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CONFLICT OF INTEREST TRANSACTIONS: FIDUCIARY DUTIES OF CORPORATE DIRECTORS WHO ARE ALSO CONTROLLING SHAREHOLDERS

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I. INTRODUCTION

On July 1, 1978 Colorado joined the increasing number of states which have enacted corporation codes based on the 1969 edition of the Model Business Corporation Act.[1] One of the most important changes effected by the new code is contained in section 7-5-114.5 of the Colorado Revised Statutes.[2] This section deals with director conflict of interest transactions, and delineates the manner in which such transactions may be validated.[3] The statute is a legislative attempt to establish uniformity of treatment for conflict of interest situations and to resolve confusion in the area created by case law.[4]

Section 7-5-114.5, however, does not control all possible conflict of interest situations. For example, it does not control the conflict which occurs

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1. COLO. REV. STAT. §§ 7-5-101 to -118 (Supp. 1978) based on Model Business Corp. Act prepared by the Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association (1969). For jurisdictions which have passed the same or similar statute, see, *e.g.*, DEL. CODE ANN. tit. 8, § 144 (1975); FLA. STAT. ANN. § 607.124 (West 1976); IND. CODE ANN. § 23-1-10-5 (Burns 1978); IOWA CODE ANN. § 496A.34 (1962) (as amended, 1976); KAN. STAT. ANN. § 17-6304 (1971); ME. REV. STAT. ANN. tit. 13-A, § 717 (1974); MICH. COMP. LAWS ANN. § 450.1545-.1546 (1973); NEB. REV. STAT. § 21-2040.01 (1977); N.Y. BUS. CORP. LAW § 713 (McKinney 1971); OHIO REV. CODE ANN. § 1701.60 (Page 1978); OR. REV. STAT. § 57.265 (1975); R.I. GEN. LAWS § 7.1.1 to 37.1 (1970); VA. CODE § 13.1-39.1 (1975); W. VA. CODE § 31-1-25 (1976); WIS. STAT. ANN. § 180.355 (West 1972).

2. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978) reads:

> Director—Conflicts of Interest. (1) No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association, or entity in which one or more of its directors are directors or officers or are financially interested shall be either void or voidable solely because of such relationship or interest or solely because such 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 solely because their votes are counted for such purpose if:
>
> (a) 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 consents sufficient for the purpose without counting the votes or consents of such interested directors; or
>
> (b) The fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve, or ratify such contract or transaction by vote or written consent; or
>
> (c) The contract or transaction is fair and reasonable to the corporation.
>
> (2) 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. (Added by H.B. 1245, L. '77, eff. 7-1-78).

3. *Id.*

4. C. Mauer & Giacomini, *The 1977 Revisions to the Colorado Corporation Code*, 7 COLO. LAW. 911, 918 (1978).

when a director who is also a controlling shareholder purchases the assets of the corporation prior to liquidation. This article will analyze to what extent the new statute controls such a situation and to what extent traditional case law must be relied upon.

Prior to addressing this specific issue, the general fiduciary duties owed to a corporation by directors who are also majority or controlling shareholders will be reviewed. It is also necessary to examine Colorado's historic conflict of interest rules governing corporate fiduciaries since some are applicable today in conflict of interest situations not covered by statute.

While the Colorado statute is the focal point of this article, the analysis is equally applicable to other jurisdictions having enacted similar conflict of interest statutes.

II. General Fiduciary Duties of Directors, Officers, and Majority or Controlling Stockholders

A. *Application of Trust Law to Corporations*

It is axiomatic in Colorado, as elsewhere, that directors and officers occupy fiduciary relationships to the corporation. Moreover, all three — directors, officers, and the corporation — occupy a fiduciary relationship to the collective body of stockholders.[5] Colorado courts, in determining the nature and extent of this fiduciary relationship, have consistently held that directors and officers are trustees with the corporate assets as the res of the trust and the stockholders as beneficiaries.[6] Therefore, the duties and responsibilites which are concomitant with this relationship are the same as those a trustee owes to his trust and its beneficiaries.[7] One such case, *Burchhalter v. Myers*,[8] held directors to be trustees on the basis of the corporate statutory law of the day,[9] which used the terms trustee and director interchangeably.[10] Courts today could reach the same conclusion for the Uniform Fiduciaries Act defines a fiduciary as both a trustee of an express trust and a director or officer of a corporation.[11]

5. *See, e.g.*, Whatley v. Wood, 157 Colo. 552, 404 P.2d 537 (1965); Rosenthal v. Four Corners Oil & Mineral Co., 157 Colo. 136, 403 P.2d 762 (1965); Hudson v. American Founders Life Ins. Co. of Denver, 151 Colo. 54, 377 P.2d 391 (1963); Morgan v. King, 27 Colo. 539, 63 P. 416 (1900); Great United Corp. v. Great Producers Coop., 41 Colo. App. 34, 588 P.2d 380 (1978); Wright v. Bayly Corp., 41 Colo. App. 313, 587 P.2d 799 (1978); Mosher v. Sinnott, 20 Colo. App. 454, 79 P. 742 (1905). At the federal level, *see, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972).

6. *See, e.g.*, Whatley v. Wood, 157 Colo. at 558, 404 P.2d at 540 (1965); Kullgren Navy Gas & Supply Co., 110 Colo. 454, 461, 135 P.2d 1007, 1011 (1943); Morgan v. King, 27 Colo. at 553, 63 P. at 421 (1900); Great W. United Corp. v. Western Producers Coop., 349 Colo. App. at 353, 588 P.2d at 382 (1978); Mosher v. Sinnott, 20 Colo. App. at 456, 79 P. at 743 (1905).

7. Whatley v. Wood, 157 Colo. at 558, 404 P.2d at 540 (1965); Hudson v. American Founders Life Ins. Co. of Denver, 151 Colo. at 58, 377 P.2d at 395 (1963); Fishel v. Goddard, 30 Colo. at 153, 69 P. at 607 (1902); Morgan v. King, 27 Colo. at 553, 63 P. at 421 (1900); Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. 545, 130 P. 1037 (1913); Mosher v. Sinnott, 20 Colo. App. at 558, 79 P. at 743 (1905).

8. 85 Colo. 419, 276 P. 972 (1929).

9. Colorado Compiled Laws §§ 2263-64, 2267-68, 2270 (1921) (current version at COLO. REV. STAT. tit. 7, "Corporations and Associations").

10. 85 Colo. 419, 276 P. 972.

11. COLO. REV. STAT. § 15-1-103 (1973).

Frequently, based on this assumption that directors are trustees, Colorado courts have applied trust law to determine the extent of the director's duty, what constitutes breach of that duty, and the extent of his liability.[12] The reliance on trust law in dealing with officers and directors is to emphasize the duty and implied obligations of fidelity owed by them to the corporation.[13]

B. *Duties of Good Faith and Undivided Loyalty*

Among the plethora of fiduciary duties imposed on a director, two of the most important (and the two most often breached in a conflict of interest situation) are the duty to act honestly and in good faith and the duty of undivided loyalty to the corporation. The latter involves the duty to administer the corporation fairly and solely in the interest of the corporation and the stockholders, and to communicate to the stockholders and the corporation all the material facts in connection with a particular transaction which the trustee knows or shall know.[14] In analyzing these two duties, the Tenth Circuit has held that mere honesty of purpose was not enough to test the propriety of the directors' conduct since their obligation was fiduciary in character and not merely to abstain from fraud. The test was expressed as follows:

> The standards of conduct for a trustee rise far above the ordinary morals of the market place. Not honesty alone, but a punctilio of honor, the most sensitive is then the standard behavior required of a trustee. He must completely efface self-interest. His loyalty and devotion to this trust must be unstinted. Its well being must always be his first consideration.[15]

Theoretically, these two duties are separate and distinct. In practical application, however, they regularly tend to overlap, for a breach of the duty of good faith invariably involves a breach of the duty of loyalty and vice versa. Hence, courts, including Colorado courts, have a tendency to discuss them in the same breath, making it difficult to analyze them separately.

In Colorado, the duties of good faith and loyalty that directors owe to the corporation and to the stockholders were first enunciated in *Kullgren v. Navy Gas & Supply Co.*[16] The supreme court, responding to a transparent

12. Whatley v. Wood, 157 Colo. at 558, 404 P.2d at 540 (1965); Hudson v. American Founders Life Ins. Co., 151 Colo. at 58, 377 P.2d at 395 (1963); Fishel v. Goddard, 30 Colo. at 153, 69 P. at 609 (1902); Morgan v. King, 27 Colo. at 553, 63 P. at 421 (1900); Glengary Consol. Mines v. Boehmer, 28 Colo. 1, 62 P. 839 (1900); Wright v. Bayly Corp., 41 Colo. App. at 315, 587 P.2d at 801 (1978); Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. at 550-51, 130 P. at 1039 (1913); Mosher v. Sinnott, 20 Colo. App. at 558, 79 P. at 743 (1905).

13. *See* Morgan v. King, 27 Colo. at 539; 63 P. at 416 (1900); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 840 (1975).

14. HENN, CORPORATIONS §§ 235-38 (1970); *see* RESTATEMENT (SECOND) OF TRUSTS § 170 (1957).

15. United States v. Gates, 376 F.2d 65, 77 (10th Cir. 1967) (relying on Meinhard v. Salmon, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928) (Cardozo, J.)).

16. 110 Colo. at 454, 135 P.2d at 1007 (1943). In *Kullgren*, the director and president of a corporation, along with the other directors, attempted to effectuate an exchange of shares between the defendant corporation, Navy Gas & Supply Co., and another corporation, The Grand Co. Eighteen shares of the Navy Gas & Supply Co. were to be exchanged for 50 shares of The Grand Co., thereby causing The Grand Co. to become a wholly-owned subsidiary. The

stock exchange scheme between related corporations, perpetrated solely to maintain certain directors in their lucrative positions, held:

> A director of a corporation is in the position of a fiduciary. . . . [H]e owes loyalty and allegiance to his corporation, a loyalty that's undivided and an allegiance that is influenced in action by no other consideration other than the welfare of the corporation. He is held in official action, to the extreme measure of candor, unselfishness and good faith. Those principles are rigid, essential and salutory. . . . The directors of a corporation act in a strictly fiduciary capacity. Their office is one of trust and they are held to the high standard of duty required of trustees.[17]

In addition, directors in Colorado are required to "manage the corporate affairs in good faith . . . . and give the corporate entity the benefit of their best judgment and care" and skill and act only in the interest of the corporation.[18] The directors must also impartially administer the corporate affairs for the good and benefit of all the stockholders and the corporation. They therefore have the duty placed upon them not to abridge the rights of the shareholders either individually or collectively,[19] and they are held to the highest degree of honesty.[20]

More specifically, Colorado courts have held that directors as trustees have the following duties: (1) not to profit at the expense of the corporation or stockholders,[21] (2) not to speculate with corporate property[22] or use corporate property or their relation to it for personal gain,[23] (3) not to secure a private advantage through the use of official powers at the expense of the corporation,[24] and (4) not to deal with corporate property in a personal

problem, however, was that all of the directors of The Grand Co., except for the one proposing the sale, were the directors of the Navy Gas & Supply Co. With The Grand Co. receiving the 18 shares of the Navy Gas & Supply Co., the directors, combining those shares with the shares they personally owned, would then have had a majority of the stock of Navy Gas & Supply Co. under their control, and therefore would be able to maintain their lucrative jobs as directors of the Navy Gas & Supply Co.

17. *Id.* at 461, 135 P.2d at 1010 (citing Turner v. American Metal Co., 36 N.Y.S.2d 356, 369). This language was used again by the Colorado Supreme Court in *Hudson v. American Founders Life Ins. Co.* to establish that the president and director of American Founders had breached his fiduciary duty by causing to be issued 15,000 shares of American Founders stock worth $2.00 a share and exchanging them for shares of dubious or worthless value of the Texas Adams Oil Co., of which he was also a director.

18. Herald Co. v. Seawell, 472 F.2d 1081, 1094 (10th Cir. 1972).

19. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. at 145, 403 P.2d at 765 (1965); Kullgren v. Navy Gas & Supply Co., 110 Colo. at 461, 135 P.2d at 1010 (1943); Laybourn v. Wrape, 72 Colo. 339, 343, 211 P. 367, 369 (1922); Wright v. Bayly Corp., 41 Colo. App. at 351, 587 P.2d at 800 (1978).

20. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. at 145, 403 P.2d at 767 (1965); Kullgren v. Navy Gas & Supply Co., 110 Colo. at 462, 135 P.2d at 1010 (1943); Laybourn v. Wrape, 72 Colo. at 343, 211 P. at 369 (1922). *See also* Monroe v. Scofield, 135 F.2d 725, 726 (10th Cir. 1943).

21. Dunnet v. Arn, 71 F.2d 912 (10th Cir. 1934); Davis v. Pearce, 30 F.2d 85 (8th Cir. 1928); Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. at 145, 403 P.2d at 766 (1965); Wright v. Bayly Corp., 41 Colo. App. at 315, 587 P.2d at 800 (1977).

22. Whatley v. Wood, 157 Colo. at 559, 404 P.2d at 538 (1965); Fishel v. Goddard, 30 Colo. at 153, 69 P. at 609 (1902).

23. Wright v. Bayly Corp., 41 Colo. App. at 315, 587 P.2d at 801 (1978).

24. Rosenthal v. Four Corners Oil & Mineral Co., 157 Colo. at 143, 403 P.2d at 766 (1965); Kullgren v. Navy Gas & Supply Co., 110 Colo. at 462, 135 P.2d at 1010 (1943).

transaction without the approval of the shareholders.[25] Finally, the Tenth Circuit has held that a director has the duty not to elevate his interests above those of the corporation or the stockholders, but instead he must place the performance of his duties above his personal interests.[26]

If a transaction involves the sale of corporate assets, it is a breach of trust for the director to sell the property at an inadequate price. As trustee, the director has a "duty to determine the fair value of the trust property before selling it, and any sale of it for an inadequate consideration measured against its fair value may be subject to being set aside as constructive fraud upon proper complaint being made."[27]

C. *Application of Fiduciary Duties to Controlling Stockholders*

Fiduciary obligations are not confined solely to directors and officers. Majority, dominant, or controlling stockholders are also said to occupy a fiduciary relationship to the corporation and to the minority stockholders.

A "controlling stockholder" as defined by the case law, does not necessarily have to own a majority of the voting stock of the corporation. Rather he is deemed to be controlling because no other person owns a greater percentage of voting stock in the corporation, and therefore, the larger stockholder is able to exert considerable influence over the policies and future of the corporation.[28]

Even though "controlling stockholder" is an inexact term, it has been defined as conferring on the corporate stockholder the power to "direct corporate policy," and as endowing him with "considerable patronage."[29] Practical or working control of the corporation exists where a stockholder or group of stockholders has the power to elect the board of directors because of ownership of a large block of shares. Such control occurs even though in terms of aggregate shares outstanding the block constitutes a minority, if the remaining shares are widely scattered. A stockholder who owns only twenty-three percent of the voting stock of a corporation will have share control of the corporation as a practical matter if no other stockholder owns more.[30]

The Securities and Exchange Commission defines control as follows:

> The term "control" (including the terms "controlling," "controlled by," and "under common control with") means the possession, directly or indirectly of the power to direct or cause the direction of the management and policies of a person whether through the

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25. Crymble v. Mulvaney, 21 Colo. 203, 40 P. 499 (1895).

26. United States v. Gates, 376 F.2d 65, 77 (10th Cir. 1967).

27. Whatley v. Wood, 157 Colo. 552, 404 P.2d 537, 541 (1965).

28. *See, e.g.*, Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962); Perlman v. Feldman, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); Gottesman v. General Motors Corp., 279 F. Supp. 361 (S.D.N.Y. 1967); Insuranshares Corp. of Del. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940).

29. Gottesman v. General Motors Corp., 279 F. Supp. at 368 (S.D.N.Y. 1967).

30. *See* Essex Universal Corp. v. Yates, 305 F.2d at 575 (2d Cir. 1962); Perlman v. Feldman, 219 F.2d at 174 n.1 (2d Cir. 1955); Gottesman v. General Motors Corp., 279 F. Supp. at 368-69 (S.D.N.Y. 1967); Insuranshare Corp. of Del. v. Northern Fiscal Corp., 35 F. Supp. at 24 (E.D. Pa. 1940).

ownership of voting securities, by contract or otherwise.[31]

The case law dealing with the issue of control under the Securities and Exchange Act have made it clear that "indirect means of discipline or influence" need not be stock ownership. It may arise from a myriad of factors including other business relationships, interlocking directorships, and family relationships. Furthermore, a controlling person need not be the only person or entity with "direct means of discipline or influence."[32] Federal cases dealing with securities violations further define a controlling person as any person who has the power to control, either directly or indirectly, the direction, management, and policies of a corporation whether by agreement, ownership, or stock or de facto control of the officers and directors of the corporation.[33]

In federal courts, the two landmark decisions which established that controlling or dominant stockholders are fiduciaries are *Pepper v. Litton*,[34] and *Southern Pacific Co. v. Bogert*.[35] *Southern Pacific* dealt with three interlocking corporations with Southern Pacific Co. dominating Houston & Texas Central Railroad by electing its directors and officers through a subsidiary which owned a majority of the Houston & Texas Central Railroad stock. In 1888, the Houston & Texas Central Railway was reorganized with all of its new stock going to the Southern Pacific Co. The minority stockholders in this transaction received nothing. In 1913, the minority stockholders brought suit to have the Southern Pacific Co. declared trustee for them of stock in the new Houston & Texas Central Railway Co. and for an accounting. The minority stockholders brought suit only against the Southern Pacific Co. and not against its subsidiary. The wrong complained of consisted of not sharing with the minority the proceeds of the common property of which Southern Pacific Co., through its majority holding, had gained control. In upholding the federal district court's decision for the plaintiffs, the Supreme Court stated:

> The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers or directors. If through that control a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale.[36]

Pepper v. Litton[37] involved the disallowance by a trustee in bankruptcy of a judgment obtained by the dominant and controlling stockholder (who was also president and board member) of the bankrupt corporation on alleged salary claims. The evidence supported the claim that the dominant stock-

31. 17 C.F.R. § 240.12(b)-2(f) (1979).
32. Harriman v. DuPont DeNemours & Co., 372 F. Supp. 101, 105 (D. Del. 1974). *See also* Klapmeier v. Telecheck Int'l, Inc., 315 F. Supp. 1360 (D. Minn. 1970).
33. Christoffel v. E.F. Hutton & Co., 558 F.2d 665 (9th Cir. 1978); Kennedy v. Tallant, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) § 95779; Rochez Bros., Inc. v. Rose, 527 F.2d 880 (3d Cir. 1975); Lanza v. Drexel Co., 479 F.2d 277 (2d Cir. 1973).
34. 308 U.S. 295 (1939).
35. 250 U.S. 483 (1919).
36. *Id.* at 487-88.
37. 308 U.S. 295 (1939).

holder had obtained the confession of judgment of his salary in the amount of $33,468.89 and employed other manipulative devices in order to avoid the payment of a debt on a lease. The Supreme Court upheld the trustee in bankruptcy's disallowance of the judgment and further held that the bankruptcy court, in allowing or disallowing the claim in issue, was also able to apply the equitable rules pertaining to fiduciaries because "a director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust . . . . [f]or that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation — creditors as well as stockholders."[38]

Three major federal court of appeals cases further cemented this principle in federal corporate law: *Perlman v. Feldman*,[39] *Zahn v. Transamerican Corp.*,[40] and *Seagrave Corp. v. Mount*.[41] All three cases dealt with transactions in which the dominant stockholder was interested, and all three relied on the above-mentioned Supreme Court cases to establish that dominant or controlling stockholders are fiduciaries.

The Tenth Circuit also unequivocally adhered to this position by holding that "[a] director of a corporation occupies a fiduciary relationship to the corporation and its stockholders, and a dominant or controlling stockholder or a group of stockholders occupies a fiduciary relationship to the minority stockholders.[42]

Colorado case law is consistent with this position.[43] The principle that *majority* stockholders have a duty to minority stockholders is by no means of recent origin in Colorado. In 1900, the Colorado Supreme Court in *Glengary Consolidated Mines v. Boehmer*[44] held that majority stockholders, in certain sit-

38. *Id.* at 307-08 (citations omitted).

39. 219 F.2d at 173 (2d Cir. 1955).

40. 162 F.2d 36 (3d Cir. 1947).

41. 212 F.2d 389 (6th Cir. 1934).

42. United States v. Gates, 376 F.2d at 77 (10th Cir. 1967). *See* Wheeler v. Abeline Nat'l Bank Bldg. Co., 159 F. 391 (8th Cir. 1908).

43. *See* Wright v. Bayly Corp., 41 Colo. App. 34, 587 P.2d 799; Security Nat'l Bank v. Peters, Writer & Christensen Inc., 39 Colo. App. 344, 569 P.2d 875 (1977).

44. 28 Colo. 1, 62 P. 839 (1900). This early litigation involved the Ibex Corporation gaining control of the Glengary Consolidated Mines Company by purchasing a majority of its stock and electing its directors. Ibex' purpose in securing control of the Glengary Company was to secure a bond and a lease on Glengary property which adjoined property of Ibex. Ibex secured a contract of this nature on its own terms and conditions through the directors it had elected. The court held the transaction void and in doing so, said:

> Ordinarily, the majority of the stockholders of a corporation have the right to control its affairs, but this right is limited to the legitimate exercise of the corporate powers. Among these is the management of the affairs of the corporation through its proper representatives and officials in the interest of all shareholders. *Meeker v. Winthrop Iron Co.*, 17 F. 48 (W.D. Mich. 1886) *rev'd* 122 U.S. 635 (1887). No combination of stockholders of a corporation less than the whole will be permitted to manage or control its affairs in their interest alone. Minority stockholders cannot be deprived of their rights by such a combination [of majority stockholders] under the guise of a policy of the corporation dictated by the majority. So far as the rights of the minority are concerned, the majority, in furtherance of their plan to reap a benefit to themselves through a transaction in which the minority do not participate, become the corporation itself, and assume the trust relation occupied by the corporation towards its stockholders.

uations, occupy the position of trustee not only toward the corporation but also toward the remaining stockholders.

The current leading Colorado case in this area is *Security National Bank v. Peters, Writer, & Christensen Inc.*,[45] which involved an alleged breach of fiduciary duties by the corporate directors against the preferred shareholders. The action complained of was the refusal of the directors to redeem the preferred shares of the stockholders even though they had already made the decision to dissolve. Additionally, the preferred shareholders were not notified of the stockholder meeting at which the decision to dissolve was made nor given the opportunity to vote on the proposition nor given an opportunity to file written objections or demands for the payment of the fair value of their shares as required by statute.[46] The directors did not wish to redeem the preferred shares because to do so would have required selling certain stock which the directors believed would increase in value. Interestingly, any such increase in value would inure only to the benefit of the common stock shareholders (the directors), for the preferred shareholders were limited by the articles of incorporation to receiving a fixed amount upon liquidation plus accumulated and unpaid dividends. In holding the directors' failure to redeem their preferred stock as constructively fraudulent and a breach of fiduciary duty, the court stated:

> Further, we note that together the four directors (including the third party defendant) owns 64,000 shares of the common voting stock. This was a substantial amount when contrasted to the total outstanding of 96,000 voting shares. Thus, in addition to the fiduciary duties they owed as directors, they also owed fiduciary duties to the preferred stockholders because of their dominant and controlling stock ownership.[47]

These fiduciary duties were not imposed on controlling or majority stockholders by virtue of their influential stock ownership alone. On the contrary, the majority rule holds that a dominant or majority stockholder does not become a fiduciary for other stockholders unless he steps out of his role as a stockholder and begins to "usurp the functions of the director in the management of corporate affairs."[48] The stockholder must assert active influence in control of corporate affairs in order to be deemed a fiduciary. The mere fact that a stockholder owns twenty-three percent of the stock "and is considered to be controlling and influential because no other stockholder owns an equal or greater percentage" and by the use of that stock elects several of its nominees as directors is not enough to make him a fiduciary when the directors so elected act independently of the stockholder.[49]

If a dominant or majority stockholder does undertake to control the

45. 39 Colo. App. 344, 569 P.2d 875 (1977).

46. COLO. REV. STAT. § 31-5-13 (1963) (now COLO. REV. STAT. § 7-5-112 (Supp. 1978)).

47. 39 Colo. App. at 352-53, 569 P.2d at 881 (1977). As recently as September 1978, the Colorado Court of Appeals reaffirmed the principle that "[t]he directors of a corporation and its controlling stockholders also owe fiduciary duties to the remaining stockholders." Wright v. Bayly Corp., 41 Colo. App. 313, 587 P.2d 799 (1978).

48. Gottesman v. General Motors Corp., 279 F. Supp. at 384 (S.D.N.Y. 1967).

49. *Id. See also* Perlman v. Feldman, 219 F.2d at 173 (2d Cir. 1955); Harriman v. E.I. DuPont DeNemours & Co., 372 F. Supp. 101 (D. Del. 1954).

corporation by dominating the corporation's transactions and management through a board of directors which he has elected, or if the majority stockholder becomes a director or officer, then he is said to also be a trustee.[50]

Although it is not clear to what extent Colorado will impose fiduciary duties on a passive controlling or majority stockholder, Colorado law is consistent with the majority rule that dominant or majority stockholders who are also directors or who also undertake to control the destiny of the corporation are held to the same fiduciary duties as directors and officers when voting such majority or controlling interest.[51] In *Glengary Consolidated Mines* the Colorado Supreme Court specifically held:

> In arranging the price and terms for this property the Ibex Company was acting for itself and not for the interest of the Glengary Company. Ostensibly the contract was by the latter, but, in fact, it was one which the Glengary Company was compelled to accept at the instance of the Ibex Company . . . . [B]eing in control of the affairs of that company for this very purpose it [the Ibex Company] occupied the relation which that company did to its stockholders, *i.e.*, their trustee. The subject-matter of this contract was the property of which it was trustee and in which the shareholders of Glengary Company, including the minority, were interested as cestui que trustent.[52]

Due to the fact these controlling stockholders are equated to directors or officers, they are then, in *all* of their corporate actions, held to the same high standard of good faith, undivided loyalty, and fairness. For example, they are trustees both in their actions as directors and in their actions as shareholders.[53] The applicable standard that the dominant stockholder is held to in these situations, in most jurisdictions, is one of absolute good faith, including the requirements that the stockholder dedicate his uncorrupted business judgment to the sole benefit of the corporation and act in all things of trust wholly for the benefit of the corporation and stockholders.[54] Like directors and officers he is also under the duty to protect the corporation's interest and to avoid exalting his own interests above those of the corporation or its shareholders. He cannot use his power for his personal advantage to the detriment of the stockholders.[55]

The Tenth Circuit has also enunciated a standard of care for dominant

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50. Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941); Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919); Bayliss v. Rood, 424 F.2d 142 (4th Cir. 1970); Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1965); Mount v. Seagrave Corp., 212 F.2d 389 (6th Cir. 1954). *See generally* HENN, CORPORATIONS § 240 (2d ed. 1970).

51. Glengary Consol. Mines v. Boehmer, 28 Colo. at 4, 62 P. at 839-40 (1900) (corporation which gained majority control of another corporation elected dummy directors in order to secure a lease for certain valuable corporate property); Wright v. Bayly Corp., 41 Colo. App. 313, 587 P.2d 799 (1978); Security Nat'l Bank v. Writer, Peters & Christensen Inc., 39 Colo. App. at 352-53, 569 P.2d at 881 (1977) (directors were also controlling stockholders).

52. 28 Colo. at 4, 62 P. at 839-40 (1900).

53. *Id.* at 4, 62 P. at 839-40. *See also* Pepper v. Litton, 308 U.S. 295 (1939); Southern Pac. Co. v. Bogert, 250 U.S. at 483 (1919).

54. Perlman v. Feldman, 219 F.2d at 176 (2d Cir. 1955).

55. Northway, Inc. v. T.S.C. Indus., Inc., 512 F.2d 324 (7th Cir. 1975), *rev'd on other grounds*, 426 U.S. 438 (1976); Farber v. Sevan Land Co., 393 F. Supp. 633 (S.D. Fla. 1974).

stockholders in the case of *United States v. Gates*.[56] The basis of that action was the transfer of substantial amounts of stock of the Gates Rubber Company into an irrevocable trust for eighteen to twenty years. The income of said stock was to be paid to the Gates Foundation, a charitable organization, with the remainder to go to the lineal descendants of the trustors. The settlors of the trust were two members of the Gates family which owned 97.6% of the stock of the Gates Rubber Company. The Internal Revenue Service challenged the transaction, claiming that the settlor should not be allowed a charitable deduction because of the possibility that the foundation would not receive any beneficial interest in the stock.[57] In making this argument the IRS relied, *inter alia*, on the contention that since the directors of the corporation and the owners of practically all of the stock were members of the Gates family, and the trust would ultimately inure to the benefit of the lineal descendants of the Gates family, the corporation might pass dividends and accumulate earnings for twenty-one years in order to benefit the remaindermen of the trust.[58] The Tenth Circuit held this contention to be untenable due to the facts and circumstances surrounding the transfer (such as the history of the directors to declare and pay dividends, the risk of accumulated earnings tax, the large reduction in income of the members of the Gates family each year a dividend was passed). It further held that even though the determination of whether a dividend would be declared was within the discretion of the board of directors, that discretion was limited in that it had to be honestly exercised for the good and benefit of the corporation and its stockholders.[59] Moreover, the court stated:

> Here the members of the Gates family form a dominant group of stockholders of the corporation, and they and the directors whom they elect control the corporation. It follows that the directors, in their official capacity and as members of such dominant group of stockholders, occupy a fiduciary relationship to the holders of minority stockholder interests, and that they owe a duty to exercise their powers as directors with unbending fidelity to their cestuis que trust and to manage the affairs of the corporation in a way that will be fair and impartial between the Gates family group, as majority stockholders, and the foundation and other holders of minority stock interests and not to the personal advantage of themselves or other members of the Gates family as to the disadvantage or detriment of the foundation and other holders of minority stock interests.[60]

In terms of scope, this standard for dominant or controlling stockholders is not unlike the rule in California which requires "that the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling

56. 376 F.2d 65 (10th Cir. 1967).
57. *See* Treas. Reg. 1.10-1(e) (1954).
58. United States v. Gates, 376 F.2d at 76 (10th Cir. 1967).
59. *Id.* at 77. The court further supported its holding by examining the facts and circumstances surrounding the transfer, such as the history of the directors to declare and pay dividends, the risk of accumulated earnings tax, the large reduction of income of the members of the Gates family each year a dividend was passed.
60. *Id.* at 77.

shareholders in this state."[61]

Because fiduciaries occupy positions of trust, it is particularly easy for them to take advantage of the corporation and its stockholders without being discovered. For this reason, courts are inherently suspicious of transactions between corporations and their individual directors, and special rules have developed in these situations to insure that the corporation and its stockholders are protected.

III. Applicable Rules in Director or Controlling Shareholder Conflict of Interest Transactions

A. *Historical*

There was some confusion in Colorado at one time as to whether transactions between a corporation and its directors, between corporations having common directors, and between a corporation and an entity in which a director had a financial interest were void or merely voidable. By far, the weight of the case law is that these transactions are merely voidable.

Colorado case law divides transactions between a corporation and one of its directors into three distinct categories: (1) transactions involving corporate property (for example, real or personal property owned by the corporation, treasury stock or other securities owned by the corporation); (2) transactions not involving corporate assets, but in which the director still holds a direct and personal interest (for example, loans by a director to the corporation, transactions or contracts between the corporation and an entity in which the director is financially interested, or approval of the director's salary) and in which the director's presence is necessary to form a quorum and his vote is needed to effectuate the transaction; and (3) transactions not involving corporate assets, where there is a quorum of disinterested directors without the interested director's presence and the transaction is approved by a majority vote of the disinterested directors.

Colorado courts have held that transactions between a corporation and one or more of its directors involving corporate property are voidable at the option of the corporation because of the trust relationship notwithstanding proof that the director acted in good faith, with fairness, and without fraud; that he paid as much or more than what the property was worth; or that the transaction was in the best interest of the corporation.[62] This doctrine has been applied where the interested director took part in the transaction on behalf of the corporation, although the corporation was also represented by other directors or officers and his vote and consent were not necessary. It also has been applied where he took no part in the transaction on behalf of the corporation, but was at the time, by reason of his official position, under a duty to look out for the interests of the corporation.[63] This was the minor-

61. Jones v. H.F. Ahmanson & Co., 81 Cal. Rptr. 592, 602, 460 P.2d 464, 474, 1 Cal. 3d 93, 112 (1969).

62. Morgan v. King, 27 Colo. at 555, 63 P. at 421 (1900); Glengary Consol. Mining Co. v. Boehmer, 28 Colo. at 4, 62 P. at 840 (1900); Mosher v. Sinnott, 20 Colo. App. at 458, 79 P. at 743 (1965).

63. *See* cases cited *supra* note 62.

ity position at the time,[64] and the substantive distinction between this type of transaction and others involving corporate directors was the belief that corporate directors were the equivalent of trustees, and the corporate property was the equivalent of the res of the trust, and the stockholders were the equivalent of the beneficiaries.[65] Therefore, based on trust law:

> A trustee cannot deal with the trust estate in the matter where his interest would or might conflict with his duty to his *cestui que trust*. In all cases where, without the full knowledge and assent of the *cestui que trust*, he has assumed to act in the capacity of a vendor and vendee, the *cestui que trust* may avoid the transaction at his election. No question of the fairness or unfairness of such a transaction can be considered. . . .[66]

Where, however, the cestuis que trust, that is, the stockholders, have *unanimously* approved a transaction between a corporation and one of its directors involving corporate property, then the transaction will be upheld as against the stockholders and creditors so long as it was fair and did not involve any actual fraud.[67] This too is consistent with trust law, which provides that a trustee may purchase trust property without being liable for breach of his duty of loyalty if the following conditions are met: (1) the trustee does not induce the sale by taking advantage of his relation to the beneficiary or by other improper conduct, (2) the trustee makes full disclosure to the beneficiaries, and finally (3) the beneficiaries are all sui juris and unanimously consent to the sale.[68]

In transactions between a corporation and one of its directors which do not involve corporate assets, but which do require the director's presence to form a quorum and his vote to effectuate the transaction, the Colorado courts are divided as to whether the transactions are void or merely voidable. Clearly, under Colorado case law a director is disqualified from not only voting personally or by proxy in a transaction in which he had a personal interest, but also from being counted in order to determine if a quorum was present.[69] The philosophy behind this rule is two-fold: (1) regarding the constitution of a quorum, the courts believe that an interested director loses his character as a director and assumes that of a stranger, and therefore he

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64. The majority of jurisdictions have held that transactions entered into between a director and a corporation were valid if entered into with good faith and were fair if the corporation was represented by a majority of disinterested directors. The transaction was then not voidable by virtue of the relationship alone. 3 W. FLETCHER, *supra* note 13, at § 931. Where, however, the interested director's vote was needed to effectuate the transaction, it was voidable at the option of the corporation without regard to fairness because of the relationship. *Id.* at § 936.

65. *See generally* cases cited at note 62 *supra*.

66. Mosher v. Sinnott, 20 Colo. App. at 459, 79 P. at 743 (1965) (quoting Glengary Consol. Mining Co. v. Boehmer, 28 Colo. at 3, 62 P. at 839 (1900)).

67. Crymble v. Mulvaney, 21 Colo. 203, 40 P. 499 (1895).

68. A. SCOTT, THE LAW OF TRUSTS §§ 170, 170.1, 216 (3d ed. 1967).

69. Irwin v. West End Dev. Co., 342 F. Supp. 687 (D. Colo. 1972) (applying Colorado law); Colorado Management Corp. v. American Founders Life Ins., 145 Colo. 413, 359 P.2d 665 (1961); Laybourn v. Wrape, 72 Colo. 339, 211 P. 367 (1922); Gold Glen Mining, Milling & Tunneling Co. v. Stimson, 44 Colo. 406, 98 P. 727 (1908); Steele v. Gold Fissure Gold Mining Co., 42 Colo. 529 , 95 P. 349 (1908); Paxton v. Heron, 41 Colo. 147, 92 P. 15 (1907); Gumaer v. Cripple Creek Tunnel, Transp. & Mining Co., 40 Colo. 1, 90 P. 81 (1907); Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. 545, 130 P. 1037 (1913).

cannot be counted as part of the quorum;[70] and, (2) regarding voting by the director on the contracts or transactions, the courts have held that "[a] director cannot with propriety vote in [*sic*] the board of directors on a matter affecting his own private interest any more than a judge could sit on his own case. . . ."[71] Moreover,

> [t]he relation of a director to the corporation which he represents in that capacity is fiduciary, and for this reason the law forbids him from making a contract in which his private interests may conflict with the interests of his principal. He cannot unite his personal and representative character in the same transaction.[72]

At this juncture, the courts appear to be divided. The most recent Colorado Supreme Court case dealing with this type of transaction, however, held that a contract between two corporations having common directors or officers is *voidable* by nature of the relationship alone, irrespective of fairness, if the vote of the common member or members is *necessary* to form a quorum of the board and to effectuate the contract.[73]

This decision differs from two much earlier supreme court cases which held that if an interested director was necessary to form a quorum any vote taken by the board of directors approving a suspect transaction was illegal for want of a quorum and therefore void.[74]

Finally, Colorado case law indicates that transactions between a director and his corporation, not involving corporate assets, are valid and binding on the corporation where there is a quorum of disinterested directors who, by a majority vote, approve the transaction. In *Steele v. Gold Fissure Gold Mining Corp.*,[75] the Colorado Supreme Court held invalid a transaction by the board of directors fixing salaries for two officers of the corporation who were also two of the three directors fixing the salary. In doing so, the court stated: "It is essential that the majority of the quorum of a board of directors be disinterested with respect to the matter voted upon in order to render it valid and binding upon the corporation."[76]

In *Burns v. National Mining, Tunnel & Land Co.*,[77] the court held that a promissory note given by a corporation to a partnership in order to secure a

70. Gumaer v. Cripple Creek Tunnel, Transp. & Mining Co., 40 Colo. 1, 90 P. 81 (1907); Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. 545, 130 P. 1037 (1913).

71. Colorado Management Corp. v. American Founders Life Ins. Co. of Denver, 145 Colo. 413, 419, 359 P.2d 665, 668 (1961) (quoting Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. at 550, 130 P. 1039 (1913).)

72. Steele v. Goldfissure Gold Mining Co., 42 Colo. at 531, 95 P. at 350 (1908).

73. Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. at 418, 359 P.2d at 668 (adopting the decision of Burns v. National Mining, Tunnel & Land Co., 23 Colo. App. 545, 130 P. 1037 (1973).

74. Gold Glen Mining, Milling & Tunneling Co. v. Stimson, 44 Colo. 406, 98 P. 727 (1908); Paxton v. Heron, 41 Colo. 147, 92 P. 15 (1907). This is due to the doctrine commonly held by the Colorado courts at that time which stated that the interested director was disqualified *by law* from being counted as part of the quorum, hence there could be no legal quorum assembled for the purpose of transacting business unless there were sufficient disinterested directors to form a quorum without counting the interested director. This is not true today under COLO. REV. STAT. § 7-5-114.5 (Supp. 1978). *See* note 80 *infra*.

75. 42 Colo. 529, 95 P. 349 (1908).

76. *Id.* at 532, 95 P. at 350.

77. 23 Colo. App. 545, 130 P. 1037 (1913).

loan was voidable at the option of the shareholders of the corporation because two of the four directors present and voting at the meeting authorizing the note were also members of the partnership. However, the court stated *inter alia*: "Where . . . a majority of the directors vote in favor of a resolution in which one member of the board has a personal interest, the resolution is not invalid by reason of that personal interest."[78] By having a disinterested board of directors represent the corporation and approve the transaction, the interests of the cestuis que trust were protected. The interested director was held not to have violated contract law which requires two persons to form a contract, nor did he violate the law of agency which prohibits an agent from representing and acting for himself and his principal in a transaction.[79]

B. *Scope and Effect of Section 7-5-114.5 of the Colorado Revised Statutes*

As noted previously, the enactment of section 7-5-114.5 of the Colorado Revised Statutes[80] and similar statutes in other jurisdictions is a legislative attempt to resolve the confusion created by the case law.[81] The scope of the statute, however, is limited to transactions (1) between a corporation and one or more of its directors, (2) between two or more corporations having directors or officers in common, and (3) between a corporation and an entity in which a director has a financial interest. The statute does not address the problem of majority shareholders entering into transactions with the corporation nor the problem of a director who enters into a transaction with his corporation and then ratifies the transaction by his vote as majority shareholder. Also, it only requires fairness to the corporation and not to the individual or minority stockholders.

The purpose of the statute is to establish guidelines for determining the validity of potential conflict of interest transactions and to eliminate the inequities and uncertainties caused by the existing rules while leaving undisturbed the power of the courts to deal with such matters under general equitable principles.[82] The statute will validate, if the prescribed tests are satisfied, a transaction with interested directors which the common law rules often made voidable or void.[83] It disposes of the technical case law rules related to quorums and voting by allowing an interested director to be counted in forming a quorum. Additionally, it establishes that the contract or transaction in which a director is interested is not void or voidable solely because of the director's interest or solely because he was present and voting on the transaction at a board of directors meeting, if the director's interest is disclosed or known to the directors whose authorization is sufficient without counting the vote of the interested director, or if such interest is disclosed or

78. *Id.* at 550, 130 P. at 1039. *See* Gumaer v. Cripple Creek Tunnel, Transp. & Mining Co., 40 Colo. 1, 90 P. 8 (1907).
79. Morgan v. King, 17 Colo. 539, 63 P. 416 (1900); Crymble v. Mulvaney, 21 Colo. 203, 40 P. 499 (1895); Mosher v. Sinnott, 20 Colo. App. 458, 79 P. 742 (1965).
80. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978).
81. *See* notes 1 & 4 *supra*.
82. ABA MODEL BUS. CORP. ACT ANN. 2d § 41, ¶ 2 (1971).
83. *Id.*

known to the shareholders who approve or ratify the contract or transaction, or if the contract or transaction is fair and reasonable to the corporation.[84]

Substantively, the statute eliminates the dichotomy between transactions which involve corporate assets and those which do not. Additionally, it eliminates the requirement (when read in conjunction with section 7-4-114)[85] that a transaction between a corporation and one of its director's involving corporate assets be approved by a unanimous vote of all the shareholders, by providing that the transaction will not be void or voidable if approved by a majority of the shareholders (or whatever vote is required by statute).[86] Finally section 7-4-114.5 eliminates the prohibition against dual representation by providing that a transaction will not be void or voidable even if a director votes on the transaction if it is fair to the corporation.[87]

Logically, however, when the statutory guidelines are not met, and therefore by definition the transaction is unfair, or the transaction has ramifications not covered by the statute (for example, where a majority shareholder is ratifying a transaction between himself either as director or as majority shareholder) or the concern is the fairness of the transaction to *minority* shareholders, then current rules of equity and law will control.[88]

The effect of the enactment of section 7-5-114.5 is better understood by analyzing separately the distinct sections of the statute within the context of the applicable case law and specific factual situations.

C. *Application of the Statute and Case Law*

1. Approval or Ratification by Disinterested Directors

In order to have a valid transaction when one or more of the directors is personally interested in the sale or contract being considered, the resolution by the board of directors must either be passed by a vote of the disinterested directors or the transaction must be ratified by the shareholders with full disclosure or the transaction must be fair to the corporation.[89] Section 7-5-114.5(1)(a) states that the approval by the board of directors of a contract or a transaction where one of the board of directors is interested in that transaction will not be void or voidable solely because of the relationship or interest if the relationship or interest is disclosed or known to the board of directors, and the board of directors approves of the transaction by a vote which is sufficient for that purpose without counting the votes or vote of the interested directors or director.

What constitutes a "vote sufficient for that purpose" is defined by section 7-5-106 of the Colorado Revised Statutes[90] which states that a majority of the aggregate number of directors of a corporation shall constitute a quo-

84. COLO. REV. STAT. § 7-5-114.5(1) (Supp. 1978).
85. *Id.* at § 7-4-114.
86. *Id.* at § 7-5-114.5(1)(b).
87. *Id.* at § 7-5-114.5(1)(c).
88. Mauer Jr. & Giacomini, *The 1977 Revisions to the Colorado Corporation Code*, 7 COLO. LAW. 910, 918 (1978).
89. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978).
90. *Id.* § 7-5-106.

rum for the transaction of business, and the acts of a majority of directors present at a meeting at which a quorum is present shall be the act of the board of directors.[91] This particular statutory provision is consistent with the prevailing law in a majority of jurisdictions as well as past Colorado case law.[92] As early as 1907 the Colorado Supreme Court upheld a resolution acknowledging a debt owed a director for extraordinary services rendered to the corporation by the director during his tenure as president where only three of the five directors voted on the resolution (one being absent, the other being the president who rendered the services).[93] The court in doing so stated: "In ordinary cases, when there is no other express provision, majority of the whole number of an aggregate body, who may act together, constitute a quorum, and a majority of those present may decide any question upon which they can act."[94] In other words, if a corporation had a total of four directors three would constitute a quorum; and in a meeting where only three directors were present, two directors would constitute a majority of that quorum and their concurring votes would be binding on the corporation.

Of equal importance is the fact that the case law establishing which directors may be counted in order to constitute a quorum has been substantially changed by the statute. Section 7-5-114.5(2) states that common or interested directors may be counted in determining the presence of a quorum at a meeting which authorizes, approves, or ratifies the transaction in which the director is interested. However beneficial this statute may appear, it also can have unanticipated adverse effects. As noted previously, section 7-5-106 requires a vote of the majority of directors *present* at a meeting at which there is a quorum in order to bind the corporation. Combining that provision with section 7-5-114.5(2) the result is that if an interested director is present at a meeting and is counted in order to determine if a quorum is present and then does not vote, he is in effect counted in the negative for the purpose of determining whether or not the resolution has been carried by a majority vote. Thus his presence could cause the resolution to fail. In other words, if a corporation has four directors (quorum being three) and all four are present and counted in determining a quorum, and two are interested in the transaction before the board and do not vote, then the resolution will fail because the votes of the other two directors do not constitute a majority of those present at the meeting.

In the same situation, if only three of the four directors are present, there is still a quorum. Even though one director is interested in the transac-

91. "This provision applies unless the act of a greater number is required by this code or the articles of incorporation or the bylaws." *Id.* at § 7-5-106.

92. *See generally* 3 W. FLETCHER, *supra* note 13, at § 419 for case law in other jurisdictions that are in accord with this principle. Many states resolved this problem by statute. IND. ANN. STAT. § 23-1-10-6 (Burns 1972); IOWA CODE ANN. § 496A.34 (West Supp. 1970); NEB. REV. STAT. § 21-2040 (1970); OR. REV. STAT. § 57.265 (1975); WIS. REV. STAT. ANN. § 180.35 (WEST SUPP. 1979).

93. Gumaer v. Cripple Creek Tunnel, Transp. & Mining Co., 40 Colo. at 11, 90 P. at 84 (1907).

94. *Id.* (quoting Sargent v. Webster, 54 Mass. (13 Met.) 497 (1847)).

tion and does not vote, the vote of the other two disinterested directors will be a majority of the quorum and will be sufficient to bind the corporation.

Nevertheless, in situations where there are not enough disinterested directors voting on a transaction between the corporation and one or more of its directors, the transaction will still not be void or voidable merely because some of the directors were interested, present, and voting if the transaction is ratified by a majority of the shareholders with full disclosure of the circumstances surrounding the transaction or if the transaction is fair and reasonable to the corporation.

2. Approval or Ratification by Stockholders of Corporation

Section 7-5-114.5(1)(b)[95] provides that a transaction between a director and his corporation will not be void or voidable solely because the director is present and votes at the meeting of the board of directors approving the transaction if the stockholders approve or ratify the transaction by the appropriate vote after full disclosure of the director's interest. This is merely the codification of the prior general rule in Colorado that voidable acts of directors and officers, for example, transactions between themselves and their corporation, can be ratified by the majority of stockholders who are disinterested in the transaction, and who act in good faith. Thereafter, as long as the transaction is fair, lacking in actual fraud, and fully disclosed, it is binding on strangers, the corporation, and the individual stockholders, including the nonconsenting minority.[96]

The statute does change, however, the requirement that transactions between a director and his corporation involving corporate property must be ratified by a unanimous vote in order to be binding.[97]

Although the statute merely requires disclosure of the director's interest, the general rule in Colorado and elsewhere is that there must be full disclosure of all of the facts and circumstances of the transaction, the terms of the contract, and, of course, the director's interest therein, for without full knowledge on the part of the ratifying general party, the ratification is ineffective and void.[98] Furthermore, notice and proxy materials sent to stockholders informing them of the meeting at which ratification of the transaction is to occur must state specifically that the purpose of the meeting is to ratify the particular transaction, and there must be approval by a spe-

95. COLO. REV. STAT. § 7-5-114.5(1)(b) (Supp. 1978).

96. Mountain States Packing Co. v. Curtis, 86 Colo. 355, 360, 281 P. 737, 739 (1929); *see* Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963). *See also* Pneumatic Gas Co. v. Berry, 113 U.S. 322 (1885); Omaha Hotel Co. v. Wade, 97 U.S. 13 (1877); Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

97. COLO. REV. STAT. §§ 7-4-115, 7-5-114.5 (Supp. 1978).

98. Hudson v. American Founders Life Ins. Co., 151 Colo. at 56, 377 P.2d at 397 (1963) ("ratification can never exist unless it is clearly shown that the party charged with ratification had full knowledge of all the material facts, and thereafter knowingly accepts and approves the contract."); Colorado Mangement Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 359 P.2d 665 (1961); Film Enterprises, Inc. v. Selected Pictures, Inc., 138 Colo. 468, 335 P.2d 260 (1959). *See also* United Hotels Co. of America, Inc. v. Mealy, 147 F.2d 816 (2d Cir. 1945); Hill Dredging Corp. v. Risly, 18 N.J. 501, 114 A.2d 697 (1955); State v. Keypoint Oyster Co., 64 Wash. 2d 375, 391 P.2d 979 (1964).

cific vote on the transaction rather than a blanket approval. In order to have a valid ratification the minutes of the meeting, and the proxy material sent to the shareholders, must show that there was full disclosure of all terms of the transaction or of the specific and exact terms necessary for an intelligent disposition of the matter (preferably the minutes should reflect a discussion of the transaction also).[99]

Finally the burden of proving ratification of a voidable contract, where the shareholder had full knowledge of all the material facts, is on the party alleging it.[100] But the rule appears to be that if there has been a valid ratification *by a majority of the stockholders who are disinterested* in the transaction, the burden of showing fraud or the unfairness of the transaction is on the one challenging it.[101]

Ratification of transactions, however, which are fraudulent, which cut off the rights of the minority stockholders, or which are oppressive to the minority are not binding, and the ratification will not preclude a court of equity from setting aside the transaction at the instance of an innocent minority stockholder.[102] This is but a logical requirement that all transactions between a corporation and one of its directors be fair, regardless of whether or not there has been ratification.[103] Further, this rule is not altered by the existence of section 7-5-114.5 which states that a contract between a corporation and one of its directors is not voidable "solely by virtue of" that interest or his voting on the transaction if the interest is disclosed and ratified by the stockholders.[104] The statute makes no provision for validating fraudulent acts; therefore, the traditional equitable rules apply. Of course, as noted earlier, a contract which is not fraudulent, but which is voidable for violating the rule that directors cannot enter into a contract for their own benefit without the knowledge and consent of the stockholders, may be ratified by the majority of the stockholders.[105] If there is actual fraud in the procurement of the ratification then it is not valid.[106]

Generally, the effect of a valid ratification by a majority of stockholders disinterested in the transaction is to render a transaction between a corpora-

99. Hudson v. American Founders Life Ins. Co., 151 Colo. at 66, P.2d at 397 (1963). *See generally* 3 W. FLETCHER, *supra* note 13, at §§ 983-984.

100. Film Enterprises, Inc. v. Selected Pictures, Inc., 138 Colo. at 468, 335 P.2d at 260 (1959). *See generally* 3 W. FLETCHER, *supra* note 13, at §§ 979-980.

101. Gropper v. North Cent. Tex. Oil Co., 35 Del. Ch. 198, 144 A.2d 231 (1955); Findanque v. American Marcaibo Co., 33 Del. Ch. 262, 92 A.2d 311 (1952).

102. Kerbs v. California E. Airways, 33 Del. Ch. 69, 90 A.2d 652 (1952); Findanque v. American Marcaibo Co., 33 Del. Ch. 262, 92 Ad. 311 (1952); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969); Chesapeake Const. Co. v. Rodman, 256 Md. 531, 261 A.2d 156 (1970); Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 862 (1952), *aff'd*, 12 N.J. 467, 97 A.2d 437 (1953); Russell v. Henry C. Patterson Co., 232 Pa. 113, 81 A. 136 (1911). *See generally* 3 W. FLETCHER, *supra* note 13, at § 983.

103. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. 136, 403 P.2d 762 (1965); Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963). *See also* Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969).

104. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978).

105. Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963); COLO. REV. STAT. § 7-5-114.5 (Supp. 1978); *see* Pollitz v. Wabash Ry., 217 N.Y. 113, 110 N.E. 721 (1912).

106. Mountain Packing Co. v. Curtis, 86 Colo. 335, 281 P. 737 (1929).

tion and one of its directors binding. Neither the corporation, individual stockholders, nor strangers can later sue to set it aside or otherwise attack its validity without showing actual fraud and unfairness.[107]

Special rules apply when the interested director is also the majority or a controlling stockholder. None of the cases analyzed dealt with a controlling stockholder; instead all dealt with majority stockholders who had a personal interest in the transaction. However, if the traditional rules concerning ratification do not apply because there is not a disinterested majority of stockholders voting due to the majority stockholders' interest, it is logical to assume that they would not apply where the resolution calling for ratification of a particular issue is only passed by counting the votes of an interested, controlling stockholder.

There is of course nothing to deprive a stockholder from voting on anything that properly comes before the stockholders on account of a personal interest in the transaction.[108] The general rule is, however, that such a ratification is not binding on the minority, nonvoting stockholders; the director or stockholder will still have the burden of proof to show that the transaction was fair.[109] Naturally, a director cannot effectively ratify as a stockholder his own acts as director which are fraudulent, a breach of fiduciary duty, or oppressive to the minority stockholders.[110]

Regardless of whether a transaction is ratified by disinterested share-

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107. Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963); Mountain Packing Co. v. Curtis, 86 Colo. 355, 281 P. 737 (1929). *See generally* Dimpfell v. Ohio & Miss. Ry., 110 U.S. 209 (1884); Pneumatic Gas Co. v. Berry, 113 U.S. 322 (1885); Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1876); Eastern Okla. Tel. Co. v. Ameco, Inc., 437 F.2d 138 (10th Cir. 1971); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969).

108. *See, e.g.*, Hodge v. United States Steel Corp., 64 N.J. 807, 54 A. 1 (1903); Beutelspacher v. Spokane Sav. Bank, 164 Wash. 227, 2 P.2d 729 (1931); Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S.E. 816 (1918); *cf.* Mountain Packing Co. v. Curtis, 86 Colo. 355, 281 P. 737 (1929) (the interested director voted his shares, but the court unheld the transaction relying on the fact that there was a majority of shareholders who approved the transaction without his vote).

109. *See, e.g.*, Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968) (where a majority of a corporation's shares were held by the directors interested in effectuating a sale of capital stock to themselves, there could be no effective ratification at least in the sense that it transferred to the attacking stockholders the burden of showing fraud. The stockholders could sue derivatively and the directors had the burden to show by clear and convincing evidence that the transaction was fair, honest and reasonable.); Sarner v. Fox Hill, Inc., 151 Conn. 437, 199 A.2d 6 (1964) (holding that a director voting as the sole stockholder present at the meeting ratifying the board of directors' actions transferring shares of treasury stock to him as compensation for managerial services did not preclude an attack by a minority stockholder on such a transaction nor absolve the director/stockholder of the burden of proving that payment for such shares was fair and reasonable compensation); Klein v. Independent Brewing Ass'n, 231 Ill. 594, 83 N.E. 434 (1907) (directors who sold property to corporation at a price that was $16,575 greater than the market value could not prevent a director suit to set aside the transaction by nonconsenting stockholder for they could not procure a ratification of the transaction by resolution); Chesapeake Constr. Corp. v. Rodman, 256 Md. 531, 261 A.2d 156 (1970) (asserted ratification would not bar a court of equity from setting aside a transaction whereby the director of the corporation sold property to the corporation at a cost several hundred thousands of dollars over the market price, when said director also owned 75% of the stock ratifying the transaction). *See generally* 3 W. FLETCHER, *supra* note 13, at §§ 761, 764, 933.

110. *See* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Chesapeake Constr. Co. v. Rodman, 256 Md. 531, 261 A.2d 156 (1970); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969); Klein v. Independent Brewing Ass'n, 231 Ill. 594, 83 N.E. 434 (1961).

holders or by counting the votes of an interested director or stockholder, those shareholders who vote to affirm a transaction involving a director or controlling stockholder after a full disclosure are estopped to attack the transaction, either individually or derivatively.[111] *Swafford v. Berry* is the most current Colorado case in this area. In that transaction four incorporators/directors (a father and three sons) transferred a business and its assets to a corporation in exchange for 10,000 shares of the corporation's common stock. These four directors then owned the majority interest in the corporation, and two other directors of the corporation owned 2,500 shares.[112] The transfer was ultimately challenged by the minority stockholders who alleged that the defendants had breached their fiduciary duties. The court first established that full disclosure of the facts and circumstances of the transaction had been made by the interested directors to the stockholders and that the transaction was fair to the corporation. The court then stated with regard to the plaintiff's ability to bring the suit:

> Stockholders' suits on behalf of a corporation are entertained only in *equity* . . . and equity has always demanded certain minimum standards of those who seek relief in its forum. Thus we find the general rule that a shareholder who, with knowledge of the material facts, has consented or acquiesced in the transaction of which he complains ordinarily cannot attack the transaction on behalf of the corporation . . . . By purchasing their shares in the corporation after being fully apprised of the details of the transaction . . . . the plaintiffs consented to or acquiesced in the transaction. We are led to the inescapable conclusion that these plaintiffs had no standing to obtain the relief they sought here.[113]

It is important to note that stockholders are not only estopped to complain about a director's voidable transactions which they have ratified or acquiesced in, but they also are estopped to complain about ultra vires or unauthorized acts of directors in which stockholders have acquiesced.[114] Furthermore, not only are the stockholders who acquiesce in or ratify voidable transactions estopped, but also their transferees are estopped to challenge the transaction except where the transfer occurred by operation of law.[115]

Nevertheless, if an interested director is unable to secure a ratification of his action by an independent board of directors or by the stockholders, his transaction with the corporation will still be valid if it is fair to the corporation, as provided for by the law paragraph of section 7-5-114.5.[116]

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111. *See* Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963); Gallup v. Pring, 108 Colo. 277, 116 P.2d 202 (1941); Boldenweck v. Bullis, 40 Colo. 253, 90 P. 634 (1907) ("Stockholders who vote in favor of a transaction and their transferees cannot maintain suit on behalf of the corporation and other stockholders to avoid the transaction"). *See generally* W. FLETCHER, *supra* note 13, § 5862; *see also* Morse Gen. Tires, Inc. v. General Tire & Rubber Co., 128 F. Supp. 74 (W.D. Okla. 1954); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969).

112. 152 Colo. at 494-98, 382 P.2d at 1000-01.

113. *Id.* at 499-500, 382 P.2d at 1002 (1963).

114. *See* Gallup v. Pring, 108 Colo. 277, 116 P.2d 202 (1941).

115. Langlois v. B. F. Merchant Inv. Co., 101 Colo. 438, 73 P.2d 1385 (1937); Boldenweck v. Bullis, 40 Colo. 253, 90 P. 634 (1907); Gumaer v. Cripple Creek Tunnel, Transp. & Mining Co., 40 Colo. 1, 90 P. 81 (1907).

116. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978).

3. Requirement of Fairness

The gravamen of the test of the validity of conflict of interest transactions in corporate law is fairness. Unless a transaction between a corporation and one of its directors is ultimately fair, it will not withstand later attack even though all the technical rules are met.[117]

Section 7-5-114.5 specifically states that a transaction between a director and his corporation will not be void or voidable solely because of that interest or solely because the interested director was present and voted at the meeting approving the transaction if the transaction is fair to the corporation.[118] The technical requirements of ratification by the shareholders or by a disinterested board of directors do not have to be present in order to make the transaction valid; however, the converse is not necessarily true. By complying with section 7-5-114.5(1)(a) and (b) which requires full disclosure of the director's interest and approval by either a majority of disinterested directors or the stockholders, an interested director is still not relieved of his duty to act fairly toward the corporation and its stockholders. On the contrary, the case law construing statutes similar to Colorado's holds that even if there has been full disclosure and ratification by the directors and stockholders, the transaction will still be voidable if found to be unfair to the corporation and the stockholders.[119]

Remillard Brick Co. v. Dandinni Co.[120] is one of the leading cases in this area. The board of directors of the Remillard-Dandinni Company consisted of three directors, two of whom controlled the majority of voting stock by proxies given to them by the stockholders, and they also had a contract with the stockholders to buy the majority interest. The third director was the sole stockholder of the Remillard Brick Company, the minority stockholder of the Remillard-Dandinni Company. The two controlling directors devised a plan whereby the Remillard-Dandinni Company would form a wholly-owned corporation to handle exclusively the promotion and sales of all the products manufactured by the Remillard-Dandinni Company and another wholly-owned manufacturing company. The sales company used almost exclusively the facilities and equipment of the manufacturing companies, and the two directors received salaries from both corporations.

During litigation, in response to the minority shareholder's allegation that the contracts between the sales corporation and the manufacturing corporations were unfair, the two directors argued that since the fact of the common directorship of the sales and manufacturing company was fully

117. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (construing a statute similar to the Model Business Code Annotated § 41); *cf.* Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 359 P.2d 665 (holding that even if a transaction in which a member of the board is interested is approved by a majority of disinterested directors, it will still be set aside if after strict scrutiny it is found to be unfair).

118. COLO. REV. STAT. § 7-5-114.5 (Supp. 1978).

119. *See, e.g.*, Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); *cf.* Pergament v. Frazer, 93 F. Supp. 13 (E.D. Mich. 1950) (applying Michigan law); Harris Trust & Sav. Bank v. Joanna W. Mills Co., 53 Ill. App. 3d 542, N.E.2d 629 (1977) (applying Delaware law). *See generally* W. FLETCHER, *supra* note 13, § 919.

120. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

known to the boards of the contracting corporations and because the majority stockholders had consented to the transaction, they were therefore in compliance with section 820 of the California Corporation Code[121] and the minority stockholders had no legal right to sue. Section 820 was substantially identical to Colorado's section 7-5-114.5 in that it provided that contracts between directors and their corporations or between corporations having common directors would not be void or voidable on that basis if the shareholders by a majority vote had approved the transaction after full disclosure. The California Court of Appeals held that argument to be untenable and stated:

> [N]either § 820 of the Corporations Code nor any other provision of the law automatically validates such transactions simply because there has been a disclosure and approval by the majority of the stockholders. That section does not operate to limit the fiduciary duties owed by a director to all the stockholders, nor does it operate to condone acts which, without the existence of a common director, would not be countenanced. That section does not permit an officer or director, by abuse of his power, to obtain an unfair advantage or profit for himself at the expense of the corporation. The director cannot, by reason of his position, drive a harsh and unfair bargain with the corporation he is supposed to represent. If he does so, he may be compelled to account for unfair profits made in disregard of his duty. Even though the requirements of § 820 are technically met, transactions that are unfair and unreasonable to the corporation may be avoided.[122]

This interpretation would, in all probability, be the one enforced in Colorado based on past Colorado case law which has held that a transaction between a director and his corporation must be fair in order to withstand later attack, notwithstanding the fact that there has been approval by a majority of a quorum of disinterested directors, or acquiescence in or ratification by the stockholders.[123] It also appears to be an interpretation the Colorado courts would readily adopt given past Colorado case law holding any transaction between a corporation and one of its directors involving corporate assets voidable without regard to the fairness or the good faith of the contract.

Section 7-5-114.5 also embodies the majority rule of American courts which holds that transactions between directors and their corporations are valid if they are open and above board, free from any taint of fraud, actual or constructive, entered into honestly and in good faith, and fair and if the director can show he has secured no advantage at the expense of the corporation.[124] The statute, however, is limited to the requirement that the transac-

121. CAL. CORP. CODE § 820 (West 1947).

122. 109 Cal. App. 2d at —, 241 P.2d at 74 (1952).

123. *See* Swafford v. Berry, 152 Colo. 493, 382 P.2d 999 (1963); Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 359 P.2d 665 (1961); Laybourn v. Wrape, 72 Colo. 339, 211 P. 367 (1922).

124. *See, e.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943) (which held that if dealings between a corporation and one of its directors are honest and to the benefit of the corporation they are as valid as transactions with a stranger); Richland v. Crandall, 262

tion be fair to the corporation. The case law expands on that requirement and requires that the transaction not only be fair to the corporation but also to those interested therein, for example, the other stockholders. Because the case law expands the requirements of section 7-5-114.5 rather than being superseded by it, this equitable principle will continue to apply in transactions between directors and their corporations.[125]

As noted earlier, section 7-5-114.5 does not treat the situations where the majority stockholder is contracting with his corporation. However, the case law in this area indicates that the rule for transactions between a corporation and its majority or controlling stockholders is the same as the rule for directors and officers if the stockholders are ones who can be deemed fiduciaries. Therefore, a controlling or majority stockholder who is engaged in self-dealing with his corporation must prove the transaction scrupulously fair, in good faith, free from actual fraud, and not oppressive to minority stockholders or the corporation.[126] Once again, meeting the technical requirements of disclosure will not protect a majority or controlling stockholder from having his transaction set aside if found to be unfair. Again quoting from *Remillard Brick Co.*:

> It would be a shocking concept of corporate morality to hold that because the majority directors or stockholders disclose their purpose and interest, they may strip a corporation of its assets to their own financial advantage, and that the minority is without legal redress.[127]

Nevertheless, where a stockholder or director makes a contract with the corporation which a stranger might make, and the contract is fair, the transaction is as valid as if it were between the corporation and the stranger. This is so even if the stockholder or director owns a majority of the stock.[128]

There is authority that a majority stockholder cannot make a contract with his corporation so long as he is also acting as an officer or agent of the corporation or so long as the directors are his puppets. This rule results from

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F. Supp. 538 (S.D.N.Y. 1967); Pergament v. Frazer, 93 F. Supp. 13 (E.D. Mich. 1950) (applying Michigan law); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Bloodworth v. Bloodworth, 225 Ga. 379, 169 S.E.2d 150 (1969); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 266 A.2d 585 (1967). *See generally* W. FLETCHER, *supra* note 13, §§ 949, 931, 919; HENN, *supra* note 14, § 467. It also appears to be the rule in Colorado at the time COLO. REV. STAT. § 7-5-114.5 (1973) was enacted. *See* Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. 136, 403 P.2d 762 (1965); Swafford v. Barry, 152 Colo. 493, 382 P.2d 999 (1963); Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 359 P.2d 665 (1961).

125. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955); Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Jones v. H.R. Ahmanson & Co., 1 Cal. 2d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Swafford v. Berry, 152 Colo. 494, 382 P.2d 999 (1963).

126. *See, e.g.*, Pepper v. Litton, 308 U.S. at 306 (1939); Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955); Gottesman v. General Motors Corp., 279 F. Supp. 361 (S.D.N.Y. 1967); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952). *See generally* W. FLETCHER, *supra* note 13, §§ 5737, 5781, 5834.

127. 109 Cal. App. 2d at —, 241 P.2d at 74 (1952).

128. Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943); Geominerals Corp. v. Grace, 232 Ark. 524, 338 S.W.2d 935 (1960). *See generally* W. FLETCHER, *supra* note 13, §§ 5737, 5781.

the prohibition against dual representation; that is, a person cannot be both buyer and seller in the same transaction, and therefore a majority stockholder cannot authorize, through his vote on the board of directors or through his control of the directors by his majority interest, a sale to himself as buyer even if the transaction is in good faith.[129] Colorado's only case on majority stockholders contracting with their corporations is *Glengary Consolidated Mines Co.* v. *Boehmer* decided in 1900.[130] In this case the Colorado Supreme Court held that the Ibex Corporation was merely contracting with itself for it had complete control of the Glengary Company (which was at Ibex's "mercy" in the language of the court). Ibex had secured control of the stock of Glengary Company for the purpose of electing its own puppet directors to the corporation in order to contract with Glengary in its own interest. The Colorado Supreme Court held the transaction void.[131] This case, however, does not have precedential value for several reasons. First, it is a 1900 case and now clearly in opposition to the weight of authority concerning these types of transactions, including section 7-5-114.5 governing contracts between corporate officers and directors personally and their corporation. Second, since directors and majority or controlling stockholders are fiduciaries to the same beneficiary it would be illogical and inconsistent to apply a stricter rule to stockholders than to directors. Third, the use of the word "void" in the case appears to be a mistake; what the court intended to mean was that the transaction was voidable.[132]

As noted earlier the weight of authority in Colorado is that these types of transactions between a director and his corporation are voidable. It would be unlikely in light of that rule that the courts would hold the same type of transaction void merely because the contracting party is a stockholder not a director when both are considered to be a fiduciary of the same nature. Following this line of reasoning, even though there are no current Colorado cases in this area, due to the fact the Colorado courts consider directors and certain controlling or majority stockholders to be corporate fiduciaries and hold them to the same levels of good faith and loyalty, it would be logical to hold majority or controlling stockholders to the same standard as directors in conflicts of interest situations, that is, compliance with section 7-5-114.5 and the case law regarding the requirements of fairness. In so doing Colorado would also be in accord with the weight of authority in most other jurisdictions.

129. *See, e.g.*, Chicago Hansom Cab Co. v. Yerkes, 141 Ill. 320, 30 N.E. 667 (1892); Crichton v. Webb Press Co., 113 La. 167, 36 So. 926 (1904) (which held that if a stockholder undertakes to discharge the functions of director and conduct affairs of the corporation, he becomes subject to the same trust relation which precludes directors from contracting with themselves).

130. 28 Colo. 1, 62 P. 839 (1900).

131. *Id.* at 839-40.

132. This conclusion is supported by the fact that the court relied on Morgan v. King, 27 Colo. 203, 40 P. 499 (1900), which held a similar transaction voidable not void. Also the court stated in the last line of the opinion that the contract was "void at the instance of the plaintiffs (stockholders of Glengary), without regard to whether Ibex Company was guilty of any actual fraud in obtaining it or not." 28 Colo. at 4, 62 P. at 84. A void contract is void ab initio without it being at the instance of anyone. Clearly, the court was again relying on *Morgan v. King* which had held that a transaction in question was voidable without regard to fairness, good faith or fraud.

4. Burden of Proving Fairness

If litigation should occur challenging a transaction between a corporation and one of its fiduciaries, the case law places additional burdens upon fiduciaries by virtue of their trust relation to the corporation and its stockholder. It is almost universally agreed that transactions between directors or dominant stockholders and their corporations are subject to rigid scrutiny by the courts.[133] Furthermore, the evidential burden of proof, including the burden of coming forward and the burden of persuasion, as to the good faith of the transaction and its inherent fairness to the corporation and the stockholders is also placed upon the director or the majority shareholder.[134] In the one case which discusses the quantum of proof necessary to establish fairness, the court held that it must be proved by clear and convincing evidence.[135]

Once again, the leading case in this area is *Pepper* v. *Litton*,[136] which not only established that majority stockholders are fiduciaries but also held that they have the same burden of proof and close scrutiny placed upon their transactions with the corporation as do the directors. In *Pepper*, the Supreme Court developed the test by which the transaction should be judged:

> Their [directors and dominant or controlling stockholders] dealings with the corporation are subject to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein . . . .[137]

Furthermore, where a director or a stockholder is seen to exercise greater control, as where he is a sole director or one of a small number of directors, then a greater burden is placed upon him to be candid and to show good faith than where there are several directors involved. Hence, "[h]is acts [are] subject to most severe scrutiny, and their validity determined by more rigid principles of morality, and freedom from motives of selfishness."[138]

Colorado courts, as early as 1922, have consistently applied the princi-

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133. Pepper v. Litton, 308 U.S. 295 (1939); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); United Hotels Co. of America v. Mealey, 147 F.2d 816 (2d Cir. 1945); Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 359 P.2d 665 (1961); Film Enterprises, Inc. v. Selected Pictures, Inc., 138 Colo. 468, 335 P.2d 260 (1959); Chesapeake Constr. Corp. v. Rodman, 256 Md. 570, 261 A.2d 156 (1970); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 226 A.2d 585 (1967).

134. Pepper v. Litton, 308 U.S. 295 (1939); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. 136, 403 P.2d 762 (1965); Wilshire Oil Co. v. Riffe, 381 F.2d 646 (10th Cir. 1967); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1967); Gottesman v. General Motors Corp., 279 F. Supp. 361 (S.D.N.Y. 1967); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 226 A.2d 585 (1967).

135. Pappas v. Moss, 393 F.2d 865, 868 (3d Cir. 1968).

136. 308 U.S. 295 (1939).

137. *Id.* at 306-07.

138. *Id.* at 307 n.14. *See also* Twin-Lick Oil Company v. Marbury, 91 U.S. at 590 (1876); Schelensky v. South Parkway Bldg. Co., 166 N.E.2d 793 (Ill. 1960); Brundage v. New Jersey Zinc Co., 226 A.2d 585 (1967).

ple that when a director makes a contract with his corporation he has the burden of showing that he acted in perfect good faith and that the contract was fair to the corporation.[139] Whenever a director enters into a contract with his corporation or two corporations having common directors enter into a contract, the transaction will be subject to rigid and close scrutiny by the courts, and "[t]he burden is on the director, officer or agent to show the validity of the contract and the fairness and honesty of his dealings with the corporation, that he has gained no advantage therefrom, and that the corporation has not suffered thereby."[140] The Colorado Supreme Court has stated that such a rule "is deemed necessary to the end that in absence of arm's length bargaining the scales may not be unfairly tipped to one side or the other even through mistake or inadvertence."[141]

Although there are no Colorado cases placing this additional burden on dominant or majority stockholders, Colorado and Tenth Circuit cases clearly establish that these additional burdens are concomitant with a fiduciary obligation. Since Colorado courts have held that a majority or dominant stockholder is a fiduciary, it would be logical for the courts to unhesitatingly extend this principle to controlling stockholders also. Finally, it should be noted that the burden and scrutiny is not shifted or altered merely because a director is dealing with a corporation which is represented by disinterested directors or officers. The interested director still has the burden to show that the transaction is fair, above board, entered in good faith, and free from fraud.[142]

Even by complying with modern statutes such as section 7-5-114.5, which were specifically enacted to provide guidelines to validate these types of transactions, the burden of proof will not shift because these statutes generally do not address that issue; therefore, it is still controlled by the equitable and legal decisions of the courts. But, of course, in certain circumstances stockholders and others interested in the transaction may lose their right to sue through ratification and estoppel. Furthermore, if the interested director is also a dominant or majority stockholder, or if the majority stockholder is also interested in the transaction proposed, then ratification by a majority (or whatever vote is necessary) of the stockholders will not change or shift the burden of proof. In such a situation, the director or majority or dominant stockholder will continue to bear the burden of proving the transaction is fair and reasonable and lacking in fraud.[143]

Pappas v. Moss[144] appears to be the leading case in this area. *Pappas* involved the sale of treasury stock of the Hydromatics Company to all of the members of the board of directors pursuant to a provision in its certificate of

139. Laybourn v. Wrape, 72 Colo. at 343, 211 P. at 369 (1922).

140. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. at 143, 403 P.2d at 766 (1965). *See also* Film Enterprises, Inc. v. Selected Pictures, Inc., 138 Colo. 468, 335 P.2d 260 (1959).

141. Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413, 418, 359 P.2d 665, 668 (1961).

142. *Id.*, 359 P.2d at 668.

143. *See, e.g.*, Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Brundage v. New Jersey Zinc Co., 48 N.J. 450, 266 A.2d 585 (1961).

144. 393 F.2d 865 (3d Cir. 1908).

incorporation which allowed such transactions to take place without shareholder approval. Nevertheless, the directors, pursuant to a request by the American Stock Exchange, asked for and received stockholder ratification of this sale. The Third Circuit decided that pursuant to a New Jersey law, the directors, absent stockholder approval, had the burden to show by clear and convincing proof that the transaction was fair and honest and reasonable and that this burden was not shifted because of the provision in the articles of incorporation. Therefore, the court reasoned, the directors still had this burden unless there had been an effective stockholder ratification in which case the burden shifted and the stockholder challenging the transaction would then have to prove that a fraud was perpetrated by the directors. In this particular situation, the directors were also the majority stockholders of the corporation and because of that fact the Third Circuit, again relying on New Jersey law, held "that where . . . a majority of shares are held by those 'interested' in effectuating the [transaction] there can be no ratification, at least in the sense that it transfers to the attacking party the burden of showing fraud."[145]

The Third Circuit then remanded the case for a determination of whether the directors who were also majority stockholders could establish by clear and convincing evidence that the transaction had been honest, fair, and reasonable.[146]

There does appear to be some confusion, however, in whether the burden shifts if a transaction between a corporation and a director who is a controlling stockholder is ratified by a majority of the stockholders who are disinterested in the transaction.[147] The better rule is that it would shift the burden for that would be consistent with the principle that voidable acts of directors are subject to ratification by the stockholders, which then makes the transaction binding on the corporation. This type of ratification can only be set aside by proof of actual fraud or bad faith, and the general rule is that the person asserting the fraud must prove it.[148]

5. Test for Determining Fairness

While there is no inflexible rule or formula as to what constitutes fairness, the test is an objective one, and the ultimate validity of a transaction depends upon the facts and circumstances of each individual case. The general test of fairness in self-dealing transactions of corporate fiduciaries is whether under all the circumstances the transaction carries the earmarks of an arm's length bargain.[149] In other words, if the transaction had been one proposed by a stranger would an independent board of directors bind its

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145. *Id.* at 868.

146. *Id.*

147. *Compare* Brundage v. New Jersey Zinc Co., 48 N.J. 450, 226 A.2d 585 (1961) *with* Gropper v. North Cent. Texas Oil Co., 35 Del. Ch. 198, 114 A.2d 231 (1955) *and* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968).

148. *See* Mountain States Packing Co. v. Curtis, 86 Colo. 355, 281 P. 737 (1929); Nye Odorless Incinerator Corp. v. Felton, 35 Del. 236, 162 A. 504 (1931).

149. Pepper v. Litton, 308 U.S. at 306-07 (1939). *See also* Twin-Lick Oil Co. v. Marbury, 91 U.S. at 590 (1876).

corporation to such a transaction.[150] The philosophy which makes this test necessary was best stated by the United States Supreme Court as follows:

> He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.[151]

There are, however, several more specific tests which can be used to determine if the fiduciary has met his burden of proof: (1) the amount of disclosure by the interested director; (2) whether there is fraud, actual or constructive; and (3) if the transaction involves the purchase of corporation assets, the amount paid by the directors for the assets as compared to their fair market value and whether the fiduciary unduly profited in the transaction. The fairness of the transaction will be judged in light of the facts and circumstances at the time of its approval or ratification; it will not be judged with the benefit of hindsight.[152]

a. *Requirement of full disclosure under Colorado law*

Full disclosure is considered a test of fairness because it is required in self-dealing transactions of directors or controlling shareholders by virtue of the fiduciary nature of their relationship[153] to the corporation. Without full disclosure, the transaction itself is considered unfair.[154]

By statute Colorado requires full disclosure of a director's personal interest in a transaction to the independent directors or the stockholders in

150. H. HENN, *supra* note 14 at § 238.

151. Pepper v. Litton, 303 U.S. at 311 (1939) (footnote omitted).

152. Pergament v. Frazer, 93 F. Supp. 13 (E.D. Mich. 1950); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Harris Trust & Sav. Bank v. Joanna W. Mills Co., 53 Ill. App. 542, 368 N.E.2d 629 (1977).

153. Lembeck & Betz Eagle Brewery Co. v. McAnarey, 287 F. 927 (W.D.N.Y. 1923); State v. Keypoint Oyster Co., 64 Wash. 2d 375, 391 P.2d 979 (1964). *See generally* 11 SCOTT TRUSTS § 170, 170.1; 14 SCOTT TRUSTS § 216 (1957).

154. Schoenbaum v. Firstbrook, 405 F.2d 215 (2nd Cir. 1968); United Founders Life Ins. Co. v. Consumers Nat'l Life Ins. Co., 337 F.2d 647 (7th Cir. 1971); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, —, 241 P.2d 66, 74 (1952); Schelnsky v. South Parkway Bldg. Co., 19 Ill. 2d 268, 166 N.E.2d 793 (1960).

order for the transaction not to be voidable because of his interest.[155] The case law in Colorado, however, broadens that requirement considerably. Due to the fiduciary nature of the relationship, in order for a transaction between a director and his corporation to be upheld when attacked, and ultimately to be considered fair, there must be full and fair disclosure of all the material facts and circumstances of the transaction.[156] This principle would logically be extended to dominant and controlling stockholders when under the circumstances they are also held to be fiduciaries.

Like fairness, there is no formula for what constitutes full disclosure, and hence it is normally determined on a case-by-case basis where the extent of the disclosure will be judged within the context of all the facts and circumstances of the case. It is difficult to draw a conclusion as to what exactly constitutes "full disclosure" for in the majority of cases dealing with disclosure, the interested party, in order to secure ratification of a transaction which he knows is questionable, discloses absolutely nothing, and of course when the transaction is litigated the ratification is summarily held ineffective. Or, in the converse situation, there has been such a full disclosure of the transaction that the issue is not even raised, or if it is, once again the court deals with it in a summary fashion. Nevertheless, an examination of Colorado case law will give an indication of what Colorado courts consider to be "full disclosure" and "knowledge of the material facts."

In *Hudson v. American Founders Life Insurance Co.*[157] Hudson, a director and the president of American Founders, was alleging that the stockholders of his corporation had ratified his action of securing the issuance of 15,000 shares of the common stock of the corporation and exchanging that stock for 17,000 worthless shares of the ultimately insolvent Texas Adams Oil Corporation of which Hudson was also a director. Hudson had secured the issuance of this stock without the approval of the board of directors. The court, in holding that there had been no effective ratification, relied on the following factors: (1) the resolution passed by the stockholders ratifying any *legal* act taken by the board of directors did not, and in fact could not, ratify an illegal invalid act such as the issuance of shares, and furthermore the resolution was passed before any discussion was entered into concerning the Texas Adams stock; and (2) neither a balance sheet which read "Stock Owned $47,600" nor Hudson's cryptic statement that the transaction was a stock exchange and not a cash transaction in which he was taking full responsibility for the investment could amount under any doctrine to full and fair disclosure.[158] Furthermore, the Colorado Supreme Court required, in order to have an effective ratification by the stockholders, that minutes of the stockholders' meeting reflect a discussion of the "specific" and "exact" details of the transaction and that all the material facts concerning the controverted

155. COLO. REV. STAT. § 7-5-114.5(1)(a)(b) (Supp. 1976).
156. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. at 142, 403 P.2d at 766 (1965); Swafford v. Berry, 152 Colo. at 498, 382 P.2d at 1002 (1963); Hudson v. American Founders Life Ins. Co., 151 Colo. 54, 377 P.2d 391 (1963).
157. 151 Colo. 54, 377 P.2d 391 (1963).
158. *Id.* at 65-66, 377 P.2d at 397.

transaction had been explained or discussed.[159]

Swafford v. Berry[160] held that in order to withstand later attack by a stockholder, the transfer of a director's business with its assets to the director's corporation in exchange for shares of the common stock of the corporation must be accompanied by "full and fair disclosure of the material facts to those who are shareholders of the corporation at the time of the transaction" and must not be attended by any unfairness or fraud.[161] In *Swafford*, within the context of a closely held corporation, the verbal notification by the interested directors to the complaining stockholders, before purchase of the stock, that they intended to transfer the assets of their business in exchange for 10,000 shares of the capital stock (valued at the time of the transfer at $10.00 a share) of the corporation coupled with the common knowledge within the community, including the complaining stockholders, that this particular business and its assets were worth in excess of $400,000 was complete disclosure of the material facts of the transaction.[162]

Lastly, a director is not prohibited from making a reasonable profit in a transaction with his corporation if full disclosure of the expected profit is made to the corporation through disinterested directors or through the stockholders.[163] Corporate directors realizing "secret profits" in transactions with their corporations are an anathema to the courts. Such profits will be considered a per se violation of the director's fiduciary duty not to gain an advantage at the expense of the corporation. Additionally, failure to disclose the anticipated profit destroys any attempted ratification and renders the transaction unfair.[164]

In summation, Colorado courts and statutes have specifically held that in order for there to be full disclosure and a knowledgeable ratification there must be (a) knowledge of the director's interest and all facts and circumstances surrounding the sale; (b) any profits expected to be realized by the transaction must be reflected in the minutes; and (c) the exact and specific details of the transaction must have been discussed so that the shareholders knew all the material facts concerning the transaction.

b. *Full disclosure as required by jurisdictions other than Colorado*

The majority of other jurisdictions are in accord with Colorado law, and they too require that in corporate transactions where a majority stock-

159. *Id.*, 377 P.2d at 397.

160. 152 Colo. 493, 382 P.2d 999 (1963).

161. *Id.* at 498-99, 382 P.2d at 1002.

162. Other factors which influenced the court were that the complaining stockholders knew what the assets of the business were, their actual cost in round figures, and the amount of time and work the directors had expended in building up the business. Finally, in a directors' meeting which took place subsequent to the transfer, the minutes reflected that the two complaining stockholders felt that the $12.00 a share was too low a price based on the assets which the corporation had received from the directors. *Id.* at 498, 382 P.2d at 1002.

163. *Id.*, 382 P.2d at 1002.

164. Rosenthal v. Four Corners Oil & Mineral Co., 157 Colo. at 142, 403 P.2d at 766 (1965) (Rosenthal as director of Four Corners failed to disclose that he was to receive as commission 40,000 shares of the 160,000 shares of Four Corners paid to another corporation in exchange for mining claims owned by that corporation).

holder or director has a personal interest, the director or controlling stockholder must make a full disclosure laying out "the truth without ambiguity or reservation, in all of its stark significance" in order for the transaction to be fair and the ratification to have a legal and binding effect.[165]

One Seventh Circuit case, *United Founders Life Insurance Co. v. Consumers National Life Insurance Co.*,[166] does aid in determining what exactly constitutes disclosure. In this transaction United owned 116,190 shares of Consumers and contracted with another person and a corporation to buy more stock in order to gain control of Consumers. United planned to eliminate Consumers' board of directors and secure a merger of United and Consumers. Directors of Consumers, in order to thwart a plan which would cost them their jobs, decided that it was in the best interest of the corporation to authorize 1,500,000 more shares of capital stock and to sell 280,000 of these shares to a group of individuals in return for their promissory notes. After a series of several more complicated machinations instituted by the directors of Consumers in order to prevent a United takeover, litigation ensued between the two corporations. United filed suit individually and derivatively against Consumers asking the court to rescind the sale of the 280,000 shares, to enjoin the voting of the shares, and to grant damages. In order to settle the litigation, a director, DaVoust, resigned from Consumers' board of directors and then presented the plan that corporate assets of Consumers with a book value of $1,473,000 be sold to D.P.C., Inc., a wholly-owned corporation of DaVoust, for $1,160,000 cash. Further, DaVoust, through D.P.C., was given an option to purchase 200,000 shares of the common stock of Consumers. D.P.C. then was to sell the corporate assets to United (in order to prevent United from showing a loss of $1,000,000 on the transfer) with payment being in the form of the 116,190 shares owned by United. In return United agreed to rescind a stock purchase agreement whereby it was to gain control of the corporation which in effect returned the stock to Consumers. DaVoust, in another litigation seeking to hold the transaction invalid, was accused of breaching his fiduciary duty to the corporation.[167]

The Seventh Circuit upheld the transaction because an independent board of directors had approved the settlement after full disclosure. Furthermore, the shareholders had received two notices about the proposed settlement containing a full disclosure of the material facts. The notices contained the following disclosures: (1) the settlement was promulgated by DaVoust, former director and chairman of the board of Consumers; (2) the assets were being transferred to D.P.C., Inc., "a corporation organized by DaVoust"; (3) the issues in the three law suits and the terms of the proposed settlement; (4) the assets were worth $1,973,072 and were being sold for

165. Breen Air Freight Ltd. v. Air Cargo, Inc., 470 F.2d 767 (2d Cir. 1972); Julien J. Sludey, Inc. v. Gulf Oil Corp., 282 F. Supp. 748 (S.D.N.Y. 1968); Raines v. Toney, 228 Ark. 1170, 313 S.W.2d. 802 (1958); United Homes, Inc. v. Moss, 154 So. 2d 351 (Fla. 1963); Selensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793; Levy v. Pacific E. Corp., 153 Misc. 488, 275 N.Y. 291 (1934); Poweroil Mfg. Co. Inc. v. Carstensen, 69 Wash. 673, 419 P.2d 793 (1966); State v. Keypoint Oyster Co., 64 Wash. 375, 391 P.2d 979 (1964). *See generally* FLETCHER, *supra* note 13, § 756 (lists 25 jurisdictions in accord with this principle).

166. 447 F.2d 647 (7th Cir. 1971).

167. *Id.*

$1,160,000; and (5) the difference between the purchase price and the sale price was due to unearned interest on one of the mortgage assets of $161,556 which Consumers had the obligation to pay the purchaser of the mortgage over a four year period and a recorded book loss of $151,516 on another asset. The Seventh Circuit held that this notice was entirely adequate to alert the cautious shareholder and his counsel that DaVoust was the central party acquiring the United interest in Consumers and to outline the consideration to be given and received by Consumers.[168]

Finally, transactions litigated under the 1933 Securities and Exchange Act[169] which requires full disclosure in connection with a purchase or sale of stock further indicate what constitutes full disclosure.

Federal proxy rules promulgated under rule 14(a) of the Securities and Exchange Act[170] require full disclosure of all material facts. "Material" is another word which escapes easy definition. The most widely accepted definition was given in the landmark case of the *Securities Exchange Commission v. Texas Gulf Sulfur*[171] in which the Second Circuit stated:

> The basic test of materiality . . . is whether a reasonable man would attach importance [to a fact] . . . in determining his choice of action in the transaction in question . . . . This, of course, encompasses any fact . . . which in reasonable and objective contemplation, might affect the value of the corporations stock or securities.[172]

Richland v. Crandall,[173] involved the sale of a construction corporation to another corporation organized specifically to purchase it. Two of the directors of the selling corporation also had a substantial ownership interest in the buying corporation, and a third director of the selling corporation agreed to become an interim director and president of the buying corporation. The court stated the general rule for determining if a material fact had been omitted was whether, if disclosed, it would have influenced a reasonable stockholder in voting on the proposal for the sale of the assets. The court further stated that the general rule for determining if a statement made was misleading was whether the claimed misstatement was of such a nature that it could normally be expected to lead a reasonable stockholder to vote in favor of the proposed sale.[174]

The court held that the proxy statement gave full and fair disclosure based on the following findings: (1) it was proper to disclose the lengthy discussion by the disinterested directors concerning the transaction and their conclusion that it was fair based on an examination of past earnings of the corporation, future prospects of the corporation, its competitive position, its

168. *Id.*
169. 15 U.S.C. §§ 78a-78KK (1934).
170. 17 C.F.R. § 240.14a-1 to a-12 (1979).
171. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).
172. 401 F.2d at 868 (2d Cir. 1968). *Accord*, Northway Inc. v. T.S.C. Indus., Inc., 512 F.2d 324 (7th Cir. 1975), *rev'd on other grounds*, 426 U.S. 438 (1976) (the test of whether omissions from a proxy statement are material must include all facts which a reasonable stockholder might consider important); Richland v. Crandall, 362 F. Supp. 528 (S.D.N.Y. 1967).
173. 362 F. Supp. 538 (S.D.N.Y. 1967).
174. *Id.* at 553.

recent construction contract experience, and its assets and market history; (2) it was not a material omission to omit the fact that the purchasers were borrowing all of the funds necessary to finance the acquisition given the fact that the loans were induced by personal guarantees of the wealthy purchasers and a $2,000,000 security deposit; (3) it was proper to disclose the backlog of construction contracts at their face value of $256,460,901, and it would have been improper to speculate as to their ultimate worth as that would have been misleading; (4) it was proper to disclose that the gross income of the corporation had declined due to increased costs and intensified competition; (5) it was not an omission to fail to assign a dollar value to the goodwill of the corporation as the nature of the business made such a designation speculative; and (6) it was proper *and* necessary to disclose that the three interested directors were not present at the meeting discussing the transaction and their interest was properly and fully disclosed in a separate section of the proxy statement which stated their respective interests, their positions in the selling corporation, the fact that they had participated in the negotiations, and all other material facts.[175]

Finally, it is important to note that in the cases dealing with this issue, federal courts have held that nondisclosure in a purchase of a corporation's assets by another corporation or a merger of two corporations of the fact that the corporations had the same or common directors or officers was materially misleading and deceptive as a matter of law.[176]

c. *Transaction must be free of fraud*

The second requirement in order for a transaction to be deemed fair is that it must be free from fraud, actual or constructive.

Actual fraud in its general sense comprises anything calculated to deceive, including all acts, omissions and concealments which breach a legal or equitable duty, trust, or confidence and which result in an undue or unconscionable advantage being taken of another. Actual fraud, of course, involves a knowing or intentional deception using any connivance, deception, artifice, or concealment of material facts in order to cheat or deceive another. It has been defined as any "concealment of a material fact which should have been disclosed or the representation of the existence of a material fact which did not exist."[177] Common law generally places the burden of proving actual fraud on the party alleging it.

Within the context of corporate self-dealing, however, fraud is a loosely used term and often used for transactions which do not fit within the term "fraud" as it is traditionally used. Liability is often imposed for transactions which constitute bad faith, breaches of fiduciary duty, acts constituting actionable negligence or gross unfairness, or acts which are truly oppressive to

175. *Id.* at 554-59.

176. Northway, Inc. v. T.S.C. Indus., Inc., 512 F.2d 324 (7th Cir. 1975); Swanson v. American Consumers, Inc., 415 F.2d 1326 (7th Cir. 1969), *rev'g* 328 F. Supp. 797 (S.D. Ill. 1971).

177. Premier Poultry Co., v. W. Burnstein & Son, Inc., 61 A.2d 632, 634 (Mun. Dist. App. Dist. Col. 1948).

the minority stockholder.[178] As to minority stockholders the general rule is that "[w]here a majority of the directors or stockholder, or both, acting in bad faith, carry into effect a scheme which, even if lawful upon its face, is intended to circumvent the minority stockholders and defraud them out of their legal rights, the courts interfere and remedy the wrong."[179]

Many times fraud need not be shown as a fact nor must it be shown that the directors or stockholders were motivated by any fraudulent intent; it is sufficient that the existence of fraud is the necessary legal inference from the facts found.[180] It seems apparent, however, that actual fraud within this context does involve some misrepresentation or omission of material facts to the innocent stockholders, and therefore the issue of actual fraud is inextricably tied to the issue of full and fair disclosure. If there has been no intentional concealment or misrepresentation concerning a transaction, actionable actual fraud does not exist, but, of course, the transaction can still be set aside as constructively fraudulent or unfair.[181]

Specifically what constitutes fraud is a question of fact, to be decided on a case by case basis. However, it appears that the requisite elements for a finding of actual fraud in the sale or purchase of corporate assets are as follows: (1) some type of misrepresentation or nondisclosure; (2) oppressive and unfair tactics toward minority stockholders; and (3) less than adequate or full consideration for the assets purchased.[182]

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178. *See generally* W. FLETCHER, *supra* note 13, § 5829.

179. Flynn v. Brooklyn City Ry., 158 N.Y. 493, 507, 55 N.E. 520, 524 (1899).

180. *See* Whitten v. Dabney, 171 Cal. 621, 154 P. 312 (1915) (California court found fraud present when the purchasers of all the stock in the corporation falsely represented to third persons that said stock was treasury stock and that the proceeds of the sale would go into the treasury and be used in developing the corporation's business when instead it was used to pay unearned dividends in order to stimulate the sale of their own holdings); Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890) (purchase of property from a stockholder by a corporation at such an exorbitant price as to necessarily lead to the inference of fraud); Humbaugh v. Hitchcock, 115 Kan. 182, 222 P. 114 (1924) (The court found fraudulent a transaction whereby a stockholder, who owned all of the preferred stock of a corporation, and a large majority of the common stock, caused the preferred stock to be cancelled and in lieu thereof caused to be issued to himself more common stock. This occurred at a meeting not attended by the minority stockholders, and so they had no knowledge of the proposed transaction. The transaction was found fraudulent without deciding the director's bad faith because it was financially beneficial to the majority stockholder and a substantial disadvantage to the minority).

181. *See, e.g.*, Levin v. Hunter, 6 Ill. App. 2d 461, 128 N.E.2d 630 (1955). (There was no proof of fraud where it was shown in an action by a stockholder to enjoin the execution of a ten-year noncancellable management contract executed by the directors, that the question of the contract had been fairly and openly discussed with the plaintiffs prior to the transaction).

182. The following cases do give an indication of what the courts will consider fraudulent when a director/majority stockholder purchases the assets of his corporation.

In *Klein v. Independent Brewing Assoc.* 231 Ill. 594, 83 N.E. 434 (1907), the court held fraudulent a sale of property to the corporation (without disclosure to the stockholders) by the dominant director at a price $16,575 in excess of the fair market value of the property.

One earlier case, *Leopold v. Inland Steel Co.*, 125 F.2d 367 (7th Cir. 1942) involved the directors and 80% stockholders of the Inland Steamship Company, forcing the dissolution of that profitable company over the objection of the minority stockholders, and then appropriating the business and all its assets to their wholly-owned corporation which was held fraudulent for several reasons. First the directors dissolved the corporation for their own personal interests and not in the best interest of the minority stockholders. Second, they represented to the minority stockholders that the business of the corporation would be discontinued when all along they intended to appropriate said business to their own corporation. Third, inadequate consideration

The second type of fraud, constructive, has long been applied in Colorado for breach of fiduciary duty.[183] Constructive fraud is defined as being:

> A breach of duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive, violate confidence or to injure public interests. Neither actual dishonesty nor intent to deceive is an essential element of constructive fraud . . . . Such fraud often arises where a special confidence or fiduciary relationship exists, which affords the power and the means of one to take undue advantage over the other . . . . A breach of fiduciary duty constitutes constructive fraud. Moreover constructive fraud, like "[a] constructive trust is . . . [a] remedial device through which preference of self is made subordinate to loyalty to others."[184]

It is a doctrine which is designed to prevent the taking advantage of the weakness or necessity of another. The conditions precedent to the application of the doctrine are (1) an inequality between the parties; (2) a weakness on one side and advantage taken of that weakness on the other; and (3) an appearance that "the dominant party either brought about the uneveness in the conditions, or finding it ready to his hand, utilized it and traded on it to extract from the servient party a gift or contract he would not otherwise have made."[185] Where such a relationship is said to exist several presumptions are used to facilitate the finding of constructive fraud:

> The law presumes in favor of the servient party against the dominant party, (1) that the relation placed the dominant party in a position to exercise influence and dominion over the servient party; (2) that such influence and dominion operated upon, and procured, the transaction; and (3) that the influence was an improper and unfair, or (to use the accepted phrase) an "undue influence."

was paid for the stockholders' interest, notwithstanding the fact that the directors had paid fair market value for the assets, because the goodwill of the corporation and its history of substantial profits were not taken into account when determining the value of the business. Finally, the directors had forced the stockholders to accept the fair market value of the assets as representative of their stocks' worth by stating that the selling corporation had no business future without the directors' corporation feeding business into it. *Id.* at 373-75.

A more blatant case of misrepresentation was *Lembeck & Betz Brewing Co. v. McAnary*, 287 F. 927 (W.D.N.Y. 1923), wherein a director and plant manager of a brewing plant caused the directors of the corporation to sell the plant to him for an inadequate price by virtue of his knowing misrepresentation as to the condition of the plant and the nature of its contents. The directors had relied on the representations of the purchasing director as an accurate account of the plant because they were too far from the plant to inspect it for themselves. *Id.* at 933.

Finally, in a more recent case, the Texas Court of Civil Appeals found a transaction fraudulent where the director of a corporation (1) conspired to obtain 80% of the selling corporation's stock; (2) formed a new company for the purpose of buying the assets and conducted the identical business previously conducted by the selling corporation; (3) excluded the minority stockholder from participating in the stock ownership of the new company; and (4) purchased the assets at less than their fair market value. Massey v. Farnsworth, 353 S.W.2d 262 (Tex. Civ. App. 1962).

183. Whatley v. Wood, 157 Colo. 552, 404 P.2d 537 (1965); Dittbrenner v. Meyerson, 114 Colo. 448, 167 P.2d 15 (1946); Security Nat'l Bank v. Peters, Writer & Christensen, Inc., 39 Colo. App. 344, 569 P.2d 875 (1961). *See also* Irwin v. West End Dev. Co., 342 F. Supp. 687 (D. Colo. 1972), *aff'd*, 481 F.2d 34 (10th Cir.), *cert. denied*, 414 U.S. 1158 (1973).

184. Security Nat'l Bank v. Peters, Writer & Christensen, Inc., 39 Colo. App. at 351-52, 569 P.2d at 880-81 (1961).

185. Irwin v. West End Dev. Corp., 342 F. Supp. at 697 (D. Colo. 1972) (citing Dittbrenner v. Meyerson, 114 Colo. at 458, 167 P.2d at 20 (1946)).

> When the relative position of the parties is such as prima facie to raise this presumption, the transaction cannot stand unless the person claiming the benefit of it is able to repel the presumption by contrary evidence, proving it to have been in point of fact fair, just and reasonable.[186]

Recent Colorado cases have held the following transactions to be constructively fraudulent and subject to rescission and award of damages: (a) a director with the connivance of a personal secretary voted himself a retroactive salary of $15,000 for operating a leasing business, to be paid from a loan received by the corporation in order to build tennis courts where no resolution was passed to that effect and even though the director was entitled to compensation for his services;[187] (b) failure of directors to redeem preferred stockholders' stock pursuant to liquidation because in order to do so would require the sale of valuable corporate-owned stock which would increase in value and thereby increase the amount the directors would receive for their common stock was gambling with corporate property which should have been used to redeem shares, which without informing the preferred stockholders, constituted a breach of fiduciary duty and constructive fraud;[188] and, (c) a sale of corporate property for an inadequate consideration as measured against its fair market value.[189]

Inadequate consideration for corporate property, as well as being constructively fraudulent, is also, logically, considered unfair. The leading case in this area is a United States Supreme Court decision, *Geddes v. Anaconda Copper Mining Co.*[190] In this action a minority stockholder challenged the sale of all the corporate property of the Alice Gold and Silver Mining Company to Anaconda Copper Company. The stockholder alleged, *inter alia*, that the sale was voidable because the property was purchased for inadequate consideration and because the transaction was negotiated by two boards of directors with common membership.[191]

The lower court had found the consideration paid to be inadequate and had the transaction set aside. The Supreme Court affirmed this decision by saying:

> The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in

186. 342 F. Supp. at 697 (D. Colo. 1972).

187. *Id.* at 687.

188. Security Nat'l Bank v. Peters, Writer & Christensen, Inc., 39 Colo. App. 344, 569 P.2d 875 (1961).

189. Whatley v. Wood, 157 Colo. 552, 404 P.2d 537 (1965).

190. 254 U.S. 590 (1921).

191. *Id.* Further, the driving force behind the sale, the president and director of the Alice Corporation, was also a dominating director and general manager of the Anaconda Corporation, as well as being the dominating director of the corporation which owned and voted the majority of the shares of the Alice Corporation.

> character. This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add in the soundest business policy[192]

The court set aside the sale even though authorized by a majority of the stockholders because the consideration was found to be inadequate.

Following this basic principle, courts will set aside, in self-dealing transactions, sales or purchases of corporate property when the property received by the corporation is worth less than what was paid or if the property sold by the corporation is worth more than what the corporation received as consideration.[193]

There are, however, several tests used by the courts to determine if adequate consideration has been paid: (1) a comparison of the fair market value of the asset sold as of the date of the agreement or ratification (including goodwill if an entire business is sold) with the amount paid by the director or stockholder;[194] (2) expert testimony and appraisals as to the value of the property;[195] and (3) what offers (or lack of offers) were received from third parties wishing to buy the same corporate assets prior to their sale to the directors or majority stockholders.[196]

The purchase of corporate assets at their fair market value is not always sufficient to protect a director or majority stockholder from liability for breach of his fiduciary duty for the director has the duty to obtain the highest price possible for the corporate assets. For example, in *Wheeler v. Abeline National Bank Building*,[197] a director, who was also president and majority stockholder, of a corporation purchased the corporate assets at fair market value. The court held the transaction voidable when it was established that a third person had offered to buy the assets at a price $1,000 in excess of fair market value. The court held that the director had breached his fiduciary duty to make the property of the corporation produce the largest possible amount.

> This devolution of unlimited power imposes on a single holder of majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock, who can act only

192. *Id.* at 598.

193. Lembeck & Betz Eagle Brewing Co. v. McAnarney, 287 F. 927 (W.D.N.Y. 1923); Gottesman v. General Motors Corp., 279 F. Supp. 361 (S.D.N.Y. 1967); Whatley v. Wood, 157 Colo. 152, 404 P.2d 537 (1965); Jordan v. Jordan Co., 94 Conn. 384, 109 A. 181 (1920); Schiff v. RKO Pictures Corp., 34 Del. Ch. 329, 104 A.2d 267 (1954); Shelensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960); Chesapeake Construction Corp. v. Rodman, 256 Md. 531, 261 A.2d 156 (1970).

194. *See* Gottesman v. General Motors Corp., 270 F. Supp. 361 (S.D.N.Y. 1967); Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967); Garbino v. Albercan Oil Corp., 35 Del. Ch. 27, 109 A.2d 824 (1955); Scheff v. RKO Pictures Corp., 34 Del. Ch. 329, 104 A.2d 267 (1953).

195. *See* Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967); Whatley v. Wood, 157 Colo. 552, 404 P.2d 537 (1965) (expert testimony established that patented mining properties which were sold by a director for $150 were worth $30,000 to $75,000); Abelow v. Midstates Oil Corp., 41 Del. Ch. 145, 189 A.2d 675 (1958); Cottrell v. Pawcatuck Co., 36 Del. Ch. 169, 128 A.2d 225 (1957); Gropper v. North Cent. Tex. Oil Co., 35 Del. Ch. 198, 114 A.2d 231 (1955).

196. *See* Wheeler v. Abeline Nat'l Bank Bldg. Co., 159 F. 391 (8th Cir. 1908); Cardin Bldg. Co. v. Smith, 125 Okla. 300, 258 P. 910 (1927); Williams v. Yocum, 37 Wyo. 432, 263 P. 607 (1928).

197. 159 F. 391 (8th Cir. 1908).

> through him, the duty to exercise good faith, care, and diligence . . . to protect the interests of the holders of the minority of the stock, and to secure and pay over to them their just proportion of the income and of the proceeds of the corporate property. Any sale of the property of the corporation by him to himself for less than he could obtain for it from another, or any other act in his interest to the detriment of the holders of the minority of the stock, becomes a breach of duty and of trust, renders the sale or act voidable at the election of the minority stockholders, and invokes plenary relief from a court of chancery . . . . The reason for this rule is the detriment to the holders of the minority of the stock from such sales and transactions, and not the benefit the holder of the majority derives therefrom . . . . It is the duty of the master of the corporation who sells its property to procure the highest possible price for it . . . , and, if he sells it to himself for less, the sale is voidable by the holders of the minority of the stock at their option, although he paid the fair market value for it.[198]

Conversely, if the corporate property was valued at a certain amount and failed to sell at that amount when placed on the market, it is not unfair for a director and/or majority stockholder to purchase it for less than what was thought to be the fair market value of the asset.[199]

Expert testimony is frequently relied on by the courts to determine the accurate value of the corporate asset sold. Courts rely heavily on those individuals who demonstrate the ability to accurately assess an asset's worth either by professional expertise and reputation, long-time experience and intimate knowledge of the corporation's balance sheet, or the use of sophisticated accounting methods in order to determine an asset's worth.[200]

Other factors used by the courts are (1) the extent of dominance of the controlling stockholder purchasing the assets; (2) whether the transaction constituted a better bargain than the corporation could have obtained in dealings with others or a detriment to the corporation as a result of the transaction; (3) whether there was a possiblity of corporate gains being siphoned off by the directors directly or through corporations they controlled; and (4) the absence of any undue or unjust advantage to the buyer of the assets.[201]

IV. CONCLUSION

Section 7-5-114.5 does not control all possible corporate conflict of interest situations. One such transaction is when a controlling shareholder, who is also deemed to be a fiduciary by virtue of his position of leadership within

198. *Id.* at 394.

199. Cardin Bldg. Co. v. Smith, 125 Okla. 300, 258 P. 910 (1927) (sale of the major asset of a corporation, a building, to a director for $85,000 where it was allegedly worth $150,000 to $200,000 was not unfair when it could be shown that the directors had placed the building on the market at $104,000 and then $90,000 and had failed to receive a bid).

200. *See* Richland v. Crandall, 362 F. Supp. 538 (S.D.N.Y. 1967); Abelow v. Mid-States Oil Corp., 41 Del. Ch. 145, 189 A.2d 675 (1958); Cottrell v. Pawcatuck Co., 36 Del. Ch. 169, 128 A.2d 225 (1957).

201. *See* Gottesman v. General Motors Corp., 279 F. Supp. at 385 (S.D.N.Y. 1967); Schelensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 703 (1960); Knudsen v. Burdett, 67 S.D. 20, 287 N.W. 673 (1939); Williams v. Yocum, 32 Wyo. 432, 263 P. 607 (1928).

the corporation, contracts with his corporation so as to place himself in a conflict of interest situation. In order to uphold such a transaction courts demand that it be in good faith and scrupulously fair to the corporation and the remaining stockholders. Further, compliance with the technical requirements of the statute cannot be in lieu of meeting the fairness requirement. Clearly such a requirement is one of the simplest and, at the same time, one of the most difficult to meet.