

October 4, 2016

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Essential Information for Corporate Officers and Directors

If you serve as an officer or director of a corporation, you may be exposed to liability for a transaction with the corporation if you derive personal benefit. Whenever an officer or director stands to personally gain in a transaction with the corporation that he or she serves, there exists a conflict of interest. This is known as an “interested director transaction” and may include:

- contracts between a corporation and one of its directors or officers;
- executive compensation agreements;
- stock option arrangements;
- asset transfers between the corporation and an officer or director;
- transactions between corporations with overlapping, or “interlocking” boards; or
- transactions with other companies in which the officer or director has a material interest, such as an ownership interest in that company.

The potential consequences of improperly engaging in such transactions are severe and can subject officers and directors to personal liability through suits initiated by the corporation, either directly or derivatively, or by its individual shareholders. This is true regardless of whether the corporation’s articles purport to relieve directors from personal liability to the corporation. Simply put, the fiduciary duties owed to the corporation dictate that officers and directors cannot advance their own interests at the expense of the corporations they serve.

Lessen or Avoid Exposure by Following Either of These Two Approaches:

Approach 1: Obtain Shareholder Approval

If the facts surrounding the director’s interest in the transaction are fully disclosed and approved by the shareholders, then the transaction falls within the safe harbor for interested transactions. Specifically, proponents of the transaction must ensure that:

- material facts concerning the director’s interest are fully disclosed;
- the shareholders approve the transaction in **good faith**; and
- shares held by interested directors are not entitled to vote.

The **good faith** requirement means that the voting shareholders themselves must not be tainted by any self-interest. If the above requirements are met, and

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approval is obtained from the shareholders, the contract's fairness and reasonableness need not be proven.

OR

Approach 2: Obtain Disinterested Director Approval

A transaction can also fall within the safe harbor for interested director transactions through approval by the corporation's disinterested directors. To qualify, the following elements must be met:

- the facts concerning the director's interest are fully disclosed;
- the board approves the contract or transaction in good faith;
- the interested director's vote is not counted; and the transaction is **just and reasonable** to the corporation at the time of approval.

Unlike a transaction or contract approved by disinterested shareholders, one approved by disinterested directors must additionally be **just and reasonable** to the corporation. That said, if the disinterested board members expressly find that a contract is just and reasonable, a court will likely apply the business judgment rule to uphold the transaction. One advantage of having the transaction approved by a disinterested majority of the board is that it places the burden on the party challenging the transaction to prove that it is not just and reasonable.

Fiduciary Duties Must Still Be Satisfied

If the interested director transaction was not approved by either of the above two methods, it may still be valid so long as the officer or director can show that the transaction was **just and reasonable** at the time it was authorized or approved.

Finally, even if the above procedures are followed, interested director transactions may nevertheless be subject to attack on other grounds. Officers and Directors should ensure that they are insulated from any potential liability in connection with such transactions. If you are an officer or director, you would be well advised to contact the Freeman Freeman & Smiley lawyer with whom you normally consult before entering into these types of transactions.

For more information in this area, please visit our [Shareholder & Derivative Litigation Practice](#). A complete list of Freeman Freeman & Smiley's alerts can be found at ffslaw.com.

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