Steve O'Rourke's

Counselor's Corner

Corporate Law Issues and Answers

In this article, corporate governance attorney Steve O'Rourke gives practical advice on how to recognize and handle the "interested director" problem

Whether you are a corporate stockholder, director, officer or anyone else who wants success for a corporation, you need to understand the law regarding "interested" directors. It applies to every corporation, privately-held or publicly traded. For any proposed corporate transaction, an "interested" director is one who expects to derive a personal financial benefit different from that expected by the corporation and its stockholders. The issue can arise, for example, when the board is voting on an employment contract with a CEO/director (who is therefore an interested director in that vote) or on a patent assignment from a director holding a related patent. The issue can also arise in the context of stockholder voting, such as to approve a merger with a company in which a director owns shares. Because of that personal interest, the director may be unable (or unwilling) to fulfill his or her duty to evaluate the proposed transaction in good faith and in the best interests of the corporation. Even so, the transaction may in fact be the best available opportunity for the company. That's the interested director problem - how to permit the corporation to take advantage of the best available opportunity and yet minimize the *effect* of the director's conflict of interest.

One clarification before we begin: each American state writes its own corporate governance statutes applicable to corporations incorporated in that state. I'll give you a high-level understanding of a mix of the laws of Delaware and California; that should give you a sense of what to look for. Because every state has different statutes and interpretations, you should seek expert legal advice on the law applicable to your specific corporation. This article will help you know when and why to seek that advice.

Among the various duties of a director is the duty to fairly disclose to other directors (or shareholders, if they are voting) the material facts known by the director about a proposed transaction, including, of course, any personal financial interest the director has in promoting or opposing the transaction. Up until the early 1900s (1930 in California) court cases describing

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the legal effect of a director's interest were inconsistent and murky, being based in large part on New York and other East Coast cases applying varying rationales to the specific facts in a lawsuit. Although we now have statutes to provide some consistency within each state, the statutes leave much uncertain. For example, although everyone agrees that directors (and in most states, officers) have "fiduciary" duties, even Delaware law is not clear as to what the various "fiduciary" duties are. In a June, 2008 Delaware case, the court stated:

> The fiduciary duty of disclosure is somewhat nebulous…. Corporate transactional attorneys worry when constructing deals about what disclosures the so called duty requires…. Corporate litigators worry about what liability may arise from a failure to fairly make all disclosures.

One reason attorneys worry is that a failure to properly disclose (or reduce the effect of) a director's conflict of interest can result in the approved transaction being enjoined (prohibited by a court) or rescinded (for example, unwinding a merger) or result in the director (or the company) being liable to pay the cash equivalent of rescission. A mistake here can destroy a company, a director or an officer.

With that in mind, let's take a look at the processes that one state provides for a corporation to achieve a "safe harbor" from the threat of rescission. "Safe harbor" is a term lawyers often use (the statutes do not). You should be careful not to assume total safety; "safe harbor" only means that if the statutory processes are followed, the transaction cannot be rescinded solely on the basis of the director's personal financial interest. The statute does not provide a defense for the director against liability for failure to disclose a personal interest. California General Corporation Law, Section 310(a) is a good "safe harbor" example for our purposes. It establishes a three-tier cascade of possibilities: (1) disclosure with shareholder approval, (2) disclosure with board approval *plus* proof that the transaction is fair, and (3) failure to disclose. I'll paraphrase the California statute's most important points:

> No corporate contract or transaction in which a director has a material financial interest is voidable for that reason if:
>
> (1) the material facts of the transaction and of such director's interest are fully disclosed or known to, and approved by, the *shareholders* (with the interested director not voting his shares, if any), *<u>or</u>*
>
> (2) those material facts are fully disclosed or known to the *board* that approves or ratifies the transaction (without counting the vote of the interested director) *and* the contract or transaction is just and reasonable as to the corporation, *<u>or</u>*
>
> (3) the person asserting the validity of the transaction [usually the company or the interested director] proves in court that the transaction was just and reasonable as to the corporation.

Delaware's statute has a somewhat similar three-tier cascade but, since 1994, Delaware courts always test for fairness; so in Delaware the effect of the first two tiers is not a "safe harbor" from rescission but is just a determiner of which side must prove fairness. That's not how the Delaware statute reads, but it is how Delaware courts apply the law. Delaware's statute includes "common" directors (persons who are directors in more than one party to a transaction) in its cascade; California addresses common directors in a separate statute having a two-tier cascade for common directors (omitting the shareholder approval tier and not requiring "just and reasonable" in the board approval tier). California courts apply disclosure duties to officers, even though its statute doesn't mention officers, and to majority shareholders. You might also be familiar with yet another area of director/officer transactional conflict of interest known as the "Corporate Opportunity Doctrine"; that is important but is separate from the Interested Director and Common Director issues. These, and other, differences among the various states are important, as are other details that we will not explore in this overview.

If the corporation does not follow the safe harbor procedures, is the transaction automatically voidable? No. The statutory procedures are always optional. Delaware will always test for fairness and California will test if informed-shareholder approval is not obtained. Delaware describes its test as one to determine "entire fairness" to the corporation. If it is entirely fair, then it cannot be voided. Here is how a Delaware court in July, 2008 described its role:

> Self-interested directorial compensation decisions made without independent protections, like other interested transactions, are subject to entire fairness review. Directors … who stand on both sides of a transaction have the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts. They are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The two components of entire fairness are fair dealing and fair price. Fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price assures the transaction was substantively fair by examining the economic and financial considerations. The … court does not focus on the components individually, but determines the entire fairness based on all aspects of the entire transaction.

If the transaction is approved by the majority of the disinterested directors, the burden shifts to the opponents of the transaction to prove that it was not fair. This statutory shift recognizes the rule that a board will be presumed (though not conclusively) to have acted in good faith, with reasonable care, and in the best interests of the company. That's the "Business Judgment Rule", which we won't examine further. Just bear in mind that the law's complexity continues far beyond what we've been able to cover here.

As a real-world example, in that July, 2008 Delaware case the directors voted themselves $1,300,000 in bonuses without following any of the statutory safe harbor processes. The court

applied the “entire fairness” test and required the directors to disgorge the entire amount of the bonuses and to pay the plaintiff’s attorneys fees for forcing them to do so.

Finally, here’s some practical advice to follow as a director or shareholder:

1. Be alert to whether you are personally “interested”.
2. Be aware of who else might be interested and act accordingly.
3. Have an expert corporate governance attorney advise as to the safe harbors and other applicable law.
4. Be prepared to prove (or disprove) procedural and substantive fairness.
5. Have the expert attorney review the company’s D&O insurance and indemnity provisions as they apply to your potential liability. Classifying the particular legal duty involved is critical to whether the company can indemnify you and to insurance coverage.
6. Require approval processes that are commensurate with the size of the transaction and the risk to you and the company. Even if all voters are honest, the right process can avoid transaction delay and litigation costs.
7. Assure that the voters receive written disclosures of interest and reports, and direct advice from the expert attorney.
8. Assure that the voters receive independent price evaluations, independent assessments of alternative transactions and so forth.
9. Assure that all of the forgoing advice, research and discussions become part of the corporate record of the approval process.
10. Keep a contemporaneous record of your own actions, questions and the responses you receive.

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