LEGAL STRATEGIES

A Legal Newsletter from Steven I. Hochfelsen

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What I Really Want to do is Direct!

(Liability of Corporate Directors)

Running a company can provide many rewards -- and just as many risks. When the company is a corporation with multiple owners, both the risks and the rewards are even greater. Most shareholders of a corporation expect its directors to manage and conduct the affairs of the corporation in such a way as to help the company flourish and grow. They rely on those directors to provide the long-range vision necessary to put (or keep) the corporation at the top of its field.

It is a great compliment to be elected a director of a corporation. It means that the shareholders trust your judgment and believe that your vision will help the company grow and prosper. Directors participate in all major corporate decisions; they set corporate policy, and choose and supervise the corporate officers. Shareholders, on the other hand, don't run the company. But they do own it. Most directors consider the shareholders to be "passive" participants in the company's success. To a large extent, the shareholders' involvement in the company normally comes only once a year, when they elect the board of directors.

This is normally true as long as the company is growing and flourishing. During growth periods, shareholders watch the value of their investment grow, and they often receive dividends on their appreciating stock.

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However, if the company founders, shareholders often become upset, and some look to the corporate directors as the reason for the company's failure to grow. In some instances dissatisfied shareholders will even file "shareholder's derivative suits" against the members of the corporate board of directors. In this type of lawsuit, a shareholder "steps into the shoes of the company" and seeks damages against the directors on behalf of the corporation. In other words, a shareholder's derivative suit seeks to assert the company's rights against the directors on behalf of the corporation, for the benefit of all corporate shareholders.

In order to best protect himself or herself, a corporate director should be aware of his or her duties to the corporation, so that any policy decisions are made in consideration of those duties. The director's duties to the corporation are said to be "fiduciary" duties. The term "fiduciary" is a legal term coming from a long line of authority, originating with trustees of the property of others. Essentially, it requires that a director act with the utmost good faith toward the corporation, and not usurp opportunities for himself or herself that would otherwise be corporate opportunities. It also requires complete disclosure of any situation where the corporate director might have even a remote chance of some type of conflict of interest with the best interests of the corporation.

A director is not a guarantor of the success of the corporation

Although a director's duty to the corporation is expressed in many forms, there really are two primary duties: 1) The Duty of Loyalty; and 2) The Duty of Care.

Duty of Loyalty

To serve the company with the requisite degree of loyalty, directors must set aside their personal interests and put the company's best interests ahead of their own. The duty of loyalty requires a director to 1) advise the board of any conflict of interest and to abstain from voting or otherwise acting on that matter; 2) advise the company of all corporate opportunities and giving the company a fair chance to take advantage of those opportunities; and 3) refrain from competing with the company.

Self-dealing

Business deals between a director and the company must be approached with great caution, if at all. If a individual director contracts with the corporation, there is an immediate conflict. For whose interests does he look out - the company's or his own? The issue of "self-dealing" normally arises in transactions involving the sale of a director's assets to the corporation or the director's purchase of assets from the corporation. Such deals are permitted, but only if, after full disclosure, they are approved by a disinterested majority of the board of directors, or ratified by a vote of the shareholders. Otherwise, if the transaction is not fair to the company, it can be voided later by the company, exposing the director to damages.

Corporate Opportunity

A director may not usurp an opportunity that is relevant to the corporation's business activities. If this occurs, the courts may force the director to return any profits made as a result of appropriating the opportunity.

When is an opportunity a corporate opportunity? A director cannot seize an opportunity that might have been pursued by the corporation unless, after an informed evaluation by disinterested directors, the board elects not to pursue the opportunity.

Competition With The Corporation

Head-to-head competition between a director and his company is a prescription for trouble. Under no circumstances may a director appropriate the corporation's business, divert customers from the company or use the company's trade secrets or other confidential information to his or her own benefit.

Duty of Care

A director also has a duty of care in managing the corporation's affairs. This duty is measured by the "business judgment rule" which requires the director to exercise the care that an "ordinarily prudent person in a like position" would use under similar circumstances. The business judgment rule actually protects directors. Even if the corporation loses money, the exercise of sound business judgment will lessen the likelihood that a director is liable for corporate losses. As one court put it, "the directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions."

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A director is not a guarantor of the success of the corporation. If acting in good faith and in a manner s/he believes to be in the best interests of the company, a director normally will not be held personally liable for mistakes in judgment.

Minimizing the Risk

So what is a director to do? What steps can be taken to minimize the risk of liability? For one thing, as a director you should attend board meetings regularly and consistently. Don't laugh--many directors get in trouble because they start skipping meetings and then make decisions without adequate information about the state of the company.

The next step is equally fundamental but often overlooked. Once you are at the meeting, you must participate. Ask questions. Read the reports. Review the company's financial statements. Don't blindly rely on the information provided by management. If you aren't satisfied with the answers you receive, investigate further.

Your decisions should be informed decisions. As a director you should know how a particular decision will impact the company and use reasonable diligence in reaching that decision. The amount of diligence required will vary depending upon the surrounding circumstances and the magnitude of the decision.

Before accepting a position as a director, you should ask whether the corporation has provisions in its charter documents which limit director liability. It is also wise to ask if the company provides indemnification (preferably through Directors & Officer's Insurance) against director liability.

If you follow the above suggestions and consult professional advisors when appropriate, you will be able to contribute to the growth of your corporation and share in its rewards while also minimizing your personal risk.

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