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CORPORATE CONFLICTS OF INTEREST UNDER THE VIRGINIA STOCK CORPORATION ACT

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Dealings between a corporation and its officers or directors present a perennial corporate law problem. Officers and directors are often the people most interested in the success of the corporation and they accordingly may well be willing to contract with their corporation on terms far more favorable to it than are otherwise available. On the other hand, these same people are often in a position to cause the corporation to enter into contracts which are highly advantageous to the officer or director involved, but which are grossly unfair and detrimental to the corporation itself.[1]

Courts have employed a variety of methods to resolve the problem of contracts between an officer or director and his corporation. Decisions prior to the turn of the century almost universally held such contracts to be voidable at the option of the corporation. However, virtually all states, including Virginia, have abandoned this Draconian approach in favor of a rule that a contract will be fully enforceable if it is fair, if the interested officer or director has fully disclosed his interest to the board of directors prior to the approval of the contract and if he does not participate in its adoption.[2] Conversely, if the interested officer or director has failed to adequately disclose his interest, the contract will be voidable at the instance of the corporation without regard to whether its terms were fair to the corporation or whether the corporation suffered any injury under it.[3]

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1. For a general discussion of conflicts of interest, including a summary of attempts to deal with such conflicts in various states, see Marsh, *Duties and Liabilities of Corporate Directors: A Symposium*, 22 BUS. LAW. 29 (1966) [hereinafter cited as Marsh].

2. *Id.* at 39-43; Kessler v. Commonwealth Doctors Hosp. Inc., 212 Va. 497, 185 S.E.2d 43 (1971); Rowland v. Kable, 174 Va. 343, 6 S.E.2d 633 (1940); Marcuse v. Broad-Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935); Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935).

3. Rowland v. Kable, 174 Va. 343, 6 S.E.2d 633 (1940). *See* Avis, Inc. v. Charmatz, 208 F. Supp. 932 (E.D. Mo. 1962), to the effect that law in Maine, Missouri and Massachusetts made contracts with officers voidable without reference to fairness if his interest was not disclosed. Defenses such as laches or estoppel may be available to the party attempting to uphold such

In recent years many states have abandoned this traditional rule for a less restrictive one based solely upon the fairness of the contract. Under this more relaxed rule, enforceability does not depend on whether there has been prior disclosure of an adverse interest.[4]

At its 1975 session, the Virginia General Assembly adopted a statute designed to conform Virginia law relating to contracts between a corporation and its officers or directors to this more "liberal" rule.[5] It is part of a comprehensive revision of the Virginia

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a contract. The application of these defenses, however, is beyond the scope of this article. The availability to the corporation of civil remedies other than voidability of such a contract is also beyond the scope of this article.

4. Marsh, *supra* note 1, at 43-44. This change has been accomplished by statute in several states. *See, e.g.*, CAL. CORP. CODE § 820 (West 1955); N.C. GEN. STAT. § 55-30 (1965); N.Y. BUS. CORP. LAW § 713 (McKinney 1963). In other states it has been accomplished by court decisions. *See, e.g.*, Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960). An accurate count of the states currently ascribing to this rule is difficult to estimate due to the lack of recent decisions in many states. Adoption of this rule appears to be another manifestation of an overall trend in many states to reduce the fiduciary responsibility of corporate management.

5. VA. CODE ANN. § 13.1-39.1 (effective June 1, 1975) provides:

> (a) No contract or other transaction between a corporation and one or more of its officers or directors or in which one or more of its officers or directors are interested and no contract or other transaction between a corporation and any other corporation, firm, association or entity in which one or more of its officers or directors are directors or officers or are interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, provided that the material facts as to his or their relationship or interest are disclosed or known:
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> (i) to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote sufficient for the purpose without counting the votes of such interested directors; or
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> (ii) to the stockholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent.
>
> (b) In any event no contract or other transaction described in subsection (a) of this section shall be void or voidable despite failure to comply with parts (i) or (ii) of subsection (a), provided that such contract or transaction was fair and reasonable to the corporation in view of all the facts known to any officer or director at the time such contract or transaction was entered into on behalf of the corporation. In an action to obtain relief for the corporation on account of a contract or other transaction described in subsection (a) in which there was no compliance with parts (i) or (ii) of subsection (a) such contract or transaction may be voided for the benefit of the corporation and the court may grant other appropriate relief unless the party seeking to uphold the contract of transaction sustains the burden of proving that such contract or transaction complied with the requirement of the first sentence of this subsection (b).
>
> The directors and officers of any public utility as defined in § 56-232 shall file in

Stock Corporation Act[6] which goes into effect on June 1, 1975. The statute will substantially alter the common law rule applicable in Virginia to contracts involving conflicts of interest. It is not intended, however, to displace totally the former common law rule, but only to amend it to the extent set forth in the statute.[7]

This article will explore the current state of the law in Virginia relating to contracts between a corporation and its officers and directors, and will focus particularly on the impact which the newly enacted legislation will have upon that law. Along the way, it will point out some ambiguities and potentially troublesome questions which remain unanswered under the new statute.

I. Corporate Conflicts of Interest Under the Common Law in Virginia

Under existing Virginia case law it is possible for an officer or director of a corporation to enter into a binding contract with that corporation if (i) the officer or director discloses the nature of his

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the State Corporation Commission a record of all offices and directorships and all sources of income in excess of twenty-five thousand dollars per year, arising from voting securities in all other corporations, which to the knowledge of the director or officer furnishes fuel with a value in excess of fifty thousand dollars per year to the public utility. Such records for the past year shall be filed or made current on or before September first of each year.

6. Va. Acts of Assembly 1975, ch. 500. This revision of the Virginia Stock Corporation Act was initially drafted by Richard K. Joynt of Richmond, Virginia. This draft of the revision was introduced in the 1973 Virginia General Assembly as H.B. No. 1151, but enactment was delayed in order to provide an opportunity for comment upon the proposed legislation. The Business Law section of the Virginia State Bar, under the chairmanship of Charles D. Fox, III, thereafter employed Professors Michael T. Dooley and J.A.C. Hetherington of the law faculty of the University of Virginia to review the proposed legislation. Their written report, Dooley and Hetherington, Comments on Proposed Amendments to the Virginia Stock Corporation Act, Nov. 15, 1973 [hereinafter cited as Comments on Proposed Amendments], was presented at a meeting of interested members of the Business Law Section held December 20, 1973 in Charlottesville, Virginia. As a result of the Comments on Proposed Amendments and this meeting, proposed Section 13.1-39.1 was revised by Mr. Joynt and Professors Dooley and Hetherington in several material respects. The proposed revision was re-introduced in the 1974 session of the Virginia General Assembly as H.B. 872, and was carried over to the 1975 session. It was enacted without change from the form introduced in the 1974 session, except for the final paragraph, which was adopted as a last minute amendment and does not relate to the substance of the remainder of the section. This final paragraph will not be discussed in this article.

7. *See* Address by Prof. Hetherington, Virginia State Bar Annual Meeting, June 22, 1974; ALI-ABA Model Bus. Corp. Act Ann. 2d § 41, comment (1969).

interest, (ii) the corporation is adequately represented by other agents, and (iii) the contract is fair to the corporation at the time it is made. If any of these criteria are not met the contract is voidable at the option of the corporation whether or not it has been harmed by the contract.[8] Each of these criteria will be examined more closely below.

In Virginia, a contract in which a director has an interest is enforceable at common law only if there has been adequate disclosure of that interest to the other directors.[9] This requirement is closely related to the requirement that the corporation be represented by independent agents. The function of such disclosure is to alert the remaining directors that the interested director will not be acting solely on behalf of the corporation. It appears that the required disclosure must include information relating not only to the nature of the conflict of interest, but also to the merits of the contract,[10] although this latter type of disclosure may arise simply from the duty of every director to reveal material information concerning corporate matters rather than from the director's conflict of interest.[11]

In order for the corporation to be adequately represented by other agents, the cases require that there be a sufficient number of disinterested directors to constitute a quorum of the board at the meeting

8. *See* note 2 *supra*. A contract in which an officer or director has an interest will sometimes be voidable on grounds independent of the conflict itself. The most likely independent ground would be fraud arising from a failure to disclose adverse information concerning the transaction. *See* 12 WILLISTON ON CONTRACTS § 1533 at 679-80 (3d ed. 1970). Failure of any officer or director to disclose information, however, will not necessarily constitute fraud justifying avoidance of the contract. For example, the materiality of the information withheld and the rights of innocent third parties must be considered, particularly where such third parties were unaware of the conflict of interest or had not authorized the party having a conflict to act on their behalf. Another potential ground for avoiding such a contract is undue influence on the corporation by the officer or director having the conflict of interest.

9. Rowland v. Kable, 174 Va. 343, 6 S.E.2d 633 (1940); Marcuse v. Broad-Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935); Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935).

10. Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935).

11. The duty of a director to disclose information relating to the merits of a contract becomes especially important if that director has a conflict of interest because of the likelihood of his having greater access to adverse information and because of a greater reluctance on his part to disclose such adverse information. This common law duty may require greater amplification by the courts in light of the new Virginia statute on conflicts of interest, which refers only to disclosures relating to the conflict itself. *See* text accompanying note 42 *infra*.

approving the contract and, further, that the contract be adopted by the majority vote of those disinterested directors.[12] An interested director cannot be counted in determining the presence of a quorum, and without a quorum the board of directors lacks authority to bind the corporation.[13] If the board lacks a sufficient number of disinterested directors to constitute a quorum, or if a contract is adopted through the affirmative votes of one or more of the directors who should have been disqualified from acting due to a conflict of interest, the stockholders have the power to ratify the irregular actions of the board and make the contract enforceable against the corporation.[14] Ratification will be binding only if the stockholders are fully apprised of all the facts, including the nature of the conflict of interest of the interested director.[15]

It is unclear whether a director who is also a stockholder is prohibited from voting as a stockholder to ratify a contract in which he has a personal interest. Some authorities indicate that ratification under those circumstances would be ineffective.[16] A more meaningful and appropriate analysis is to determine whether a stockholder who acts as a stockholder will violate any duty to the corporation by voting on a matter in which he is personally interested, regardless of whether he is also a director. Certainly a contract should be subjected to the closest scrutiny if the same people that have a personal interest in its adoption have both originally authorized the contract as directors and then ratified it as stockholders.

Normally a stockholder is free to vote in his own best interest and there appears to be no reason to deprive a stockholder of this right simply because he also happens to be a director.[17] A dominant or

12. Crump v. Bronson, 168 Va. 527, 191 S.E. 663 (1937); Marcuse v. Broad-Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935); 2 W. FLETCHER, PRIVATE CORPORATIONS § 426 (1969 rev. vol.) [hereinafter cited as FLETCHER].

13. Crump v. Bronson, 168 Va. 527, 191 S.E. 663 (1937); Marcuse v. Broad-Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935); VA. CODE ANN. § 13.1-39 (Repl. Vol. 1973); 2 FLETCHER, *supra* note 12, §§ 419, 426.

14. Koch v. Seventh St. Realty Corp., 205 Va. 65, 135 S.E.2d 131 (1964); Addison v. Lewis, 75 Va. 701, 721 (1881).

15. *See* cases cited note 14 *supra*.

16. *See generally* Folk, *Conflicts of Interest under State Law*, THIRD ANNUAL INSITITUTE ON SECURITIES REGULATIONS, 179, 181 (A. Fleischer & R. Mundheim, ed. P.L.I. 1972).

17. 3 FLETCHER, *supra* note 12, § 983; Northwest Trans. Co. v. Beatty, 12 App. Cas. 589 (P.C. 1887). *See* Marsh, *supra* note 1, at 49, to the effect that in many jurisdictions interested

controlling stockholder, on the other hand, has a fiduciary duty to act fairly toward the corporation and minority stockholders.[18] This by itself should restrict his freedom in voting upon a contract in which he has an interest, even if he has refrained from placing himself on the board of directors. The net result is that a dominant or controlling stockholder probably will be allowed to vote on the ratification of a contract in which he has an interest, but that ratification will be ineffective if the contract is unfair or oppressive to the corporation.[19]

A type of corporate conflict closely related to the problem of stockholder ratification involves contracts in which a non-director controlling stockholder of the corporation has an interest. This is a very troublesome area. It differs from ratification in that a stockholder cannot act for the corporation and therefore is not in a position in which he can directly cause the corporation to enter into a contract.[20] If the board of directors is itself disinterested there will be no need for ratification. Nevertheless, it will normally be difficult to say that such a contract was formulated on an arms length basis. The solution adopted by the Virginia Supreme Court is to treat a director, if he can be shown to be representing a controlling stockholder rather than the best interests of the corporation, as having a conflict of interest.[21] A contract adopted by the vote of one or more such "dummy" directors will then be voidable due to the lack of disinterested directors, rather than because of an interest of the corporation's controlling stockholder.

Regardless of the mechanical process used to adopt a contract in which a director is interested, that contract is voidable at common law if it is unfair to the corporation. This is true even if a disinterested majority of the directors has voted for the contract after full

directors may vote as stockholders to ratify contracts.

18. Pepper v. Litton, 308 U.S. 295 (1939); Mardel Sec., Inc. v. Alexandria Gazette Corp., 320 F.2d 890 (4th Cir. 1963) (applying Virginia law).

19. This results from a violation of the fiduciary duty owed the corporation as a controlling stockholder, not as a director.

20. The management of a corporation is vested by statute in the board of directors, and, while stockholders have the power in certain instances to affirm contracts, they lack the power to adopt a contract initially. VA. CODE ANN. § 13.1-35 (Repl. Vol. 1973).

21. Mardel Sec., Inc. v. Alexander Gazette Corp., 320 F.2d 890 (4th Cir. 1963) (applying Virginia law); Marcuse v. Broad-Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935), *citing with approval, In re* Webster Loose Leaf Filing Co., 240 F. 779 (D.N.J. 1916).

disclosure of the interest of the interested directors.[22] The basis for this rule is that the director cannot truly put himself in the status of an unrelated third party because he will continue to have the trust and good will of the rest of the board.[23] In fact, the board of directors may well be less critical of a contract in which a fellow director is interested than of contracts generally, either because of a reluctance to deal harshly with an associate or because of an inherent trust of a person who normally has the interests of the corporation in mind.[24]

In the event that the corporation wishes to avoid a contract on the grounds that it is unfair, the courts have placed the burden of proving the fairness of the contract upon the officer or director who is trying to uphold it, since he is a fiduciary and should be held strictly accountable.[25] This seems particularly appropriate, since it is unlikely that the board which adopted a contract would seek to avoid it and therefore, the plaintiff is usually a trustee in bankruptcy or a minority stockholder bringing a derivative action. In either case, the interested director will normally have greater access to the relevant proof.[26]

The Virginia cases on conflict of interest have dealt only with directors or with officers who were also directors. The language used, however, is sufficiently broad to encompass a non-director officer, and the same rules appear to be applicable to either group.[27] Certainly if an interested officer has taken part in negotiating a contract it should be voidable, because the corporation may well have been deprived of the best bargain it could have obtained. Similar considerations apply if the interested officer attempts to influence the board of directors, at least in the absence of disclosure of the officer's interest. If, on the other hand, the interested officer has had

22. Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935); 3 FLETCHER, *supra* note 12, § 919.

23. Deford v. Ballentine Realty Corp., 164 Va. 436, 448, 180 S.E. 164, 169 (1935).

24. *See* Comments on Proposed Amendments, *supra* note 6, at 39.1-1, -2.

25. Pepper v. Litton, 308 U.S. 295 (1939); Mardel Sec., Inc. v. Alexandria Gazette Corp., 320 F.2d 890 (4th Cir. 1963); 3 FLETCHER, *supra* note 12, § 921.

26. *See* Marsh, *supra* note 1, at 55-56, as to the usual procedural posture of such cases.

27. *See* Kessler v. Commonwealth Doctors Hosp., Inc., 212 Va. 497, 185 S.E.2d 43 (1971); Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935). *But cf.* BALLENTINE ON CORPORATIONS § 123 (1927), suggesting that other rules may apply to officers.

no influence on the terms of the contract or on its adoption, there may be no potential harm to the corporation despite a failure to disclose the interest of that officer. Nevertheless, it is not always possible to accurately determine after the fact the role which a particular officer may have played in the adoption of a contract. Also, the subtle influences which an officer may exert upon his fellow officers or the directors may be difficult for the interested officer to avoid, or for the disinterested officers and directors to detect, without prior disclosure that a conflict exists. In addition, a corporation generally relies upon each of its officers to do his best to negotiate a contract or to find alternative contracts. Such considerations may well justify a prophylactic rule rendering such a contract voidable, at least in the event that the contract is determined to have been unfair to the corporation.

II. The Virginia Statute on Conflicts of Interest

The 1975 General Assembly enacted Virginia Code § 13.1-39.1, relating to contracts in which an officer or director of a corporation has an interest adverse to that of the corporation.[28] The statute is modeled on § 41 of the Model Business Corporation Act,[29] which is, in turn, similar in both form and substance to statutory provisions adopted in California and several other states, although substantial differences do exist among § 13.1-39.1, the Model Corporation Act and the various other state provisions.[30]

Under this new statute, a contract in which an officer or director has an adverse interest will not be voidable due to the existence of that conflict if (1) after adequate disclosure of the conflict to the board of directors, it is nevertheless approved without counting the votes of any interested directors, or (2) after adequate disclosure of the conflict to the stockholders, they nevertheless appprove it, or (3) whether or not any disclosure has been made, the contract appears fair and reasonable to the corporation at the time it is approved based upon all of the facts then known by any officer or director.

28. Va. Code Ann. § 13.1-39.1 (effective June 1, 1975); Va. Acts of Assembly 1975, ch. 500, at 17. The full text of section 13.1-39.1 is set out at note 5, *supra*.

29. ALI-ABA Model Bus. Corp. Act. Ann. 2d § 41 (1969).

30. *Compare* ALI-ABA Model Bus. Corp. Act Ann. 2d § 41 (1969) *with* Cal. Corp. Code § 820 (West 1955), N.Y. Bus. Corp. Law § 713 (McKinney 1963), S.C. Code Ann. § 12-18.16 (Cum. Supp. 1974) *and* Va. Code Ann. § 13.1-39.1 (effective June 1, 1975).

A. Scope of Virginia Code § 13.1-39.1

Virginia Code § 13.1-39.1 deals with the voidability of contracts purely on the grounds that an officer or director has an adverse interest in that contract. Its purpose is only to eliminate certain common law rules relating to voting by directors or officers having a personal interest in a transaction.[31] It in no way negates any remedies which a corporation may have against an officer or director resulting from his failure to perform his duties to the corporation in connection with such a contract, or with the avoidance on other grounds of a contract in which an officer or director happens to have an interest. These are matters which will continue to be left to the courts for determination under general equitable principles.[32] Nor does the statute deal with the voidability of contracts in which a stockholder, including a controlling stockholder, may have an interest.[33] It is broader than many statutes relating to conflicts of interest, however, in that it applies to conflicts of officers as well as those of directors.[34] The statute does not speak directly to the problem of a director who has no personal interest in a contract but who merely sits as a representative of another person who does have an interest.[35] Presumably the common law rule still applies that a director is considered to be an interested director if he is "dominated" by or acting on behalf of a person having an interest in the contract.[36]

The statute applies to a wide varity of conflicts which could potentially disqualify a director's or officer's vote. The Model Corporation Act and the statutes of many states refer only to contracts or other transactions in which a director has a financial interest.[37] This

31. ALI-ABA MODEL BUS. CORP. ACT ANN. 2d § 41, Comment (1969).

32. *Id.*; Address by Prof. Hetherington, Virginia State Bar Annual Meeting, June 22, 1974.

33. ALI-ABA MODEL BUS. CORP. ACT ANN. 2d § 41, Comment (1969); Address by Prof. Hetherington, Virginia State Bar Annual Meeting, June 22, 1974; Hetherington, *Proposed Amendments to the Virginia Stock Corporation Law*, 4 BUS. LAW SEC. NEWSLETTER No. 1, at 2 (October, 1974). See text accompanying notes 18-21 *supra* for discussion of law relating to conflicts of interest of controlling stockholders.

34. Comments on Proposed Amendments, *supra* note 6, at 39.1-1.

35. Address by Prof. Hetherington, Virginia State Bar Annual Meeting, June 22, 1974; letter from Prof. Hetherington to A.C. Epps, Jr., March 1, 1974.

36. *See* note 21 *supra* and accompanying text; Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964).

37. *See, e.g.*, ALI-ABA MODEL BUS. CORP. ACT ANN. 2d § 41 (1969); CAL. CORP. CODE § 820 (West 1955); N.Y. BUS. CORP. LAW § 713 (McKinney 1963).

limitation to financial interests was reflected in an early draft of the Virginia statute.[38] It was amended to its present form to expand the statute's coverage to any type of interest which would cause a division of the director's loyalty, including, for example, a contract in which a relative of a director has a direct interest.[39] It also covers indirect interests of officers and directors, such as contracts with other corporations of which they are also directors or officers.

B. Contracts Subject to Affirmance Under Virginia Code § 13.1-39.1(a)

Subsection (a) of the statute[40] provides that a contract will no longer be automatically voidable due to the fact that the vote of one or more interested directors is counted for its adoption. To the extent that this language validates the vote of an interested director, it constitutes a major break with the common law in Virginia. To illustrate this point, assume a situation involving a five man board of directors, two of whom have personal interests in a contract to be voted upon. Assume further that the two interested directors and one disinterested director vote in favor of the contract while the other two disinterested directors vote against it. At common law the contract would have been rejected, having been defeated by a two to one vote of the disinterested directors.[41] Under this statute, however, it would be adopted by the board by a three to two vote and,

38. H.B. No. 1151 (1973).

39. Comments on Proposed Amendments, *supra* note 6, at 39.1-1.

40. VA. CODE ANN. § 13.1-39.1(a) (effective June 1, 1975) provides:

(a) No contract or other transaction between a corporation and one or more of its officers or directors or in which one or more of its officers or directors are interested and no contract or other transaction between a corporation and any other corporation, firm, association or entity in which one or more of its officers or directors are directors or officers or are interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, provided that the material facts as to his or their relationship or interest are disclosed or known:

(i) to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote sufficient for the purpose without counting the votes of such interested directors; or

(ii) to the stockholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent.

41. *See* text accompanying note 12 *supra*.

if one of the tests for enforceability set forth in the statute is met, it would not be subject to later avoidance by the corporation.

In order for a contract to be approved under either parts (i) or (ii) of subsection (a), an interested director must disclose "the material facts as to his . . . relationship or interest"[42] to the directors or stockholders, respectively. This is broader than the requirement in the Model Act and earlier drafts of the Virginia statute, which would have required disclosure only of the fact that a conflict of interest existed, but not of the material facts related to the nature of that interest.[43] The disclosure called for by the statute, however, still does not require an interested director to supply information relating to the merits of the contract.[44] Presumably the duty to supply this additional information continues under the general duty of every director to supply relevant information to the corporation.[45]

A board of directors is not qualified to take any action unless a quorum of directors is present.[46] The statute does not state whether an interested director may be counted in determining the presence of a quorum. Presumably the common law rule that the interested director cannot be counted in determining the presence of a quorum still controls,[47] since statutes in derogation of the common law should be strictly construed. This view is bolstered by a comparison of the new statute with the Model Corporation Act and with earlier drafts of the Virginia statute. Both of these sources include specific authorization for counting interested directors to determine the presence of a quorum; that authorization, however, was deleted in the final draft of the Virginia statute.[48] If a contract is approved at a board meeting at which an interested director was needed to con-

42. VA. CODE ANN. § 13.1-39.1(a) (effective June 1, 1975).

43. H.B. No. 1151 (1973); ALI-ABA MODEL BUS. CORP. ACT ANN. 2d § 41 (1969). The inadequacy of this coverage was pointed out in Comments on Proposed Amendments, *supra* note 6, at 39.1-5.

44. *See* Comments on Proposed Amendments, *supra* note 6, at 39.1-5, -6, which urged the inclusion of the following language in section 13.1-39.1(a):

> The material facts as to his relationship or interest and as to the contract or transaction are disclosed . . . .

45. *See* note 11 *supra*.

46. VA. CODE ANN. § 13.1-39 (Repl. Vol. 1973).

47. *See* text accompanying note 13 *supra*.

48. *Compare* VA. CODE ANN. § 13.1-39.1 (effective June 1, 1975) *with* ALI-ABA MODEL BUS. CORP. ACT ANN. 2d § 41 (1969) *and* H.B. No. 1151 (1973).

stitute a quorum, that contract will be voidable, not because he was there or voted, but because it was approved at a meeting which lacked a quorum.[49] Accordingly, such a contract cannot be validated pursuant to § 13.1-39.1, which does not relate to the enforceability of contracts which are voidable because adopted at an improperly constituted meeting.

C. *Contracts Approved by Disinterested Directors*

The first statutory test for validating a contract in which officers or directors have an interest is contained in part (i) of § 13.1-39.1(a). This provides that such a contract will not be voidable due to that interest if, after adequate disclosure, it is adopted or ratified "by a vote sufficient for the purpose without counting the vote of such interested directors."[50] Action by the board of directors requires the favorable vote of a majority of the directors present at a meeting at which a quorum is present.[51] A vote "sufficient for the purpose," therefore, would require the vote of that number of disinterested directors sufficient to constitute a majority of the total number of directors present, including interested directors. In determing whether the contract had been validated pursuant to part (i) of subsection (a), the votes of interested directors would in effect be treated the same as negative votes, and a greater number of favorable disinterested votes would be needed than if the interested directors had not been present. This is not to say that a contract adopted by a majority of the total number of directors present, but not a majority of the disinterested directors, would not have been validly adopted. Nor would it necessarily be voidable. In order for it not to be voidable it must merely meet one of the other statutory tests.

D. *Contracts Approved by Stockholders*

Part (ii) of subsection (a) validates a contract in which an officer or director has an interest if, after disclosure, the stockholders au-

49. *See* text accompanying note 13 *supra*.

50. VA. CODE ANN. § 13.1-39.1(a)(i) (effective June 1, 1975).

51. *Id.* § 13.1-39 (Repl. Vol. 1973). *See* Comments on Proposed Amendments, *supra* note 6, at 39.1-1 (discussing rejection of a rule allowing approval by disinterested directors constituting less than majority of board members present); Rapoport v. Schneider, 29 N.Y.2d 396, 278 N.E.2d 642, 328 N.Y.S.2d 431 (1972) (implying necessity of disinterested quorum in absence of specific statutory authority).

thorize, approve or ratify the contract. Stockholder ratification is generally necessary in situations in which the directors lack the authority to bind the corporation.[52] At common law, actions of the board of directors which were otherwise subject to avoidance could be ratified and made the binding act of the corporation if knowingly approved by the stockholders.[53] The procedure set forth in part (ii) of subsection (a) of the statute is largely a statutory recognition and refinement of the common law concept of ratification.[54]

The statute clearly allows a stockholder having an interest in a contract to vote for its ratification, even if he was the officer or director whose conflict of interest had caused the approval of the stockholders to be necessary.[55] The language of part (ii) of subsection (a) referring to the vote of all "stockholders entitled to vote" contrasts sharply with the language of part (i), which specifically excludes the "votes of . . . interested directors".[56] The language relating to stockholders "entitled to vote" parallels the statutory language which accords the right to vote to each outstanding share of stock.[57]

The statute does not require resort first to part (i) to uphold a contract in which a director has an interest, with recourse to subsection (ii) only if an insufficient number of disinterested directors had been present at the board meeting to make compliance with subsection (i) possible.[58] The desirability of such a result is questionable. The board of directors is charged with the duty of managing the corporation,[59] and recourse should be had to the stockholders only

52. 2 FLETCHER, *supra* note 12, § 429.

53. *Id. See* text accompanying note 14 *supra*.

54. Section 13.1-39.1(a)(ii) is not an affirmative grant of authority to stockholders to adopt contracts. *See* note 20 *supra* and accompanying text as to the lack of such power. *See also* Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 260 P.2d 823 (1953); Lewis v. Steinhart, 40 App. Div. 2d 817, 338 N.Y.S.2d 552 (1972); ALI-ABA MODEL BUS. CORP. ACT ANN. 2d, § 41, Comment (1969).

55. *See* text accompanying notes 18-21 *supra* for common law rules relating to ratification by stockholders.

56. VA. CODE ANN. § 13.1-39.1(a)(i), (ii) (effective June 1, 1975). N.Y. BUS. CORP. LAW §713(a)(2), now in substance identical to VA. CODE ANN. § 13.1-39.1(a)(ii) (effective June 1, 1975), was amended specifically to authorize interested stockholders to vote. N.Y. LAWS 1962, ch. 834, § 52 (1963).

57. VA. CODE ANN. § 13.1-32 (Repl. Vol. 1973).

58. See text accompanying notes 46-49 *supra* for discussion of contracts adopted at a meeting at which an interested director was necessary to make a quorum.

59. VA. CODE ANN. § 13.1-39 (Repl. Vol. 1973).

when the board is legally unable to act in a manner conclusive upon the corporation. If a quorum of disinterested directors is present to act upon the contract and, without counting the votes of interested directors, had rejected it, it is difficult to see why the interested directors should be afforded a second chance to make the contract binding upon the corporation. This, in effect, will substitute the judgment of the stockholders for that of the disinterested directors. This may be justifiable if there are not enough disinterested directors to constitute a majority of a quorum. It is not justified when the disinterested directors would be competent to act for the corporation were it not for the presence of a sufficient number of interested directors at the meeting that the act of a majority of the disinterested directors is not the act of a majority of the total number of directors present. It would have been preferable for the statute to have treated a contract under such circumstances as voidable as at common law, unless shown to be "fair and reasonable" pursuant to subsection (b) of the statute.

Another salutary rule would have been to require disclosure to the board as a prerequisite to seeking stockholder ratification, particularly since such disclosure might well affect the vote of some of the directors. It would be particularly egregious for an interested director to intentionally refrain from disclosing his interest to the other directors and, following adoption of the contract by the board, to then disclose his interest to the stockholders when seeking ratification pursuant to subsection (ii). In such a case, the only recourse of the corporation is to recover damages from the director based on his breach of his fiduciary duty or, in some cases, to seek avoidance of the contract on other grounds.[60] Needless to say, the right to recover damages may be grossly inadequate to compensate the corporation, depending upon the financial resources of the director.

E. The Requirement of Fairness

At common law a contract in which an officer or director had an interest was required to be fair, in addition to having satisfied requirements of disclosure and independent corporate representation analogous to parts (i) and (ii) of subsection (a). This seems to be a salutary policy, for it is clearly not safe to assume that simply be-

60. *See* note 8 *supra*.

cause disclosure is made the board of directors will not enter into an unfair contract. In addition to the normal risk that a board of directors may simply do a poor job of evaluating a contract, there is a substantial risk that the board of directors will be more obliging and less critical in their scrutiny of a contract with a fellow director.

A literal reading of subsection (a) would indicate that a contract involving a conflict of interest which had been approved under either of parts (i) or (ii) of subsection (a) would be enforceable against the corporation even if it was unfair. This view is supported by the fact that "fairness" is set forth in section (b) of the staute as a separate and independent ground for upholding such a contract.

Nevertheless, faced with unfair contracts approved under the terms of a California statute nearly identical to § 13.1-39.1, the California courts have consistently imposed a requirement of fairness to the corporation in addition to technical statutory compliance.[61] Several commentators on similar statutes have consistently taken the view that this judicially imposed requirement of fairness was appropriate and should be applied under other similar statutes.[62] Normally a court, in interpreting a statute similar to that of another jurisdiction, will consider as persuasive the case law of that other jurisdiction. Hopefully the California approach will be followed in Virginia.[63] Such a judicially imposed requirement would presumably look to the concept of fairness established by prior case law, which relates to the actual fairness of the transaction at the time at which it was entered into. Clearly, the adoption of a contract which the directors, in the exercise of due care, should have known was unfair is a breach of the duty owed by those directors to the

61. Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

62. C. Israels, CORPORATE PRACTICE 135 (1963); Hornstein, *Analysis of Business Corporation Law*, app. 1, N.Y. BUS. CORP. LAW 441, 469 (McKinney 1963); Note, *The "Unfair" Interested Directors' Contract Under The New York Business Corporation Law*, 16 BUFFALO L. REV. 840 (1967).

63. Address by Prof. Hetherington, Virginia State Bar Annual Meeting, June 22, 1974; letter from Prof. Dooley to the author, January 7, 1974, stating that the intention under section 13.1-39.1 is that a contract with an interested director in all cases be voidable on the ground of unfairness, with compliance with the statutory procedures merely shifting the burden of proof on the question of fairness. *But see* Comments on Proposed Amendments, *supra* note 6, at 39.1-2, indicating that an unfair contract approved pursuant to the literal terms of the Virginia statute might be sustained.

corporation, and avoidance of such contracts is the only adequate remedy available to the corporation.

Regardless of the existence of any superimposed requirement of fairness, the Virginia statute on conflicts of interest specifically provides that fairness alone will validate a contract, without having to obtain the consent of either the stockholders or the disinterested directors. Subsection (b) of § 13.1-39.1[64] provides that a contract in which an officer or director has an interest will not be voidable if "fair and reasonable" to the corporation. This approach is in keeping with common law developments in many states.[65] It was specifically inserted by the drafters of the legislation, who felt that "fairness" as a separate ground for affirmance was necessary to validate beneficial contracts in which there has been an inadvertent failure to recognize or disclose a conflict of interest.[66]

Subsection (b) states that fairness alone is sufficient to prevent avoidance of contracts involving conflicts of interest. It makes no distinction between cases in which the approval of the disinterested directors or the stockholders was intentionally not sought and those cases in which it was omitted through oversight. It would literally validate even a contract which the disinterested directors and the stockholders had refused to validate, if a court could be convinced that the terms of the contract fell within the broad spectrum which could be classified as "fair and reasonable".[67]

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64. VA. CODE ANN. § 13.1-39.1(b) (effective June 1, 1975) provides:
In any event no contract or other transaction described in subsection (a) of this section shall be void or voidable despite failure to comply with parts (i) or (ii) of subsection (a), provided that such contract or transaction was fair and reasonable to the corporation in view of all the facts known to any officer or director at the time such contract or transaction was entered into on behalf of the corporation. In an action to obtain relief for the corporation on account of a contract or other transaction described in subsection (a) in which there was no compliance with parts (i) or (ii) of subsection (a) such contract or transaction may be avoided for the benefit of the corporation and the court may grant other appropriate relief unless the party seeking to uphold the contract or transaction sustains the burden of proving that such contract or transaction complied with the requirement of the first sentence of this subsection (b).

65. *See* note 4 *supra* and accompanying text.

66. Letter from Prof. Dooley to the author, January 7, 1974. *But see* Hetherington, *Trends in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961*, 1963 WIS. L. REV. 92, 150 [hereinafter cited as *Trends in Legislation*], for view that there is no legitimate reason for the failure of a fiduciary to disclose his interest.

67. *See Trends in Legislation, supra* note 66, at 149-51, discussing this problem in connec-

The requirement that a contract be fair and reasonable to the corporation does prevent the corporation from being substantially harmed by the contract. However, a corporation is entitled to have not only a fair contract, but the best bargain which its agents can negotiate. A contract can easily fall within the broad range of contracts which can be called fair and yet be far short of the best contract terms available.[68] Such a result would be particularly reprehensible when the officer or director having the conflict actively participates in contract negotiations which result in terms more beneficial to the other party than were necessary to reach agreement. The corporation is entitled to be represented by an advocate rather than a mediator, or at least to be warned that it is not so represented. Unless the actions of the interested officer or director provide other grounds for rescission, the only recourse of the corporation would be against the officer or director personally to recover the difference between what was obtained and what could have been obtained by an agent unhampered by a conflict of interest. In such a suit, unfortunately, it may be impossible to determine what contractual terms could have been obtained.

There are some interpretive problems relating to the test of fairness set forth in subsection (b). The test calls for fairness and reasonableness "in view of all of the facts known to any officer or director" at the time the contract was entered into.[69] Clearly this standard would invalidate a contract which any single officer or director, including the officer or director having a conflict of interest, knew to be unfair. It is less clear whether the statute would invalidate a contract if one director knew undisclosed facts which, had they been disclosed, would have caused a second director to realize, in view of facts known only to that second director, that the contract was unfair. A literal reading of "any officer or director" might invalidate a contract only if a single person has knowledge of sufficient facts to show that the contract is unfair or unreasonable, and would validate a contract for which reference must be made to the knowledge of more than one director to show the contract to be unfair. The thought of looking to the knowledge of a single director,

tion with N.Y. BUS. CORP. LAW § 713 (McKinney 1962).

68. *Id.*; Marsh, *supra* note 1, at 49.

69. VA. CODE ANN. § 13.1-39.1(b) (effective June 1, 1975).

much less a single officer, is contrary to the concept of the board of directors as a deliberative body.[70] A review of the aggregate facts known to the entire board seems more reasonably in keeping with general corporate principles, and is clearly the more desirable interpretation of the language of the statute. Such an interpretation is supported by the duty of each director and officer to disclose such negative information as he has in his possession to the board, so that all of such facts should have been available to the board. Suffice it to point out, however, that the failure of the director to mention such information may have been completely innocent in that his information alone may not have been harmful, even though if it had been combined with undisclosed information held by others it would have led to the discovery of the unfairness of the contract.

The reference to "any officer and director" should include directors who were not present at the adoption of the contract. If reference to the facts known to such directors were not available to defeat a defense of a contract based on subsection (b), the intent of the statute could be subverted by an interested director intentionally staying away from the board meeting. The justification for including facts known to all officers is less direct, but serves the same general prophylactic function. The corporation is entitled to disclosure of information known by its officers, and should not be penalized by the failure of an officer to perform his duty.

The operation of subsection (b) does not depend upon the actual disclosure of adverse facts to the board of directors. Nor does it matter whether any officer or director actually believed the contract to be unfair. Subsection (b) simply states that the facts upon which a court must make a decision as to the fairness and reasonableness of the contract are limited to the facts within the knowledge of the officers and directors at the time that the contract was adopted. This is at least a slight relaxation of the common law, which would have allowed a review of all facts concerning the contract, including facts not available to the corporation, to determine whether it was fair at the time of its adoption.[71]

The statute does retain the common law rule placing the burden

70. 2 FLETCHER, *supra* note 12, § 392.

71. Deford v. Ballentine Realty Corp., 164 Va. 436, 180 S.E. 164 (1935); 3 FLETCHER, *supra* note 12, § 919.

of proving the fairness of the contract under subsection (b) on the officer or director having the conflict of interest.[72] It would not seem appropriate to draw the correlative inference that the burden of proving unfairness shifts to the corporation when it attacks a contract approved pursuant to subsection (a). In the absence of an express change, the burden of proof should presumably remain with the interested officer or director.

III. CONCLUSION

One positive result of the adoption of § 13.1-39.1 is the creation, under most circumstances, of certainty as to the status of contracts involving conflicts of interest. While the requirements of the statute are unclear or ambiguous in certain respects, in practice there should be relatively few situations which require clarification of these requirements for their resolution. Certainly the statute has removed several questions which existed at common law. It provides a procedure whereby officers and directors can enter into contracts beneficial to the corporation with a substantial degree of safety. Assuming that the Virginia courts will continue to require an officer or director to be fair in his dealings with a corporation, and to void contracts which are not fair,[73] the procedures outline in subsection (a) of the statute should provide adequate protection to a corporation in most cases.

The statute does not deal with several problem areas related to contracts involving conflicts of interest, including related contract defenses such as fraud and undue influence. Unfortunately, the exact scope of these defenses is not very well defined in the corporate context because most cases involving them relate to contracts which were previously subject to avoidance because they also involved a conflict of interest with a director or officer.[74] Now that such conflicts of interest will not be available as a separate ground for avoidance of many such contracts, the parameters of fraud and undue influence will have to be more clearly defined in this context by the courts.

72. *See* text accompanying note 25 *supra*.
73. *See* text accompanying note 63 *supra*.
74. *See, e.g.*, 13 WILLISTON ON CONTRACTS § 1625A at 793-95 (3d ed. 1970).

The statute most radically departs from its common law antecedents by validating contracts involving conflicts of interest solely on the ground that the contract is fair and reasonable to the corporation. While this position has been taken elsewhere,[75] it has never before been the law in Virginia. The Virginia Supreme Court has repeatedly insisted upon disclosure of adverse interests as an additional condition to holding such contracts enforceable.[76]

This departure from the common law is not altogether desirable. Little is gained by the statute's abrogation of the common law requirement of disclosing personal interests. The cases in which an officer or director has a material interest in a contract and fails to realize it should be sufficiently rare as not to warrant protection. If a board member intentionally keeps his interest a secret from the board, the common law rule which would have let the corporation void the contract does not appear harsh.

It is only through the disclosure of such interests that the corporation is in a position to adequately protect itself by having agents of undivided loyalty act on its behalf. Only through representation by such agents is the corporation likely to arrive at contract terms most favorable to it. If the corporation receives anything less, even though fair, it has been cheated, and it will, in most instances, have no adequate remedy.

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75. *See* note 4 *supra* and accompanying text. *See also Trends in Legislation*, *supra* note 66, at 149-51, for a persuasive attack on the adequacy of "fairness" as an independent ground for upholding contracts.

76. Kessler v. Commonwealth Doctors Hosp., 212 Va. 497, 185 S.E.2d 43 (1971); Rowland v. Kable, 174 Va. 343, 6 S.E.2d 633 (1940).