Curbing Management Conflicts of Interest -- The Search for an Effective Deterrent

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CURBING MANAGEMENT CONFLICTS OF INTEREST—THE SEARCH FOR AN EFFECTIVE DETERRENT

Jayne W. Barnard*

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A recurring concern among observers of corporate governance issues is whether the law is doing enough to curb self-dealing by corporate officers and directors.¹ Some commentators would suggest that this concern is misplaced, inasmuch as transactions between corporations and their managers are merely an efficient means of providing executive compensation. Others argue that market forces will make it difficult for corporations which engage in such transactions to raise capital, and that the presence of market mechanisms has already minimized self-dealing.²

These assertions reflect an unwarranted confidence in the effectiveness of market-based and other existing deterrents to self-dealing. They certainly suggest a failure to appreciate the degree to which material corporate conflict of interest transactions occur.

Consider Crazy Eddie, Inc., a New York electronics firm which, prior to going public in 1984, was controlled by the Antar family. During this period, the Antars “virtually [used] the company as a private bank.”³

Crazy Eddie . . . made interest-free loans totalling $470,000 to some of the Antars. It . . . paid two of their wives $75,000 each.

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². See infra notes 117-21 and accompanying text.

And the New York-area company was owed more than $3 million by other Antar [family] enterprises, including a son-in-law's audio and videocassette business with the concession to sell tapes in Crazy Eddie stores.

A shoe-store chain, which had filed a petition under federal bankruptcy law, controlled by another relative had $500,000 of its debts guaranteed by Crazy Eddie. And yet another troubled Antar business [with ties to Crazy Eddie] was a Caribbean medical school, the University of St. Lucia School of Medicine, which [had] since closed.4

Or consider Allegheny International, Inc., a poorly-performing Fortune 500 company whose directors approved $32.3 million in low-interest (2%) loans for themselves and several Allegheny executives;5 a $10,000 per day consulting contract to one of its outside directors;6 a $16 million purchase of a controlling interest in a Florida condominium complex in which top Allegheny officers had substantial financial interests;7 and the purchase of the Dover Hotel “for the benefit of [the Chairman’s] son, who occupied a $1 million penthouse suite” there.8 Disgruntled shareholders claimed that overall, Allegheny’s directors sanctioned widespread abuse of executive perquisites and nepotism in hiring, “used and wasted the company’s assets for their personal benefit and embarked upon a reckless acquisition and expansion spree [that] brought the Company to the brink of ruin.”9 The Securities and Exchange Commission (SEC) concluded that many of Allegheny’s self-dealing transactions were not sufficiently disclosed to its shareholders10 and Allegheny’s self-dealing management has now been replaced.11

Transactions and business relationships like those attributed to Crazy Eddie and Allegheny International—those (1) providing financial benefits to corporate managers (and their families) appar-

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4. Id.
6. Symonds, supra note 5, at 60; Complaint, supra note 5, at ¶ 39(i).
7. Symonds, supra note 5, at 56-57, 60; Complaint, supra note 5, at ¶ 39(vi).
8. Complaint, supra note 5, at ¶ 39(viii). The son, Christopher Buckley, was also installed as hotel manager, even though he had no hotel experience. Symonds, supra note 5, at 59.
9. Complaint, supra note 5, at ¶ 5(b).
ently in excess of appropriate compensation and (2) potentially detrimental to the interests of non-management shareholders—are not merely anecdotal. The author has recently undertaken a survey of ninety-two American corporations, the results of which indicate that both privately-held and publicly-held corporations frequently engage in substantial conflict of interest transactions with their officers and directors.

Of the forty-four privately-held corporations surveyed, 97.7% had engaged in transactions during the preceding three years in which officers or directors had received benefits at least $60,000 in excess of their routine compensation through some conflict of interest mechanism. Among the forty-eight publicly-held corporations, 77% had engaged in such transactions during their most recent operating year.

This Article first reviews the empirical data and explores the nature of the transactions in which corporate officers and directors received corporate payments beyond their routine compensation and in some cases beyond what would appear to be reasonable compensation. It distinguishes the types of self-dealing transactions common to privately-held corporations from those common to publicly-held ones. It then attempts to identify those transactions, in both private and publicly-held contexts, which cannot be supported as a means of providing reasonable compensation or as an exercise of sound business judgment—in short, those which ought to be deterred as a matter of public policy.

The Article then identifies existing deterrents to unacceptable corporate self-dealing transactions and explores why those deterrents have been largely ineffective. Finally, the Article reviews several policy responses which have been or might be considered, and makes some tentative policy recommendations.

I. THE SCOPE OF THE PHENOMENON

A. Privately-Held Corporations

Identifying the degree to which privately-held corporations are making payments to their officers and directors in excess of routine compensation is methodologically imprecise. No state requires its domiciliary corporations to provide public record disclo-

12. For purposes of this Article, "routine compensation" is defined, in the case of officers and employees, as salary and authorized bonuses and stock options; in the case of directors, as directors' fees and stock purchase rights.
sure of corporate conflict of interest transactions. Only California requires certain of its domiciliary corporations to disclose such transactions to their shareholders, and those reports are not made part of any public record.13 Thus, there is no uniform repository for information concerning the transactions of privately-held corporations in which officers and directors receive personal benefit in excess of routine compensation.

Nevertheless, it is possible to review the conflict of interest experiences of a subset of privately-held corporations. Closely-held corporations which choose to “go public” are subject to the disclosure requirements of the Securities Act of 1933.14 Specifically, such companies must file with the SEC a Form S-1 Registration Statement,15 which contains a broad range of information about the registrant, including retrospective conflict of interest information as required by Item 404 of Regulation S-K.16

This writer reviewed seventy-two Form S-1 Registration Statements for initial public offerings filed with the SEC consecutively during June, 1986. After deleting from consideration debenture offerings and reorganizations of established companies, conversions by mutual financial institutions and insurance companies, corporate spin-offs, going-private transactions and limited partnership offerings, each of which seemed to present conflict of in-

13. See infra notes 148-52 and accompanying text.
16. 17 C.F.R. § 229.404 (1987). In the context of initial public offerings, Item 404 requires disclosure of all transactions dating back three years preceding registration up to and including those which are anticipated at the time of registration, in which the registrant (or its subsidiaries) was or is expected to be a party, in which the amount involved exceeds $60,000, and in which any executive officer, director, or member of his immediate family “had, or will have, a direct or indirect material interest.” 17 C.F.R. § 229.404(a) (1987). Members of a person’s “immediate family” include his spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, and brothers- and sisters-in-law. Id.

Whether such a person has a “material interest” in any transaction(s) is to be determined by the registrant, taking into account “[t]he importance of the interest to the person having the interest, the relationship of the parties to the transaction(s) with each other and the amount involved in the transactions.” Id.

Disclosure is required regardless of whether the interested persons profited or lost from the transaction(s). Id. Disclosure is not required if the interest represents less than a 10% equity ownership of another corporation furnishing services to the registrant or if the transaction represents rates or charges which were determined by competitive bids. Id.

Item 404 also requires disclosure of loans made by the corporation during the preceding fiscal year to directors, executive officers, or members of their immediate families, in excess of $60,000. 17 C.F.R. § 229.404(c) (1987).
terest problems uncharacteristic of more conventional nonpublic entities, forty-four companies remained, which for the remainder of this Article shall be referred to as the “pre-public” companies.

The review of these companies’ Form S-1’s disclosed that in the period immediately preceding their initial public offerings, all but one had engaged in transactions with (and consequently had provided non-routine benefits to) officers, family members or businesses controlled by them, significant enough to be reportable under Item 404. At the same time, more than half of them had engaged in “reverse” conflict of interest transactions by which the corporations received benefits (such as loans or loan guarantees) from their officers, directors, their family members or affiliated entities.

A selection of the conflict of interest disclosures contained in the Form S-1 sample illustrates the sorts of self-dealing transactions common to these relatively small, “pre-public” ventures. These transactions may be categorized as they most frequently appeared—transfers of real estate to and from corporate managers; insider loans; consulting agreements with “outside” directors and miscellaneous conflict of interest transactions (including investments in manager-operated businesses, operating agreements and licensing agreements).

1. Acquisitions of Property and Equipment from Management Insiders

On September 1, 1984, the Company leased property for a center in San Francisco from a California limited partnership which includes as partners the three children and a son-in-law.

17. It should be noted that the nature and extent of management self-dealing among corporations going public is not necessarily reflective of conflict of interest transactions occurring among corporations with no present or future intention of going public. Evidence suggests that the phenomenon of self-dealing is even more common among closely-held corporations than among those privately-held corporations which go public. See, e.g., Barnard, Corporate Loans to Directors and Officers—Every Business Now a Bank? (to be published shortly in the 1988 Wisconsin Law Review). This can be attributed, in part, to the sanitizing influence which accompanies the expectation of going public, cf. infra note 133 and accompanying text, and, in part, to the reality that many closely-held companies are simply alter egos for their owners, who feel free to strip corporate resources for their personal benefit to a degree that entrepreneurs with growth aspirations may not.

18. It is assumed throughout this Article that such transactions reflect a beneficial, perhaps life-infusing, managerial role rather than a predatory one. They are therefore referred to, albeit with some hesitation, as “benefactor” transactions. See, e.g., Neidert v. Neidert, 637 S.W.2d 296 (Mo. Ct. App. 1982) (loans made to corporation by shareholders).
year ending April 30, 1986.]26

3. “Consulting” Agreements with Directors

The Company has retained the firm of [RM], Inc. as its public relations firm since July 1984. The Company's payments on this account were approximately $60,000 during fiscal [year] 1984, $280,000 during fiscal [year] 1985 and $57,000 during the first quarter of fiscal [year] 1986. [A] director of [the Company] serves as Chairman of the Board of [RM], Inc.27

For the 12 months ended June 1, 1986, . . . a business owned by . . . a director of the Company, received approximately $87,000 for consulting services provided to the Company.28

In January 1985, the Company entered into an Advisory Agreement with [NC] Corp. . . . pursuant to which [NC] Corp. rendered to the company financial advisory consulting services for a monthly consulting fee. [NC] Corp. is an affiliate of [a director of the Company]. The total paid to [NC] Corp. in 1985 was $22,000. 29

In fiscal [year] 1985 the Company paid legal fees totalling $18,359 to . . . a law firm in which . . . a director of the Company, is president.30

4. Other Transactions

Since April 1, 1983, several affiliated parties, including [the president and CEO of the Company], his spouse and children and various directors and officers of the Company, have held interests in entities that own or have owned franchises [associated with the Company].31

The Company maintains life insurance policies on the life of [an officer/director] totalling $10,250,000. The proceeds of policies in the amount of $7,250,000 are payable to a life insurance trust established for the benefit of [certain shareholders affiliated with the officer]. . . . The Company also maintains for its own

benefit a key-man life insurance policy on the life of [the officer] in the amount of $3,000,000. 83

The Company has guaranteed a $300,000 line of credit to MBI, which is currently fully utilized. [The president and CEO of MBI is also chairman of the board of the Company]. 88

In June 1982, the Company conveyed a number of royalty and overriding royalty interests in certain coal leases to [a trust, the beneficiaries of whom are several officers and directors of the Company plus their children. The income from these royalties totalled $10.5 million during 1983, $12 million during 1984 and $11.4 million during 1985]. 84

The pre-public corporations in the Form S-1 sample freely utilized all four forms of conflict of interest mechanisms, favoring them in the following order: miscellaneous transactions (54.5% of reporting companies), consulting agreements (54.5%), loans to officers, directors and affiliates (43.2%), and property transactions (38.6%). The amounts involved were in many cases significant, ranging up to $982,000 annually for property rentals, $339,000 for individual insider loans, and $606,000 for consulting agreements. Inasmuch as the "miscellaneous" transactions frequently did not involve direct transfers of cash, they are more difficult to quantify, but one involved the guaranty of the unrelated business debts of two corporate executives totalling $982,746 85 and another involved payment of $322,000 in "dealer fees." 86

Registrants frequently defended these transactions by offering such comments as "[t]he company believes that the terms of this [transaction] are comparable to other [transactions] the Company has entered into with unaffiliated [businesses]." 87 Some of these

33. Id. at 32.
37. American Learning Corp., supra note 19, at 20. See also Union Valley Corp., Form S-1 No. 33-6111, filed June 2, 1986, at 34 ("The company believes that each management agreement is on terms and conditions at least as favorable to the company as those available from unaffiliated third parties."); Convex Computer Corp., supra note 27, at 28; Pacific Southwest Airlines, Form S-1 No. 33-6024, filed June 3, 1986, at 17; Shoe City Corp., Form S-1 No. 33-6201, filed June 4, 1986, at 23; American Woodmark Corp., supra note 21, at 19; Bonneville Pacific Corp., supra note 26, at 22; O'Brien Energy Systems, Inc., Form S-1 No. 33-6463, filed June 13, 1986, at 30; Cellular Communications, Inc., supra note 36, at 31.
assertions were not entirely convincing:

In the opinion of [the Company's] board, of which Mr. [S] is one of two members, the legal fees charged by Mr. [S's] law firm are as reasonable as and no greater than those which would have been charged by an unaffiliated law firm with comparable expertise for the same services. 38

Other registrants disclosed the terms of their transactions, but simultaneously announced that these relationships were being terminated, effective upon the success of the public offering. 39 A few announced not only the termination of previous contractual arrangements but a revealing change in their corporate practices:

The Company has adopted a policy that transactions between the Company and its officers, directors, principal shareholders or affiliates of any of them will be on terms no less favorable to the company than could be obtained from unaffiliated parties and will be approved by a majority of the independent and disinterested directors of the company. 40

B. Publicly-Held Corporations

Ascertaining the scope of self-dealing transactions among publicly-held corporations is far easier than in the case of closely-held corporations. The Securities Exchange Act of 1934 41 and accom-
panying regulations require registration with the SEC of all issuers whose securities are traded on a national securities exchange, and all issuers having total assets exceeding $5,000,000 and 500 or more equity shareholders. Every issuer registered with the SEC must file periodic reports with the agency, including a lengthy annual report on Form 10-K. Form 10-K requires disclosure of a wide range of corporate information, and specifically requires the issuer to disclose annually those transactions covered by Item 404 of Regulation S-K.

The author reviewed forty-eight Form 10-K's filed with the SEC during October 1986. These 10-K's represented Fortune 500 companies, "household word" companies, and many largely unknown although, for SEC purposes, "public" companies. The shares of seventeen of these companies were, at the time of filing, traded on one or more stock exchanges, and the shares of thirty-one companies were traded over-the-counter or were inactive. Many of the conflict of interest transactions reported by these "already public" companies were similar to those found in the pre-public companies.

The range in values for the conflict of interest transactions of

46. The following disclosures, grouped according to transaction type, are representative of the Form 10-K sample:

(a) Property and Equipment Transactions

Bastian [a subsidiary] leases the building in which it operates from a partnership composed of four individuals, one of whom is a vice-president of Bastian. Metal Arts Co., Inc., Form 10-K, filed Oct. 28, 1986, at 44.

(b) Favorable Loans
[The Company's board approved a $400,000 10% loan to a substantial shareholder to exercise a special $2/share stock option, later amended to make it non-interest bearing.] Acro Energy Corp., Form 10-K, filed Oct. 28, 1986, at 18.

As of September 30, 1986, [the] Vice President and Trustee of the Trust and an employee of the Trust and its predecessors for 29 years, was indebted to the Trust in the amount of $108,742 . . . Of this amount $4,000 is a demand non-interest bearing education loan made to assist [the Vice President] in providing tuition for his children in college. [The remainder, repayable at 12%, was to facilitate share purchases.] New Plan Realty Trust, Form 10-K, filed Oct. 29, 1986, at 36-37.
the publicly-held corporations was consistently higher than those found in the pre-public corporations. For example, property rentals ranged up to $1,440,000 annually; insider loan authorizations ranged up to $840,000; and consulting agreements ranged up to $2,462,088. Miscellaneous transactions included a $15 million purchase of a business from an executive’s wife and the purchase of a 39% interest in a savings and loan in which the company’s Chairman and CEO are, respectively, Vice-President and Chairman.

[The Company’s new group Vice President for Marketing and Communications was provided a $200,000 interest-free loan “only to purchase a new residence.” Redken Laboratories, Inc., Form 10-K, filed Oct. 29, 1986, at Item 11.

(c) Consulting Agreements

Allen & Company Incorporated . . . of which [a director of the Company] is a vice president and managing director . . . received $1,100,000 in cash for its services as placement agent for [the Company’s] private placement of the Debentures. Integrated Barter Int’l, Inc., Form 10-K, filed Oct. 28, 1986, at 48.

[The Company] has paid consulting fees to [a corporation] in which [a substantial shareholder of the Company] had a financial interest [from August 1, 1985 to October 22, 1985, these fees totalled $127,177; for the year ending July 31, 1985, they totalled $552,000, and for the year ending July 31, 1984, they totalled $517,000.] In addition, the Company buys insurance from brokerage companies in which certain directors of the Company have a financial interest. [The premiums for the year ending July 31, 1986 totalled $303,000. For the year ending July 31, 1985, they totalled $496,000, and for the year ending July 31, 1984, $484,000.] Simplicity Mfg. Co., Form 10-K, filed Oct. 28, 1986, at 24.

[The Chairman of the Board] has a 3-year consulting agreement to provide up to 25 hours per month of management consulting for $5,000 per month. ATI Medical, Inc., Form 10-K, filed Oct. 29, 1986, at 22.

(d) Other Transactions

The Company acquired the assets of SNC in June, 1984 for $8.2 million in cash. [A director of the Company owns a 47.5% interest in SNC. Integrated Barter Int’l, Inc., supra at 51.]

The Company entered into a Facilities Management Service Agreement . . . with JHPC, a professional medical corporation of which a 28.9% shareholder of the Company, is the sole shareholder. . . . JHPC and its predecessors owed the Company approximately $208,507 as of July 31, 1986. . . . H&S Treat & Release, Inc., Form 10-K, filed Oct. 29, 1986, at 30; see also Langer Biomechanics Group, Inc., Form 10-K, filed Oct. 29, 1986, at 55 (facilities management agreement with partnership composed of company’s officers and directors).

“Already-public” companies engaged in proportionately fewer of all types of conflict of interest transactions than pre-public companies. Moreover, the overall profile of transactions reported by the already-public companies differed from that found in the registration statements of the pre-public companies, as reflected in Figure 1.49

Figure 1

<table>
<thead>
<tr>
<th>Category</th>
<th>Pre-public Companies</th>
<th>Public, Reporting Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans to Property Transactions</td>
<td>38.6</td>
<td>54.5</td>
</tr>
<tr>
<td>Loans to Directors, Officers &amp; Affiliates</td>
<td>35.4</td>
<td>43.8</td>
</tr>
<tr>
<td>Consulting Agreements</td>
<td>16.7</td>
<td>52.3</td>
</tr>
<tr>
<td>Miscellaneous Transactions</td>
<td>54.5</td>
<td>43.2</td>
</tr>
</tbody>
</table>

49. Some qualitative differences are not reflected in this Figure. For example, the stated purpose for several of the loans by the public companies was to permit the exercise of stock option rights, which was never the stated purpose for loans made by the pre-public companies, presumably because they had not yet reached a state of maturity sufficient to generate such opportunities. (Some of the pre-public corporations did, however, grant loans to directors to finance basic stock purchases.) In a similar light, several of the public companies had “golden parachute” agreements inuring to the benefit of corporate managers, whereas none of the pre-public companies did.
What do these samples indicate? At the very least, they demonstrate that conflict of interest transactions between corporations and their officers and directors constitute a substantial business phenomenon in corporations of all sizes. But frequency alone does not indicate whether this phenomenon requires some public policy response. What matters is the quality and consequences of these transactions.

II. THE REQUISITE VOCABULARY

In considering whether a particular extra-compensatory transaction between a corporation and its officers or directors is desirable, benign, or cause for deterrence, one must deal initially with questions of definition.

A. "Conflicts of Interest"

There is no uniform protocol for determining whether or not a particular corporate transaction involves a "conflict of interest" on the part of its officers or directors. A number of definitions have been advanced. The Revised Model Business Corporation Act (RMBCA) defines a conflict of interest transaction as one "with the corporation in which a director of the corporation has a direct or indirect interest." "Direct interest" is not defined in the RMBCA, although the official commentary thereto includes within the concept of direct interest any transaction where the director "or the immediate members of his family have a financial interest in the transaction or a relationship with the other parties to the transaction such that the relationship might reasonably be expected to affect his judgment."

An "indirect interest" arises under the RMBCA if a transaction involves

(1) another entity in which [the director] has a material financial interest or in which he is a general partner . . . or (2) another entity of which he is a director, officer or trustee . . . and the transaction is or should be considered by the board of direc-

50. Figure 1 may also indicate the efficacy of mandatory disclosure requirements and/or hypothesized market forces as a deterrent to certain types of conflict of interest transactions. See infra text accompanying notes 161-65.
51. REVISED MODEL BUSINESS CORP. ACT (1984) [hereinafter RMBCA].
52. Id. § 8.31(a).
53. Id. § 8.31 comment 5.
Inexplicably, the RMBCA does not concern itself with conflict of interest transactions involving corporate officers or non-officer executives.\(^{55}\)

The most recent published drafts of the ALI Proposed Principles of Corporate Governance addressing the issue of conflict of interest\(^{56}\) articulate a similar definition. Within the rubric of the “duty of loyalty,”\(^{57}\) certain procedural requirements are imposed when any director, “senior executive,”\(^{58}\) or “dominating shareholder”\(^{59}\) enters into a transaction with the corporation “other than a transaction involving the payment of compensation.”\(^{60}\)

The transactions governed by this provision may include “supplying property to the corporation or acquiring property from the corporation, by sale, lease, or otherwise, furnishing services to the corporation in some capacity other than as a director or senior executive (such as an investment advisor, investment banker, or attorney), supplying or acquiring services from the corporation, or making loans to or receiving loans from the corporation.”\(^{61}\) They

\(^{54}\) Id. § 8.31(b).

\(^{55}\) The official commentary to the RMBCA suggests, however, that a transaction involving officers may be challenged on the ground that it constitutes waste, that “it was not authorized by the appropriate body, that it violated other sections of the [RMBCA] or that it was unenforceable under other common law principles.” RMBCA, supra note 51, comment 1.

\(^{56}\) See A.L.I. PRINCIPLES, supra note 1, Tent. Drafts Nos. 5 and 7.

\(^{57}\) Note that this terminology is proposed to be changed to the “duty of fair-dealing.” A.L.I. PRINCIPLES, supra note 1, Tent. Drafts Nos. 5 and 7.

\(^{58}\) “Senior executive” is defined in Tentative Draft No. 5, §§ 1.28 and 1.22, as including a corporation’s “chief executive, operating, financial, legal, and accounting officers . . . chairman of the board of directors (unless the chairman neither performs a policymaking function other than as a director, nor receives a material amount of compensation in excess of director’s fees), president, treasurer, secretary and controller, and [any] vice-president who is in charge of a principal business unit, division or function (such as sales, administration, or finance) or performs a major policymaking function for the corporation.” Id.

\(^{59}\) “Dominating shareholder” is defined in Tentative Draft No. 5, § 1.12, as any shareholder who, either alone or with others, “owns, and has the unrestricted power to vote, more than 50 percent of the outstanding voting securities of a corporation” or otherwise in fact exercises control over the management. Id.

\(^{60}\) Id., Tent. Draft No. 5, § 5.02(a).

\(^{61}\) Id., Tent. Draft No. 5, § 5.02 comment c. Section 5.02 generally does not apply to “transactions involving fungible goods or services that are offered generally to the public upon terms fixed in advance . . . by the person offering the service or property.” Id. Additionally, section 5.02 generally would not apply to transactions “whose terms are not negotiated, but rather are determined by competitive bids submitted to the corporation, unless it appears that competition has been artificially diminished or eliminated through the
include transactions which involve "associates" of directors or senior executives, including a spouse, child, parent or sibling. An "associate" may also be "any person for whom a director, senior executive or shareholder has financial responsibility or with whom he has a business relationship, that is sufficiently substantial that it would reasonably be expected to affect his judgment with respect to the transaction in question in a manner adverse to the corporation." 64

Neither the RMBCA or the proposed Principles of Corporate Governance limit the concept of conflict of interest transactions to those involving some minimum amount of money. A conflict of interest exists under these formulations even where the cost to the corporation or the financial benefit to the interested person is de minimis.

For purposes of this Article, a conflict of interest transaction is defined as one in which either a director, executive officer or holder of at least 10% ownership in a corporation (the "interested person") has a direct or indirect interest. An indirect interest may arise out of several situations, including the following:

(a) the interested person serves as a director or officer of or has at least a 10% equity ownership in the contracting entity;

(b) any member of the immediate family of the interested person is the contracting party. The "immediate family" includes a spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law and brothers and sisters-in-law;

(c) any member of the immediate family of the interested person serves as a director or officer of, or has at least a 10% equity ownership in, the contracting entity.

B. "Material Conflicts of Interest"

The term "material conflict of interest transaction" lends itself, unfortunately, to two differing interpretations. A conflict of interest transaction may be material to the corporation in an accounting sense. 65 Regardless of whether the transaction is material in

62. Id., Tent. Draft No. 5, § 5.08.
63. Id. § 1.02(a)(1).
64. Id. § 1.02(a)(2).
65. "In spite of its pervasiveness, materiality remains an ill defined concept. There is
an accounting sense, it may nonetheless be of material interest to a shareholder of the corporation in deciding whether to retain or dispose of his investment or in deciding how to cast his vote at a shareholders' meeting.

The relevance of this latter test was established by the United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* There, the court held that, for purposes of section 14(a) of the Exchange Act which governs proxy solicitations, information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." Courts have repeatedly held that the existence of a substantial transaction with a corporation which is beneficial personally to an officer or director constitutes material information to the voting shareholder. This is so whether the vote being sought concerns

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68. 426 U.S. at 449.
69. See, e.g., Kas v. Financial Gen. Bankshares, Inc., 796 F.2d 508, 515 (D.C. Cir. 1986) (fact that directors of subsidiary corporation about to be acquired in a cash-out merger also serve as legal counsel to management of acquiring company is material because this information "would in all probability have assumed actual significance in the deliberations of a reasonable shareholder [contemplating a vote to approve the merger]"); SEC v. Falstaff Brewing Corp., 629 F.2d 62, 67-68 (D.C. Cir.), cert. denied, 449 U.S. 1012 (1980) (proxy statement seeking approval of a charter amendment is deficient when it fails to disclose the details of the benefits the controlling shareholder will receive if amendment is passed); Gladwin v. Medfield Corp., 540 F.2d 1266, 1271 (5th Cir. 1976) (failure of proxy solicitation to disclose the "true extent of the economic benefit" accruing to a director engaged in conflict of interest transactions with the corporation as well as failure to disclose the "concomitant cost to the corporation" of these transactions constitutes a material omission); Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 773-74 (3d Cir. 1976) (fact that certain directors who had negotiated for themselves a cash-out in connection with a proposed merger, while seeking approval of a share exchange applicable to all other shareholders, were subject to "conflicting interests," was "obviously of material interest" to the shareholders whose votes were being solicited); Mills v. Electric Autolite Co., 403 F.2d 429, 435 (7th Cir. 1968), vacated and remanded on other grounds, 396 U.S. 375 (1970) (failure of proxy solicitation clearly to disclose potential personal benefit to board members advocating favorable vote on a proposed merger constitutes a material omission); Televest, Inc. v. Wisconsin Real Estate Inv. Trust, 489 F. Supp. 250, 254 (E.D. Wis. 1980) (failure of proxy solicitation to inform shareholders that president and trustee of a real estate investment trust had a direct interest in the trust's property management company and was receiving a substantial proportion of the payments made to the property manage-
approval for the transaction itself or merely election of a directorial slate;\textsuperscript{70} whether the transaction involves criminal misconduct\textsuperscript{71} or, as is more frequently the case, merely financial opportunism. The SEC regards the disclosure of managerial conflict of interest transactions so necessary to demonstrate the presence or absence of management integrity and competency\textsuperscript{72} that it now expressly requires this information to be disclosed in annual proxy solicitations.\textsuperscript{73}

\textsuperscript{70} For a thoughtful discussion of the parameters of this concept, see Ferrara, Starr & Steinberg, \textit{Disclosure of Information Bearing on Management Integrity and Competency}, 76 NW. U.L. REV. 555 (1981).

\textsuperscript{71} \textit{See} United States v. Fields, 592 F.2d 638, 649 (2d Cir. 1978), \textit{cert. denied}, 442 U.S. 917 (1979) (failure to disclose corporate payment of “finder’s fee” to a third party for services never performed, followed by substantial kickback to officers and director who arranged the payment, constitutes a material omission under section 17(a) of 1933 Act; SEC v. Kalvex Inc., 425 F. Supp. 310, 314-15 (S.D.N.Y. 1975) (scheme involving payments to vendor followed by kickback to director/president was material and had to be disclosed in annual proxy solicitation for election of directors).

\textsuperscript{72} But see Biesenbach v. Guenther, 588 F.2d 400 (3d Cir. 1978) (loans made by directors to corporation on exploitive terms might constitute a breach of fiduciary duty, but no issue is presented under federal securities laws); Browning Debenture Holders’ Comm. v. DASA Corp., 560 F.2d 1078, 1084 (2d Cir. 1977) (failure of corporation seeking approval of sale of assets to disclose conflict between the directors’ interest as stockholders and the interests of debenture holders is solely a matter of state law fiduciary duties, not governed by the federal securities laws); Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1144-46 (D. Or. 1984) (relationship of investment banker, lawyers, and officer to corporation seeking approval of a leveraged buy-out held not to constitute a conflict of interest requiring disclosure); Perelman v. Pennsylvania Real Estate Inv. Trust, 432 F. Supp. 1298, 1304 (E.D. Pa. 1977) (since omissions concerning payments made to investment trust President, although material, do not make any statements made in a proxy statement false or misleading, Rule 14a-9(a) was not violated); Anaconda Co. v. Crane Co., 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975) (claim that the directors of a corporation resisting a tender offer were affiliated with target corporation’s lending banks held not to constitute proof of a conflict of interest requiring disclosure); Lewis v. Dansker, 357 F. Supp. 636, 642-43 (S.D.N.Y. 1973) (ninety percent shareholders are not required to disclose the tax benefits incurred by them personally as a result of corporate transactions, inasmuch as this information is not material); Evans v. Armour & Co., 241 F. Supp. 705, 709 (E.D. Pa. 1965) (director’s relationship with investment banking firm representing proposed merger partner and with subsidiary of which proposed merger partner owns 700,000 shares both held to be too attenuated to be of material interest to shareholders).

\textsuperscript{73} \textit{See} Perelman, 432 F. Supp. at 1303.
The theory behind requiring disclosure of managerial conflicts of interest has been variously stated by the courts. The Second Circuit has noted that "Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly relevant to a determination of whether they are qualified to exercise stewardship of the company."\(^\text{74}\) Another court has observed, "One does not elect as a director an individual who is using the corporation he represents for personal gain."\(^\text{75}\) Yet a third court has added that "one does not elect as a trustee or director an individual who knows, or should know, that other directors or trustees are using the corporation for a personal gain and vote in favor of such transactions, or, raise no objection to such transactions."\(^\text{76}\)

While these pronouncements may overstate the case,\(^\text{77}\) it is at least fair to say that reasonable shareholders might regard as a significant factor in their electoral decisions the existence of transactions in which a corporate officer or director (a) receives a substantial personal (or familial) benefit, (b) receives a substantial proportion of the corporation's earnings whether or not the amount represents a substantial benefit to the director personally, (c) enjoys opportunities to contract with the corporation disproportionate to his position among competitors for those opportunities, or (d) may be the beneficiary of inadequate or indiscriminate corporate contracting practices. Any such transaction, or a series of transactions permitting similar conclusions, would, under TSC, be of material interest to the voting shareholder.

74. Maldonado v. Flynn, 597 F.2d 789, 796 (2d Cir. 1979).
77. Not all business transactions involving a corporation and one of its officers, directors or their family members are improper:

An officer or director often may have something to exchange that would be advantageous for the corporation to have. An example is unique property, the ownership of which would facilitate the development of the corporation's business. More obviously, all officers and directors who receive compensation are providing services that the corporation requires from someone at some price. If the duty of loyalty precluded such sales of goods or services by an officer or director, the corporation would be the loser and its interest would suffer.

Hazard, Foreword to The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (Tent. Draft No. 5, 1986) at x.
C. "Unacceptable Conflicts of Interest"

Neither term—"conflict of interest transaction" or "material conflict of interest transaction"—necessarily describes a situation adverse to the corporation's best interests. There are some conflict of interest transactions, however, which are objectionable as a matter of public policy—transactions which no prudent exercise of business judgment can justify. They do not represent a unique opportunity to the corporation. They do not represent compensation for needed services. They may not reflect any "benefit" to the corporation at all and in a universe limited to arm's length bargaining among strangers, presumably such transactions would not occur.

These transactions—here denominated "unacceptable" conflict of interest transactions—are surely includable in the universe of transactions which are material to non-management shareholders. It is these transactions especially to which any public policy response to the phenomenon of conflict of interest transactions as a whole must be addressed. Thus, it is instructive to review those cases which have scrutinized transactions involving managerial conflicts of interest to determine if any consistent themes exist which will assist in identifying those transactions which are, as a matter of law, "unacceptable." Some general categories immediately become apparent.

First are the "overreaching" or "unfairness" cases in which the consideration received by the corporation as a consequence of the conflict of interest transaction is grossly disproportionate to that which is given up. Examples include sales or rentals of property to an insider at grossly understated values,\(^78\) substantial loans returning far less than could be earned by the corporation were it to have made alternative investments,\(^79\) and lease arrangements in which the corporation pays excessive rents to an insider for leased space.\(^80\)

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80. See Fill Bldgs., Inc. v. Alexander Hamilton Life Ins. Co. of America, 396 Mich. 453,
Second are the "temporal shift" cases in which a management insider induces the corporation to engage in a business transaction which, even assuming it occurs at a reasonable price, is inconsistent with and detrimental to the corporation's prior business plan or current financial needs. The problem is not the terms of the transaction, but rather its timing. Examples include a director inducing a corporation to accelerate cash payments ahead of a previously anticipated payment schedule resulting in the impairment of the corporation's financial condition,\textsuperscript{81} directors inducing a cash-poor corporation to offset accounts receivable from another entity owned by them against accounts payable to that entity, rather than collecting the receivables in cash,\textsuperscript{82} and an officer inducing his corporation to pay him back salary and repay a demand note with interest at a time when the corporation had no operating funds and had to obtain a bank loan in order to make the required payments.\textsuperscript{83}

Third, and most common, are the "misappropriation" cases in which a manager simply converts corporate property to his own use, with or without the assistance or knowledge of other managers. Examples include a corporate executive drawing checks on the corporate account for payment of his personal expenses or for purchase of equipment for his own unrelated business ventures\textsuperscript{84} or physically removing corporate assets for his personal or business use.\textsuperscript{85}


\textsuperscript{82} Planhouse, Inc. v. Breland & Farmer Designers, Inc., 412 So. 2d 1164 (Miss. 1982) (copying company plans and using them in competition with company after leaving it held to be violation of fiduciary duty); Emergency Patient Servs., Inc. v. Crisp, 602 S.W.2d 26 (Mo. Ct. App. 1980). See also Minnesota Valley County Club, Inc. v. Gill, 356 N.W.2d 356, 361
While these categories do not exhaust the field of unacceptable conflict of interest transactions, they do illustrate the sorts of corporate transactions which courts have found unacceptable and which any well-developed public policy would seek to deter. As will be seen, different types of unacceptable conflict of interest transactions may respond to different deterrent approaches.

III. EXISTING DETERRENTS TO UNACCEPTABLE CONFLICTS OF INTEREST

Mechanisms already exist which arguably serve to deter unacceptable conflicts of interest. These mechanisms, however, are of limited practical utility.

A. IRS Disallowance of Deductions for Unreasonable Payments

One primary mechanism of deterrence is that provided by enforcement of the Internal Revenue Code. Section 162(a)(3) of the Code specifically addresses the problem of excessive payments by a corporation for the rental of property. That section allows a deduction for “rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which [the corporate taxpayer] ... has no equity.” Under this provision the Service has on many occasions disallowed corporate deductions for excessive payments made to shareholders, managers or their family members, or affiliates for rents and royalties.

(Minn. App. 1984) (director's pledge of corporate assets to secure personal loans unlawful); Mountain Top Youth Camp, Inc. v. Lyon, 202 S.E.2d 498 (N.C. App. 1974) (president's transfer of not-for-profit corporation's land to himself and his wife without authority or consideration held void).

88. Id.
89. “Although the statute [§ 162] does not limit deductions for rental payments to a 'reasonable' amount, the reasonableness of such payments must be explored to determine whether they are 'ordinary and necessary' and thereby properly deductible under § 162, or whether they are 'excessive.'” Harmon City, Inc. v. United States, 733 F.2d 1381, 1383 (10th Cir. 1984). Rental payments are presumed reasonable unless a close relationship exists between the lessor and lessee, in which case the court will try to determine what rent would have been paid in an arm's length transaction. Id. In Harmon, the court held rental payments to be excessive and nondeductible when a family-owned corporation engaged in a sale-leaseback transaction with a related family-owned partnership. Id. at 1385. For other cases disallowing deduction of rental payments, see, e.g., Milbrew, Inc. v. Comm'r,
Section 162(a)(1) addresses the consulting fee problem. Under this provision, a corporation is entitled to deduct a "reasonable allowance for salaries or other compensation for personal services actually rendered." The Service frequently has relied on this provision to disallow a business deduction claimed by a corporation for compensation paid to shareholders, or managers or their relatives for services purportedly but not in fact rendered, or for services valued at arm's length at considerably less than the amount actually paid. Arguably the threat of deduction disallowance is the most painful of all tax deductions, and the Service is quick to use this provision to disallow deductions claimed for compensation paid to relatives of shareholders. A few cases illustrate the Service's approach:

- Miland Ford Tractor Co. v. Comm'r, 277 F.2d 111 (8th Cir. 1960); Utter-McKinley Mortuaries v. Comm'r, 225 F.2d 870 (9th Cir. 1965); Stanwick's, Inc. v. Comm'r, 15 T.C. 556 (1950), aff'd, 190 F.2d 84 (4th Cir. 1951); Kamen Soap Prods. Co. v. Comm'r, 25 T.C.M. (P-H) 626 (1956); Floridan Hotel Operators, Inc. v. Comm'r, 22 T.C.M. (P-H) 145 (1953); Manos Amusements, Inc. v. Comm'r, 20 T.C.M. (P-H) 652 (1951) (corporation paid excessive rent for property owned by sole shareholder's wife).

- Cf. Velvet Horn, Inc. v. Comm'r, 50 T.C.M. (P-H) 749, 754 (1981) (corporation's rent paid to a partnership comprised of the corporation's shareholders was deductible because the rent was reasonable); William E. Davis & Sons, Inc. v. Comm'r, 50 T.C.M. (P-H) 571, 575 (1981) (family-owned grocery corporation was allowed to deduct rent paid to family members because the lease was entered into during an arm's length transaction).

91. Id.
92. See, e.g., Medina v. Comm'r, 52 T.C.M. (P-H) 1026, 1036 (1983) (salary paid to majority stockholder's son was not deductible because the corporation failed to prove that the son actually rendered any services to the corporation); Morrison v. Comm'r, 51 T.C.M. (P-H) 2719, 2734-35 (1982) (compensation paid to sole shareholder's children was not deductible because the corporation failed to prove that the children actually performed any services for the corporation); Heim v. Comm'r, 47 T.C.M. (P-H) 581, 589-90 (1978) (payments made to shareholder's mother and to his girlfriend were not deductible because the recipients of these gifts had not rendered any services for the corporation); Berry v. Comm'r, 33 T.C.M. (P-H) 1184, 1192 (1964) (payments made to sole shareholder's wife were not deductible because the corporation could not prove when, if ever, she had rendered services for the corporation); Duffey v. Lethert, 11 A.F.T.R.2d 1317, 1320 (D. Minn. 1962) (salary paid to the sister of corporation's president was not deductible because the sister admitted that she performed no services during the months that she was paid).

93. When compensation for services has not been determined by arm's length bargaining, the Commissioner will scrutinize all the circumstances to ensure that the compensation is "reasonable," considering the following factors: the employee's qualifications, the nature of the work, compensation paid to comparable employee of other businesses, and the amount of any dividend distributions paid by the corporation. Barton-Gillet Co. v. Comm'r, 39 T.C.M. (P-H) 750, 759 (1970) (citing Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949)). Any compensation in excess of "reasonable" compensation is not deductible under I.R.C. § 162(a)(1) (1982). For cases holding that compensation paid to shareholders was excessive, and therefore not deductible, see Northlich, Stolley, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966); Barton-Gillet Co. v. Comm'r, 39 T.C.M. (P-H) at 758; Tele-ception of Winchester, Inc. v. Comm'r, 36 T.C.M. (P-H) 1326, 1329 (1967); Logan Lumber Co. v. Comm'r, 33 T.C.M. (P-H) 809, 817-19 (1964). In other cases, it has been held that compensation paid to a shareholder's relatives was excessive. See, e.g., Proctor v. Comm'r, 50 T.C.M. (P-H) 1617, 1640-42 (1981) (shareholder's mother re-
lowance under these provisions deters corporations from making excessive payments to management shareholders or their family members in the guise of rental payments, "consulting contracts," or other personal service contracts.

Corporate "loans" to managers have also run afoul of the Service's enforcement powers, at least where the managers receiving the loans are also shareholders. Where corporate funds are "loaned" to a shareholder but the Service finds by the surrounding circumstances that there was no intent to create a bona fide creditor-debtor relationship, the Service has treated these transfers as constructive dividends taxable as current income to the shareholder.94

Some of the precise sorts of transactions disclosed in the SEC filings have specifically been disallowed by the Service under § 162. For example, the Service has declined to permit corporate deductions for life insurance premiums paid by the corporation for policies the beneficiaries of which are the relatives of insured corporate executives.95

94. I.R.C. § 301 (1982). See, e.g., Busch v. Comm'r, 728 F.2d 945 (7th Cir. 1984) (sole shareholder of corporation withdrew $300,000 and tendered non-interest-bearing uncollateralized notes; court found no contemporaneous intent to repay, and treated advances as constructive dividends); Dolese v. United States, 605 F.2d 1146 (10th Cir. 1979), cert. denied, 445 U.S. 961 (1980) (court treated periodic withdrawals by sole shareholder cumulating to $1,817,133 as constructive dividends); Oyster-Shell Prods. Corp. v. Comm'r, 313 F.2d 449 (2d Cir. 1963) (shareholders of closely-held corporation found to have received constructive dividends notwithstanding corporate records reflecting their indebtedness); Lewis v. Comm'r, 54 T.C.M. (P-H) 2499 (1985); Rapoport v. Comm'r, 47 T.C.M. (CCH) 205 (1983); Piekos v. Comm'r, 51 T.C.M. (P-H) 2662 (1982); Pizzarelli v. Comm'r, 40 T.C.M. (CCH) 156 (1980); Smith v. Comm'r, 49 T.C.M. (P-H) 75 (1980); Mclemore v. Comm'r, 42 T.C.M. (P-H) 259 (1974); Holman v. Comm'r, 32 T.C.M. (CCH) 1323 (1973); Electric & Neon, Inc. v. Comm'r, 56 T.C. 1324 (1971), aff'd without opinion, 496 F.2d 876 (5th Cir. 1974); Chesapeake Mfg. Co. v. Comm'r, 33 T.C.M. (P-H) 1406, 1415-16 (1964). Payment made to a family member of a shareholder can constitute a section 301 distribution by the corporation with respect to the stock of the shareholder. In proper circumstances it is appropriate to hold that a payment to a family member represents a distribution by the corporation to the shareholder for he enjoys the use of such property as much as if the corporation had distributed it directly to him. Morrison v. Comm'r, 51 T.C.M. (P-H) 2719, 2735 (1982).

95. Cf. NFC Leasing, Inc., supra note 22; Quidel, supra note 32; Champion Trophy Mfg. Corp. v. Comm'r, 41 T.C.M. (P-H) 1291, 1298-99 (1972) (corporation was not allowed to deduct the cost of insuring the life of its president where beneficiary of the insurance policy was the president's son because the corporation had not formally authorized the
There are thus a variety of disincentives to unacceptable conflict of interest transactions present in the Code, but they are only effective to the extent that (1) corporate taxpayers claim deductions and (2) the Service audits individual corporate returns and identifies disallowable expenditures. During taxable year 1984, the Service audited only 58,947 corporate returns or less than 3% of the 1,465,800 which were filed. Moreover, the IRS deterrent would seem to address only the “overreaching” type of unacceptable conflict of interest transaction, and not the temporal shift or misappropriation types.

B. Statutory Sterilization Procedures

Forty states have now enacted so-called “safe-harbor statutes” which, although adopted to foster self-dealing transactions; the premiums were taxed as gross income to the president). Generally, however, the cost of life insurance premiums is considered additional compensation to the insured officer or employee, and is deductible by the corporation, if reasonable and necessary, even though the beneficiary is a relative of the employee. Brown Agency, Inc. v. Comm’r, 21 B.T.A. 1111, 1113 (1931); Berizzi Bros. Co. v. Comm’r, 16 B.T.A. 1307 (1929); Peerless Pacific Co. v. Comm’r, 10 B.T.A. 103, 106 (1928). But cf. Proctor v. Comm’r, 50 T.C.M. (P-H) 1617, 1637 (1981) (corporation was not allowed deduction for the cost of medical insurance premiums paid for shareholder’s brother who was not an employee of the corporation). See also Bongiovanni v. Comm’r, 45 T.C.M. (P-H) 575, 579-80 (1976), where the court disallowed a claimed deduction by a closely-held corporation of the cost of medical bills and nursing care for the mother of the shareholders. The money paid by the corporation was taxed to the shareholders as constructive dividends.

96. INTERNAL REVENUE SERVICE, UNITED STATES DEPARTMENT OF THE TREASURY, 1985 ANNUAL REPORT OF COMMISSIONER AND CHIEF COUNSEL 60.


These statutes, and the cases interpreting them, have been the subject of much com-
tions, have had the salutary effect of encouraging boards of directors to actively participate in any corporate decision to enter into a conflict of interest transaction. A paradigm of these statutes appears in the RMBCA, which permits conflict of interest transactions, but only if one of the following procedures was observed:

1. the material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
2. the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or
3. the transaction was fair to the corporation. 98

In the drafts of the Principles of Corporate Governance (PCG) submitted to the American Law Institute in April, 1986, and April, 1987, 99 the council of the ALI has advocated a similar approach to transactions in which corporate officers, directors or dominating shareholders are “interested.”

Under the ALI view, directors, “senior executives,” 100 and “dominating shareholders,” 101 when personally interested in a matter affecting the corporation, 102 are obligated to “deal fairly”...
with the corporation, and to take certain affirmative steps to ensure a “disinterested” review of the transaction. 103

A director, senior executive, or dominating shareholder of a corporation who enters into a transaction with the corporation (other than the receipt of routine compensation) in which he has a personal interest, is expected under the PCG to make full disclosure concerning both the nature of his conflict of interest 104 and the details of the transaction 105 to whatever “corporate decisionmaker” 106 must authorize the transaction. 107 In most cases, that decisionmaker will be the “disinterested” members of the board. 108

These self-executing provisions reflect a belief (and a judicially recognizable presumption) that reasonable disinterested directors serve as effective monitors—they would not approve business arrangements favorable to their co-directors unless those arrangements were at the same time affirmatively in the best interests of the corporation. Available empirical evidence of the extent of such transactions indicates, however, that these sterilization procedures, like IRS oversight, are an imperfect mechanism to protect minority shareholders from many unacceptable conflict of interest transactions. 109 If the “safe-harbor” provisions were truly effective deterrents, companies would not feel compelled upon going public to announce not only the abandonment of longstanding conflict of interest relationships, but also the alteration of corporate policies which heretofore favored these questionable relationships. 110 Nor would one find the courts of the states which have enacted sterilization procedures continually called upon to review

“has a financial or familial relationship” with a party to the transaction. A.L.I. PRINCIPLES, supra note 1, Tent. Draft No. 5, § 1.18(a). A dominating shareholder is interested in a transaction only where he is a party to it. Id. § 1.18(b).


104. Id., Tent. Draft No. 5, § 5.02. “Disclosure concerning a conflict of interest” is defined in Tentative Draft No. 5, § 1.09(a), as disclosure of “material facts known to [the director, senior executive or dominating shareholder] concerning his conflict of interest.”

105. Id. “Disclosure concerning a transaction” is defined in Tentative Draft No. 5, § 1.09(b), as disclosure of “material facts known to him concerning the transaction.”

106. Id. “Corporate decisionmaker” is defined in Tentative Draft No. 5, § 1.07, as the “corporate official or body with the authority to make a particular decision for the corporation.”

107. Id., Tent. Draft No. 5, § 5.02(a)(1).

108. Defined by negative inference by referring to Tent. Draft No. 5, § 1.18, supra note 102.

109. See supra note 96 and accompanying text.

110. See supra note 39 and accompanying text.
disputes involving allegations of unacceptable conflicts of interest.\textsuperscript{111}

There are several reasons for the ineffectiveness of the sterilization approach. In many cases, there may not be a “disinterested” quorum large enough to approve\textsuperscript{112} or suitable to consider a proposed conflict of interest transaction.\textsuperscript{113} In other cases, the board,  

\textsuperscript{111} See, e.g., Lynch v. Patterson, 701 P.2d 1126 (Wyo. 1985) (decision of directors to contract with service company wholly owned by them, resulting in loss to the corporation but substantial profit to the service company, plus sale of property to same directors at a loss to the selling corporation, constitute breaches of fiduciary duty to minority shareholders—Wyoming safe harbor statute in effect); Rivercity v. American Can Co., 600 F. Supp. 908, 919-22 (E.D. La. 1984), aff'd, 753 F.2d 1300 (6th Cir. 1985) (corporation's grant of real estate purchase option at a grossly inadequate price to partnership made up primarily of the corporation's directors was not enforced—Louisiana statute in effect); Midwest Management Corp. v. Stephens, 353 N.W.2d 76 (Iowa 1984) (director and chairman of corporation who induced its board—and ultimately its shareholders—to invest essentially all corporate assets into start-up broker-dealer venture promoted by his son without giving accurate disclosure of his role, breached his fiduciary duty and had to make up the loss—Iowa statute in effect); Apicella v. PAF Corp., 479 N.E.2d 315 (Ohio Ct. App. 1984) (corporation's grant of lease to enterprise wholly-owned by corporation's director and his family, for unreasonably low rental fees, constitutes breach of duty to minority shareholder—Ohio statute in effect); Ohio Drill & Tool Co. v. Johnson, 625 F.2d 738, 742 (6th Cir. 1980) (defendant officer/directors who permitted corporation's employees to work without reimbursement for another corporation in which defendants were principals breached their fiduciary duty—Ohio statute in effect); Rowen v. Le Mars Mut. Ins. Co. of Iowa, 282 N.W.2d 639 (Iowa 1979) (directors of a mutual insurance company who agreed to resign their board positions en masse and cede control to the purchasers of a related company owned by one of them without consideration to the mutual failed to discharge their fiduciary duty—Iowa statute in effect); Newton v. Hornblower, Inc., 224 Kan. 506, 582 P.2d 1136 (1978) (two directors' use of corporate funds to pay expenses rightfully incurred by another corporation of which they were the sole shareholders, plus personal expenses including insurance premiums and travel expenses held to constitute breach—Kansas statute in effect); Washington Nat'l Trust Co. v. W.M. Dary Co., 116 Ariz. 171, 568 P.2d 1069 (1977) (three transactions by which corporation sold real estate to or for the benefit of its president/director at an extreme and unjustified discount held to be “patently unfair”—California statute in effect); Fill Bldg., Inc. v. Alexander Hamilton Life Ins. of America, 396 Mich. 453, 241 N.W.2d 466 (1976) (commercial lease signed by corporation with lessor wholly owned by lessee's principal shareholder, secretary and director with board approval notwithstanding serious corporate financial difficulties held void—Michigan statute in effect); Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517 (Iowa 1974) (use of corporate funds to repay personal indebtedness, purchase of supplies from vendor owned by corporate director, and director's excessive compensation all found to constitute breach of duty—Iowa statute in effect); Smith v. Robinson, 343 F.2d 793 (4th Cir. 1965) (directors who received kickbacks from construction contractor in guise of rental payments, even where disinterested directors had knowledge of and approved the payments, breached their fiduciary duty—North Carolina statute in effect).

\textsuperscript{112} The ALI proposal would require at least two disinterested board members to vote in favor of a conflict of interest transaction before it would be entitled to a presumption of propriety. A.L.I. PRINCIPLES, supra note 1, Tent. Draft No. 5, § 1.10.

\textsuperscript{113} Sometimes the sterilization procedures fail because courts construe the “disinter-
although independent in an economic sense, may fail because of collegiality to apply the exacting competitive standards to the proposed transaction which it (presumably) would apply in non-conflict of interest situations. In still other cases, unacceptable conflict of interest transactions may occur simply because the board has abused its control relationship and, confident that shareholders will "never know," does not concern itself with traditional standards of fairness. While the sterilization approach may serve to deter unacceptable transactions when corporate managers act in good faith, it does nothing to deter or detect them when they do not. Moreover, even when disinterested directors do act in good faith, the sterilization procedures can only serve to inhibit the overreaching and temporal shift types of conflict of interest transactions. They do not address the problem of misappropriation.

C. "Market" Deterrents

Contractarian theorists assert that additional deterrents to unacceptable conflict of interest transactions are present in the form of market pressures on managers to act for the maximization of shareholder gain. According to this view, managers are themselves commodities, competing in a managerial labor market which determines their value by the performance of their employing firm. If these managers engage in unacceptable conflict of inter-

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114. See Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. 83 (1985); Brudney, supra note 1, at 610-13, 622; Lasker v. Burks, 567 F.2d 1208, 1212 (2d Cir. 1978), rev'd on other grounds, 441 U.S. 471 (1979); Schwartz, A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125, 1154 (1976). Professor Conard has suggested that reliance on purportedly "disinterested" directors is misplaced and that de novo judicial review should be applied to all challenged conflict of interest transactions. Conard, Theses for a Corporate Reformation, 19 U.C. DAVIS L. REV. 259, 283-85 (1986). Note, however, that the very collegiality which leads to questionable judgments where managerial conflicts are concerned, may also lead to stronger overall business leadership. Haft, Business Decisions by the New Board: Behavioral Science and Corporate Law, 80 Mich. L. Rev. 1, 9 (1981).

115. See supra text accompanying notes 153-58.

interest transactions (or permit their comangers to do so), their personal worth in the marketplace will drop, making such transactions unlikely to occur. Alternatively, if managers engage in unacceptable transactions and otherwise manage poorly and fail to maximize shareholder wealth, "the market for corporate control, particularly the merger and the tender offer, [will] provide a mechanism for displacing [them]."

Thus, according to contractarian theory, there are already in place in our economic marketplace "incentives [for] managers . . . to make business decisions in the best interest of shareholders" and disincentives to act in their own short-term interests by engaging in unacceptable conflict of interest transactions. The possibility that managers will diverge from this ideal is addressed when the shareholder discounts the price he is willing to pay for his shares.

Initially, this construct seems to fall squarely within the "never-never world of neoclassicist economics," at least as far as the shareholder's ability to negotiate a discounted purchase price is concerned. How would such negotiation take place? It is possible in the context of an underwritten public offering that the underwriter would, in effect, conduct this negotiation. Both the pricing of the issue and the terms of the underwriting agreement would reflect market apprehension over the prospect that the issuer's managers, for any number of reasons including potential conflicts of interest, would fail to maximize shareholder wealth. It is more difficult to conceive of a comparable negotiating opportu-

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118. Fischel, The "Race to the Bottom" Revisited, supra note 116, at 919.

119. Id. at 922.

120. This theory, if valid, would seem to deter with equal effectiveness all three types of unacceptable conflict of interest transactions—those involving overreaching, temporal shift and misappropriation.


Equally suspect is the concept that managers engage in self-policing in order to enhance their value in a market for managerial employment. Self-dealers cannot be assumed to aspire to job mobility, and it is unrealistic in many business situations to believe that amorphous "market pressures" will contain the opportunistic instincts of managers in a position to indulge them undetected.

It may be that these theories work in the rarified world of publicly-held corporations whose activities (and public filings with the SEC and other regulatory agencies) are routinely scrutinized by market analysts. Among the less actively traded ventures, however, which make up the overwhelming majority of American business corporations, the evidence does not support the con-

123. Assume, for example, that a potential investor is approached to invest in a business venture—say in an intrastate or a Regulation D offering. See 15 U.S.C. § 77c(a)(11) (1982); 17 C.F.R. §§ 230.501-506 (1987). Depending on the state and the circumstances under which the offer occurs, he may be entitled to basic information concerning the offeror and its managers, but practically speaking, if it is an attractive offer, he is not going to be given any additional opportunity to negotiate special purchase terms in order to accommodate his aversion to conflicts of interest. Rather, he will be offered the opportunity to participate at the stated price, or to forfeit that opportunity. A real-world purchaser is unlikely to articulate the proposition that "based on the disclosures you have provided me, I think there is a 15% chance these managers are going to engage in self-dealing or otherwise be deficient in terms of managerial integrity or competence. Accordingly, I will purchase your shares if you grant me a 15% discount." Moreover, even assuming price negotiation on the basis of anticipated conflicts of interest is feasible, the far more likely scenario will find the purchaser with no material information about the likelihood that the offeror's managers will engage in conflict of interest transactions. Unless substantial disclosure is made, the purchaser will have no basis upon which to make even an initial determination that corporate managers are potential self-dealers, let alone to quantify his bargaining position. E.g., Warren, Legitimacy in the Securities Industry: The Role of Merit Regulation, 53 BROOKLYN L. REV. 129, 137 (1987) (“[U]nlike institutions and most 'accredited' investors, many individual investors lack the information and experience to compare different types of offerings, have no negotiating leverage, and rely extensively on securities salesman eager to confirm sales.”). Cf. Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 COLUM. L. REV. 1403, 1412-16, 1420 (1985).

As has been suggested in the field of insider trading, "[t]he contract analogy simply fails to offer a workable format because its central condition—a capability on the part of the parties to reliably estimate their respective costs and benefits—cannot be satisfied . . . ." Cox, Insider Trading and Contracting: A Critical Response to the "Chicago School," 1986 Duke L.J. 628, 655.

124. This process necessarily involves a risk assessment. Where the perceived gain from a conflict transaction exceeds the perceived diminution or risk of diminution in the insider's "market value," the insider will succumb to opportunism. See Fischel & Bradley, supra note 116, at 266 (“Poor performance [or self-dealing] is a rational strategy if the present gains exceed the present value of future costs.”).

125. See infra notes 153-56 and accompanying text.
tractarian model. A perusal of virtually any of the decided cases finding "unacceptable conflict of interest" transactions involving such corporations suggests that forces different from those contemplated within a market for managerial labor are at work. Executives of these companies are not competitors in the market for managerial labor, but people trying to keep (and if possible to exploit) the jobs they currently possess. The mechanism of potential displacement is not the merger or the tender offer, but rather bankruptcy and impending unemployment, and perhaps local disgrace. The operative incentives in these frequently marginal operations encourage, rather than discourage managerial overreaching.

Even in publicly-traded corporations, managerial conflicts of interest usually involve sums too small to activate the hypothe-

126. See supra notes 46-50 and accompanying text.
127. Cf. Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. REV. 738, 748 (1978) (Managers in non-public corporations "have unusually great opportunities to cheat without detection and [consequently] they have unusually great incentives to do so.").

Two examples from the cases should illustrate the point. Washington National Trust Co. v. W. M. Dary Co., 116 Ariz. 171, 568 P.2d 1069 (1977), involved a closely-held company substantially controlled by its majority shareholders/directors, Mr. and Mrs. Dary. Through their efforts, the company engaged in a series of real estate transactions each of which was later found by the court to constitute an unacceptable conflict of interest on the Dary's part. First, the Dary's induced the corporation to sell them a valuable tract of land in exchange for an unsecured promissory note for $85,000 at 6% interest. Id. at 173, 568 P.2d at 1071. The company thereafter sold another tract to a third party for $150,000, of which $140,000 was transferred to the Dary's rather than being retained by the company. In return, the Dary's tendered an unsecured note for $135,000 at 4% interest. Id. Finally, the company deeded another tract of land to Mr. Dary for no consideration.

A second illustrative case is Cattafi v. O'Neill (In re Nuisance Corp.), 17 Bankr. 80 (D.N.J. 1981), a case (not uncharacteristically) heard in bankruptcy court. There, a group of officer/directors purchased a judgment from the corporation's judgment creditor at a discount, then converted the judgment into a security interest in the corporation's assets, enabling them to collect the entire debt to the exclusion of minority shareholders.

While the facts in these cases may be mundane, each represents a paradigmatical unacceptable conflict of interest transaction—in neither case were the managers' actions furtive, such as would be the case where managers engage in direct misappropriation or conversion. In both cases, rather, the opportunistic conduct was known to co-managers and corporate employees who failed to act. The contractarian literature would suggest that subordinate corporate employees would serve as a monitor of such misconduct. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 228, 293 (1980).

In both cases the managers' actions were carefully orchestrated. Contrary to the contractarian vision, these managers did not have in mind maximizing shareholder wealth or supporting a high share price. Rather, what they had in mind was quick personal profit in total disregard for the long-term expense to other shareholders. Presumably, they felt insulated against future market repercussions.
sized market forces. Nonetheless, there is some evidence that market forces serve to deter at least egregious conflict of interest transactions in this limited corporate universe. Admittedly, there are few litigated cases finding a challenged conflict of interest transaction unacceptable as respects a widely-traded company.

If the contractarian model has validity, it can only be in a market where information concerning past and potential conduct implicating unacceptable conflicts of interest is available to shareholders. As will be seen presently, most business ventures do not operate in such a market. Moreover, the model can only serve as a deterrent where the firm is sufficiently desirable to attract predators for whom the benefits of a tender offer or merger outweigh the disruptions inherent in such a transaction.

In short, market forces are merely derivative of the information gathering and dissemination process. If information concerning executive conflicts is not effectively conveyed to the marketplace, the predictable and arguably deterrent market responses to that

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129. The business press can be counted upon to publicize truly audacious executive conflicts, pinpointing the offender and compromising his value in the market for managerial labor. The more "public" the enterprise, the greater the likelihood that the press, and/or critical market analysts will serve this role, which magnifies the effectiveness of whatever self-limiting market forces may exist.

130. It is not necessarily true that this information will be reflected in the price of the corporation's shares. See generally Gordon & Kornhauser, Efficient Markets, Costly Information and Securities Research, 60 N.Y.U. L. Rev. 761, 764-65, 841-46 (1985).

131. Scott, supra note 121, at 939 ("Proxy contests and takeover bids are risky and expensive, attributes which the SEC seems intent on increasing still further. As a result the gains from ousting self-rewarding management must become quite sizeable before they outweigh the costs. Furthermore, by taking rewards in less visible forms (e.g., self-dealing transactions, insider trading, or appropriated corporate opportunities), management can increase investigation costs and information uncertainties for any potential acquirer and hence move still further out the bound on management rents set by the corporate control market."). Cf. Eisenberg, New Modes of Discourse, supra note 128, at 582-83 ("The discipline of the market for corporate control is limited by a number of elements, including the high transaction costs of takeover bids, the necessity to offer a premium well in excess of market price, the requirements of relevant statutes, the defensive techniques available, the incentives to take over efficiently run as well as inefficiently run companies, and the time lag often experienced by potential acquirors in ascertaining lack of managerial efficiency.").
conduct cannot occur.  

D. Mandatory Disclosure

Consistent with the prescription of Louis D. Brandeis that "sunlight is the best disinfectant; electric light the best policeman," commentators for years have regarded mandatory corporate disclosure as a means of deterring unacceptable conflict of interest transactions. During his tenure as a law professor, William O. Douglas observed that:

[P]ublicity alone can accomplish much—not publicity in the sense of a registration in some dusty file in Washington or in some state capitol, but publicly in the sense of direct and unequivocal statement in the periodical reports to stockholders . . . . That simple expedient will go far as a corrective of conditions which have been constantly recurring in our corporate history. Its prophylactic effects will equal in importance any other single measure which can be adopted.

More recently, some critics have come to disparage reliance on this "confessional" system of disclosure. They suggest that mandatory disclosure at best raises the "embarrassment cost" incurred by a corporation and its managers, but does not significantly deter managerial misconduct.

The SEC, embracing the Douglas view, requires that corporations subject to its reporting requirements annually disclose all

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132. As Professor Dooley has pointed out, "the market mechanisms might . . . be better at disciplining opportunistic behavior if we had mechanisms to bring conflicts of interest to public attention. If so, there is always the possibility that we would be better off redirecting the focus of conflict of interest laws away from deterrence and punishment to rules that are more clearly designed to force disclosure about the existence of such conflicts." Schwartz, Clark & Dooley, Genesis: Panel Response, 8 Cardozo L. Rev. 687, 697 (1987).
133. L. Brandeis, Other People's Money 92 (1914). Cf. Frankfurter, Securities Act: Social Consequences, Fortune, Aug. 1933, at 55 ("The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening.").
conflict of interest transactions in excess of $60,000. A significant limitation of this requirement is the fact that it covers so few business entities. Only 12,450 corporations are currently subject to SEC oversight. For the majority of corporations which are not subject to SEC oversight, with one narrow exception, mandatory disclosure does not provide shareholders with any effective notice of, and so cannot effectively deter, unacceptable conflict of interest transactions.

As an initial proposition, a corporation’s obligation to disclose information concerning management conflicts of interest depends on its state of incorporation. Each state's corporate regulatory statutes contain “access” provisions specifying the information to which shareholders of domiciliary corporations are entitled. While to some it “seems self-evident that shareholders should be adequately informed about . . . material conflict of interest transactions between the corporation and its managers,” only one state requires such disclosure.

A handful of states require that domiciliary corporations disseminate basic financial information—generally, the most recent financial statement and balance sheet—to all shareholders within a short period of time following the close of each fiscal year. This is the approach adopted in the Revised Business Model Corporation Act (RMBCA). The majority of states require disclosure of comparable financial information but only upon written

137. See supra note 134 and accompanying text.
140. See infra notes 148-52 and accompanying text.
141. Eisenberg, The Modernization of Corporate Law, supra note 128, at 196.
142. This state is California. See infra notes 148-52 and accompanying text.
144. The RMBCA requires that shareholders be sent within 120 days of the close of a corporation’s fiscal year an annual financial statement, which includes a balance sheet as of the end of the fiscal year, an income statement for the year and a statement of changes in shareholders’ equity for the year unless that information appears elsewhere in the materials. RMBCA § 16.20. They also are to receive specific notice of any shares issued for promissory notes or for promises to render services in the future, and of any indemnification payments made to a director. Id. § 16.21. These rights to affirmative disclosure are in addition to the shareholders’ right to initiate an inspection of the accounting records of the corporation, or other records concerning the directors’ activities. Id. § 16.02.
shareholder request. In several states impose no requirement that a corporation make financial disclosure but permit shareholders access to corporate information based upon the statutory right to inspect or examine corporate books and records. In some states even that right is limited to those shareholders who can satisfy certain threshold requirements of percentage ownership or ownership duration. None of these states require their domiciliary corporations as a matter of course to disclose the existence of conflict of interest transactions.

Only California requires annual disclosure to shareholders of managerial conflict of interest transactions. In its Annual Report to Shareholders, a California corporation must disclose any


This formulation may be traced to section 46 of the original Model Business Corporation Act (MBCA), adopted by the Section on Business and Banking Law of the American Bar Association in 1950. Section 46 remained in this form in the 1969 revision of the MBCA and was renumbered § 52.


147. Such statutes can lead to absurd results. See, e.g., Caspary v. Louisiana Land & Exploration Co., 707 F.2d 785 (4th Cir. 1983), aff'g 560 F. Supp. 855 (D. Md. 1983) (shareholder who had invested approximately $3 million in a corporation incorporated in Maryland was not afforded access to shareholders' list in the midst of a proxy fight because his holdings represented only .3% of the outstanding shares and the Maryland access statute required 5% ownership for at least six months in advance of the request. Comment, Caspary v. Louisiana Land & Exploration Co.—The Common Law Right to Inspect Corporate Records for Proper Purpose, 43 Md. L. Rev. 572 (1984).

148. The California General Corporation Law provides that the board of directors of a California corporation must circulate to the shareholders within 120 days of the end of the fiscal year and at least 15 days prior to the shareholders' meeting an annual report containing a balance sheet as of the end of the fiscal year, plus an income statement and a statement of changes in financial position for that fiscal year. Cal. Corp. Code § 1501(a) (West Supp. 1987).
transaction (other than routine compensation or those involving competitive bids) during the preceding fiscal year involving an amount in excess of $40,000 to which the corporation was a party and in which any director or officer or any holder of more than 10% of the outstanding voting shares of the corporation had a direct or indirect material interest. Where such transactions have occurred, the corporation’s report must name the person and identify his relationship to the corporation, the nature of his interest in the transaction and, where practicable, the amount of his interest. California law, however, exempts from this provision corporations with less than 100 shareholders, and corporations which are subject to SEC oversight.

Thus, from a total universe of approximately three million domestic corporations, only 12,450 are subject to the SEC’s disclosure requirements and 8,000 more to California’s. Further subtracting the truly closely-held corporations (in which the familiarity among investors arguably would afford them at least constructive notice of transactions or business relationships involving management conflicts of interest), approximately 160,000 corporations remain which have significant public ownership but no obligation to provide information concerning conflict of interest transactions. This is so even where the information is, in the TSC sense, material to investors, or where managerial

149. Id. § 1501(b)(1). In addition, the annual report for most California corporations must also describe any indemnification payments aggregating more than $10,000 made to officers or directors of the corporation. Id. § 1501(b)(2).
150. Id. § 1501(b)(1).
151. Id. § 1501(b).
152. Id. § 1501(b)(1).
153. See supra note 139.
154. At year end 1985, California had 416,700 corporations in good standing with the Secretary of State (letter from Office of Secretary of State, on file with the Rutgers Law Review). Eisenberg estimates that those with 100 or more shareholders represent 2% of this total. M. Eisenberg, supra note 1, at 39. Using this estimate and rounding downward to account for some duplication with the SEC companies, there are roughly 8,000 California corporations disclosing conflict of interest transactions to their shareholders.
155. Eisenberg estimates closely-held entities (defined conservatively as having 10 or less shareholders) to represent 94% of all corporations, so for purposes of this exercise delete 2,820,000. M. Eisenberg, supra note 1, at 39, 42.
156. See Knauss, The Problems of Smaller Public Corporations, in Commentaries on Corporate Structure and Governance 141, 144 (D. Schwartz ed. 1979) (“It is for this group of companies—those that are not close corporations but that do not have publicly-traded securities—that the procedural and organizational state corporation laws are most needed.”).
157. 426 U.S. at 449. See supra text accompanying note 68.
conduct, in the sense recognizable in court, has been unacceptable.

The result in these cases is that a corporation may take its chances with the IRS audit lottery, and its directors may either fail to conduct a sterilization review or disregard their fiduciary duties while doing so (not to mention disregarding the applicable “market pressures”), and the shareholders will never know what has occurred.

Whatever the merits of mandatory disclosure, there is no question that the existing mandatory disclosure system serves no deterrent function for the many business entities to which it currently does not apply. The harder question, of course, is whether mandatory disclosure serves as an effective deterrent in those companies to which disclosure rules do apply. While the commentators have decried the lack of “scientifically acceptable evidence” on this subject, there are indicators which suggest that mandatory disclosure does serve a deterrent function, albeit imperfectly. It is certainly possible, for example, to point to situations in which questionable, if not unacceptable, conflict of interest transactions have occurred in companies not only subject to SEC oversight but also totally in compliance with SEC disclosure rules.

158. See infra notes 162-66 and accompanying text.
159. See, e.g., Easterbrook & Fischel, Mandatory Disclosure, supra note 136, at 693.
160. Several representative transactions may be cited. The business press has recently castigated the Diamond Shamrock Corporation, “an energy conglomerate with large, persistent losses,” for its investment through a subsidiary in a biotechnology company partially owned by a Diamond director. The Downfall of a CEO—the Inside Story of Bill Bricker’s Reign at Diamond Shamrock, Bus. Wk., Feb. 16, 1987, at 76. After the director’s outstanding loans to the biotechnology company had been repaid allegedly out of the proceeds of Diamond’s investment, Diamond abandoned the venture. Id. The entire series of transactions was duly disclosed in Diamond’s SEC filings. Id. See DIAMOND SHAMROCK CORP., PROXY STATEMENT 8 (Mar. 7, 1986).

Horn & Hardart, a food service conglomerate with substantial losses in 1986, paid $1.2 million over three years to a company owned by its chairman for the use of two corporate jets. Why Didn’t They Pay Him to Stay Home?, FORBES, June 15, 1987, at 120-21. The payments were disclosed in Horn & Hardart’s annual SEC filing. See HORNE & HARDART, INC., PROXY STATEMENT 11 (1987).

Mobil Oil chairman William Tavoulareas in 1979 responded to press criticisms of Mobil’s multimillion dollar dealings with a London shipping concern in which Tavoulareas’ son was a principal, pointing out that contemporaneous SEC reporting requirements applied to transactions between related persons “only if they resided under the same roof. Otherwise, no reporting was necessary at all.” W. TAVOULAREAS, FIGHTING BACK 136 (1985). (The relationship between Mobil and the London shipping concern was later characterized by the court which adjudicated Tavoulareas’ libel claim arising out of the incident as
A comparison of the conflict of interest experiences of pre-public companies (which generally are not subject to mandatory disclosure requirements) and public companies (which are) suggests a number of answers to the question "is mandatory disclosure an effective deterrent?" Referring back to Figure 1, mandatory disclosure requirements seem to have little, if any, impact on the willingness of a corporation to rent or purchase property or equipment from its managers. This may be due to the benefits of leasing, rather than owning, real estate. It may also be because the valuation of real or personal property is seen as systematic and concrete. So long as a reporting company can point to an appraisal or comparable valuations of the property interest being acquired, or at least can argue that it needs a facility and this particular one was available at a reasonable price, the corporation is not likely to be deterred by the prospect of mandatory disclosure from entering into a lease or purchase acquisition from its managers.

The same may not be true of corporate loans made to directors, officers, their family members, or affiliates. Here, investor skepticism comes into play more instinctively than in the case of property acquisitions, because that which is received from the corporate manager—a promise of future repayment—is of less immediate and concrete value to the corporation than a building or a computer system. Valuation is more difficult as well. Where a


Allegheny International induced former Secretary of State Alexander M. Haig, Jr. to join its board of directors by offering him not only director's fees, but also a consulting contract to provide the company with "advice 'in the area of safety and protection devices' at $50,000 for no more than five days [sic] work per year." Symonds, supra note 5, at 60. The arrangement was disclosed in the company's 1984 Form 10-K. Allegheny Int'l, Inc., Form 10-K, filed Jan. 30, 1984, Exhibit 10h. (This and a number of other conflict transactions involving Allegheny insiders, however, were not disclosed in Allegheny's proxy solicitations, in violation of SEC guidelines. See Allegheny Int'l, Inc., Proxy Statement 11, (Mar. 28, 1985); SEC v. Allegheny Int'l, Inc., Litigation Release No. 11533, Sept. 9, 1987; Allegheny International Sued by SEC, supra note 10, at 10.)


162. Cf. Weiss, Economic Analysis, Corporate Law, and the ALI Corporate Governance Project, 70 CORNELL L. REV. 1, 19 (1984) ("The transactions that kindle duty of loyalty lawsuits usually do not involve property or services with readily ascertainable market prices." (footnote omitted)). Scott, supra note 121, at 939 ("Most cases involve goods or services that are not fungible and for which no trading market price is available.").
corporation rents its headquarters from a partnership made up of the chairman of the board and his brother-in-law, a lender or investor can "see" whether the company is getting its money's worth. However, where a corporation allocates $200,000 of its assets to a director to enable her to exercise outstanding stock options, repayable at 4%, it is far more difficult for an investor to know whether the value of resultant director loyalty and gratitude outweighs opportunity costs. Hence, in the case of a property acquisition, the consideration provided by the insider is apparent; in the case of a loan, the consideration is less so. These factors may explain the results in Figure 1, which suggest that corporations are deterred from making certain loans by the existence of a mandatory disclosure requirement.

There is another equally plausible explanation, however. The disparity in loan-making behavior between pre-public and public companies may be explained on the basis of corporate "maturity"—that is, the public corporations, having advanced beyond the pre-public stage, are more likely to attract "professional" managers who are less in need of direct financial support from the corporations which they serve than may be the case in start-up companies. These managers may (and frequently do) receive more sophisticated forms of compensation than direct cash loans.163 If this is the case, then the disparity between the loan-making behavior of the pre-public and public companies may not be attributable to the existence of a mandatory disclosure requirement, but rather to the stage in the life-cycle of the companies in question.

These same factors may explain the results in Figure 1 with respect to directorial consulting agreements and miscellaneous conflict of interest transactions. In each case, the pre-public companies engaged in proportionately more such transactions than did public companies. In the case of consulting agreements, the disparity was substantial; in the case of other transactions it was less so. Again these differences may be explained either by the existence of disclosure obligations or by the corporate maturity factor discussed above. In the case of mature corporations, their wider resources may render resort to insider consulting agreements or other self-dealing transactions unnecessary. If so, the

163. See, e.g., Hewitt Associates, Highlights of Compensation and Benefits for Outside Directors in the Fortune 100 Industrials (Sept. 1987).
existence of a mandatory disclosure requirement may be irrelevant to a corporation’s choice of vendors. Mature corporations may choose non-insider vendors over insider-vendors not because a disclosure requirement encourages them to do so but because, unlike pre-public corporations, they have the experience and confidence to do so. They are more likely than pre-public companies to have formalized purchasing protocols. In addition, they are not as restricted as pre-public companies are likely to be with respect to geographic limitations on contracting.

In short, the evidence suggests, but hardly proves, that the imposition of mandatory disclosure requirements on publicly-held corporations may indeed deter them from engaging in certain material conflict of interest transactions. The deterrent effect may differ among types of conflict of interest transactions.\textsuperscript{164}

For the present—based upon available anecdotal evidence and abiding further research—one may assume at least that mandatory disclosure (either alone or in connection with the market forces which are activated thereby) plays a role in limiting unacceptable conflict of interest transactions. That it does so imperfectly can be attributed to obfuscatory drafting, shareholder passivity,\textsuperscript{165} and non-compliance for which inadequate disincentives exist.\textsuperscript{166}

\textsuperscript{164} What the evidence does not reveal, and what remains to be demonstrated by “scientifically acceptable” proof is whether mandatory disclosure requirements effectively deter unacceptable conflict of interest transactions or, based upon the phenomenon of “embarrassment costs” or otherwise, merely deter material conflict of interest transactions which would, if undertaken, be benign or affirmatively beneficial to the corporation.

\textsuperscript{165} See, e.g., H. Krippke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 27 (1979); Fischel, The Corporate Governance Movement, supra note 116, at 1274-75.

\textsuperscript{166} Although judicial rhetoric encourages creativity in remedying inadequate disclosure, J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964); In re Caesar’s Palace, 360 F. Supp. 366, 392 (S.D.N.Y. 1973), courts in fact have approached remediation very cautiously. Remedies for inadequate disclosures in proxy statements typically involve resolicitation with curative disclosure. Gladwin v. Medfield, 540 F.2d 1266, 1270, 1271 (5th Cir. 1976) (affirming trial court’s order of a new election preceded by appropriate disclosure, where corporation had failed to disclose director’s self-dealing); Lebhar Friedman, Inc. v. Movielab, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,162, at 95,739 (S.D.N.Y. 1987) (enjoining shareholders’ meeting and ordering resolicitation where proxy statement failed to disclose adverse material information concerning directors seeking reelection); Telvest, Inc. v. Wisconsin Real Estate Inv. Trust, 489 F. Supp. 250, 254, 255 (E.D. Wis. 1980) (proxy statements of both management and insurgents voided and resolicitation ordered where management failed to disclose the half-million dollar conflict of interest of one of the trustees); Bertoglio v. Texas Int’l Co., 488 F. Supp. 630, 659, 663 (D. Del. 1980) (election set aside and resolicitation ordered where insurgent group failed to disclose con-
E. Liability Rules

There is another possible deterrent to unacceptable conflict of interest transactions—the manager's fear of personal liability to shareholders in a derivative suit claiming corporate waste and diversion of funds.\(^{167}\) Litigation may address one or all forms of conflict of interest transactions—overreaching, temporal shift, or misappropriation. A manager's fear that liability rules may apply to him, however, is illusory in all but the most egregious cases.\(^{168}\)

First, where disclosure of conflict of interest transactions is not required, shareholders, wholly in the dark as to the existence of such transactions, are unlikely to challenge them in court. Where shareholders do come into possession of information necessary to generate litigation, the existence of statutory safe harbor provisions, or in their absence, the common law “intrinsic fairness” defenses, together with the onerous burden of proof imposed on plaintiffs in such cases,\(^{169}\) frequently render the shareholder's likelihood of success very small.\(^{170}\) Even where the cost-sharing

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flicts and management group likewise failed to disclose material information).

Compensatory damages are regarded as incalculable, Howard v. Furst, 140 F. Supp. 507, 513, aff'd, 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957), and punitive damages are not authorized. 15 U.S.C. § 78bb(a) (1982) (limiting damage awards in actions under Securities and Exchange Act to “actual damages”). No court has held that a director who sanctions the withholding from shareholders of material information concerning his conflicts of interest should be disqualified from serving.

167. Professor Schwartz asserts, based upon personal experience, that “the plausible threat of a shareholder suit has influenced the terms of many [self-dealing] transactions and discouraged others from being undertaken.” Schwartz, In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley, 71 CORNELL L. REV. 322, 331 (1985). Even Professors Fischel and Bradley concede that “the spectre of civil liability (and/or imposition of criminal penalties) is probably a useful deterrent [but only] to large one-shot frauds.” Fischel & Bradley, supra note 116, at 270.

168. Cf. Weiss, supra note 162, at 18 (“The mere existence of a duty of loyalty does not eliminate managers' incentive to enrich themselves at the expense of their corporations. It does, however, inspire managers to frustrate enforcement of the duty by making it appear that no breach has occurred. The fact that most shareholders own only a small proportion of a company's stock enhances the prospect that such tactics will succeed, because those shareholders have little incentive to incur the cost of closely monitoring management conduct or of maintaining derivative lawsuits to recover corporate losses.”).

Others have made the point that derivative suits are an especially inefficient, and sometimes irrational way to secure loyal performance by corporate managers. Fischel & Bradley, supra note 116, at 271-73. I do not pursue that point here. For further discussion of problems raised by the use of the derivative suit as a means of deterring unacceptable conflict of interest transactions, see Coffee, Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis, 52 GEO. WASH. L. REV. 789, 809-11 (1985).

169. See A.L.I. PRINCIPLES, supra note 1, Tent. Draft No. 5, § 5.02(b).

170. See Marsh, supra note 1, at 55-57. The fact that the likelihood of success is smaller
mechanism of the derivative suit is available, a single shareholder (or his attorney) may have insufficient incentive to pursue a self-dealing claim against these odds. This is especially true in corporations willing to advance litigation costs to self-dealing directors in order to support their vigorous defense.\footnote{171}

Even when plaintiffs prevail in establishing to a court's satisfaction that a conflict of interest transaction is, as a matter of law, unacceptable, the remedy to the corporation is usually merely to void the transaction and return the parties to status quo. Directors found to have engaged in inappropriate self-dealing are not routinely removed from (or enjoined from re-taking) their board positions. Punitive damages are seldom awarded\footnote{172} and constructive trusts seldom imposed.\footnote{173} Neither the corporation nor its managers are at substantial economic or reputational risk.\footnote{174}

IV. Possible Additional Deterrents

From the foregoing, it is evident that the available deterrents, even when taken together, fail to curb many conflict of interest abuses of the corporate control relationship. There are several possible responses to this fact.

The first is to consider reinstatement of the prohibition against managerial self-dealing, which would be both regressive and potentially costly to shareholders. The second is to assert that the risk of abuse is one of the inherent risks of investment, not suitable for further policy response. The cost of any additional regula-

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\footnote{171} Cf. RMBCA § 8.53. Indeed, the availability of indemnification to corporate managers who (inevitably) settle such cases severely impairs the deterrent impact of liability rules.

\footnote{172} But see Stone v. Martin, 355 S.E.2d 255, 260 (C.A.N.C. 1987); Holi-Rest, Inc. v. Troloar, 217 N.W.2d 517, 525-26 (Iowa 1974).


\footnote{174} As one example of the lack of opprobrium attendant to claims of self-dealing, one might cite the current circumstances of Alexander M. Haig, the former beneficiary of Allegheny International's $10,000 per day consulting agreement, supra note 160, and currently a candidate for nomination to be President of the United States.
tory action would likely far outweigh the resultant savings from protection against managerial opportunism which would inure to shareholders as a whole or in any single corporation. If an investor is concerned about managerial conflicts of interest, he may limit his investments to those corporations subject to SEC oversight, or to those with 100 or more shareholders incorporated in California, where he can be assured at least of annual disclosure and the opportunity, in most cases, to exercise his exit option. He may also advance charter amendments prohibiting conflict of interest transactions or requiring their disclosure in individual companies. Across-the-board regulatory action, however, is inappropriate and not cost effective.

The third response is to try to identify a mechanism in addition to those already in place by which unacceptable conflict of interest transactions can be more effectively deterred within all corporations. This is, of course, the challenge currently facing the ALI Project on Corporate Governance. Several mechanisms have been, or might be, suggested.

A. Private Ordering

Some contractarian scholars have suggested that problems of conflict of interest may most fruitfully be addressed by private arrangements among shareholders. For example, Judge Easterbrook sparked substantial debate when, at the 1986 ALI meeting, he suggested that shareholders by charter amendment be permitted to “opt out” of any general policy restrictions on managerial self-dealing advocated in the Principles of Corporate Governance. Presumably, Judge Easterbrook would acknowledge that shareholders in a given corporation similarly could agree to go beyond the aspirational goals of the ALI, and vote to “opt in” and

175. Cf. Easterbrook, supra note 117, at 546 (“It is inevitable that a substantial amount of undesirable slack or self-dealing will escape punishment by markets. The question is not whether it occurs, but whether the costs of this [conduct] can be reduced by mechanisms that are not themselves more costly.”); Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 259 (1977) (“A paradox thus results: maximizing the yield to investors generally may, indeed almost surely will, result in a number of cases of fraud or self-dealing; and eliminating all fraud or self-dealing may decrease the yield to shareholders generally.”).

limit managerial conflict of interest transactions more than would the Principles of Corporate Governance or than does current state law. Corporations could build into their charters a prohibition against conflict of interest transactions or a dollar limitation on those transactions which could be authorized without submission to the shareholders.

This solution raises a number of problems. First, it puts the burden of identifying those conflict of interest transactions most pernicious to a given corporation on those least informed about them and least capable of evaluating their potential harm. Second, it assumes the existence of a shareholder/fomentor willing to undertake substantial costs solely in anticipation of managerial wrongdoing—costs which include the expense of gathering and analyzing information and soliciting proxies, as well as the potential cost of isolation and oppression by the managing majority. Only institutional shareholders are likely to undertake these costs. Third, reliance on private ordering assumes equal bargaining power, e.g., the shareholder/fomentor who does emerge is considered capable of fashioning a consensus. In fact, the likelihood that a non-management shareholder will successfully advance and secure a charter or bylaw amendment is slight, particularly where the very focus of the amendment involves a limitation on management discretion. Thus, while private ordering does have the advantage of tailoring a solution to the particular needs of a corporation and not interfering with corporations not in need of restraint, that advantage is essentially meaningless, particularly in those corporations where minority shareholders are already oppressed.

B. Prior Restraint

One institutional way to deter unacceptable business relationships would be to require advance submission of all proposed conflict of interest transactions to outside evaluators who would determine whether or not such transactions were "fair," or affirmatively advantageous to the corporation.

1. Shareholder Waiver of Conflict

Traditional agency principles would suggest that proposed conflict of interest transactions should be submitted to a corporation's shareholders for their express advance consent. This proce-
dure would be consistent with the fiduciary principles expressed in the *Restatement (Second) of Agency*? which requires an agent contemplating a transaction in which a conflict of interest might arise between himself and his principal to inform his principal of the potential conflict and to receive the principal's consent before proceeding.\(^{178}\)

Agency principles have been applied in the professional world to require advance disclosure and consent to potential conflicts of interest in a variety of settings. The application most familiar to lawyers is that required under the ABA Model Rules of Professional Conduct when a lawyer is approached by a prospective client the representation of whom might impermissibly divide the lawyer's loyalties.\(^{179}\) The general rule for lawyers, consistent with the *Restatement*, is that the lawyer may undertake the representation, notwithstanding her potential conflict of interest, so long as she has made full and complete disclosure to the prospective client in advance of the representation, detailing the nature of her conflict, and the client has waived the conflict.\(^{180}\)


178. *Id.* § 390. Of course, the use of agency principles does not provide a perfect match because directors are more than agents for the shareholders in whose interest they serve. A.L.I. *Principles*, *supra* note 1, Tent. Draft No. 5, at 15 (“Since directors have ultimate control over the corporation (subject only to approval by the shareholders in certain limited circumstances), they do not stand in the traditional relationship of an agent to his principal.”); *Restatement*, *supra* note 177, § 14 comment c (“The directors of a corporation for profit are fiduciaries having power to affect its relations, but they are not agents of the shareholders since they have no duty to respond to the will of the shareholders as to the details of management.”); cf. *Brudney*, *supra* note 123, at 1428-30; *Winter*, *supra* note 175, at 278.


180. Rule 1.8(i) of the *Model Rules of Professional Conduct* provides:

A lawyer related to another lawyer as parent, child, sibling or spouse shall not represent a client in a representation directly adverse to a person who the lawyer knows is represented by the other lawyer except upon consent by the client after consultation regarding the relationship.

A similar constraint is imposed on real estate brokers who find themselves negotiating with a relative on behalf of a client in the sale or purchase of a house. Like the attorney with a potential conflict of interest, the broker violates his duty if, unknown to his employer and in the latter's behalf, he undertakes to sell to, or purchase from, one to whom he is related by the ties of kindred, for his natural desire to favor his own would be more or less detrimental to the interests of his employer. He cannot, in negotiating for the sale or purchase of property, act as a representative of both seller and purchaser, unless each of the latter consents to such an arrangement.

Annotation, *Duty of Real Estate Broker to Disclose That Prospective Purchaser is a Relative*, 26 A.L.R. 2d 1307 (1952). See generally *Horstman, Dispelling Myths: Modern Rules*
If agency principles were applied to managerial conflict of interest transactions, disinterested shareholders would be entitled, as is the prospective legal client, to advance notice of the transaction; to a full illumination of the material facts bearing on the potential risks to their interests, before those interests are compromised; to an opportunity to weigh the potential risk against the potential advantages; and to the choice of whether to prohibit the transaction or permit it to proceed.

The use of this analogy in a business conflicts context is obviously problematical. There is the problem of direct cost. Certainly it is far more cumbersome—and costly—to attempt at a meeting or through the mail to induce a perhaps considerable number of shareholders to waive a potential conflict of interest, than to induce a single prospective client to do so.\(^{181}\)

There is additionally the policy question as to why a shareholder, or more precisely the entire body of shareholders (presumably excluding those who will profit from the proposed conflict of interest transaction), should be entitled to vote on a transaction otherwise clearly within the province of corporate employees or the board of directors simply because of the identity of the parties thereto.

Current views of the appropriate locus of corporate governance hold that only the most “fundamental transactions” are subject to direct shareholder control, and even those transactions generally must be overseen by management.\(^{182}\) Certainly, shareholders

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\(^{181}\) Cf. Brudney, supra note 123, at 1437 (“Consent by dispersed investors in the context of a single transaction to which alternatives are rarely offered is hardly the kind of consent a single principal can give to resolve uncertainty about his agent’s discretion.”); Eisenberg, New Modes of Discourse, supra note 128, at 584 (“Direct review by the body of shareholders is seldom an efficacious instrument of accountability in publicly held corporations because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues.”).

\(^{182}\) Under the RMBCA, the determination and timing of distributions (dividends) is totally within the purview of the board, RMBCA § 6.40; the board may remove and replace officers without shareholder assent, § 8.43(b); the board may in several ways amend the articles of incorporation without shareholder approval, § 10.02; and in any event must initiate any proposed amendment to the articles submitted to the shareholders, § 10.03. The board must also initiate any proposed merger, share exchange or sale of assets other than in the regular course of business, §§ 11.01, 11.02, 12.02; the board has the sole author-
are not entitled—nor should they be—to a dispositive vote on
day-to-day operating issues such as consultant selection, the
appropriate terms for property rental agreements, and the myriad
miscellaneous contractual issues raised by conflict of interest
transactions.

A few states currently require shareholder approval before a
corporation may make certain loans to corporate directors or
others. Presumably, a policy determination was made in these
states that these sorts of transactions—involving the expenditure
of funds inuring to the benefit of management insiders—present
such an opportunity for insider abuse that shareholders ought to
be entitled, as a prophylactic act, to advance notice and the specif-
cific right to approve or disapprove them. The Waiver of Conflict
Model would rest on a comparable policy determination that non-
loan transactions involving management conflicts of interest rep-
resent the sort of conduct which presents such risks of abuse
that advance shareholder scrutiny is required.

Advancing on this ground a shareholder Waiver of Conflict con-
cept would not only fail to acknowledge the declining commit-
ment of the states to statutory director-loan enabling provi-
sions, but would also fail to recognize some exigencies of

183. E.g., COLO. REV. STAT. § 7-3-101(1)(f) (1986) (requires affirmative two-thirds vote of
shareholders to authorize a loan to a director, unless articles of incorporation dictate oth-
ernwise); N.J. STAT. ANN. § 14A:6-11 (West Supp. 1986) (loans to directors are limited to
those granted pursuant to employee benefit plans adopted by the shareholders or reflected
in the certificate of incorporation or by-law adopted by the shareholders); N.Y. BUS. CORP.
LAWS § 714 (McKinney 1986) (any loan to a director must be approved by the sharehold-
ers); N.C. GEN. STAT. § 55-22 (1983) (any loan to a director, officer or dominant share-
holder must be approved by the shareholders); UTAH CODE ANN. § 16-10-43 (1987). See
generally Barnard, supra note 16.

184. Most states currently permit executive loans so long as the corporation’s board has
determined that the loan or guarantee “benefits the corporation.” Shareholder approval is
not required.

The Delaware General Corporation Law provides:

Any corporation may lend money to, or guarantee any obligation of, or other-
wise assist any officer or other employee of the corporation or of its subsidiary,
including any officer or employee who is a director of the corporation or its sub-
sidiary, whenever in the judgment of the directors, such loan, guaranty or assis-
tance may reasonably be expected to benefit the corporation.

DEL. CODE ANN. tit. 8, § 143 (1983).

See also ALA. CODE § 10-2A-69 (1980); ARIZ. REV. STAT. ANN. § 10-047 (1977); CAL. CORP.
CODE § 315 (West Supp. 1987) (applies only to corporations with 100 or more shareholders
corporate life. Loan approval seldom presents an emergency to the corporation. By contrast, there may be a genuine corporate need to consummate a supply contract or a property lease which incidentally involves a conflict of interest long before shareholder approval could be obtained.185

In short, notwithstanding its arguable doctrinal origins, the Waiver of Conflict Model is impractical and too expensive to advance as a serious proposal.

2. Administrative Intervention

An alternative mechanism of prior restraint would be the submission of any proposed conflict of interest transaction to an independent reviewer. In his seminal article on corporate conflicts of interest two decades ago,186 Professor Marsh proposed that the Securities and Exchange Commission conduct an administrative review of any conflict of interest transaction contemplated by a corporation subject to its oversight.187 This proposal presents direct cost problems similar to those evident in the Waiver of Conflict Model, as well as others.

First, any proposal that the SEC engage in “merit regulation” of conflict of interest transactions would certainly be met with jurisdictional objections. Even if these were overcome (by legislative action, for example), legitimate questions would remain as to what the SEC’s enforcement priorities should be.


184. Even where circumstances provide adequate time, the shareholders authorized to vote on the matter may have insufficient incentive to respond effectively. Cf. Anderson, supra note 127, at 784.

186. Marsh, supra note 1.

187. Id. at 73-76.
Given that the SEC through its comprehensive disclosure requirements already addresses itself, albeit imperfectly,\(^{188}\) to problems of managerial conflicts of interest in companies subject to its oversight, expansion of its regulatory authority to include transactional review would likely only marginally reduce the incidence of insider abuse in those companies, at substantial cost. Rather, the need for external intervention, if one exists, is greater in the case of those corporations not subject to SEC oversight.\(^{189}\)

This raises the spectre of state regulators, already engaged in merit regulation of securities offerings and other transactions by both SEC and non-SEC entities, evaluating the “fairness” of proposed corporate conflict of interest transactions. Such a process would necessarily raise the cost of any such contemplated transaction, sometimes in a manner out of all proportion to the value of the transaction to the corporation itself. For example, assume a corporation has the opportunity to rent factory or office space at an advantageous price from one of its directors or an entity controlled by her. When factoring in the cost of securing regulatory approval, both direct (such as attorneys fees) and indirect (most notably the cost of time, especially in those states where merit regulators already experience substantial backlogs),\(^{190}\) the transaction no longer presents any competitive advantage. The corporation therefore has no incentive to drive a good bargain with its officers or directors, who might be inclined to submit to such terms more so than arm’s length bargainers.

There may be other problems with administrative intervention, including regulatory competence, employee integrity and creating adequate incentives to maximize shareholder value where the decisionmaker herself is not a shareholder.\(^{191}\) Many of these objections could be satisfied by resort to some form of peer review.\(^{192}\)

But regardless of the locus of review, requiring prospective

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188. See supra text accompanying notes 137-40.
189. See Knauss, supra note 156.
192. Many professions enforce professional standards of conduct by a peer review mechanism. While it typically involves an after-the-fact inquiry, some settings (for example, those involving medical/ethical considerations) require prospective peer evaluation.
scrutiny of all conflict of interest transactions in order to detect those that may be unacceptable is, like shareholder Waiver of Conflict, too costly and too intrusive to constitute a serious proposal.

C. Retrospective Review

Professor Brudney has recently suggested that management be required to submit conflict of interest transactions to some administrative agency for post-facto review. Shareholder-initiated review is a better proposal given that most transactions brought forward would already have passed some threshold of suspected unacceptability. Such a process would surely be advantageous to managers when compared with uniform mandatory review. It would also provide substantial time and cost savings over litigation to a shareholder seeking the opinion of a third party as to the propriety of a particular transaction.

Central to the viability of such a proposal are (1) the availability to shareholders of necessary information and (2) some resolution on the issue of relief. Options as to the latter range from a binding decree annulling an unacceptable transaction (unlikely in any forum short of litigation) to an advisory opinion declaring unacceptability, immediately disclosed to the public and specifically disclosed to shareholders in the next proxy solicitation.

Shareholder-initiated peer review (which the author prefers to governmental review) would provide an additional, relatively unintrusive deterrent to unacceptable conflict of interest transactions in both publicly- and privately-held corporations, would en-

193. Brudney, supra note 123, at 1431 n.73 and accompanying text. Professor Eisenberg has suggested at least that "structural changes" raising conflict of interest problems should be submitted to some governmental body for review. M. Eisenberg, supra note 1, at 35-36. He includes within this framework corporate contractions, liquidations and mergers into acquiring companies. Id. at 32-33.

194. See infra notes 204-06 and accompanying text.

195. Just as lawyers, through bar disciplinary panels, may be called upon to review client complaints of professional misconduct, it should be equally possible to encourage corporate executives, through a self-regulatory process, to review shareholder complaints of unacceptable self-dealing. Possibly the National Association of Corporate Directors, which purports to "accredit" corporate directors and "promot[e] effective corporate leadership through programs and services," NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, PROGRAMS AND SERVICES HANDBOOK 2, could organize such an undertaking, much as the National Association of Securities Dealers has done through its Arbitration Program to address investor complaints. Alternatively, the newly-formed United Shareholders Association might play this role.
hance the efficiency of the market for managerial labor, and would promote the enforcement of group norms within the "profession" of corporate fiduciaries.

D. Registry

An alternative less burdensome than prior restraint or retrospective review would be a system requiring disclosure of all conflict of interest transactions to a centralized registry, much as is currently required of persons acquiring 5% or more of the shares of an SEC-registered corporation or of certain shareholders when they acquire or dispose of their holdings.

This model, aimed at companies not already providing disclosure pursuant to SEC guidelines, is derived from the federal Ethics in Government Act (EIGA), which requires federal officials to make annual disclosures of their personal and family business activities in order to permit the public to be informed concerning potential external influences on their decisions. The EIGA was crafted "to preserve and promote the accountability and integrity of public officials and of the institutions of the Federal Government," and in part to "deter conflicts of interest from aris-

199. Under the Act, members of Congress, candidates for Congress and certain persons on the congressional staff must file an annual report which discloses, among other things, the source and amount of any income received during the preceding year from any source other than their legislative salary, the source and value of gifts received, and their investments, debts, and purchases. Id. § 702.

Much of the information which must be disclosed for the member of Congress, candidate or staff member must also be disclosed with respect to the income, gifts, investments, debts and purchases of his spouse or dependent child. Id. § 702(d)(1). Except in the case of spouses who are estranged, living apart and contemplating dissolution of their marriage, there must be disclosure (somewhat more limited than that required of the "reporting individual") of the spouse's income, most gifts and reimbursements. Id. §§ 702(d)(2), 702(d)(1)(A)-(C). Spouses' (and children's) investments, liabilities and purchases must be reported unless (i) they represent the spouse's (or child's) sole financial interest or responsibility and which the reporting individual has no knowledge of; (ii) they are not in any way, past or present, derived from the income, assets or activities of the reporting individual, and (iii) the reporting individual does not derive or expect to derive any financial or economic benefit from them. Id. § 702(d)(1)(D). The financial disclosure, once filed, becomes a public record. Id. §§ 703-704. Similar disclosures are required of the President, Vice President, members of the federal judiciary, high-ranking military officers, and highly placed officials of the executive branch. 18 U.S.C. §§ 201-207 (1982 & Supp. IV 1987).

Although the Act does not prohibit a member of Congress (or members of his family) from accepting honoraria, gifts or interest-free loans, etc., it was designed to "ensure that what he does will be subject to public scrutiny." 202 "Public financial disclosure," Congress believed, "[would] better enable the public to judge the performance of public officials. By having access to financial disclosure statements, an interested citizen [would be able to] evaluate the official's performance of his public duties in light of the official's outside financial interests." 203

Similar purposes could be served by imposing, under state corporate law, comparable reporting requirements upon members of corporate management. Just as public voters are informed by financial disclosure bearing on their representatives' independence, information concerning management conflicts of interest would be of use to shareholders in evaluating officers' and directors' performance of their fiduciary duties. 204

Paraphrasing liberally from the Ethics in Government Act, corporate officers and directors under this model could be required to disclose annually to centralized registry some or all of the following information:

(1) the source and amount of any income received during the preceding [fiscal] year from any entity which does, or has solicited, business with the corporation
(2) the source and value of any gifts received in value exceeding $200 from any entity which does, or has solicited, business with the corporation;
(3) information concerning the nature and extent of investments or management involvement in, any entity, which does, or has solicited business with the corporation;
(4) information concerning indebtedness in excess of $200, to any entity which does, or solicits business with, the corporation. 205

201. Id. at 4238.
202. Id.
203. Id.
204. The issue may be posed as whether these corporate fiduciaries should, as a matter of public policy, be entitled as one of the perquisites of their position to enrich themselves or their families without the knowledge of the shareholders whom they serve, or whether they should be held to a standard of disclosure to their "constituents" not unlike that to which public officials are held.
205. A similar formulation, until recently utilized by the British under the United Kingdom Companies Act, required comparable information to be included in the annual report (there known as the "Directors' Report").
Consistent with the EIGA, the information required to be disclosed would include information concerning officers or directors personally, as well as spouses or dependent children. Investors and others concerned with conflict of interest transactions could then consult the registry prior to voting at the annual meeting or prior to lending money to the reporting corporation.

Mandatory retrospective disclosure of this sort does not pose either the philosophical or logistical problems present in the prior restraint models. It does not intrude into necessary management decisionmaking processes. Unlike other forms of financial reporting, such as audited financial statements, projections or line of business information, the cost of conflict of interest disclosure is minimal. 206

The registry format is especially sensible because it does not involve multiple printing or distribution costs, and puts material information only into the hands of persons—including investment advisors, lenders and individual shareholders—willing to ask for and arguably inclined to act on it. More generally, this proposal would, as Professor Brudney advocates, reduce the disparity between what investors generally believe (e.g., that managers are considerably constrained in their ability to divert corporate assets to themselves) and reality. 207

There are of course shortcomings to the registry format. The

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206. See Securities Act Release No. 6441, Exchange Act Release No. 19290, Dec. 2, 1982, 1982 Fed. Sec. L. Rep. [CCH] ¶ 83,281, at 85,533. As initially proposed, Item 404 would have required disclosure of transactions involving all relatives of primary reporting persons who were “no more remote than first cousins.” Id. at 85,536. This proposal provoked complaints that it would impose an “impracticable compliance burden,” and ultimately was amended to limit the class of persons for whom disclosure was required to “members of the immediate family.” Id. The SEC in adopting this change felt that the “immediate family” reporting requirement would facilitate adequate disclosure . . . of those transactions in which conflicts of interest are most likely to exist without imposing undue burdens upon registrants.” Id.

207. Brudney, supra note 123, at 1440, 1415-20.
most basic concerns the questionable effectiveness as a deterrent of any form of mandatory disclosure, already discussed. Additional drawbacks focus upon notions of corporate "privacy" and upon the administrative costs of centrally maintaining and retrieving the filed information.

Of the two, privacy is the more compelling concern. State corporate law traditionally has required corporations to make available to the public only the most basic of identifying information. The RMBCA requires annual disclosure only of the corporation's name, headquarters address, identity and location of its registered agent, identities and business addresses of its directors and principal officers, a brief description of the nature of its business, and the total number of authorized and issued shares. Financial disclosure is not required, nor is information concerning specific management decisions during the preceding fiscal year. Even those states which require mandatory annual disclosure to shareholders do not require financial or other information which would be material to investors to be filed for public access. Creating a central registry of conflict of interest information would not only alter this tradition of corporate privacy but would, in the absence of a centralized registry of financial information, place disproportionate emphasis on the conflict of interest issue.

E. Response to Inquiry

A modest approach to deterring unacceptable conflict of interest transactions would be to amend state shareholder access provisions to require corporations not already subject to SEC disclosure guidelines to disclose the existence of and material facts concerning conflict of interest transactions to shareholders requesting that information. This would be consistent with the current practice in most states of requiring corporations to provide annual financial reports only to those affirmatively requesting them and is not unworkable, as the more demanding California experience demonstrates. Such an approach could be proposed when the ALI completes its work on shareholder entitlement to

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208. See supra notes 158-62 and accompanying text. Registry as an alternative to proxy disclosure does offer the advantages of brevity and focus. Item 404 information frequently escapes shareholder scrutiny as a result of the length, detail and complexity of a prospectus or proxy solicitation.

209. RMBCA § 16.22.
corporate information.\textsuperscript{210}

This simple proposal would minimize objections based on cost, privacy, and corporate governance considerations. Like the registry proposal, it would avoid the problems of informational overload on those shareholders whose economic incentives are insufficient to lead them to process management information. It would reward the diligent. The ALI Corporate Governance Project might in fact find a partial solution to the problems presented by Part V of that project\textsuperscript{211} simply by making an affirmative statement regarding shareholder's rights to receive information concerning managerial conflicts of interests in Part III.

V. A Model

None of the existing statutory models for disclosure of management conflicts of interest—Item 404 of Regulation S-K,\textsuperscript{212} Section 1501 of the California Corporations Code\textsuperscript{213} or the Ethics in Government Act\textsuperscript{214}—provides a wholly satisfactory model for a state statute mandating annual corporate disclosure of material conflict of interest transactions. For example, the SEC requires disclosure of all conflict of interest transactions in which the amount involved is $60,000 or more.\textsuperscript{215} California requires disclosure of conflict of interest transactions involving $40,000 or more.\textsuperscript{216} What this approach misses is that transactions involving considerably less than these amounts—transactions which may, not be material to the corporation in an accounting sense—may nonetheless be material to non-management shareholders in their capacity as voters reflecting upon managerial competence and integrity.\textsuperscript{217}

\textsuperscript{210} A.L.I. Principles, supra note 1, § 3.25 (forthcoming).
\textsuperscript{211} A.L.I. Principles, supra note 1, Tent. Drafts Nos. 5 and 7.
\textsuperscript{212} See supra note 16.
\textsuperscript{213} See supra notes 148-49.
\textsuperscript{214} See supra notes 198-99.
\textsuperscript{215} 17 C.F.R. 229.404(a) (1987).
\textsuperscript{216} CAL. Corp. Code § 1501(a)(1) (West Supp. 1987).
\textsuperscript{217} See supra notes 65-68 and accompanying text. For example, suppose that a corporation with $1 million in annual sales makes $25,000 payments annually to the CEO's mother as a "consulting fee." Upon discovery by the IRS, deductions for the payments are disallowed. Or take a corporation which leases office space from a partnership in which three directors are the general partners. The annual rental is $36,000, but the space is vacant and unused (or used by the partners for non-corporate purposes). Either of these transactions may not be material to the corporation in an accounting sense, but may, under the circumstances, be material to the non-management shareholder in the TSC sense. While selecting a figure beyond which any transaction may be deemed material is a
A second correctable defect involves California's failure to require disclosure of executive compensation. Compensation payments may be challenged by the IRS, but under California's formulation, so long as the officers do not engage in contractual relationships with the corporation outside of their compensation, excessive compensation need not be disclosed. As the SEC has recognized, any proper proposal must include mandatory disclosure of executive compensation.

The EIGA's limitation on reportable transactions to those involving "dependent children" similarly overlooks the significant possibility of abuse where non-dependent children are concerned. Perhaps most importantly, California's waiver of the disclosure requirement for corporations with less than 100 shareholders fails to protect many of the shareholders most in need of protection.

It would seem a small step to amend existing state corporation laws to require that the information now required to be provided annually to shareholders, whether automatically or upon request, be extended to include the following information:

Transactions (including the payment of routine compensation) between the reporting company and any of its directors; transactions (including the payment of routine compensation) between the reporting company and any of its officers or senior executives; transactions (including the payment of routine compensation) between the reporting company and any member of the immediate family of any of its directors, officers, or senior executives; and transactions between the reporting company and any entity in which a director, officer, or senior executive or any member of his immediate family owns 10% or more equity.

reasonable approach to mandatory disclosure, any proposal whose intent is to deter exploitive or improper conflict of interest transactions—or at least to expose for scrutiny those of material interest to non-management shareholders—may have to take into account other formulas as well.

221. As one court observed in the context of a public official's potential conflict:
Although common sense dictates that an official may have no economic interest in [the property of a nondependent child], nevertheless he may react favorably, or without total objectivity, to a proposal which could materially enhance the value of that property. Disclosure might . . . inhibit any such sympathetic reaction . . . .
222. CAL. CORP. CODE § 1501(b) (West Supp. 1987).
interest.

An exemption from these requirements could be adopted for corporations of thirty-five or fewer equity participants ("closed corporations") in which the familiarity and interaction among shareholders would take the place of disclosure. This exemption, however, should be available only upon approval by a super-majority of shareholders entitled to vote.

Individual transactions with a dollar value of $10,000 or less need not be disclosed. Where a number of such transactions with an aggregate value in excess of $10,000 occur, however, all such transactions must be disclosed.

VI. CONCLUSION

Managerial conflicts of interest are neither new nor unique to the corporate setting.223 They are a fact of life in a world where business decisions are driven by human beings.

Even among publicly-held and publicly-traded corporations, where existing deterrents to self-dealing are most confluent, managerial conflicts of interest—notwithstanding their embarrassment potential—are a common occurrence.

While much of this behavior may be wholly benign, it may also reflect uncritical patterns of corporate decisionmaking detrimental in the long term to shareholder wealth and economic stability.224 Some self-dealing is, of course, harmful in the short run and unacceptable as a matter of law. In either case, it is important that such behavior continue to be scrutinized and new ways tested to deter its excesses. The task to date has been impeded by


224. Cf. Lawrence, Kummer & Arshadi, Inside Borrowing Practices of Commercial Banks, 11 Issues Bank. Reg. 28 (Summer 1987) (study of 1000,171 banks indicates that while excessive insider loans may not be the direct cause of bank failures, the existence of such loans may indicate poor management practices overall and is a major warning sign that a bank may eventually fail Id. at 29-30).
the lack of a constituency to challenge institutional self-dealing, whereas its advocates enjoy a strong political voice.

Both legal and business scholars have a role to play here. More research is needed correlating managerial conflicts of interest with corporate performance. Continuing thought must be given to creating workable limitations on agency costs.

Consigning problems raised by managerial self-dealing to the IRS and the SEC, neither of whose purposes include enhancing corporate performance, is not a sufficient answer. Nor is reliance on idealized notions of economic behavior.

Rather, the search must continue, incorporating the insights of many disciplines. Managerial conflicts of interest and the resulting widespread diversion of corporate funds cannot continue to be treated as a trivial or intractable phenomenon.