THE "INTERESTED" DIRECTOR OR OFFICER TRANSACTION

By Andrew G. T. Moore*

MR. MOORE: We turn to the question of the "interested director transaction." What that basically means in the simplest terms is where you find the director who is either serving on two boards and the two corporations have some interrelated activities, or where you have a director who is involved in a transaction with his own company where that transaction is designed to benefit that director personally, you face what is known as an interested director transaction and a specific set of rules that solely govern that type of problem.

But underlying the entire concept of the interested director transaction is a fundamental precept of Delaware law, recognized by every state in this country, and found in the classic language of Guth v. Loft¹ (where Chief Justice Layton said):

This rule demands of a corporate director or officer peremptorily and inexorably the scrupulous observance of his duty, not only in an affirmative way to protect the interests of the corporation, but also to refrain from doing anything that would work injury to the corporation or to deprive it of profit or advantage.²

That is the law of Delaware. It has never been changed, and has been followed by virtually every state in this country.

The rule does not rest simply on any ground that the corporation must show that it was damaged in some way. Where a fiduciary breaches a duty to his corporation or his stockholders, the law is inexorable in its effect, and the fundamental precept, also stated in Guth v. Loft, as being upon a broad foundation of public policy, is that, for the purpose of removing all temptation, it extinguishes all possibility of profit flowing from the breach of confidence imposed by the fiduciary relation.


1. 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

2. Id. at 263, 5 A.2d at 510; see also Singer v. Magnavox, 380 A.2d 969, 977 (Del. 1977).
There can be no safe harbor by virtue of divided loyalties. It is no defense to go into court and say, "Well, Your Honor, I was a director of X corporation and Y corporation and I was put in an impossible position." The law just simply does not recognize that as an adequate answer where one is charged as a director with the failure to properly perform one's duties. When directors are on both sides of the transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.

Since there can be no dilution of this responsibility, even in the case of dual or multiple directorships, the law really puts it to this director by telling him that he owes the same duty of good management to both corporations, which duty is to be exercised in light of what is best for both companies. I think that places the director in an extremely difficult position, but it is not a hopeless one, and with careful attention to the legal standards, I think there are ways in which this problem can be approached and the difficulties, which are great, avoided.

So what are the standards and what is the result where you are faced with this type of problem? First, the Intrinsic Fairness Rule is the applicable standard by which the conduct of a director will be judged. That is, where one stands on both sides of a transaction he has the burden of establishing its entire fairness sufficient to pass the careful scrutiny by the courts.

You might ask, what is "fairness" and how is that determined? In a parent-subsidiary context, where there is an element for potential self-dealing, we face these immediate principles: (1) the director will not be able to avail himself of the Business Judgment Rule at all. There are some exceptions, but we start with the basic principle that the Business Judgment Rule will not be applicable. (2) The director cannot avail himself of an army of experts, investment bankers or lawyers who will deliver an opinion saying that the transaction is utterly fair, and thus ask the courts to invoke the Business Judgment Rule.

In this concept, use of opinions from outside experts will not justify invocation of the Business Judgment Rule. I guess the rationale is best exemplified by a simple story that I once heard. Two well known corporate lawyers were walking into court, one of whom was surrounded by a covey of expert witnesses; the other was alone.

The one who walked in alone came over to his friend and said, "Are these your expert witnesses in this case?" and he said "Indeed they are." He said, "I quit. I give up. I've used those same witnesses twice myself."

The third rule is simply that a court will examine the matter de novo to determine if the transaction is intrinsically fair. What does that mean? Well, I don't think it's like a court out in the old west sitting for an important case and announcing that shortly before trial the judge had received $10,000 from the plaintiff and the previous day had received $15,000 from the defendant, and just wanted everybody to know that he was returning the defendant's extra $5,000, and now was ready to proceed with the case.

The Intrinsic Fairness Doctrine shifts the burden of proof to show that the transaction is fair after careful review by the Court. Fairness embodies two essential concepts; one is the item of fair dealing. Here, many questions must be answered. How was the transaction structured? How was the transaction initiated? How was it negotiated? How was it presented to the directors? What approval was given by the directors and the stockholders?

The second aspect of fairness deals with the concept of fair price, and I think we would be safe to refer to the large body of appraisal law that pertains to the intrinsic value of stock. This involves the consideration of all traditional elements of value: assets, market value, earnings, and any other factors or elements that are unique to a company, directly affecting the intrinsic or inherent value of its stock.

Courts in Delaware have tried to define fairness by certain objective standards. In one case the Supreme Court equated it to conduct by a theoretical, wholly-independent board of directors, acting upon the information furnished in the matter. While perfection, of course, is not possible, the courts have approved the type of transaction where the corporation appoints a set of independent directors to negotiate independently, who are able to retain their own advisors and to resolve the transaction at arms-length.

The case of Puma v. Marriott is an example of that, and another one is Harriman v. E. I. DuPont de Nemours, which was the DuPont-Christian merger case.

7. 33 Del. Ch. 293, 93 A.2d 107.
11. 283 A.2d 693, 696 (Del. Ch. 1971).
12. 411 F. Supp. 133.
The courts have also attempted to define fairness by reference to acts which were adjudged as unfair. The courts have employed some of Sam Arsht's less favorite phrases in defining conduct that is not intrinsically fair, such as "gross and palpable overreaching," 13 "bad faith," "gross abuse of discretion," "reckless indifference to or deliberate disregard of stockholders," or "self-dealing," as in a parent-subsidiary relationship, where by virtue of its dominance the parent receives something from the subsidiary to the exclusion of and detriment to the minority stockholders of the subsidiary. 14

But there is an important aspect to this that one must remember. Despite the strictures of this rule, it does not mean that the parent has to engage in any form of self-sacrifice for the benefit of the minority. 15 It simply means that each side must deal with one another fairly and equally, and there is no requirement whatever that the parent company must somehow give up that which in normal business transactions would not be required.

Now there are some exceptions to the Intrinsic Fairness Rule, but they are rare in application. They are set out on page 6 of the outline, but I would just like to mention one briefly—the so-called Sudden Emergency Doctrine. That is best described in the case of Bennett v. Propp, 16 where a chairman of the board tried to entrench himself by resisting a threatened or perceived take-over by pledging the credit of the company to buy its own stock in the open market.

He didn't tell the other directors, but later assembled them at a weekend meeting and told them that on Monday sizeable debts would come due to brokers, and they had to authorize a very, very substantial extension and procurement of credit on behalf of the corporation.

The result was that the directors did approve it, they in essence had a gun to their heads, and of course the Court exonerated the so-called innocent directors but held the chairman and the president, both of whom knew in advance what was happening, liable for the damage sustained by the company.

The examples of interested director transactions are numerous, but one of the important ones is the Corporate Opportunity Doctrine. Thus, if there is presented to a corporate officer or director a business opportunity which the corporation is (1) financially able to undertake, (2) from its nature in the line of the corporation's business and is of practical advantage to it, and (3) one in which the corporation has an

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13. 267 A.2d at 887.
15. 267 A.2d at 888.
interest or reasonable expectancy, and by embracing the opportunity the self-interest of the director or officer will be brought into conflict with that of the Corporation, the law will not permit him to seize the opportunity to the detriment of his company.\textsuperscript{17}

However, an important aspect to remember is that even if all of the traditional factors are present to invoke the Corporate Opportunity Doctrine, if the company itself is totally unable to financially pursue that opportunity, then the doctrine is not applicable.\textsuperscript{18}

Similarly, the doctrine has no applicability where a director can show that in his individual capacity the opportunity came to him, rather than in his official capacity, and the opportunity is one which because of the nature of the enterprise is not in its normal line of business or essential to the corporation and is one in which it has no interest or expectancy, and the officer has not embarked the assets or the resources of the corporation therein.\textsuperscript{19}

But there is one major caveat here. If an officer can show all the factors that negate the concept of a corporate opportunity, but in any way employed or embarked the assets or the credit of the company on behalf of the transaction, he may well find himself accounting to the company and losing the opportunity.\textsuperscript{20}

Another type of interested director transaction involves various and myriad efforts or attempts to perpetuate management in control by means other than the regular corporate processes of democracy. There have been many such efforts forbidden by the Delaware courts—attempts to purchase the company’s stock to prevent take-overs and manipulating corporate machinery in such a way that it deprives the challenger of an ability to meaningfully seek a fair vote from stockholders.\textsuperscript{21}

Manipulation of corporate machinery is something that one must approach with a great deal of caution, because it is uniformly held in Delaware that if you follow the Corporation Law to the letter, the by-laws to the letter, the certificate of incorporation to the letter, but have engaged in a manipulative act which is designed to perpetuate yourself in control, that conduct will be forbidden, and that act will be stricken despite total compliance with Delaware law.\textsuperscript{22}

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\footnotetext{17} Guth v. Loft, 23 Del. Ch. 255, 273, 5 A.2d 503, 511 (1939).
\footnotetext{19} 23 Del. Ch. at 272-73, 5 A.2d at 510-11.
\footnotetext{22} Singer v. Magnavox Co., 380 A.2d at 975.
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Another example of the interested director transaction is a cash-out merger, and since that is the subject of an entire program here, I will not dwell on it except to point out that not only must you concern yourself with the problems under the General Merger Statutes, sections 251, 252 and 253,\textsuperscript{23} but be very much on the lookout for any problems that would invoke the interested director or interested transaction rules.

The remedies available under Delaware law to a stockholder, or to one who is injured as a result of a breach of any of these fiduciary duties, are extensive and can be extreme. People have lost their fortunes and lost their companies because of a failure to perceive the type of duty and the high standards that Delaware inexorably requires of those who stand in the fiduciary relationship of a director to a Delaware company.\textsuperscript{24}

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