HAVE DIRECTORS AND OFFICERS ENGAGED IN WRONGFUL SELF-DEALING WITH THE CORPORATION?

By Robert M. Heller

Each member of a corporation's board of directors owes a fiduciary duty to the corporation and its shareholders. That duty fundamentally has two obligations: the duty of care (directors must perform their jobs diligently and competently) and the duty of loyalty (directors cannot use their positions of trust to further the private interests of any third party – including themselves). Under both these duties, but especially the duty of loyalty, the interests of the corporation and its shareholders must always come first.

As part of the duty of loyalty, directors and officers (as well as controlling shareholders) are required to act with "inherent fairness" to the corporation. That especially relates to any contracts that the board is called upon to approve. It can sometimes be the case that contracts would be between the corporation and one or more individual board members. Any such contract must be fully disclosed and approved by a majority of board members who are not themselves contracting with the corporation. If approval is not given in this way, the contract may be considered void.

In California, so long as certain requirements are met, a contract or other transaction between a director or officer and the corporation is "neither void nor voidable" simply because of the director's or officer's interest in that contract. However, if those requirements are *not* met, the transaction covered by the contract will be upheld only if the director or officer can *prove* its "fairness" to the corporation.

A. What Constitutes an "Interested-Director" Transaction:

(1) **Contracts between a director and the corporation:** ANY contract or transaction directly between the corporation and one or more of its directors is subject to the requirements described in Part B below. The director involved in such a contract is called an "interested director," and it is presumed that the director's interest is material.

Typically, a material interest includes compensation arrangements, stock option agreements, buying or selling assets, leasing property or similar actions that produce a financial benefit for the director.

(2) **Contracts with another company in which the director has "material financial interest":** A contract or other transaction with another entity is also subject to the requirements below if a director has a "material financial interest" in such a firm. An example would be a company board member who is also an executive of an investment group, such as a private equity firm, that has taken an ownership stake in the company.

B. Requirements to Avoid a Conflict-of-Interest Challenge: Contracts between a corporation and one of its directors are "*neither void nor voidable*" simply if the director has a personal financial interest in the transaction, but this is only the case if the following specific legal requirements are met.

(1) **Shareholders approve the contract after receiving full disclosure about it:** A contract cannot be challenged because of a director's financial interest if the *material facts* about the contract were communicated to the shareholders. After such communication, the contract must be approved by a majority of shareholders (and/or the shares they represent) not directly involved in the contract. All materials facts about the director's interest in the transaction and about the contract itself, must be disclosed to the shareholders if they are not already aware of them. Any shares held by the director who has an interest in the contract are not entitled to vote. A majority of those shareholders without an interest (called "disinterested shareholders) must give good faith approval of the contract.

No showing of fairness is required. If disinterested shareholders give such approval, the contract does *not* have to be shown "just and reasonable" to the corporation – as it must be without such approval (below).

(2) The **board approves after receiving full disclosure and concluding that the contract was fair to the corporation:** A second way in which a contract is protected from challenge over a director's self-interest in the transaction is if (a) the *material facts* were disclosed to the board, (b) a *disinterested majority* of the directors approve *and* (c) the approving directors deem the contract to be "*just and reasonable* for the corporation at the time they authorized, approved or ratified it. A more detailed explanation of all three elements will make this clearer.

a. Full disclosure: All materials facts regarding the director's interest, and the contract itself, must be disclosed or known to the board before it acts upon the matter.

b. Disinterested majority: The "interested" director cannot vote on the contract. The board vote to authorize the transaction must *exclude* the interested director.

c. Fairness requirement: If approval is only by vote of the board (and not of the shareholders), the transaction must also be demonstrated "just and reasonable to the corporation" at the time of such approval.

Approval by a disinterested majority of the board is presumed to demonstrate that those voting concluded the contract is fair to the corporation, so that the burden of proving its *lack* of fairness is on any party who challenges the contract. Such challenges could be raised either by a shareholder in a derivative action, by the corporation itself or by its creditors.

(3) **Without approval by a disinterested board or shareholders, fairness must be proved:** Failure to obtain disinterested board or shareholder approval does not necessarily invalidate an interested director contract. However, in such cases, the burden rests on the party seeking to *uphold* the contract (normally, the "interested" director) to prove that it was "just and reasonable" to the corporation at the time it was authorized or entered into.

C. **Remedies available to the corporation for a problem transaction**: If the contract or transaction fails to meet the requirements above for shareholder or board approval, two main remedies are available to the corporation. It may either.

- *Rescind* the contract and recover anything of value that the contract paid to the director or;
- Affirm the contract and sue the interested director for *damages* (the amount of the "unfairness" or excessive price charged to the corporation).

If the corporation fails or refuses to bring an action against the director, any shareholder may institute a derivative lawsuit on the corporation's behalf.

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