When Conflicts of Interest Can Work

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BY DOUG RAYMOND

In recent years, a persistent theme in corporate governance has been the board's role in protecting the corporation from the predations of management or significant shareholders. Ever since the creation of the corporate form, which facilitated the separation of management from investment capital, there have been concerns that unscrupulous management or controlling shareholders may seek unfair advantage at the expense of other shareholders. Indeed, the fiduciary duties imposed on directors are based, in significant part, on the need to establish protections for shareholders who do not have an effective voice in managing the business or protecting their investment. These duties — the duty of care and the duty of loyalty — require directors to act in good faith and with reasonable care and prudence. They further require directors to act always in the best interest of the corporation and the shareholders, not for their own personal benefit.

Because of these fiduciary duties, it is often said that boards should avoid every conflict of interest, and that the corporation should avoid any transaction where a director or significant shareholder has an interest that is not common to all other shareholders. However, directors and shareholders can add significant value to the corporation by leveraging their other relationships and connections. It can be short-sighted, in the name of "best practices," to lose these opportunities. If the board employs appropriate procedures and protections, it can confidently approve related-party and other conflicted transactions that benefit both the corporation and the conflicted party.

In general, courts will not substitute their judgment for that of corporate directors. When board decisions are challenged, a court typically will presume that the directors acted on an informed basis and with the honest, good-faith belief that the decision was in the best interest of the corporation. This presumption, known as the business judgment rule, protects most board action from being successfully challenged.

However, if the board approves an action in which some of the directors or a significant shareholder has an interest, a court will not presume the independence and good faith of the directors. It will instead take a more careful look through a process called "entire fairness review." When entire fairness review applies, directors must demonstrate both "fair price and fair dealing." First, they must establish that the deal was structured, negotiated, timed and disclosed in a fair manner. Second, they must establish that all relevant aspects of the price of the transaction were fair to the corporation and its shareholders (other than the conflicted parties).

Fortunately, the board can take relatively simple steps to avoid getting caught in an extended legal review of conflicted transactions. If only one or two directors (and less than a majority) have a conflict, they should report this to the board as soon as possible and be insulated from any discussion of or participation in the board's consideration of the transaction. The remaining directors can then independently evaluate the conflict and the transaction, or delegate the matter to a board committee comprising only nonconflicted directors. If a majority of the directors have a conflict of interest, but there is no significant shareholder involved, it is also possible for the board to regain the deference of the business judgment rule. This is, however, provided that the transaction is conditioned upon the approval of a well-informed and a fully independent committee of directors.

Creation of this independent committee is crucial for approval of conflicted transactions. When the board creates a committee in any of the above scenarios, the committee members should not have any financial, economic or even close personal connections to the conflicted persons. And it is important that the committee be constituted and authorized to negotiate, approve or reject a transaction before any true negotiations begin. Additionally, the committee should consider engaging outside advisers, including experienced counsel and financial advisers, who can opine on the fairness of the proposal to the company.

Transactions involving a controlling shareholder require a greater effort to avoid entire fairness review and will be given business judgment deference only if, from the outset, the transaction is conditioned upon approval not only by a well-informed, fully independent committee of directors, but also is approved by the non coerced, fully informed vote of the unaffiliated, minority shareholders. This rule applies to mergers and acquisitions and also to less significant commercial transactions, including real estate transactions and consulting, service, licensing and asset purchase agreements.

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Many boards are understandably reluctant to have shareholders vote on less significant transactions, even with a controlling shareholder. And not seeking shareholder approval makes it impossible to avoid entire fairness review all together. However, conditioning the transaction upon the approval of an appropriately structured independent committee can still provide reasonable protection. If the process employed was fair, the burden of demonstrating that the result was substantively unfair will fall on those challenging the transaction. Although this variation on entire fairness is not as deferential as the business judgment rule, flipping the burden of proof will make it more difficult for any challenger to be successful.

Overall, enhanced judicial review of conflicted transactions should not deter corporations from partaking in them altogether. Paying close attention to the steps outlined above, along with good corporate governance in general, should facilitate a fair deal process such that any challenge will be unlikely to stand up in court. This will allow boards to confidently engage in a variety of transactions that will benefit both the corporation and the conflicted party. ■

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