

A Catch-22 or a Catch-All?: Delaware and Texas Grasp for Certainty in Shareholder Ratification

I. INTRODUCTION

In the wake of corporate calamities such as Enron and World Bank, a renewed interest in corporate law has arisen among legislators, judges, lawyers, and businesspeople. Specifically, in the post-Enron corporate environment, corporate management must understand their fiduciary duties to the corporation and the situations in which legal annulment alleviates a breach of these duties. One way directors may avoid litigation for breaching their fiduciary duties when involved in self-dealing transactions is by the safety net known as shareholder ratification. Broadly defined, shareholder ratification is “any approval of challenged board action by a fully informed vote of shareholders, irrespective of whether that shareholder vote is legally required for the transaction to attain legal existence.” This Comment will focus on self-

1. The phrase “Catch-22” originated in Joseph Heller’s 1961 novel of the same name. The term as created in the novel refers to a situation where one bureaucratic regulation depends on another, which in turn depends on the first. More commonly, this thought of as a vicious cycle. JOSEPH HELLER, *CATCH-22* 45 (Simon & Schuster 1961) (1961).

2. Kirstine Drew, *Enron, the FCPA and the OECD Convention*, (April 9, 2002), at <http://www.globalpolicy.org/socecon/crisis/2002/0409enron.doc>.

3. Carol Giacomo, *World Bank Corruption May Top \$100 Billion*, (May 13, 2004), at <http://www.globalpolicy.org/socecon/bwi-wto/wbank/2004/0513corrupt.htm>.

4. Self-dealing transactions are also commonly referred to as “conflict-of-interest” transactions or simply “interested transactions.”

5. *See, e.g.*, DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005); 1 CAL. CORP. CODE § 310 (West 2003); N.Y. BUS. CORP. LAW § 713 (McKinney 2003); REV. MODEL BUS. CORP. ACT §§ 8.63-8.64.

6. In re Wheelabrator Tech., Inc. S’holders Litig., 663 A.2d 1194, 1201, n.4 (Del. Ch. 1995) (hereinafter *Wheelabrator II*). Generally speaking, ratification is the “[c]onfirmation and acceptance of a previous act, thereby making the act valid from the moment it was done.” BLACK’S LAW DICTIONARY 1288 (7th ed. 1999).

interested transactions that do not necessarily require both directorial and shareholder approval to become operative.

Under the corporate law statutes of many states, validating a conflict-of-interest transaction requires ratification by either disinterested directors or a majority of the shareholders. However, to the chagrin of would-be corporate organizers hoping for bright-line rules, shareholder ratification of conflict-of-interest transactions is infamous for its ambiguity. Both Delaware and Texas have statutory provisions which provide “safe harbors” for self-dealing transactions. Although both states have long recognized the power of shareholder ratification, the effect of such ratification remains incompletely resolved. This Comment will explain the legal significance in the subtle difference in language between the Delaware and Texas conflict-of-interest statutes.

Part II of this Comment introduces the differing language in the conflict-of-interest statutes of Delaware and Texas. Part III explains the concept of the business judgment rule and defines corporate fiduciary duties, describing the necessary component of shareholder ratification in corporate law. Part IV clarifies the legal requirements for valid shareholder ratification. In light of Texas’s amended conflict-of-interest statute, Part V addresses the legal effect of shareholder ratification in Delaware and Texas, highlighting the insight provided in Delaware’s *In re the Walt Disney Company Derivative Litigation* and Texas’s *Landon v. S & H Marketing Group, Inc.* Part VI addresses the benefits of Dela-

7. See *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996). Three common examples of actions which require such dual approval are “amendments to the certificate of incorporation (8 *Del. C.* § 242); mergers or consolidations of domestic corporations (8 *Del. C.* § 251); and sales of all or substantially all of a corporation’s assets (8 *Del. C.* § 271, which permits a sequence that may vary from the sequences applicable to amendments or mergers).” *Id.*

8. See, e.g., DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005); 1 CAL. CORP. CODE § 310 (West 2003); N.Y. BUS. CORP. LAW § 713 (McKinney 2003); REV. MODEL BUS. CORP. ACT §§ 8.63-.64 (2005).

9. DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

10. The power of fully informed shareholder ratification to cloak transactions in the business judgment rule, or to extinguish a breach of fiduciary duty claim entirely, is by no means absolute. Unfortunately for directors, shareholders, litigants, and their attorneys, Delaware’s law concerning the effect of shareholder ratification in the face of an alleged breach is not a model of clarity. See *Solomon v. Armstrong*, 747 A.2d 1098, 1113 (Del. Ch. 1999).

11. 731 A.2d 342 (Del. Ch. 1998).

12. 82 S.W.3d 666 (Tex. App. 2002) *no pet.*

2006

A Catch-22 or a Catch-All?

ware as compared to Texas with respect to corporate choice of a state of incorporation, expressing how Delaware's statute feasibly creates a catch-22 for corporate management. Ultimately, the Comment asserts that the Texas approach to self-interested transactions provides directors with greater certainty and predictability, thus making Texas more alluring as a location for incorporation.

II. DELAWARE'S SECTION 144(A) VS. TEXAS'S SECTION 2.35-1(A)

To fully comprehend the differing legal effects of Delaware's and Texas's similar statutory provision, it is necessary to examine the language of the statutes in full. Additionally, the full language will be helpful throughout the Comment as a point of reference for understanding the comparisons made between the statutes.

Delaware's conflict-of-interest statute reads:

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

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum;
or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by a vote of the shareholders;
or

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

Prior to 1997, Texas corporate law reflected Delaware's section 144(a) and, notably, identically mirrored the introductory paragraph of the Delaware code. However, in 1997 the Texas State Legislature amended Texas's conflict-of-interest statute. Current Texas corporate law provides that:

An otherwise valid contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other domestic or foreign corporation or other entity in which one or more of its directors or officers are directors or officers or have a financial interest, shall be valid notwithstanding whether the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if any one of the following is satisfied:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative vote of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and

13. DEL. CODE ANN. tit. 8 § 144(a) (2005).

14. TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 1996):
A. No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers or have a financial interest, shall be void or voidable solely for this reason, solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose. . . . *Id.*

15. S.B. 555, 75th Gen. Assem., Reg. Sess., at § 13 (Tex. 1997).

2006

A Catch-22 or a Catch-All?

the contract or transaction is specifically approved in good faith by vote of the shareholders; or

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

The language of these statutes reflects both similarities and differences to the respective approaches taken by the legislatures of Texas and Delaware. Both Delaware and Texas allow the validation of a self-dealing transaction by one of three ways: a majority vote by disinterested directors; a majority vote by fully informed shareholders; or by establishing the transaction was fair to the respective parties. The Delaware statute, however, expresses that a self-dealing transaction is not “void or voidable” purely because of its self-dealing nature if a statutory safe harbor applies. In contrast, the introductory language of Texas’s current self-dealing statute provides that a self-dealing transaction “shall be valid” if one of the statutory safe harbors applies. This slight variation in language significantly impacts the effect of shareholder ratification in each state.

III. WHEN AND WHY CORPORATE LAW REQUIRES SHAREHOLDER RATIFICATION

To appreciate the impact shareholder ratification has on corporate law, one must understand both the legal and policy aspects of directorial fiduciary duties. As a legal precept, the business judgment rule and the scope of the fiduciary duties of corporate directors are both intricately linked to shareholder ratification. Of equal importance is the legal distinction between a void and a voidable transaction. When these legal concepts are understood in the context of real world decision-making, the value of shareholder ratification as an option to validate self-dealing transactions is unmistakable.

16. TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

17. DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

18. DEL. CODE ANN. tit. 8 § 144(a) (2005).

19. TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

20. See *infra* notes 71-126 and accompanying text.

A. *The Business Judgment Rule*

In an effort to avoid judicial meddling into a corporation's internal workings, corporate law has long recognized the business judgment rule, which protects directors against suits for corporate losses resulting from poor business decisions. The simple theory behind the business judgment rule asserts that "[t]he directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions." The business judgment rule favors management by presuming that, in making business decisions, the board of directors act in good faith and in the best interests of the company. This presumption is rebuttable, but the burden of persuasion lies with the party challenging the decision. Upholding the business judgment rule presumption, however, requires only that the directors articulate a single, rational, good-faith reason for making the decision.

Although greatly beneficial to corporate management, some limitations exist regarding the business judgment rule. The business judgment rule does not protect transactions in which directors have breached a fiduciary duty, committed fraudulent conduct, or where the transaction is deemed a waste of corporate assets. If successfully rebutted due to director misconduct, the business judgment rule ceases to apply and the business decision

21. See, e.g., *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889) (instructing that "the courts do not interfere" when a shareholder seeks redress only for the harmful effects of business decisions, "however unwise or inexpedient such acts might be"); *Kamin v. Am. Express Co.*, 383 N.Y.S. 2d 807, 812 (1976) ("The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken... presents no basis for the superimposition of judicial judgment.").

22. *Kamin*, 383 N.Y.S. 2d at 812.

23. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 927-28 (Del. 2003).

24. *Id.*

25. See *Kamin*, 383 N.Y.S. 2d at 812 (demonstrating that even though harmful to shareholder value, the business judgment rule protects business decisions made only for the reason of increasing good will); *FDIC v. Wheat*, 970 F.2d 124, 131 n.13 (5th Cir. 1992) (stating in jury instructions that a "director or officer of a bank shall not be held liable for honest mistake of judgment if he acted with due care, in good faith, and in furtherance of a rational business purpose").

26. See *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992) (noting that the business judgment rule does not apply where "the corporate decision lacks a business purpose, is tainted by conflict of interest, is so egregious to amount to a no-win decision, or results from an obvious... failure to exercise oversight").

is evaluated through the more stringent entire fairness test, which evaluates the substance of the decision. There is, thus, much importance in understanding how a director can breach a fiduciary duty, thereby requiring a showing of entire fairness.

B. *The Basis of Corporate Fiduciary Duties*

The business judgment rule does not protect transactions in which a director has breached his fiduciary duty to the corporation. The concept of a fiduciary relationship originated in agency law. A true fiduciary duty signifies that the fiduciary has a legal duty to protect the interests of another before his private interests. Under corporate law, courts have acknowledged that controlling shareholders, corporate directors, and corporate officers owe a fiduciary duty to both the corporation and the corporation's minority shareholders. For the purposes of this Comment, the duties of corporate directors are of the utmost importance.

Directors in Delaware and Texas have three basic duties to the corporation and its shareholders: (1) the duty of care; (2) the duty

27. See *Solomon*, 747 A.2d at 1112; *Roth v. Mims*, 298 B.R. 272, 283 (N.D. Tex. 2003). For an explanation of the entire fairness test, see *infra* notes 73-81 and accompanying text.

28. *Brown*, 812 F. Supp. at 726.

29. RESTATEMENT (SECOND) OF AGENCY § 13 (2003) ("An agent is a fiduciary with respect to matters within the scope of his agency."). This fiduciary duty concept is evident in other sections of agency law. See RESTATEMENT (SECOND) OF AGENCY § 39 (2003) ("Unless otherwise agreed, authority to act as agent includes only authority to act for the benefit of the principal."); RESTATEMENT (SECOND) OF AGENCY § 388 (2003) (requiring an agent who makes a profit in transactions connected to his agency relationship to give said profits to the principal).

30. Put another way, the fiduciary duty is "[a] duty of utmost good faith, trust, confidence, and candor owned by a fiduciary . . . to the beneficiary . . . ; a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person." BLACK'S LAW DICTIONARY (8th ed. 2004). See also RESTATEMENT (SECOND) OF AGENCY § 387 (2003) (stating that the general principle of the fiduciary relationship between an agent and a principal is the agent's duty "to act solely for the benefit of the principal").

31. These fiduciary duties were recognized as long ago as 1875 in the Supreme Court case of *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 588 (1875).

32. Though outside the scope of this Comment, duties of the directors often serve as a preamble to the duties of officers and controlling shareholders. For example, duties of corporate officers in Texas are identical to those of a director. See *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). Further, because there is not a consensus among states if the business judgment rule even protects the acts of corporate officers, an analysis of shareholder ratification could be futile. John F. Olson et al., *Director and Officer Liability: Indemnification and Insurance*, DOLIAB § 1:26 (2003).

to act lawfully; and (3) the duty of loyalty. Because directors can contractually protect themselves from a breach of the duty of care and shareholder ratification cannot validate an unlawful action, the breach of the duty of loyalty is of specific importance in the context of self-dealing transactions.

C. *The Duty of Loyalty and Self-Dealing Transactions*

Shareholder ratification demands understanding of the duty of loyalty because breach of the duty of loyalty implicates conflict-of-interest statutes. The duty of loyalty is a “duty not to engage in *self-dealing* or otherwise use his or her position to further personal interests rather than those of the beneficiary.” Delaware has struggled with the definition of “self-dealing.” It is settled that self-dealing (and thus a breach of the duty of loyalty) occurs when a director enters into a transaction between himself and the corporation, between corporations with interlocking directorates, and when directors take advantage of corporate opportunities. More generally, a director entering into a contract or transaction which benefits him personally breaches the duty of loyalty through self-dealing.

Early common law decisions embraced the concept that all self-dealing transactions were voidable by the corporation, regardless

33. *Smith v. Van Gorkam*, 488 A.2d 858, 872 (Del. 1985).

34. *See, e.g.*, DEL. CODE ANN. tit. 8 § 102(b)(7) (2005) (allowing eradication or restriction of director’s personal liability for breach of duty of care, but expressly prohibiting the same limitations for breach of duty of loyalty or duty to act lawfully); TEX. REV. CIV. STAT. ANN. art. 1302, § 7.06 (Vernon 2005) (permitting exclusion of liability for director’s breach of duty of care under the Texas Miscellaneous Corporation Laws Act).

35. DEL. CODE ANN. tit. 8 § 144(a) (2005).

36. BLACK’S LAW DICTIONARY (8th ed. 2004) (emphasis added).

37. For example, Delaware courts have collectively compiled a non-exclusive list of transactions found to be self-dealing. *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 396 n.2 (2003).

38. JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 10.09 (2d ed. 2003).

39. Further, under the statutory language of both Delaware and Texas, a director is “interested” if the transaction is a contract “between a corporation and one or more of its directors . . . , or between the corporation and any other . . . organization in which one of more or its directors . . . are directors . . . , or have a financial interest” DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

2006

A Catch-22 or a Catch-All?

of the actual substance of the transaction. Jurisdictions have since adopted a less restrictive approach, opting for statutory regulation of self-dealing instead of complete prohibition.

D. Void or Voidable

Despite statutory regulations that provide safe harbors for self-dealing transactions, adherence to such statutes does not necessarily cure *every* self-dealing transaction. Application of both the business judgment rule and the statutory safe harbor of shareholder ratification generate a distinction between “void” acts and “voidable” acts. The Delaware Supreme Court described the distinction between void and voidable acts:

The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent, or waste of corporate assets.

A void act does not provide for the best interest of the corporation. Shareholder ratification cannot validate void acts considered “repugnant to public policy” and, thus, such acts do not fall under the protection of the business judgment rule. Interest-

40. See *Pearson v. Concord R.R. Corp.*, 62 N.H. 537 (1883); *Munson v. Syracuse, G. & C. Ry. Co.*, 8 N.E. 355, 358 (N.Y. 1886).

41. WILLIAM FLETCHER, *CYCLOPEDIA OF CORPORATIONS* § 931 (rev. ed. 1994). For examples of such conflict-of-interest statutes, see DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005); REV. MODEL BUS. CORP. ACT § 8.61 (2003); CAL. CORP. CODE § 310 (West 2003). Generally, meeting the requirements in a conflict-of-interest statute mandates approval by a majority of disinterested directors, ratification by majority of shareholders, or proof of the transactions fairness to the corporation—will protect the transaction from automatic voidability. See, e.g., DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

42. *Michelson v. Duncan*, 407 A.2d 211, 218-19 (Del. 1979).

43. *Id.* The list of void acts, while not exclusive, is nonetheless very restricted. Void acts include fraud, gift, waste, or *ultra vires* acts. See also *Solomon*, 747 A.2d at 1114, n.45 (“[*U*]l*tr*a *v*ires acts. . . [include] acts specifically prohibited by the corporation's charter, for which no implicit authority may be rationally surmised, or those acts contrary to basic principles of fiduciary law.”).

44. *Michelson*, 407 A.2d at 218-19.

45. See, e.g., *Solomon*, 747 A.2d at 1114 (noting that acts hostile to sound public policy are “void *ab initio*”).

ingly, unless clearly contradictory to public policy, a *unanimous* shareholder vote may ratify a void act (although such unanimity is highly improbable).

Voidable acts, on the other hand, receive more protection under the business judgment rule because of shareholder ratification. The business judgment rule ceases to protect directors entirely when they breach their fiduciary duty to the corporation by entering into a voidable transaction, such as a contract or transaction in which they have a personal interest. In order to reinstate the protection of the business judgment rule, the voidable transaction must meet a procedural, statutory safe harbor provided in the jurisdiction's conflict-of-interest statute; namely either disinterested director approval or shareholder ratification. Taken in the best interest of the company but lacking the requisite authority, voidable acts may have their lack of authority retroactively repaired by a fully-informed majority shareholder vote. In proving that good-faith shareholder ratification occurred, the board effectively eliminates the conflict-of-interest that previously restrained application of the business judgment rule.

46. *Lewis v. Vogelstein*, 699 A.2d 327, 335 (Del. Ch. 1997). *See also* *Schrieber v. Bryan*, 396 A.2d 512, 518 (Del. Ch. 1978) (recognizing that it is well-settled law that unanimous shareholder consent is required to validate a waste of corporate assets)(citing *Saxe v. Brady*, 184 A.2d 602, 605 (Del.Ch. 1962)); *Pruitt v. Westbrook*, 11 S.W.2d 562, 565 (Tex. Civ. App. Ft. Worth 1928) *writ ref'd* (suggesting that shareholder ratification of transactions "inhibited by the common law as against public policy" require greater than majority approval).

47. *See Brown*, 812 F. Supp. at 726 (noting that the business judgment rule does not apply where "the corporate decision lacks a business purpose, is tainted by conflict of interest, is so egregious to amount to a no-win decision, or results from an obvious. . . failure to exercise oversight").

48. DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005). Under both Delaware and Texas corporate law, a conflict-of-interest transaction may also be validated if it is found to be entirely fair to the corporation. *See* DEL. CODE ANN. tit. 8 § 144(a) (2005) ("The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders."); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005) ("The contract or transaction is fair as to the corporation as of the time it is authorized, approved, or ratified by the board of directors, a committee thereof, or the shareholders.").

49. *See Michelson*, 407 A.2d at 218-20 (holding that the lack of director authority that rendered an act voidable was alleviated by "after-the-fact [valid] shareholder ratification").

50. *Id.* at 218-20; *Pace v. Jordan*, 999 S.W.2d 615, 624 (Tex. App. Houston [1st Dist.] 1999) *pet. denied* (advancing that in order to invoke protection of the business judgment rule, the board must prove to the court that prior to making a decision, the directors were informed "of all material information reasonably available to them").

2006

A Catch-22 or a Catch-All?

E. The Importance of Shareholder Ratification

Although presumably less efficient, shareholder ratification maintains several advantages over disinterested director approval. Shareholder ratification may be the *only* option to validate a self-dealing transaction in situations in which disinterested directors do not exist. For example, the entire board of directors may have a direct conflict-of-interest or interested directors may control the board. In such situations, shareholder ratification proves a useful option. Further, where self-interested transactions have occurred prior to a proposed directorial approval, directors may be less likely to reject the transaction. Moreover, because directorial relationships may influence voting decisions, shareholder ratification creates a higher likelihood of an outcome devoid of self-interest. Self-dealing transactions force disinterested directors into the awkward position of passing judgment on members of their own body. As the New York Supreme Court declared, “[t]he moment the directors permit one or more of their number to deal with the property of the stockholders, they surrender their own independence and self control.” Ultimately, in de-

51. Obviously, the efficiency of directorial approval lies in the lower transaction costs involved in calling a vote of directors, whereas shareholder votes require notice and a proxy. Additionally, shareholder ratification may result in increased litigation following ratification. *Vogelstein*, 699 A.2d at 335.

52. See, e.g., *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378, 379-80 (N.Y. 1918) (“A dominating influence may be exerted in other ways than by a vote.”).

53. Richard M. Buxbaum, *Conflict-of-Interest Statutes and the Need for a Demand on Directors in Derivative Action*, 68 CAL. L. REV. 1122, 1127 (1980) (expressing the opinion that “it is excessively difficult to repudiate a transaction already effected by one’s fellow directors...subjecting them...to financial sanctions”).

54. See *COX & HAZEN*, *supra* note 38, at § 10.10. It cannot be ascertained what amount of influence any particular director exerts in favor of any matter in which he has an interest coming before his board. Although not voting, he may by argument or discussion induce votes from his fellow members, as well as by friendship, association, or confidence, or by knowledge that although he refrains from voting he desires favorable action by others. *Id.* But see *In re W. Nat’l Corp. S’holders Litig.*, No. 15927, 2000 WL 710192 (Del. Ch.) (“Delaware law generally respects the committee process as a legitimate method to produce disinterested and independent decisions, where some directors on the board, but not on the committee, arguably have conflicting interests.”).

55. See *Cumberland Coal & Iron Co. v. Parish*, 42 Md. 598, 606 (1875) (“[T]he remaining [disinterested] directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of one of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation.”).

56. *Cumberland Coal & Iron Co. v. Sherman*, 30 Barb. 553, 573 (N.Y. Sup. Ct. 1859).

termining whether to use directorial approval or shareholder ratification, the corporation should consider good-faith implications of each, wherein shareholder ratification has a marked advantage. As such, shareholder ratification generates a safe harbor resulting in the resolution most beneficial to the corporation.

IV. REQUIREMENTS FOR SHAREHOLDER RATIFICATION

If employed as a means to validate a self-dealing transaction, valid shareholder ratification entails certain statutory requirements. The interested party must prove the statutory validity of the ratification in order to protect the transaction from automatic voidability. The two main requirements for valid shareholder ratification are (1) good-faith approval of the transaction by a majority of the shareholders entitled to vote (2) after full disclosure of material facts.

A. *Good-Faith Majority Vote by Shareholders*

Both the Texas and Delaware statutes include a threshold finding of a good faith majority vote in order to validate a self-dealing transaction through shareholder ratification. At the bare minimum, this good faith necessitates neutrality in the shareholders' decision-making process.

Certainly, the ratification of a self-dealing transaction by only disinterested shareholders implies good-faith approval. Neither section 144(a)(1) nor article 2.35-1(A)(1), however, specifically require *disinterested* shareholders, while clearly requiring disinterested directors. From a policy perspective, disinterested share-

57. See COX & HAZEN, *supra* note 38, at § 10.12.

58. See *VanGorkam*, 488 A.2d at 893 (“The burden must fall on the defendants who claim ratification based on shareholder vote to establish that the shareholder approval resulted from a fully informed electorate.”).

59. See DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005).

60. DEL. CODE ANN. tit. 8 § 144(a)(2) (2005) (“... transaction is specifically approved in good faith by vote of the shareholders”); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A)(2) (Vernon 2005) (“transaction is specifically approved in good faith by vote of the shareholders”).

61. COX & HAZEN, *supra* note 38, at § 10.12.

62. Compare DEL. CODE ANN. tit. 8 § 144(a)(1) (2005) (“...by the affirmative votes of a majority of the disinterested directors. . .”) with DEL. CODE ANN. tit. 8 § 144(a)(2) (2005) (“... approved in good faith by vote of the shareholders. . .”).

holders ratifying a self-dealing transaction satisfies the primary goal of voting—assessing the group preference while negating the transactional inefficiencies of self-interested voting. Regardless, the 1976 Delaware case of *Fleigler v. Lawrence* settled the issue of requiring disinterested shareholders, declaring that a vote had to be by *disinterested* shareholders in order to validate a self-dealing transaction. This holding seems sensible because it makes little sense to permit director-shareholders to approve their own self-interested transactions by simply putting on their “shareholder hat.” For this reason, the stance in *Fleigler* appropriately interprets the Texas conflict-of-interest statute as well.

B. Full Disclosure Requirement

Besides a good-faith majority vote, valid shareholder ratification requires full disclosure. The theory behind the full-disclosure requirement suggests that directors essentially breach a duty of

63. The majority requirement assumes that “if more shareholders favor a transaction than oppose it, the gains to those favoring it will exceed the losses to those opposing it and, therefore, the transaction will result in a net gain.” RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 643 (2d ed. 1995). For an analysis of and proposed solutions to strategic voting, see Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741 (1997). *But see*, Kirwan v. Parkway Distillery, 148 S.W.2d 720, 723 (Ky. Ct. App. 1941) (commenting that it should not matter if a shareholder is interested in a vote because a stockholder “has the legal right to vote with a view of his own benefits and is representing himself only”).

64. 361 A.2d 218, 222 (Del. 1976).

65. *Id.* (summarizing that despite defendants’ contention that the Delaware statute did not require shareholders to be independent, the court read the statute’s absence of disinterested requirement as “merely [removing] an ‘interested director’ cloud when its terms are met and provides against invalidation of an agreement ‘solely’ because such a director or officer is involved”).

66. *See Fleigler*, 361 A.2d at 221; *but see* Wiberg v. Gulf Coast Land & Dev. Co., 360 S.W.2d 563, 566 (Tex. App. Beaumont 1962) *writ ref’d n.r.e.* (suggesting that director-shareholders could vote to ratify a self-dealing transactions, but also finding that the transaction was substantively fair to the corporation).

67. DEL. CODE ANN. tit. 8 § 144(a) (2005); TEX. BUS. CORP. ACT ANN. art. 2.35-1(A) (Vernon 2005) (both requiring that “[t]he material facts as to . . . [the interested director’s] . . . relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders . . .”). *See also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (1993) (stating that protection of self-interested transactions rest partially on disclosure to and subsequent approval of shareholders); Dunagan v. Bushey, 263 S.W.2d 148, 152 (Tex. 1953) (finding that without “full and complete disclosure of all facts” by the interested directors to the voting shareholders, an action against the corporation’s interest could not be authorized).

candor when any non-disclosure occurs. Substantial debate over what information full disclosure requires rages on, although such detail is beyond the scope of this Comment. Generally speaking, full disclosure requires disclosure of material facts.¹ A fact is considered material if there exists a substantial likelihood that, under all the circumstances, the omitted fact would have influenced the decision of a reasonable shareholder.² Full disclosure of these material facts assures ratifying shareholders vote judiciously.

V. EFFECTS OF SHAREHOLDER RATIFICATION

With an understanding of the necessity and requirements of shareholder ratification, the unclear legal effects of shareholder ratification create even more questions. Primarily, if a court determines that inadequate shareholder ratification occurred, the transaction must meet the entire fairness test. Still, even legally valid shareholder ratification generates uncertain outcomes. Delaware courts toiling over the correct legal effect of valid shareholder ratification recently summarized their judicial confusion in *In re the Walt Disney Company Derivative Litigation*. Fortunately for Texas, the 1997 amendment to its self-dealing statute made the mechanism of shareholder ratification considerably more reliable, creating a much less ambiguous outcome for corporate management.

A. *The Entire Fairness Test*

If neither directorial approval nor shareholder vote validates a self-interested transaction, the transaction is voidable by the corporation unless the self-dealing directors can prove the entire

68. See *Vogelstein*, 699 A.2d at 327 (observing that even when shareholder ratification is not required for a transaction but is still employed, "fair process" demands that full disclosure be made and if it is not, that it generate a remedy).

1. See *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 279 (Del. Ch. 1986) (comparing the test for materiality to that in federal securities laws).

2. *Roberts v. Gen. Instrument*, No. 11639, 1990 Del. Ch. LEXIS 138, at **29-30 (Del. Ch. Aug. 13, 1990).

71. *Marciano*, 535 A.2d 400, 404 (Del. 1987).

72. 731 A.2d at 368.

2006

A Catch-22 or a Catch-All?

fairness of the transaction to the court's satisfaction. The entire fairness test applies in situations where the statutory safe harbors do not apply, such as deadlock or where self-interested parties also serve as controlling shareholders. The entire fairness test requires the satisfaction of two prongs: (1) fair-dealing and (2) fair-price. The Delaware Supreme Court outlined the two prongs of the entire fairness test in *Weinberger v. UOP, Inc.*:

[Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. [Fair price] relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

Thus, when considered together, the substantive aspect (namely, price) and the procedural aspect (the decision-making process) must coalesce to produce an entirely fair result to the corporation. Meeting the entire fairness standard results in a le-

73. Notice that in a self-dealing transaction, the business judgment rule does not automatically protect the actions of the interested director(s). Additionally, if the self-interested director is also a controlling shareholder, then the entire fairness test automatically applies.

74. *Marciano*, 535 A.2d at 404 (recognizing that in some conflict-of-interest transactions, "the sole forum for demonstrating intrinsic fairness may be a judicial one").

75. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

76. *Id.* at 711. See also *Globe Woolen Co.*, 121 N.E. at 378, 380-81 (N.Y., 1918) (illustrating that the domineering behavior and nondisclosure of pertinent information by an interested director fell short of fair dealing); *Felty v. Nat'l Oil Co. of Tex.*, 155 S.W.2d 656, 658 (Tex. Civ. App. San Antonio 1941) *writ denied* ("[W]here the fairness of [self-dealing] transactions is challenged the burden is upon those who would maintain them to show their entire fairness and . . . full adequacy of the consideration.") (quoting *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921)).

77. *Weinberger*, 457 A.2d at 711 ("However, the test for fairness is not a bifurcated one as between fair dealing and price . . . All aspects of the issue must be examined as a whole since the question is one of entire fairness.").

gally valid transaction. Generally, the burden of proving these two prongs lies with the interested director.

Despite the fact that entire fairness can protect a self-dealing transaction from legal review, difficulties arise in proving entire fairness because the court considers everything relevant to the transaction. Consequently, more attractive options lie in directorial approval and shareholder ratification because they may invoke the protection of the business judgment rule if properly utilized. And, as previously discussed, under the protection of the business judgment rule, the self-interested director need only provide a single, rational reason to validate the transaction.

B. Delaware

Read literally, Delaware's section 144(a) creates a catch-22; even valid shareholder ratification does not assure business judgment rule protection. Correspondingly, the Delaware Supreme Court in *Fleigler* construed compliance with Delaware's section 144 as "merely remov[ing] an 'interested director' cloud . . . and provid[ing] against invalidation of an agreement 'solely' because

78. See *Marciano*, 535 A.2d at 404-05 (determining that even without director or shareholder approval, a self-interested transaction can be upheld as valid if the "transaction withstands close scrutiny" by the court). *But see* *Talbot v. James*, 190 S.E.2d 759 (S.C. 1972) (demonstrating that some jurisdictions may require directorial or shareholder approval even if the transaction is deemed fair and such approval would not be enough to meet the director and shareholder approval safe harbors).

79. See *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963) ("Contracts between a corporation and its officers and directors are not void but are voidable for unfairness and fraud with the burden upon the fiduciary of proving fairness. . ."); *Neponsit Inv. Co. v. Abramson*, 405 A.2d 97, 99-100 (Del. 1979) ("[I]t is clearly established that when corporate directors are on both sides of a transaction, they have the burden of showing that the transaction was entirely or intrinsically fair. . .").

80. See *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 772 (2d Cir. 1980) (finding the directors did not meet the burden of proving entire fairness for charging a lower rent price to an affiliated company even though the directors admitted into evidence the financial records of the renting company which showed that no higher rent could be charged).

81. See *Kamin*, 383 N.Y.S.2d at 815 (determining that wanting the income statement to appear healthy despite serious losses was a rational reason for making a decision that harmed shareholder value).

82. DEL. CODE ANN. tit. 8 § 144(a) (2005).

such a director or officer is involved.” Under this interpretation, judicial review of the fairness of a transaction threatens even valid shareholder ratifications.

Working from *Fleigler’s* somewhat imprecise explanation of section 144, Delaware courts have since produced an array of holdings concerning the legal effect of shareholder ratification. the 1997 case of *Lewis v. Vogelstein*, Delaware’s Chancery Court outlined the three foremost possible effects of valid shareholder ratification: (1) the ratification extinguishes any breach of duty claims; (2) the ratification shifts judicial review of the act from a fairness test to a waste test; and (3) the ratification shifts the burden of proving entire fairness to the plaintiff. If taken in the order given by the court, these approaches increasingly extend flexibility for courts and disgruntled shareholders, but also fuel uncertainty for corporate management.

1. *Claim-extinguishment in Delaware*

Delaware case law provides that fully-informed shareholder ratification prevents any kind of further review of the transaction for duty of *care* violations. Courts, however, have been reluctant to apply the claim-extinguishment interpretation to duty of *loyalty*

83. *Fleigler*, 361 A.2d at 222. Even before *Fleigler*, outside of Delaware this interpretation of a conflict-of-interest statute was devised by California in *Remillard Brick Co. v. Remillard-Dandini Co.*, decided in 1952. In that case, which involved shareholder ratification of a self-interested common directorship transaction, the court ardently pronounced that “[e]ven though the requirements of [the conflict-of-interest statute] are technically met, transactions that are unfair and unreasonable to the corporation may be avoided.” *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 74 (Cal. Ct. App. 1952).

84. *Fleigler*, 361 A.2d at 222 (“Nothing in the statute sanctions unfairness. . . or removes the transaction from judicial scrutiny.”).

85. 699 A.2d at 327.

86. *Id.* at 344. The court also mentioned a fourth option: The ratification has no legal effect. However, this approach to the effect of shareholder ratification has not been utilized by a Delaware court. *Id.*

87. See *Wheelabrator II*, 663 A.2d at 1194, 1200; *Van Gorkom*, 488 A.2d. at 889 (“[F]ailure of the Board to reach an informed business judgment constitutes a voidable, rather than a void, act. Hence, the merger can be sustained, notwithstanding the infirmity of the Board’s actions, if its approval by majority vote of the shareholders is found to have been based on an informed electorate.”).

claims. A more recent Delaware decision explained that rarely do situations involving shareholder ratification of self-dealing transactions result in claim-extinguishment. In fact, the Delaware Supreme Court has held that shareholder ratification results in claim-extinguishment in only two situations involving breach of the duty of care: (1) when directors exceed their authority but act in good faith; and (2) when “directors fail ‘to reach an informed business judgment.’” Arguably, shareholder ratification of interested transactions implicating duty of loyalty claims should also result in claim-extinguishment. Whether ratifying a breach of the duty of care or loyalty, if a majority of fully-informed shareholders vote to approve a self-dealing transaction, they should not afterward be afforded the chance to challenge the very transaction they permitted. However, because Delaware has yet to assert this line of reasoning, claim-extinguishment by shareholder ratification is largely restricted and infrequently employed.

2. *The Business Judgment Rule and Waste*

Unlike claim-extinguishment, Delaware has settled the application of the business judgment rule to self-interested claims ratified by shareholders. In the 1987 case of *Marciano v. Nakash*, the Delaware Supreme Court, in dictum, remarked that good faith compliance with the safe harbors of directorial approval or share-

88. See *Williams*, 671 A.2d at 1379 (agreeing that duty of care claims may be completely extinguished by shareholder ratification but refusing to “express [an] opinion on the question whether a “duty of loyalty claim” may or may not be ratified”); *Schlossberg v. First Artists Prod. Co.*, 1986 WL 15143, *8 (Del. Ch. 1986) (finding that although summary judgment for the fully-informed directors was appropriate on other grounds, that “the fully informed vote of the minority stockholders provides an independent basis for a summary judgment in favor of defendants”); but see *Wheelabrator II*, 663 A.2d at 1202 (remarking that the interpretation that shareholder ratification constitutes a “full defense” to all breach of duty claims is “overbroad, because the case law governing the consequences of ratification does not support that view and, in fact, is far more complex”).

89. *Wheelabrator II*, 663 A.2d at 1202-04.

90. See *Michelson*, 407 A.2d at 219 (holding that “a validly accomplished shareholder ratification relates back to cure otherwise unauthorized acts of officers and directors” because it provides the needed authority for the directors to act).

91. *Van Gorkom*, 488 A.2d at 889.

92. See *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 842 (Del. 1987) (giving deference to informed shareholder votes by observing that a minority shareholder who votes in favor of a transaction “cannot thereafter attack the fairness of the merger price”).

93. 535 A.2d at 400.

holder ratification “permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.” This interpretation of the legal effect of compliance with section 144 was reiterated in *In re Wheelabrator Technologies, Inc. Shareholders Litigation* (“*Wheelabrator II*”) in which the Chancery Court ruled that good faith shareholder ratification of a merger results in application of the business judgment rule.

Although not quite as protective of management as complete claim-extinguishment, application of the business judgment rule will most often validate even self-interested directorial decisions. In order to overcome the presumption of the business judgment rule, plaintiffs have the burden of proving that the transaction constituted waste. To prove waste, the plaintiff must demonstrate that “no person of ordinary sound business judgment could view the benefits received as a fair exchange for the consideration paid by the corporation.” Although frustrating for shareholder plaintiffs, the difficulty of satisfying such a test benefits corporate management because it makes wealth-creating decisions less risky. Thus, although application of the business judgment rule provides a chance for displeased shareholders to contest a self-interested transaction, the probability of a successful challenge undoubtedly favors corporate management.

94. *Id.* at 405. In *Marciano*, claims for loans during liquidation proceedings were enforced although the loans were created through self-interested transactions. Neither directorial approval nor shareholder ratification were possible because of director-shareholder deadlock. *Id.*

95. *Wheelabrator II*, 663 A.2d at 1194.

96. *Id.* at 1200. *See also Van Gorkom*, 488 A.2d at 889-90 (finding that failure of the board to make an informed business judgment regarding a merger could be sustained through a majority vote of informed shareholders).

97. *See supra* notes 21-27 and accompanying text (explaining the effect of the business judgment rule).

98. *Walt Disney*, 731 A.2d at 368-69. Clearly, “a transfer for no consideration amounts to a gift or waste of corporate assets.” *Michelson*, 407 A.2d at 217.

99. *See Steiner v. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, *1 (Del. Ch. 1995).

100. *Id.* at *5. (“There surely are cases of fraud; of unfair self-dealing and, much more rarely negligence. But rarest of all—and indeed, like Nessie, possibly non-existent—would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!”).

3. *Shift of the Burden of Persuasion*

Unfortunately for corporate management, the Delaware Chancery Court clouded the business judgment rule interpretation of section 144 in *Cooke v. Ollie*. *Cooke* illustrates the many cases in Delaware holding that compliance with section 144(a)(1) or 144(a)(2) merely shifts the burden of persuasion of entire fairness to the plaintiffs rather than resulting in application of the business judgment rule. This interpretation was advanced in *Kahn v. Lynch*, in which minority shareholders accused the controlling shareholder of a breach of fiduciary duty stemming from his conflict-of-interest in a merger deal. Relying on an earlier Delaware Supreme Court case, the *Kahn* court overtly identified that valid shareholder ratification by a majority of minority shareholders in conflict-of-interest transactions involving a controlling shareholder shifts the burden of persuasion of entire fairness to

101. No. Civ. A. 11134, 1997 WL 367034 (Del. Ch. 1997):

[T]he Delaware Supreme Court has, since *Marciano*, more fully developed the standard by which this Court should judge a board's actions when it engages in a transaction with one or more of its own directors. . . It is now clear that even if a board's action falls within the safe harbor of section 144, the board is not entitled to receive the protection of the business judgment rule. Compliance with section 144 merely shifts the burden to the plaintiffs to demonstrate that the transaction was unfair. *Id.* at *9.

102. *Id.* (explaining that in order for director's to shift the burden of proof, they must prove they were entitled to use the safe harbor provision by showing they were "truly independent, fully informed, and had the freedom to negotiate at arm's length")(quoting *Kahn v. Lynch Commc'n Sys.*, 638 A.2d 1110, 1120-21 (Del. 1994)); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1141, 1154 (Del. Ch. 1994) (finding that a tender-offer and resulting merger approved by disinterested board members must still have been fair to the corporation, but the burden of proof shifts to the plaintiffs).

103. *Kahn*, 638 A.2d at 1110.

104. *Id.* at 1111.

105. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985) (identifying that in a conflict-of-interest transaction involving a majority shareholder who stood on both sides of a merger with an oil company, an "informed vote of a majority of the minority shareholders" shifted the burden of persuasion under the entire fairness standard to the plaintiffs, although such ratification was "not a legal prerequisite")(citing *Weinberger*, 457 A.2d at 703).

the plaintiff. Thus, the plaintiff must somehow prove the unfairness of the transaction—a difficult, but not impossible, task. A simple rationale lies behind such an interpretation: “Since the shareholders . . . approved a transaction tainted by board self-interest, as complainants they must bear the burden of showing why this Court should step in and protect the shareholders against a deal for which they already have voiced their approval.” Regardless of the plaintiff’s ability to prove unfairness, the interested party has the initial burden of verifying that the ratification was in fact valid.

4. *Making Sense of Delaware’s Shareholder Ratification.*

Based on the inconsistent case law concerning the legal effect of shareholder ratification in Delaware, discerning the legal effect of shareholder ratification under section 144 “may be one of the most tortured areas of Delaware law.” Nevertheless, the Delaware Chancery Court attempted to reconcile the various interpretations of the effect of shareholder ratification in *In re the Walt Disney Company Derivative Litigation*. To facilitate this goal, the court

106. *Kahn*, 638 A.2d at 1117. See also *In re Santa Fe Pac. Corp. S’holder Litig.*, 669 A.2d 59, 67 (Del. 1995) (illustrating that a fully-informed stockholder ratification on a merger did not extinguish shareholder claims for breach of duty of loyalty in hostile bidding but did extinguish claims for breach of duty of care); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990) (“[I]n a parent-subsidiary merger context, shareholder ratification operates only to shift the burden of persuasion, not to change the substantive standard of review (entire fairness).”). In a similar context, to determine if burden shifting is suitable in a conflict-of-interest *merger* transaction, a two-part test applies: It is appropriate to shift the burden of persuasion to the plaintiff if (1) the controlling shareholder did not “dictate the terms of the merger,” and (2) an independent special committee existed that possessed “real bargaining power.” See *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648, *6 (Del. Ch. 1990).

107. See *Walt Disney*, 731 A.2d at 342, 368 (citing *Rosenblatt*, 493 A.2d at 937).

108. *Walt Disney*, 731 A.2d at 368.

109. See *Rosenblatt*, 493 A.2d at 937 (observing that the controlling shareholder involved in the self-dealing transaction “retained the burden of showing complete disclosure of all material facts relevant” to the shareholder ratification); *Walt Disney*, 731 A.2d at 368, n.70 (“Section 144...expressly [conditions] the validity of [shareholder] ratification upon the Board’s full disclosure of all material facts.”); *Citron*, 584 A.2d at 502 (“The parties who assert the defense of shareholder ratification have the burden to establish that they fully disclosed all material facts in their proxy disclosures.”).

110. *Solomon*, 747 A.2d at 1114.

111. *Walt Disney*, 731 A.2d at 368.

distinguished classic self-dealing transactions (involving an interested transaction between a director and the corporation) and controlling shareholder self-dealing (involving an interested transaction between a majority shareholder and the corporation). Interested transactions involving the former invoke the protection of the business judgment rule if ratified by a majority of fully-informed disinterested shareholders, thus reaffirming the analysis of shareholder ratification in cases like *Marciano*. Summarizing the *Walt Disney* analysis, a later court explained:

[I]n a classic self-dealing transaction the effect of a fully-informed shareholder vote in favor of that particular transaction is to maintain the business judgment rule's presumptions. To rebut those presumptions at the motion to dismiss stage the plaintiff must "allege facts showing that no person of ordinary sound business judgment could view the benefits received as a fair exchange for the consideration paid by the corporation," *i.e.*, that the transaction was irrational or amounted to waste.

Interested transactions involving controlling shareholders, on the other hand, do not allow the protection of the business judgment rule even with valid shareholder ratification. In these circumstances, the transaction must undergo entire fairness review, but valid shareholder ratification shifts the burden of persuasion of entire fairness to the plaintiff. The rationale for this interpretation of section 144 lies in the idea that, unlike classic self-dealing transactions, ratification of controlling-shareholder transactions may not truly reflect the wishes of the minority shareholders due to increased risk of coercion. By confirming the legitimacy of the risk of coercion as a reason to allow minority shareholders the op-

112. *Id.*

113. *Id.*

114. *Solomon*, 747 A.2d at 1115-16 (reaffirming and citing *Walt Disney*, 731 A.2d at 362-64, 368). This interpretation was accepted in *In re Walt Disney Co.*, No. Civ. A. 15452, 2004 WL 2050138, *7 (Del. Ch. Sep. 10, 2004).

115. *Walt Disney*, 731 A.2d at 368.

116. *Id.*

117. *Citron*, 584 A.2d at 490, 502 ("Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder.").

2006

A Catch-22 or a Catch-All?

tion of fairness review, the burden-shifting interpretation in cases such as *Cooke* and *Kahn* remains good law.

In re the Walt Disney Co. Derivative Litigation succeeded in providing guidelines for applying the various interpretations of section 144(a). Still far from certain, the legal effect of shareholder ratification in Delaware can still amount to a no-win situation for corporate management: Without shareholder ratification of a self-dealing transaction, the transaction could be automatically void, but even after exerting the energy to employ shareholder ratification the transaction is not inevitably validated.

C. Texas

Prior to 1997, Texas corporate law offered no more clarity than did Delaware corporate law on the issue of the effect of shareholder ratification. Texas corporate law entertained the same vicious circle as did Delaware: Failing to use one of the safe harbors provided in the conflict-of-interest statute could result in invalidating the transaction, but even using one of the safe harbors did not necessarily make the transaction valid. However, when the seventy-fifth Texas State Legislature rewrote article 2.35-1 of the Texas Business Code, the desired result was to “modernize and add flexibility” to the corporate law. Thus, the introductory paragraph in article 2.35-1(A) was changed from declaring that no self-interested transaction “shall be void or voidable” to announcing that an otherwise valid self-interested transaction “shall be valid” if it employs a statutory safe harbor.

The “modernized” amendments to article 2.35-1(A) clearly reflected a desire by the legislature for less ambiguity in the legal effects of the article. The alteration in wording indicates that the legislature intended for valid shareholder ratification to effectively abolish the use of the entire fairness test with regard to self-interested transactions. The Texas Court of Appeals briefly ana-

118. *Walt Disney*, 731 A.2d at 368.

119. *Compare* *In re Jackson*, 141 B.R. 909, 916 (N.D. Tex. 1992) (finding a breach of fiduciary duty when interested directors failed to meet one of the statutory safe harbors in Article 2.35-1(A)) *with Fleigler*, 361 A.2d at 221-22 (asserting that “[n]othing in [the conflict-of-interest statute]...removes the transaction from judicial scrutiny”).

120. SRC-AAA S.B. 555 75(R) BILL ANALYSIS; Senate Research Center Committee Report (April 21, 1997), *available at* <http://www.capitol.state.tx.us>.

121. *Compare* TEX. BUS. CORP. ACT ANN. art. 2.35-1 (Vernon 1996), *with* TEX. BUS. CORP. ACT ANN. art. 2.35-1 (Vernon 2005).

lyzed the effects of the amendment to article 2.35-1(A) in *Landon v. S & H Marketing Group, Inc.*

It appears that this statute alters common law with respect to the requirement that the directors prove that the contract or transaction is fair to the corporation for every challenged transaction. Only one of the validation methods listed in the statute requires a showing of fairness. The other two methods—disinterested director approval and shareholder approval—do not explicitly require a showing of fairness. The statute lists the three validation methods disjunctively. Furthermore, the statute explicitly states that compliance with any one of the methods is sufficient.

Landon represents a sweeping view of the conflict-of-interest statute, effectively interpreting that execution of article 2.35-1(A) shields the self-dealing director from all further judicial inquiry. *Landon* also discussed the problematic nature of fulfillment of article 2.35-1(A)(3) without meeting the safe harbor of either shareholder ratification or directorial approval.

The freedom from the fairness test explained in *Landon* does not automatically validate any self-interested transaction ratified under article 2.35-1(A)(2). The statute's requirement that a transaction must be "otherwise valid" evidences that a self-interested transaction could still be attacked on the grounds that it constitutes corporate waste, gift, or fraud. This prerequisite emphasizes the basic corporate law notion that a majority shareholder vote cannot ratify some self-interested transactions and therefore will not meet the statutory validation criteria. With only this slight limitation, valid directorial approval or shareholder ratification could conceivably authorize a fundamentally unfair transaction. Therefore, the broad regulatory purpose of the

122. 82 S.W.3d 666 (Tex. App. 2002) *no pet.* (examining the validity of several interested transactions in which the former president and board member of S & H Marketing Group, Inc. engaged in relation to the amended Article 2.35-1(A)).

123. *Id.* at 673.

124. *Id.* at 678 ("Moreover, even for a determination of fairness to be made under Article 2.35-1(A)(3), approval by the board of directors or shareholders is required."). The change in wording did not change the fact that without meeting any of the three safe harbors, a self-interested transaction is invalid. See *Health Discovery Corp. v. Williams*, 148 S.W.3d 167, 168 (Tex. App. Waco 2004) *no pet. hist.* (recognizing that "because the directors did not comply with the requirements of Article 2.35-1(A)" their transactions to obtain shares were invalid).

125. 20 Tex. Prac., Business Organizations § 20.40 (2d ed.).

126. See *supra* notes 44-46 and accompanying text (explaining void acts).

2006

A Catch-22 or a Catch-All?

amended article 2.35-1(A) positioned Texas corporate law to embrace a claim-extinguishing effect of compliance with its conflict-of-interest statute.

VI. HAS TEXAS CAUGHT UP TO DELAWARE?

Catching on to Delaware's ability to attract the eye of corporate management, Texas has created a more appealing law in article 2.35-1(A) compared to Delaware's competing conflict-of-interest statute. The selection of a state of incorporation is critical for corporate organizers and Texas's claim-extinguishment is unmistakably more attractive to corporate management than the less lucid Delaware law for three main reasons. Primarily, article 2.35-1(A) offers more predictability, and thereby protection, than section 144(a). This predictability encourages corporate management to engage in wealth-creating activities:

If courts were permitted more freely to "second guess" the terms of corporate contracts (on for example a "reasonableness" ground) there would be a substantial disincentive created for officers and directors (especially directors who generally receive no incentive compensation) to approve risky transactions. Yet the corporate form, with its limited liability and potential for investor diversification, has great utility in part because these characteristics encourage the assumption of economic risk.

Secondly, the amended article 2.35-1(A) complements the business judgment rule instead of conflicting with it like section 144(a). Just as the business judgment rule seeks to keep business decisions out of the courtroom, article 2.35-1(A) prevents courts from "second-guessing the diligent and fair deliberations of independent shareholders." Although several Delaware cases have given substantial effect to shareholder ratification, the obscure language of section 144(a) does not compare with the security of-

127. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 101 (8th ed. 2000). A corporation follows both the statutory and case law of the state in which it is incorporated, so it is important for organizers to find a jurisdiction that suits their business's needs. *Id.*

128. *Steiner*, 1995 WL 441999 at *1.

129. *Id.*

130. *See Kamin*, 383 N.Y.S.2d at 812; COX & HAZEN, *supra* note 38, at § 10.12.

ferred to corporate management by article 2.35-1(A). Unlike section 144(a), the philosophy of article 2.35-1(A) impeccably integrates into the design of corporate law projected by the business judgment rule.

Third, article 2.35-1(A) is a more efficient rule than section 144(a). In Delaware, uncertainty reigns supreme in determining the result of valid shareholder ratification. Having a clear rule in Texas means less litigation and, likewise, a more efficient judicial system. Taken together, the predictability, congruence with the business judgment rule, and efficiency of article 2.35-1(A) makes it superior to Delaware's section 144(a).

Interestingly, the strongest argument against the claim-extinguishing philosophy in Texas makes Texas a more attractive state of incorporation. In one of the first cases to interpret a conflict-of-interest statute, California illustrated its disagreement with the claim-extinguishment interpretation by propounding that "[i]t 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." Although cynical, the ability for corporate management to have a greater margin of error in self-interested transactions makes Texas more attractive than Delaware as a state of incorporation on this issue. Furthermore, the California idea of a feeble group of minority shareholders is less a reality today than in the 1950's. The dramatic increase in institutional shareholders over the last fifty years has resulted in a tightly concentrated shareholdership. This concentration produces easier coordination and communication so that institutional shareholders are "increasingly activist." Thus, an intense need to protect minority

131. See, e.g., *Zupnick v. Goizuetta*, 698 A.2d 384 (Del. Ch. 1997) (dismissing a claim that retroactive compensation constituted corporate waste because the compensation package had been approved under a § 144(a) safe harbor).

132. See *supra* notes 82-129 and accompanying text (discussing the effect of shareholder ratification in Delaware).

133. *Remillard Brick*, 241 P.2d at 74.

134. See EISENBERG, *supra* note 127, at 158-66 (8th ed. 2000) (detailing the increasingly important role of institutional investors, which hold almost sixty percent of equities in the 1,000 largest U.S. corporations).

135. *Id.*; *Vogelstein*, 699 A.2d at 338 (commenting that shareholder assent is a better way to supervise compensation than are judicial determinations because "institutional shareholders have grown strong and can more easily communication").

2006

A Catch-22 or a Catch-All?

shareholders in publicly-held companies when they have the option to veto a self-dealing transaction by a majority vote no longer exists.

VII. CONCLUSION

As long as corporations exist, so will self-interested transactions. Certainly, some believe that “[t]he risk of [self-interested] behavior is an elemental threat to the utility of the corporate form.” However, only a utopian fantasy could imagine a corporate law system wherein conflicts-of-interests do not occur. The key is not to try and get rid of self-interested transactions, but to monitor them in a manner that benefits management and shareholders alike. The optimum situation creates a system that both affords management extensive discretion in making business decisions and has the means to monitor self-dealing. Texas’s article 2.35-1(A) is that system: It affords directors broad freedom in decision-making and wholly respects the decision of fully-informed shareholders to veto or sanction self-dealing transactions.

Essentially, the ability of both Delaware General Corporation Law section 144(a) and Texas Business Corporation Act article 2.35-1(A) hinges on the sections’ abilities to allow corporate directors and officers enough liberty to make necessary business decisions, while at the same time protecting the corporation and its shareholders’ investments. Delaware is certainly winning the race to convince states to incorporate within by adjusting its corporate law to favor managers, even at the expense of shareholders. However, the amended article 2.35-1(A) demonstrates that not only has Texas caught on to Delaware’s game, but it has surpassed Delaware in manager-friendly legislation in its conflict-of-interest statute.

136. *Steiner*, 1995 WL 441999 at *2.

137. *Id.* For some proposed solutions to self-dealing, see Goshen, *supra* note 37, at 401-08.

138. W. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 669 (1974). Numerically speaking, Delaware boasts incorporation of fifty-six percent of all corporations listed on major stock exchanges. EISENBERG, *supra* note 127, at 101.

*Krystal Pfluger Scott**

* * The author would like to thank Professor Robert Ragazzo of the University of Houston Law Center for his guidance in writing this Article.