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Common Pitfalls of Fiduciary Duties of Officers and Directors and How to Avoid Them: Essential Guidance for In-House and Corporate Counsel

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Common Pitfalls of Fiduciary Duties of Officers and Directors and How to Avoid Them: Essential Guidance for In-House and Corporate Counsel

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Fiduciary Relationships

- Two types of fiduciary relationships:
  - 1. Those created under the law:
    - (a) as applied to particular relationships governed by statute (i.e. partner and partnership) or by legal proceedings (i.e. administrator and heir)
    - (b) as applied to contractual relationships (i.e. principal and agent; attorney and client)
  - 2. Those created by case law where the factual circumstances underlying the relationship of the parties and the transaction at issue called for a fiduciary relationship.
    - Facts that suggest one person has and exercises control over another, dominates another, or is dependent on the other are signs of a fiduciary relationship
      - American Bar Association: Business Torts Litigation Second Edition: Chapter 1: Breach of Fiduciary Duties, Robert A. Kutcher (2005)

Fiduciary Duties

- Most commonly recognized fiduciary duties, generally:
  - Duty of care
  - Duty of loyalty
  - Duty of confidentiality
  - Duty of full disclosure
  - Duty of good faith and fair dealing
  - Duty to account
  - Duty to act fairly

- Most commonly recognized fiduciary duties, for officers and directors:
  - Duty of care
  - Duty of loyalty
    - *In re Dollar Time Group, Inc.*, 223 B.R. 237, 245 (Bankr. S.D. Fla. 1998).

Fiduciary Duties & the MBCA: Directors

MBCA § 8.30. Standards Of Conduct For Directors

- (a) Each member of the board of directors, when discharging the duties of a director, shall act:
  - (1) in good faith; and
  - (2) in a manner the director reasonably believes to be in the best interests of the corporation.
- (b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.
- (c) In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule.

Fiduciary Duties & the MBCA: Officers

MBCA § 8.42. Standards Of Conduct For Officers

- (a) An officer, when performing in such capacity, has the duty to act:
  - (1) in good faith;
  - (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and
  - (3) in a manner the officer reasonably believes to be in the best interests of the corporation.
- (b) The duty of an officer includes the obligation:
  - (1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and
  - (2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is likely to occur.

Duty of Loyalty

- Courts rely on the unique facts of a case to determine whether there's been a breach of loyalty
  - Sometimes, a breach can happen unintentionally. See *A.C. Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111-114 (Del. Ch. 1986).
- Historically, the scope of the duty of loyalty to a corporation is defined by case law, instead of by statute:
  - The fiduciary duty of loyalty includes a duty to avoid conflicts of interests and self-dealing. *Michael v. F.D.I.C.*, 687 F.3d 337, 351 (7th Cir. 2012) (citing *Matter of Seidman*, 37 F.3d 911, 933 (3d Cir. 1994)
  - Self-dealing, conflicts of interest, or even divided loyalties are inconsistent with fiduciary responsibilities. *Howell v. Motorola, Inc.*, 633 F.3d 552, 566 (7th Cir. 2011), *cert. denied.*
- But the MBCA has a related provision: § 8.62. Directors' Action
  - Makes any automatic rule of voidability for conflict of interest transactions inapplicable where it was fair or was approved by directors in the manner provided by the balance of § 8.62

Duty of Loyalty

- Examples of where courts have found a breach of duty of loyalty:
  - Sales to or purchases by the corporation from directors or entities in which the directors have an interest;
  - Dealings between a parent corporation and its subsidiary
  - Unfair treatment of minority stockholders by a majority stockholder in matters such as corporate acquisitions and reorganization transactions
  - Use of corporate funds to perpetuate control;
  - Sale of control
  - Demands of stockholders to commence derivative suits
  - Excessive compensation
  - Insider trading
  - Usurpation of corporate opportunities
  - Competition with the corporation by officers or directors
  - Improper use of corporate position, property, or information
    - See *Aviall, Inc. v. Ryder System, Inc.*, 913 F.Supp. 826 (S.D.N.Y. 1996), *aff'd*, 110 F.3d 892 (2d Cir. 1997); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 Bus. Law 2065-66 (1990).

Duty of Loyalty: Where's The Line?

- Duty of loyalty may be breached where the director has an interest in the transaction at issue
  - Directors are "interested" when they're on both sides of the transaction or if they're getting a personal financial benefit from a transaction (i.e. self-dealing) instead of a general benefit to the whole corporation or the stockholders
    - *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). See also *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 269 (Del. 1989)
- Without being interested, a director still must be capable of rendering independent judgment to avoid violating their fiduciary duties. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).
  - "Independence" comes from the ability to view and decide on a transaction based on its merits and not by extraneous considerations or influences. See *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985).

Business Judgment Rule

- Some decisions by directors are protected by the business judgment rule, which blocks a claim for breach of fiduciary duty
- Whether the BJR applies to actions by a director is factually sensitive
- Directors have a presumption of independence that is rebuttable by proof regarding their relationships or behavior relative to a given transaction.

Business Judgment Rule

- Under the BJR, courts won't interfere with the exercise of business judgment by corporate directors unless there is bad faith, fraud, illegality, or gross overreaching. *Henderson Square Condominium Ass'n v. LAB Townhomes, LLC*, 2015 IL 118139, ¶ 77, opinion modified on denial of reh'g (Jan. 28, 2016)

- Under Illinois common law BJR, "corporate directors, acting without corrupt motive and in good faith, will not be held liable for honest errors or mistakes of judgment, and a complaining shareholder's judgment shall not be substituted for that of the directors." *Treco, Inc. v. Land of Lincoln Sav. And Loan*, 749 F.2d 374, 377 (7th Cir. 1984)

Usurpation of Business Opportunity

- Tort of usurpation of business opportunity is intertwined with fiduciary principles
  - The duty to not usurp a business opportunity arises only because of the existence of a fiduciary relationship
- Typical scenario: a recognized fiduciary diverts a business opportunity for his or her own benefit
  - The fiduciary will usually have confidential information obtained from another party and will use that information to give themselves a prospective economic advantage
  - Example: corporate directors cannot receive compensation for services performed personally where ordinarily, the services may be performed by the corporation.
    - *Steelman v. Mallory*, 716 P.2d 1282 (Idaho 1986); *Stangenberg v. Allied Distribution & Bldg. Servs. Co., Inc.*, No. 86-12-II, 1986 WL 7618(Tenn. Ct. App. July 9, 1986).
- Usurpation of corporate opportunities will not normally receive business judgment protection.
  - *Robinson v. R & R Pub. Inc.*, 943 F. Supp. 18 (D. D.C. 1996).

Usurpation of Business Opportunity

- In Illinois, it is prohibited for a corporation's fiduciary to take advantage of a business opportunity considered to belong to the corporation. *Graham v. Mimms*, 111 Ill. App. 3d 751, 761 (1st Dist. 1982)
- Core principle: a corporation's fiduciary cannot usurp a business opportunity that was developed through the corporation's assets.
- Example: corporate officers may not purchase property for themselves if the corporation has an actual or expectant interest in the property or if the purchase would hinder or defeat the corporation's legitimate business plans and purposes.
  - *In re Flagship Healthcare, Inc.*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001); *Bookland of Maine v. Baker, Newman & Noyes, LLC*, 271 F. Supp. 2d 324, 326 (D. Maine 2003) (addressing accounting malpractice); *Schact v. Brown*, 711 F.2d 1343 (addressing civil RICO suit).

Usurpation of Business Opportunity

- Without the following factors, no usurpation has occurred:
  - There must be a fiduciary relationship present
  - The opportunity must be of practical advantage to the corporation
  - The opportunity must fit into the business of the corporation or an established corporate policy that the acquisition of the opportunity would forward
    - *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966).
  - There must be a tangible expectancy of an opportunity for profit
    - *T. P. Group, Inc. v. Wilson*, No. 89-CIV. 2227 (KMW), 1990 WL 52131 (S.D. N.Y. Apr. 17, 1990); *Sauer v. Moffitt*, 363 N.W.2d 269 (Iowa Ct. App. 1984).
  - The corporation must be financially capable of taking advantage of the opportunity
    - *In re Century Glove Inc.*, 73 B.R. 528 (Bankr. D. Del. 1987); *Warren v. Century Bankcorp*, 741 P.2d 846 (Okla. 1987); *Solimine v. Hollander*, 16 A.2d 203, 215 (N.J. 1940).

Fiduciary Responsibilities: Illinois

- Both Federal and State courts uniformly uphold the principle that fiduciary duties may arise either from (1) a particular relationship or (2) special circumstances of the parties' relationship
  - i.e. where one justifiably places trust in another so that the latter gains superiority and influence over the former.
  - Factors creating this special relationship can include:
    - Disparity in age
    - Degree of kinship
    - Education and business experience
    - Extent to which the subservient party entrusted his will to the dominant party
      - *Chow v. University of Chicago*, 254 F.2d 1347 (7th Cir. 2001).

Fiduciary Responsibilities: Illinois

- In the last 10 years, Illinois courts have found the following:
  - Breach of fiduciary duty against physicians and lawyers are merely duplicative of the basic malpractice cause of action sounding in negligence. *Neade v. Portes*, 193 Ill.2d 433 (2000); *Majumdar v. Lurie*, 274 Ill.App.3d 267
  - A partner may not eliminate or reduce a partner's fiduciary duty in a partnership agreement. *1515 N. Wells, LP v. 1513 N. Wells, LLC*, 392 Ill.App.3d 863 (2009) (citing The Uniform Partnership Act, 805 ILCS 206/103(b)(3)).
  - A liability insurance company owes a fiduciary duty to its insured where the policy terms give the insurer an irrevocable power to determine whether policy limits should be offered to compromise a lawsuit. *O'Neill v. Gallant Insurance Co.*, 329 Ill.App.3d 1166 (5th Dist. 2002).

Common Breaches of Fiduciary Duties

- Self-dealing
  - (i.e. through conflict of interest or reaping of extra profits)
- Usurpation of business or corporate opportunity
- Misappropriation of funds or property
- Neglect, imprudence, or want of skill
  - (e.g. failure to administer trust property as prudent administrator, failure to properly diversify ERISA plan investments, or improper reliance on professionals)
- Failure to act in another's best interest
- Misrepresentation/omission as to a statement of fact
  - (e.g. financial condition/statement of affairs)
- Inducement
- Breach of an assumed duty
  - (e.g. to provide accurate information)
- Misuse of confidential information/breach of confidentiality
- Misuse of superior knowledge
- Failure to disclose
- Aiding and abetting or acting in concert with another
  - S & K Sales Co. v. Nike, Inc., 816 F.2d 843, 848-49, 851 (2d Cir. 1979)
- Rendering inappropriate advice
  - (e.g. bad business or investment advice)
- Misuse of superior or influential position
  - (e.g. refusal to release security interest, wrongful exercise of payment –acceleration clause, or refusal to loan or extend credit)

Breach of Fiduciary Duty: Corporate Nonfeasance

- A director's duty is generally determined by the laws of the corporation's state of incorporation.
  - *MHC Investment Co. v. Racom Corp.*, 254 F.Supp.2d 1090 (S.D. Iowa 2002); *In re TEU Holdings*, 287 B.R. (Bankr. D. Del. 2002)

- Courts have found that instances of nonfeasance constitute breach of fiduciary duty.
  - Corporate directors that fail to keep informed about the corporation's activities is an example
  - Corporate directors "should acquire at least a rudimentary understanding of the business of the corporation" and therefore, a director "should become familiar with the fundamentals of the business in which the corporation is engaged." *Francis v. United Jersey Bank*, 432 A.2d 814, 821-22 (N.J. 1981)

- Although mostly developed by state courts, federal courts have started to develop their own ideas about nonfeasance.
  - In *Gould v. American-Hawaiian Steamship Co.*, the Court affirmed the finding of liability against an outside director for failing to prevent the dissemination of a misleading proxy statement issued in connection with a corporate merger., 535 F.2d 761 (3d Cir. 1976).

Avoidance of Problematic Scenarios: Things To Look Out For

- Avoid usurpation by complete disclosure
  - When in doubt, DISCLOSE!
- "Interested" can be a grey area
  - With complicated organizational structures, whether an officer or director is interested in a potential transaction is not always clear.
- Investor management skills are key
  - Investors without experience can become problematic

Avoidance of Problematic Scenarios: Things To Look Out For

- Recordkeeping 101
  - Document meetings and conferences. Proving disclosure is not just email!

- Be aware of 'self-dealing' – the appearance matters
  - Litigation can ensue even where no wrong has been committed. Self-dealing can be raised for even relatively small matters. Avoid the appearance of impropriety
  - Document the benefit to the company and disclose material facts

How To Address Conflicts That Arise

- Recent surge in shareholder litigation means it is worth the time to address complaints
  - In 2016, the number of federal securities class action litigation filings rose to their highest level in 20 years
  - Companies should revisit company documents to confirm authority/ownership and other key issues are addressed (see next slide)
  - Clear valuation terms can reduce litigation that is often brought purely to avoid traditional lack of control and marketability discounts impacting minority shareholders

Documentation is the First Line of Defense

Company documents should be sure to address:

- Voting rights and limitation on voting rights
- Board of Directors (voting, removal, powers)
- Amendments to the operating agreement or shareholder agreement (voting power)
- Buyout provisions/valuation
- Interplay between employment agreements and officers/directors

Disclosure Tips

- Transaction must be fair to the company
- Material facts relating to the transaction disclosed to shareholders or members (voting/non-voting)
- The Officer or Director discloses the potential interest/conflict
- Board of Directors or shareholders/members entitled to vote authorize or ratify (after full disclosure)
- Take a vote

Common Pitfalls of Fiduciary Responsibilities

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