 1998, the Court finds that the opinion testimony of such witnesses is not entitled to any weight.
88 In a letter to Marvin L. Karp and Patrick F. McCarten from Judge Angelotta dated Aug. 2, 1982, the Judge stated:
   Now a brief reference to experts. I am told that Oscar Wilde once described a cynic as a person 'who knows the cost of everything and the value of nothing.' Mr. Wilde describes an expert. If I had any reservation about the value of the experts, that is, any good reservation, it was totally destroyed by Mr. Desmond when he stated, 'you can prove anything you want with numbers, that's easy.' Now, really, when a judge listens to testimony from experts who testify that CSC has a value...
I place myself in the position of the board. The only question before me is the value of Cleveland Stadium Corporation. I review the report and conclude Stadium operations to be a worthwhile purchase. I further review the report and with particular reference to page 23 thereof, I note the indebtedness as it relates to the land and with lesser reference to the hotel investment. I recognize neither the land nor hotel have anything to do with football. I know the Browns neither seek investment or diversification. I would have noted that to be profitable the whole transaction must be worth in excess of $14,000,000 to the Browns. Six million dollars is being spent to buy the stock of the CSC, in excess of $8,000,000 of CSC debt is being assumed. I would have voted 'nay'.

ranging from negative $69,000 to plus $12.4 million, the whole subject becomes somewhat ludicrous. No responsible person could make an intelligent judgment from such testimony. I charge myself with the applicable law to weigh expert testimony, to apply the usual rules for testing credibility, and to determine the weight to be given to the testimony of experts. In this case I place no value on the testimony of experts.

Id. at page 2. Appellee's Brief at app. 1-2, Gries, 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986).

The Ohio Supreme Court majority appears to have accepted a transactional test with respect to “fairness” based on the timing, structuring, negotiation, disclosure and approval of one transaction. 26 Ohio St.3d at 21, 496 N.E.2d at 964. See also Comment, “Interested Director’s” Contracts - Section 713 of the New York Business Corporation Law and the "Fairness" Test, 41 FORDHAM L. REV. 639 (1973).

89 During a taped interview between the trial judge and a radio station reporter Jeffrey N. Schudel on August 23, 1984, the trial judge observed:

Judge: And I took myself back to March 16th, 1982 at which time the Board of Directors of the Cleveland Browns had to make a decision and the information they had before them was this valuation of Cleveland Stadium Corporation made by McDonald & Company and it is from that evaluation that the Board made a decision and it is from that evaluation that I made a decision. I dismissed the testimony of all of the experts because they came later.

Schudel: Yeah. Okay so then . . .

Judge: They were just coming in to either validate what Modell . . . or validate what Gries said, depending on which side they were on.

Schudel: Okay, so if the numbers could be made to say anything, how can a judgment be made on what it’s worth?

Judge: On the Cleveland Stadium Corporation evaluation of March 16, 1982. That’s what the Board of Directors had in front of them when they, when they decided to buy.

Schudel: Okay, I thought that’s what it said, I thought that evaluation said it was worth 6 million or whatever they paid, is that what that evaluation said?

Judge: Um, if you accept the valuation as being conclusive, yes, but as you read it, there were, for example, on the land it was apparent to me that there was a debt of almost $2 million on the land. That isn’t what the report said.
It is not necessary for the purposes of this article to consider which, if any of the seven opinions in the Gries case correctly applies Delaware law with respect to the safe harbor statute. In the aggregate, the several opinions demonstrate that this approach to self-dealing transactions is not helpful in providing an efficient solution to the problem presented in this context. "Disinterest" is simply not practicable in a context where the relationships among the directors and shareholders will inevitably be complex. 90 The close corporation that would have any number of directors who were not related to the majority shareholder in some way through finances, family or employment would be rare indeed. The ultimate result is to defer the business decision to a prolonged and expensive judicial proceeding. Then one ultimate decision is made by a judge neither with a background in the particular business nor with constraints imposed by the market. 91 In the Gries case, the transaction was voided after four years of litigation and the expenditure of millions of dollars in counsel and expert fees by both the shareholders and the corporation. 92 It can

Schudel: Oh.
Judge: You see in the report McDonald & Company says that we value the land in 1975 at, I don't remember what the figures were, and I'm obviously not looking at anything right now, but 3.2 million and then they said that same land, five years later by adding a percentage, whatever percentage you're applying, would run the value up, of the land up to over $5 million in 1980. Well that isn't the way you make an evaluation of land. You don't say that it was worth so much today and then 5 years later it's worth so much, what you do is 5 years later you go out to the land and look at it.

Schudel: In other words, they speculated more than evaluated it, is that right?
Judge: Well, they just put a percentage, and ran it up by those numbers. But, really what they should have done in 1982, was go out to the land and make an evaluation and they didn't do that. So I rejected their value of this, of 3.8 million, I think the value of the land was more in the area of $750,000 and it does have a 2.6 million debt. Consequently, the Browns bought a debt of almost $2 million.

Appellee's Brief at app. 14-16, Gries, 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986). The Supreme Court, sustained the trial court’s conclusions on fairness on the basis of the finding that the purchase increased the Browns' indebtedness by $8,000,000. 26 Ohio St. 3d at 22, 496 N.E.2d at 965.

90 For example, Richard Cole not only had numerous business relationships with Arthur Modell; he was also Robert Gries' former brother-in-law.
92 Plaintiffs filed an application asking for over one million dollars in attorney fees to be awarded from the corporation. At the same time it was estimated that the Cleveland Browns and Modell had spent 1.6 million dollars in attorney fees. Legal Arms Earn More Than Kosar, The Plain Dealer, Oct. 15, 1986, at 1B, col. 1; Modell-Gries Settle Their Suit Over The Browns, The Plain Dealer, Dec. 7, 1986, at 5B, col. 1. On March 17, 1986, the Corporation was enjoined by the Supreme Court from selling the stock of the Stadium Corporation for $7 million; which is 1 million more than had been paid for it and $4 million more than the plaintiff had contended it was worth. 25 Ohio St. 3d at 35, 496 N.E.2d at 77.
easily be surmised that shareholders would not have adopted such a rule if they had considered the problem at the time of incorporation.

V. PROPOSALS FOR STATUTORY REFORM

A number of law reform projects surfaced in the latter part of the 1970's and early part of the 1980's. These efforts have been directed to major revisions of the general corporation laws and much of their focus has been on conflicts of interest. They provide little in the way of gap-filling for the close corporation. The Committee on Corporate Laws of the American Bar Association Section of Corporation Banking and Business Law promulgated a Revised Model Business Corporation Act in 1985. Although an earlier version cast the entire problem of conflicts of interest in terms of fairness and the burden of proof with respect to fairness, the

93 See Fischel, supra note 92.
94 See Hamilton, supra note 4.
95 1983 REVISED MODEL BUSINESS CORP. ACT § 8.31 (Exposure Draft 1983). The text of the earlier version was as follows:

Section 8.31. DIRECTOR OR OFFICER CONFLICT OF INTEREST.
(a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director or officer of the corporation has a direct or indirect interest in the transaction is not a ground for invalidating the transaction or for imposing liability on that director or officer.
(b) In a proceeding contesting the validity of a transaction in which a director or officer has an interest, the person asserting validity has the burden of proving fairness unless:

(1) the material facts of the transaction and the director's or officer's interest were disclosed or known to the board of directors or a committee of the board and the board or committee authorized, approved, or ratified the transaction by the vote of a requisite quorum of directors who has no interest in the transaction; or
(2) the material facts of the transaction and the director's or officer's interest were disclosed to the shareholders entitled to vote and they authorized, approved, or ratified the transaction by the vote of a requisite quorum of shareholders who had no interest in the transaction.
(c) the presence of, or votes entitled to be cast by, the director or officer who has a direct or indirect interest in the transaction may be counted in determining whether a quorum is present but may not be counted when the board of directors, a committee of the board, or the shareholders vote on the transaction.
(d) For purposes of this section, a director or officer has an indirect interest in a transaction if an entity in which he has a material financial interest or in which he is an officer, director, or general partner is a party to the transaction. A vote or consent of that entity is deemed to be a vote or consent of the director or officer for purposes of subsection (c).
final version reverted to language similar to that which had been included in the Model Business Corporation Act in 1969.96

The American Law Institute, in 1981, began a study of the principles of corporate governance.97 A substantial portion of the work of the project is directed toward the duty of loyalty and in turn to the question of conflicts of interest.98 In the initial proposal directed to conflicts of interest, transactions were approached as a breach of the duty of loyalty unless authorized by "disinterested"99 directors after full disclosure of the material facts.100 A later draft announces the principle that directors have a duty, when personally interested in a matter affecting the corporation, to deal fairly with the corporation. A director fulfills that duty in a transaction with the corporation if there is full disclosure concerning both the conflict and the transaction, and the transaction is (1) fair to the corporation; (2) authorized by disinterested directors and could be reasonably believed to be fair to the corporation; or (3) authorized by disinterested shareholders and does not constitute waste.101

A new rule, in the later draft, provides input, that a "dominating" shareholder who enters into a transaction with the corporation fulfills his duty of loyalty to the corporation if the transaction is approved by disinterested shareholders.102 At first glance, the dominating shareholder rule is more helpful to the close corporation than prior rules which focus on transactions at the director level. By concentrating on the shareholder level, it is easier to determine questions of disinterest which can be directly related to the shareholders' financial interest in the transaction. There is unlikely to be the same difficulty with the relationship of nominees to the transaction at the shareholders level.103 A study of the Comment to the rule, however, shows that the problems of concern to the drafters were those of minority shareholder freeze-out by dominating parent corporations rather than the garden variety of close corporation self-dealing.

96 Model Business Corp. Act Ann. § 8.31 (3d ed. 1985). A separate provision validated corporate loans or guarantees to directors if (a) approved by a majority of disinterested shareholders, or (b) approved by the directors on a determination that the loan or guarantee benefits the corporation. Id. at § 8.32.

97 See supra note 5.


99 A.L.I., Principles of Corporate Governance, § 5.02, (Tent. Draft No. 7 1986). The reporter points out the importance of the nature of disinterested representations as a technique for dealing with conflict of interest. This is expressly stated in the context of the public corporation. Id. (Comment to § 5.02(a)(2)(C)).

100 A.L.I., Principles of Corporate Governance § 5.08 (Tent. Draft No. 3 1984).

101 A.L.I., Principles of Corporate Governance § 5.02 (Tent. Draft No. 5 1986). This section is cited in the concurring opinion in the Gries case as supporting the fairness decision in one case. 26 Ohio St. 3d at 31, 496 N.E.2d at 971-72.

102 A.L.I., Principles of Corporate Governance § 5.10 (Tent. Draft No. 5 1986).

103 Id. at § 1.12 (defining a dominating shareholder "as one who owns 50% of the outstanding voting remainder or executive control over management.").
transactions.\textsuperscript{104} The proposed rule would not offer any solution to the problem of judicial review where there is a failure to obtain disinterested shareholder approval.

VI. Close Corporation Statutes

Since the adoption of the first special laws for close corporations by New York in 1948,\textsuperscript{105} followed by North Carolina in 1955,\textsuperscript{106} a majority of states have passed provisions designed to accommodate the close corporation's need for intra-corporate flexibility.\textsuperscript{107} These acts either consist of an integrated statute collecting provisions applicable to close corporations in a separate chapter or subdivision of the business corporation law\textsuperscript{108} or a series of provisions designed for close corporations spread throughout the general business corporation act.\textsuperscript{109} In both cases, the objectives of the provisions are: (1) to allow informality in the corporation's internal affairs; (2) to validate shareholders agreements respecting matters such as employment or profit distribution as against case law holdings that such agreements were void in that they sterilized the board of directors; (3) to allow or require restrictions on the transfer of shares; and (4) to provide remedies for disension, deadlocks, and shareholder oppression.\textsuperscript{110} None of these provisions are self-executing. They depend upon shareholder implementation, by agreement, insertion in corporate documents or the institution of judicial or arbitration proceedings. The Delaware close corporation sections,\textsuperscript{111} typically, allow for agreements restricting discretion of directors,\textsuperscript{112} management by shareholders,\textsuperscript{113} the appointment of a custodian\textsuperscript{114} or provisional director\textsuperscript{115} in the event of deadlock, the elimination of the objection to the validity of corporate agreements on the basis that the corporation is being operated as a partnership,\textsuperscript{116} and provisions allowing one or more shareholders the right to dissolve the corporation at will or upon a given contingency.\textsuperscript{117}

\begin{flushleft}
\textsuperscript{104} In addition the drafters defer the implementation to judicial decision rather than statute. \textit{Id.} (Comment to §§ 5.10(b) to (c)).
\textsuperscript{105} \textsc{New York Stock Corporation Law}, § 9 (1948).
\textsuperscript{107} J. F. O'\textsc{neal}, \textit{supra} note 1, at § 1.14.
\textsuperscript{108} \textit{Id.} at § 1.14b.
\textsuperscript{109} \textit{Id.} at § 1.14.
\textsuperscript{110} Id.
\textsuperscript{111} \textsc{Del. Code Ann.} tit. 8 §§ 341-356.
\textsuperscript{112} \textit{Id.} at § 350.
\textsuperscript{113} \textit{Id.} at § 351.
\textsuperscript{114} \textit{Id.} at § 352.
\textsuperscript{115} \textit{Id.} at § 353.
\textsuperscript{116} \textit{Id.} at § 354.
\textsuperscript{117} \textit{Id.} at § 355.
\end{flushleft}
These statutes are enabling. They are affirmative only to the extent that they promote remedial action by judicial proceedings. While the emphasis since their inception has been on allowing the shareholders of a close corporation to design their own corporate structure through contractual arrangements, little thought appears to have been given to providing a general form of contract presumed to be what they would adopt had they thought about it. Although it is very likely that a transaction involving a conflict of interest may trigger one of the close corporation provisions concerning dissension, deadlock or oppression, a presumptive resolution is not provided.\textsuperscript{118}

In 1981, The Committee on Corporate Laws of the Section of Banking, Business and Corporation Law of the American Bar Association promulgated the Model Close Corporation Supplement to the Model Business Corporation Act.\textsuperscript{119} Prior to that time the Model Business Corporation Act had been amended from time to time to include many provisions applicable to close corporations on a non-integrated basis.\textsuperscript{120} The new Supplement not only provided an optional integrated statute such as Delaware's but also included typical provisions which would apply to the corporation unless otherwise provided by the shareholders. These include share transfer prohibitions,\textsuperscript{121} and the compulsory purchase of shares after the death of shareholders.\textsuperscript{122} In the Official Comment, the drafters of the Close Corporation Supplement explain their inclusion of such provisions.

This section sets out a standardized transfer prohibition that automatically applies unless the articles of incorporation provided otherwise. The prohibition is designed to accomplish two purposes, first, to provide a prohibition that fits the needs of a 'typical' close corporation; and second, to facilitate alteration in order to fit the special needs of the shareholders in a particular corporation.\textsuperscript{123}

No attempt, however, was made by the drafters of either the Revised Model Act or any other statute to find provisions which would apply to problems of conflict of interest in the close corporation, where the shareholders had not made a separate agreement. In every case, provi-
sions of the general corporation law directed to such transactions, when they exist, apply to both public and close corporations.

VII. PARTNERSHIP TREATMENT OF CONFLICTING INTERESTS

Since the close corporation is frequently considered an incorporated partnership,\textsuperscript{124} it is useful to examine statutory law applicable to self-dealing transactions by partners and its possible applicability to the close corporation.

The Uniform Partnership Act (UPA) has now been adopted in fifty-one jurisdictions.\textsuperscript{125} In major part, it presents an example of a statutory gap filler. To the extent that the UPA affects dealings by the partners, inter se, it is in effect a statutory standard form of contract, which partners may vary by drafting to accommodate individual needs and desires. In the absence of a specific agreement to the contrary, the statutory provisions establish a rule to be applied to the given transaction. Conflict of interest transactions, in the main, are covered by section 21(1) to wit:

Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.\textsuperscript{126}

It is readily observed that the rule is derived from general principles of trust and agency law and that the effect is basically to prohibit self-dealing transactions absent the consent of the other partners.\textsuperscript{127} Although such a rule in the corporate setting undermines majority control,\textsuperscript{128} case law developments with respect to close corporations, by applying the fiduciary principles among shareholders, have gone a long way toward requiring such a result.\textsuperscript{129} Partnerships have consistently

\textsuperscript{124} See Kessler, supra note 119, at 663.
\textsuperscript{125} Uniform Laws Annotated (1969 & Supp. 1986) (Uniform Partnership Act; Table of Jurisdictions where Act has been adopted).
\textsuperscript{127} Id. Restatement (Second) of Agency §§ 387-98 (1958); See also Restatement (Second) of Trusts § 170 (1959); Ribstein, An Analysis of Georgia's New Partnership Law, 36 Mercer L. Rev. 443, 474 (1985).
\textsuperscript{128} One author writing in the general context of self-dealing in corporations has suggested that breaches of legality reduce the amount of the investment minority shareholders will make, providing incentive to management to avoid these problems. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 Stan. L. Rev. 926, 938 (1983). See also Anderson Conflicts of Interest, Efficiency, Fairness and Corporate Structure, 25 UCLA L. Rev. 739, 773 (1978).
\textsuperscript{129} Donahue v. Rodd Electrotype Co. of New England, 367 Mass. 578, 328 N.E.2d 505 (1975); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). See LaGarga, Conflict of

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operated on this principle. A statutory provision would lend certainty to
the procedures for conducting business. It is also very likely that a rule
requiring unanimous consent of the shareholders (or of a majority of the
shareholders not directly involved in the transaction) would be the rule
adopted by close corporation shareholders if they had bargained in
advance with respect to conflicts of interest.

VIII. PARTNERSHIP RULES AS APPLIED TO CLOSE CORPORATION TRANSACTIONS

It is instructive to consider the result in the Gries case had Delaware
corporation law provided that majority shareholders, absent a share-
holder agreement to the contrary, might only deal with the corporation
with the consent of a majority of the other shareholders. Had that been
the case, the resolution of the controversy concerning the acquisition of
the Cleveland Stadium Corporation would have been precisely the same
as that ultimately reached by the Ohio Supreme Court but without five
years of litigation and millions of dollars in costs and fees. Although the
result would have been unpalatable to the majority shareholder and
might have precipitated other shareholder strife between him and the
plaintiff in the action, it would have at least brought a degree of certainty
to the parameters of dealing in the organization. Alternative plans could

Interest Transactions: Fiduciary Duties of Corporate Directors Who Are Also Controlling
Shareholders, 57 DEN. L.J. 609 (1980). See also Beane, The Fiduciary Relationship of a
Partner, 5 J. CORP. L. 483 (1980). The author comments as follows:

It has therefore been universally agreed that a joint adventurer or partner is
prohibited from self-dealing during the pendency of the venture, and that any
profits realized from self-dealing belong to the venture or partnership. In a case
involving the managing partner of a wholesale partnership which sold merchan-
dise to a retail partnership of which he was also a member, even though the
wholesale partnership could not show it was injured, the court held the partner
assumed the burden of proving that the wholesale firm was not injured by his
dealing between the two firms of which he was a member. However, if the
agreement between the partners relied upon permitted self-dealing, such a
provision is not in and of itself violative of law, and there would be no breach of
the fiduciary duty.

Id. at 503 (emphasis original) (footnotes omitted). See also Empirical Research Project,
Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation

A rule could be developed which would be based on total lack of participation as the
test for noninvolvement (or disinterest).

Observation of six interviews by students at Cleveland State University of purported
clients seeking to form a close corporation elicited from the clients the desire to have a veto
over such transaction in five of six cases.

It has frequently been argued that the alternate solution for such disagreements is
dissolution, again the partnership solution. See Hetherington, Trends in Legislation for
Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and
have been made for the disposition of the Cleveland Stadium Corporation\textsuperscript{133} or some settlement could have been arrived at between the disagreeing shareholders. Importantly, it would have reserved the decision making to the participants in the enterprise rather than to the uncertain concept of “fairness” as applied by the judiciary.

The existence of a statute providing a fixed rule, not dependent on proof of fairness, e.g.:

Unless otherwise provided by the Articles of Incorporation, no contract or other transaction between a corporation and one or more of its directors shall be valid without the approval of a majority of the shareholders of the corporation, who are not parties to the transaction, after disclosure concerning both the conflict of interest and the transaction,\textsuperscript{134}

would also serve the ends of initial planning. In the case of the Cleveland Browns Football Company, the parties were undoubtedly represented in the formation of the corporation and subsequent shareholder arrangements. The existence of a fixed provision could have served as a signal to counsel to provide a rule for future transactions.

\textbf{IX. CONCLUSION}

The \textit{Gries} case demonstrates that statutory provisions relating to conflict of interest transactions which focus on approval of disinterested participants at the director level do not serve the close corporation well. They, in fact, serve only to defer the decision with respect to any disputed transaction to a judicial determination of fairness for which there is little in the way of objective guidelines in the close corporation setting. Although a rule prohibiting such transactions unless approved by the non-participating shareholders may produce minority rule, it is preferable to have a rule of easy application rather than rules which are impossible of application and uncertain of result. The inclusion in modern corporation laws of a rule similar to that of partnership law prohibiting such transactions unless the parties provide to the contrary in the articles, bylaws or separate contract would have the virtue of certainty and reflect, as well, the wishes of most close corporation participants, who would be free to contract to the contrary if they choose.

\textsuperscript{133} As to later proposed alternative transactions see \textit{supra} note 93.

\textsuperscript{134} \textit{Cf.} A.L.I., \textit{Principles of Corporate Governance} §10 (Tent. Draft No. 5 1986).