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# CORPORATE DIRECTOR LIABILITY

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## INTRODUCTION

In recent years, directors of corporations have become increasingly aware that they may be held personally liable for their actions taken as directors. Often, creditors will look to the directors of an insolvent corporation, hoping to find a deeper pocket from which to recover their losses, especially during periods of economic downturn. In addition, stockholders will often turn to the directors of the corporation when the corporation ceases to perform as expected, and the stockholders have a weak or nonexistent claim under the securities laws. The potential for massive liability, when compared with the relatively minimal benefits that an outside director can expect to receive from his position, often causes potential outside directors to refuse such invitations. As a consequence, many corporations that need the independent, knowledgeable advice that an outside director can provide must settle for inside directors or less knowledgeable, less independent outside directors.

This article, while not exhaustive of the topic, will discuss four major areas of potential director liability and discuss the standards involved under each area. The four major sources of director liability arise from (1) breach of the fiduciary duty of due care, (2) conflict of interest transactions (self-dealing), (3) usurpation of corporate opportunities, and (4) statutory liability. In relation to the fiduciary duty of due care, Colorado has passed a new statute which allows corporations to limit the monetary liability of their directors for their gross negligence. This statute and its relevant history will also be discussed in detail.

## I. BREACH OF THE FIDUCIARY DUTY OF DUE CARE

Colorado has long recognized that directors are in a fiduciary relationship to their corporation. They owe undivided loyalty to their corporation and "an allegiance that is influenced in action by no consideration other than the welfare of [their] corporation."[1] The directors hold an office of trust, and, accordingly, are held to the high standard of duty required of trustees. The directors have a duty to protect the rights of the company, and to act openly and above board. "They must manage the corporate affairs in good faith, within the limits of the law applicable, and give the corporate entity the benefit of their

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1. Kullgren v. Navy Gas & Supply Co., 110 Colo. 454, 461, 135 P.2d 1007, 1010 (1943), *quoted in*, Hudson v. American Founders Life Ins. Co. of Denver, 151 Colo. 54, 58, 377 P.2d 391, 393 (1962). The court in *Kullgren* noted that directors are held "to the extreme measure of candor, unselfishness and good faith." 110 Colo. at 461, 135 P.2d at 1010.

best judgment and care."[2] Moreover, directors of a corporation are "liable jointly and severally for losses of the corporation caused by their bad faith or willful or intentional departures from duties, their fraudulent breaches of trust, their gross or willful negligence, or their ultra vires acts."[3]

### A. *Business Judgment Rule*

Although directors are treated as fiduciaries, they need merely act in accordance with the business judgment rule, which has considerable vitality in Colorado. The business judgment rule provides that the good faith acts of directors, which are within the powers of the corporation and within the exercise of honest business judgment, may not be challenged.[4] Courts will not interfere with or regulate the conduct of directors who act reasonably and honestly in the exercise of their business judgment and duties.[5] A director has a large amount of discretionary power which is not subject to control by either the stockholders or the courts, if exercised honestly and with reason. When the stockholders are dissatisfied with the management of the company, their recourse is to elect new management rather than to seek redress in the courts.[6]

Although errors of judgment will not be corrected by the courts, that judgment must be exercised with reason.[7] Colorado law suggests that the negligent exercise of judgment must amount to clear and gross negligence before the courts will hold a director liable.[8] Generally, Colorado courts require some evidence of fraud or self-dealing before they will impose liability on directors.[9]

The business judgment rule in its purest form only protects directors from liability for errors of *judgment*. It does not protect directors from liability for negligence in the *process* by which they reached their

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2. Great Western United Corp. v. Great Western Producers Coop., 41 Colo. App. 349, 353, 588 P.2d 380, 382 (1978), *aff'd*, 200 Colo. 180, 613 P.2d 873 (1980). The court concluded that directors of Great Western United Corporation could not be held liable for breach of contract in failing to use "best effort" to persuade shareholders to approve the sale of its subsidiary since the directors had a fiduciary duty to the shareholders, which included protecting the rights of the company and to act openly and above board. *Id.* at 353-54, 588 P.2d at 382-83.

3. Holland v. American Founders Life Ins. Co. of Denver, 151 Colo. 69, 75, 376 P.2d 162, 165 (1962).

4. *See, e.g.*, Rywalt v. Writer Corp., 34 Colo. App. 334, 337, 526 P.2d 316, 317 (1974). Several property owners within a subdivision brought an action against their homeowner's association to enjoin it from constructing tennis courts, claiming that the association board acted arbitrarily in approving the tennis courts. The court determined that the board's judgment was valid absent a showing of bad faith or fraud. *Id.* at 337, 526 P.2d at 317.

5. *Id.* at 337, 526 P.2d at 317.

6. Herald Co. v. Seawell, 472 F.2d 1081, 1094 (10th Cir. 1972) (applying Colorado law).

7. *See id.*

8. *Holland*, 151 Colo. at 75, 376 P.2d at 166. Mere error in judgment is not enough to impose liability upon a director.

9. *See Rywalt*, 34 Colo. App. at 337, 526 P.2d at 317. When a director has committed fraud or self-dealing then he has breached the duty to act reasonably and honestly in the exercise of his judgment.

judgment.[10] This statement comes as a surprise to most people given the broad language courts have used in their statement of the business judgment rule. For instance, in *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*,[11] the court stated that the reason for the business judgment rule is that "in order to make the corporation function effectively, those having management responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of having to be liable for an honest error in judgment."[12] Of course, many decisions cannot be made "quickly and finally" unless they are made without the benefit of a complete and thorough investigation. Further, broad dicta in *Rywalt v. Writer Corp.*[13] stated that courts will not "interfere with or regulate the *conduct* of the directors in the reasonable and honest exercise of their judgment and duties."[14] Such broad statements can give directors a false sense of security in believing that they would not be liable, not only for errors of judgment, but also for errors in investigating the facts supporting their judgments.

### B. Smith v. Van Gorkom

A recent Delaware case has demonstrated that false sense of security. In *Smith v. Van Gorkom*,[15] the Delaware Supreme Court determined that, while the business judgment rule protected the directors from personal liability for an error in judgment, it did not protect the directors for gross negligence in failing to investigate the facts supporting their judgment.[16] In *Van Gorkom*, Trans Union Corporation could not generate a sufficient amount of taxable income to utilize its substantial investment tax credits. Trans Union's earnings were principally generated from its rail car leasing business which was very capital intensive. As a consequence, the company had a large amount of fixed assets and a correspondingly large amount of depreciation due to the accelerated cost recovery program. The accelerated depreciation reduced Trans Union's taxable income to such an extent that the company could not use its investment tax credits. This problem was causing considerable concern for the company.[17]

Management's proposed solution was a leveraged buyout in which

10. Hansen, *The ALI Corporate Governance Project — Of the Duty of Due Care and the Business Judgment Rule*, 41 BUS. LAW. 1237, 1240-41 (1986). The author of this article argues strongly that the American Law Institute's standard of "due care" is flawed since it literally requires due care in exercising judgment as well as in the process of forming a judgment.

11. 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973). In an action based on Rule 10b-5 of the Securities and Exchange Commission, the court referred to the business judgment rule in determining the timeliness of the special earning report. The court concluded that the decision by directors to release such report was a matter of discretion. *Id.* at 518.

12. *Id.* at 518.

13. 34 Colo. App. 334, 526 P.2d 316 (1974).

14. *Id.* at 335, 526 P.2d at 317 (emphasis added).

15. 488 A.2d 858 (Del. 1985).

16. *Id.* at 872.

17. *Id.* at 864-65.

the group acquiring Trans Union would have sufficient taxable income to make use of the tax credits. Senior management had not yet completed a study to determine the necessary selling price of Trans Union's stock in the buyout. However, management had done some preliminary studies which indicated that a leveraged buyout would be easily feasible, if the stock were priced at $50.00 per share, but difficult if priced at $60.00 per share.[18] At the time of the proposal, the current market price for Trans Union stock was approximately $38.00 per share.[19]

Van Gorkom, the Chairman and Chief Executive Officer, vetoed the idea of a leveraged buyout but was receptive to the idea of selling Trans Union to a company with sufficient income to absorb the tax credits. Accordingly, Van Gorkom, on his own initiative, entered into negotiations for the sale of Trans Union. He did this without the knowledge or approval of the board or senior management.[20] Van Gorkom eventually struck a deal whereby Trans Union would merge into New T Company, a subsidiary wholly owned by Jay Pritzker, at a price of $55.00 per share. However, Pritzker attached several stipulations to this merger proposal. First, he would be entitled to purchase one million shares of Trans Union stock at $38.00 per share. Second, Trans Union could accept, but could not solicit, other offers for the purchase of Trans Union. Finally, Pritzker required that the Trans Union board of directors approve the merger proposal within three days.[21]

Van Gorkom called an emergency meeting of the board of directors at which time he gave a twenty minute oral presentation of the merger proposal. The board of directors was not given a copy of the proposed merger documents, and Van Gorkom did not disclose the methodology by which he determined the $55.00 per share figure. The president of Trans Union spoke in favor of the merger proposal. The chief financial officer of the company discussed his leveraged buyout study and stated that the $55.00 per share figure was at the low end of a fair price range, but his studies could not conclusively show the intrinsic value of the company. The board meeting lasted a total of two hours, and ended with the board ultimately approving the merger proposal.[22]

The board was composed of five inside directors and five outside directors. The five inside directors had backgrounds in law and accounting, with 116 years of collective employment by the company and 68 years of combined experience on its board. The five outside directors included four chief executives of major corporations and an economist who was former dean of a school of business. The outside directors had 78 years combined experience as chief executive officers and 50 years of cumulative experience as directors of Trans Union.[23]

Despite the collective experience of the directors, the court deter-

18. *Id.* at 865.
19. *Id.* at 867.
20. *Id.* at 866.
21. *Id.* at 867.
22. *Id.* at 867-69.
23. *Id.* at 880 n.21.

mined that the board had been grossly negligent in (1) failing to adequately inform themselves as to Van Gorkom's role in forcing the sale of the company and in establishing the per share purchase price, and (2) failing to inform themselves of the intrinsic value of the company.[24] The court stated that the business judgment rule was a presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company.[25] The business judgment rule, however, provides no protection for directors who have made "an unintelligent or unadvised judgment."[26] Further, the court stated that whether a business judgment may be termed as informed turns on whether the directors "have informed themselves prior to making a business decision, of all material information reasonably available to them."[27] The court also noted that gross negligence would be the standard for determining whether a business judgment was an informed one.[28]

Accordingly, the court concluded that the board was grossly negligent in relying upon Van Gorkom's representations that $55.00 per share was a fair price. The court further found that the board failed to read the merger documents prior to approving the transactions, failed to engage the services of an investment banker, failed to do a study of the intrinsic value of the company, and approved the merger upon only two hours of consideration, without prior notice and without the exigencies of a crisis or emergency. The court was not persuaded by the fact that the merger price was at a substantial premium over the current market price, or that the board, because of its experience and long history with the company, did not require a full scale study to know that the $55.00 figure was a fair price for the company, or that the merger had in fact been very beneficial for Trans Union.[29] Rather, the court only focused on the fact that the board of directors accepted the $55.00 price without conducting a formal investigation to determine whether that price was the best the stockholders could receive.[30]

Needless to say, *Van Gorkom* has caused considerable concern in corporate board rooms around the country. In essence, *Van Gorkom* stands for the proposition that directors can be held personally liable for failing to conduct a formalized investigatory process before they approve a merger price.[31] Under the decision, a board of directors can no longer rely upon their business acumen or their intuition that a proposed deal will be beneficial to the corporation. Instead, the board of directors must constantly be conscious of all of the factors that go into the deci-

24. *Id.* at 874.
25. *Id.* at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
26. *Van Gorkom*, 488 A.2d at 872.
27. *Id.* (quoting *Aronson*, 473 A.2d at 811).
28. *Id.* at 873.
29. *Id.*
30. *Id.*
31. *See* Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 Bus. Law. 1187, 1191 (1987).

sion-making process, and must ensure documentation and investigation of each factor. This may require the unnecessary hiring of an investment banker, performing an audit when corporate records could suffice, and additional reliance upon lawyers to prepare the documents that would provide an aura of formalism and circumspection on the part of the board.[32]

In addition, *Van Gorkom* undermines one of the most stark realities of the business world. Good business deals often occur under extreme time constraints. Quick business decisions can often mean the difference between being the first to market a product or business failure. Business decisions are often made by corporate executives who have made a career out of taking too little information, adding a little business acumen and intuition, and producing quality decisions.

### C. *Legislative Response to* Van Gorkom

These concerns, floating in the wake of the *Van Gorkom* decision, prompted the Delaware legislature to rewrite its corporate laws to effectively overrule *Van Gorkom.* The new statute essentially provides that a corporation may amend its articles of incorporation to provide that corporate directors may not be held liable for monetary damages to the corporation or to its stockholders for a breach of fiduciary duty, amounting to gross negligence, to the corporation.[33]

Colorado also passed legislation that adopted substantially the same statute that Delaware enacted.[34] The Colorado limitation of director liability also applies to nonprofit corporations,[35] state banks,[36] and savings and loan associations.[37] The Colorado statute provides that a corporation may include in its articles a provision limiting or eliminating the personal liability of directors in the following manner:

> If so provided in the articles of incorporation, to eliminate or limit the personal liability of a director to the corporation or to its shareholders for monetary damages for breach of fiduciary duty as a director; except that such provision shall not eliminate or limit the liability of a director to the corporation or to its shareholders for monetary damages for: Any breach of the director's duty of loyalty to the corporation or to its shareholders; acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; acts specified in section 7-5-114; or any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director to the corporation or to its shareholders for monetary damages for any act or omis-

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32. *See id.* at 1191-92. The authors comically note that, in addition, directors, who are more intent on formalism than business, may make poorer decisions.

33. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

34. H.R. 1142, 56th Colo. Gen. Assembly §§ 1-2 (1987)(to be codified at COLO. REV. STAT. §§ 7-2-102(1.5)(d), 7-3-101(1)(u)).

35. *Id.* at §§ 3-4 (to be codified at COLO. REV. STAT. §§ 7-21-102(1.5), 7-22-101(1)(r)).

36. *Id.* at § 5 (to be codified at COLO. REV. STAT. § 11-3-101(2.5)).

37. *Id.* at § 6 (to be codified at COLO. REV. STAT. § 11-41-112(1)(n)).

sion occurring prior to the date when such provision becomes effective.[38]

Essentially, the statute allows a corporation to eliminate the personal liability of a director for his simple or gross negligence. The Colorado statute is merely a restatement of the business judgment rule with the exception that it protects against gross negligence. Of course, the negligent decisions of directors, made in good faith, have always been protected under the business judgment rule,[39] unlike intentional misconduct, self-dealing,[40] and statutory liability,[41] which were not covered. Accordingly under the business judgment rule, clear and gross negligence did not survive.[42] Although the new statute does protect directors for acts of gross negligence, it does not make an explicit exception for gross negligence, as it does for breaches of loyalty, bad faith, intentional misconduct, or statutory liability.

The courts might construe gross negligence as an act not taken in good faith. "Good faith" has been variously defined but is generally used to describe a state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation. It may mean an honesty of purpose, and freedom from knowledge of circumstances which ought to put the actor upon inquiry rather than diligence or non-negligence.[43] The Uniform Commercial Code defines "good faith" to mean honesty in fact.[44] Gross negligence, on the other hand, consists of a conscious or voluntary act likely to result in harm of which the actor is or reasonably should be aware.[45] To the extent that gross negligence includes a conscious disregard of duty, creditors and shareholders could reasonably argue that such acts are not taken in good faith.

Although it may be argued that negligence constitutes lack of good faith, the argument should fail because it ignores the history and intent of the Delaware statute. The new statute was passed by Delaware in response to a case holding directors personally liable for their gross negligence. Clearly, if the statute is to add anything beyond what the

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38. *Id.* at § 2 (to be codified at COLO. REV. STAT. § 7-3-101(1)(u)).

39. *See* Rywalt v. Writer Corp., 34 Colo. App. 334, 526 P.2d 316 (1974)(stating that the acts must be within the boundaries established by the corporation's articles and the exercise of honest business judgment); *see also supra* notes 4-9 and accompanying text.

40. *See infra* notes 55-80 and accompanying text.

41. *See infra* note 81 and accompanying text.

42. Holland v. American Founders Life Ins. Co. of Denver, 151 Colo. 69, 376 P.2d 162 (1962); *see supra* notes 7-8 and accompanying text.

43. *See* Wendling v. Cundall, 568 P.2d 888, 890 (Wyo. 1977)(the Wyoming Supreme Court attempted to define the term "utmost good faith" which was present in a contract); BLACK'S LAW DICTIONARY 623-24 (5th ed. 1979); 18A WORDS & PHRASES 83, 106-09 (1956 & Supp. 1986); *cf.* Whitlock v. Alexander, 160 N.C. 465, 76 S.E.2d 538 (1972)(requiring "good sense and reasonable business prudence").

44. COLO. REV. STAT. § 4-1-201(19) (1973).

45. BLACK'S LAW DICTIONARY, *supra* note 43, at 931-32. Colorado does not recognize the concept of gross negligence, but defines willful and wanton negligence similarly. Adams v. Colorado & S. Ry. Co., 49 Colo. 475, 113 P. 1010 (1922); Foster v. Redding, 97 Colo. 4, 45 P.2d 940 (1935).

common law has already provided, it must eliminate director liability for gross negligence.

The new statute also may not protect directors from personal liability for their recklessness. To the extent that the Colorado courts define recklessness as including some element of intent, such actions could constitute either intentional misconduct or acts taken not in good faith. Recklessness is generally defined to be action taken either with knowledge of the danger or with knowledge of facts which would disclose the danger to a reasonable man.[46] A reckless act is one that is intentionally done with the knowledge that there is a significant risk of harm to others.[47] Note that the difference between recklessness and gross negligence is minuscule.[48] If the courts determined that gross negligence could not support liability under the new statute, but recklessness could, courts could with little effort transform a grossly negligent act by a director into a reckless act. Therefore, considering the intent of the legislature and the history of the new statute, recklessness and gross negligence also should not support personal liability under this statute.

Other than the items specifically excluded from the statute, it is important to note what the statute does not protect against. The statute does not itself eliminate or limit the personal liability of directors. The corporation must act by amending its articles of incorporation in order to shield its directors from liability.[49] A problem of construction arises from this provision since some corporations already include limitations of liability in their articles similar to those allowed by the statute. The question arises as to whether the grossly negligent action of a director, which was taken after the articles were amended to include the limitation of liability, but prior to the effective date of the statute, will be protected from liability. Essentially, can a corporation limit the liability of a director through its articles of incorporation prior to the effective date of this statute?

Fletcher seems to suggest this is possible although no persuasive authority for the proposition is cited.[50] The authority cited by Fletcher is a Colorado case, holding that article provisions relieving directors of liability for conflict of interest transactions "create no license to steal" and will not validate unfair transactions.[51] In any event, the new statute seems to presume that such provisions were invalid prior to its enactment.[52]

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46. RESTATEMENT (SECOND) OF TORTS § 500 (1965); *see* Hackbart v. Cincinnati Bengals, Inc., 601 F.2d 516, 524 (10th Cir. 1979).

47. *Hackbart*, 601 F.2d at 524.

48. Both recklessness and gross negligence require the knowledge or reasonable knowledge of a danger which is likely to occur. *Compare* BLACK'S LAW DICTIONARY, *supra* note 43, at 931-32 and RESTATEMENT (SECOND) OF TORTS, *supra* note 46, at § 500.

49. H.R. 1142, 56th Colo. Gen. Assembly, §§ 2, 4-6 (1987) (to be codified at COLO. REV. STAT. §§ 7-3-101(1)(u), 7-22-101(1)(r), 11-3-101(2.5), 11-41-112(1)(n)).

50. 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1047 (rev. perm. ed. 1986).

51. Irwin v. West End Dev. Co., 342 F. Supp. 687, 701 (D. Colo. 1972).

52. The argument would be that the legislature would not have passed a law allowing

Second, the new statute will not protect action of a director taken in a capacity other than that of a director.[53] For instance, if a director who is also the president of a corporation takes an action in his capacity as president rather than as director, he will be subject to monetary liability in the same manner as any other officer of a corporation.

Finally, the statute does not protect a board of directors against declaratory or injunctive relief or a claim for rescission. It only protects the director against monetary liability.[54] Therefore, a director may still incur personal attorney fees, and, if appropriate, be assessed attorney fees for the opposing party, in a suit not seeking monetary liability against the director personally.

Thus, the new statute should not be construed as the solution for all the problems presently faced by directors. It contains difficult constructional problems, such as whether gross negligence or recklessness will constitute acts not taken in good faith. Additionally, it does not protect directors from personal involvement in litigation seeking non-monetary damages. To the extent that the new statute prevents the occurrence of cases such as *Van Gorkom*, however, it is a step in the right direction to allow free and unencumbered decision-making by directors.

## II. Breach of Fiduciary Duties of Loyalty and Good Faith

### A. *Conflict of Interest Transactions*

Directors, as fiduciaries, owe their undivided loyalty to the corporation. In Colorado, this principle was first announced in *Kullgren v. Navy Gas & Supply Co.*[55] The court stated:

> A director of a corporation is in the position of a fiduciary; that is a principle deeply rooted in our law. He owes loyalty and allegiance to his corporation, a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of his corporation. He is held in official action, to the extreme measure of candor, unselfishness, and good faith. Those principles are rigid, essential and salutary.[56]

Historically, transactions between an interested director and his corporation have been considered voidable by the corporation.[57] The rule of strict voidability, however, has been slowly repudiated as courts

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the corporation to limit the liability of its directors if it believed that corporations already had such power.

53. H.R. 142, 56th Colo. Gen. Assembly §§ 2, 4-6 (to be codified at COLO. REV. STAT. §§ 7-3-101(1)(r), 7-22-101(1)(r), 11-3-101(2.5), 11-41-112(1)(n)).

54. *Id.*

55. 110 Colo. 454, 135 P.2d 1007 (1943).

56. *Id.* at 461, 135 P.2d at 1010 (quoting Turner v. American Metal Co., 36 N.Y.S.2d 356, 369 (1942), *rev'd*, 268 A.D. 239, 50 N.Y.S.2d 800 (1944), *appeal dismissed*, 295 N.Y. 822, 66 N.E.2d 591 (1946)).

57. *See* de La Garza, *Conflict of Interest Transactions: Fiduciary Duties of Corporation Directors Who are also Controlling Shareholders*, 57 DEN. U.L. REV. 609, 619-22 (1980); *see also*, Morgan v. King, 27 Colo. 539, 555, 63 P. 416, 421 (1900); Glengary Consol. Mining Co. v. Boehmer, 28 Colo. 1, 4, 62 P. 839, 840 (1900); Mosher v. Sinnott, 20 Colo. App. 454, 458, 79 P. 742, 743 (1905).

recognized that interested transactions may be beneficial to the corporation.[58] Today, most states, including Colorado, have adopted statutes repudiating the rule of strict voidability. These statutes provide that no contract or transaction between a corporation and one or more of its directors shall be either void or voidable because of the relationship or interest of the director if one of several conditions is met.[59]

Literally read, Colorado's statute allows a corporation and its directors to retain the benefits of an interested transaction if any of the three conditions are met. Thus, the director would not be liable on the basis of the interested transaction if (1) a majority of the disinterested directors voted for the transaction, (2) a majority of the shareholders, whether interested or not, voted for the transaction, *or* (3) it was fair to the corporation. Under this strict interpretation, an unfair transaction would not be voidable so long as one of the first two criteria was met. Accordingly, an interested director, who was also a majority shareholder, could engage in an interested transaction which was unfair to the corporation so long as he, as a majority shareholder, voted in favor of the transaction.

However, the correct analysis does not involve a strict interpretation of the statute for two reasons. First, the statute itself states that the transaction will not be voidable *solely* because it is an interested transaction.[60] If the transaction is both interested and unfair, a court of equity may void the transaction even though it is supported by disinterested director approval or shareholder approval.[61] Second, a transaction is not necessarily validated simply because one of the three criteria is met. The statute only states that the transaction *will not be voidable* solely on the basis that the transaction was interested.[62] It does not state that the

58. E. BRODSKY & N.P. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS § 3:01 (1984).

59. Colorado's statute provides:

> (1) No contract or transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers or have a financial interest, shall be void or voidable solely for that reason or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes, approves, or ratifies the contract or transaction solely because his or their votes are counted for such purpose if:
>
> (a) The material fact as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes, approves, or ratifies the contract or transaction by the affirmative vote of a majority of the disinterested directors, even though the disinterested directors are less than quorum; or
>
> (b) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically authorized, approved, or ratified in good faith by vote of the shareholders; or
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> (c) The contract or transaction is fair as to the corporation as of the time it is authorized, approved, or ratified by the board of directors, a committee thereof, or the shareholders.

COLO. REV. STAT. § 7-5-114.5(1) (1986).

60. *Id.*

61. *See* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

62. COLO. REV. STAT. § 7-5-114.5(1).

transaction is valid if the criteria are met. Although the technical requirements of the statute are fulfilled, transactions that are unfair and unreasonable may still be considered invalid.[63] Indeed, it would be incongruous for the courts to hold that a majority shareholder, simply by disclosing his purpose to injure the majority shareholders, could make his interested transaction not voidable under the statute.

If each interested transaction must be fair to the corporation and the minority shareholders, does the director or the challenging shareholder have the burden with respect to fairness? Under Colorado law, the burden has always been on the director to prove the fairness of his transaction with the corporation.[64] Section 7-5-114.5 does not alter that burden.[65] The fact that the transaction received disinterested director approval or shareholder approval does not and should not relieve the director of the burden of proving fairness to the corporation.[66]

In this regard, the American Law Institute has proposed changes to its Model Business Corporation Act, upon which Colorado's statute is based, which allows the burden of proof of fairness to shift to the shareholder under certain circumstances. In the case of disinterested *shareholder* approval, the burden will be on the party challenging the transaction to prove that the transaction constituted a waste of corporate assets.[67] In the case of disinterested *director* approval, the challeng-

63. Rivercity v. American Can Co., 600 F. Supp. 908 (E.D. La. 1984), *aff'd*, 753 F.2d 1300 (5th Cir. 1985)(a mere disclosure of impropriety does not remove the taint of unfairness nor allow director to take advantage of an opportunity at the expense of the corporation); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952)(a director is not allowed to obtain an unfair advantage or profit at the expense of the corporation).

64. Rosenthal v. Four Corners Oil & Minerals Co., 157 Colo. 1, 403 P.2d 758 (1965).

65. Lynch v. Patterson, 701 P.2d 1126 (Wyo. 1985)(applying WYO. STAT. § 17-1-136.1 (1977), which is substantially similar to Colorado's statute).

66. *Fliegler*, 361 A.2d at 221; *see also* Gelb, *Corporate Disloyalty — A Wyoming Case and the ALI Project*, 21 LAND & WATER L. REV. 111, 119-27 (1986).

67. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (Tent. Draft No. 5 1985). The draft reads as follows:

> (a) *General Rule*. A director or senior executive who enters into a transaction with the corporation (other than a transaction involving the payment of compensation) fulfills his duty of loyalty to the corporation with respect to the transaction if:
>
> (1) Disclosure concerning the conflict of interest and the transaction is made to the corporate decisionmaker who authorizes or ratifies the transaction; and
>
> (2) (A) the transaction is fair to the corporation when entered into; or
>
> (B) the transaction is authorized, following such disclosure, by disinterested directors, and could reasonably be believed to be fair to the corporation at the time of such authorization; or
>
> (C) the transaction is authorized or ratified, following such disclosures, by disinterested shareholders, and does not constitute a waste of corporate assets at the time of the shareholder action.
>
> (b) *Burden of Proof; Ratification of Defective Disclosure*. A party who challenges a transaction between the director or senior executive and the corporation has the burden of proof, except that the director or the senior executive has the burden of proving that the transaction is fair to the corporation if the transaction was not authorized by disinterested directors, or authorized or ratified by disinterested shareholders, following disclosure concerning the conflict of interest and the transaction. The disclosure requirements of § 5.02(a)(1) will be deemed to be satisfied at any time (but no later than a reasonable time after suit is filed chal-

ing party will have the burden of proving that the disinterested directors could not reasonably have believed the transaction to be fair to the corporation.[68]

B. *Usurpation of a Corporate Opportunity*

Under the corporate opportunity doctrine, a corporate officer or director must refrain from entering into activities in competition with the corporation or from acquiring assets in which the corporation has an interest. The general rule is stated as follows:

> An officer of a corporation is duty bound to purchase property for the corporation, or to refrain from purchasing property for himself, if the corporation has an interest, actual or in expectancy, in the property or if the purchase of the property by the officer or director may hinder or defeat the plans and purposes of the corporation's legitimate business.[69]

Before a director is prevented from acquiring such assets, the corporation must show an interest or expectancy in the property. To demonstrate this, the corporation must establish that not only did the property possess value to it, but that it had a practical, not a mere theoretical, use for it.[70] Further, the director owes no specific duty to use or pledge his personal funds to enable the corporation to take advantage of the opportunity.[71]

Merely because a corporation is negotiating for the purchase of the property does not establish an expectancy or interest. The corporation must show not only that it was interested in the property, but that it had a specific use for the property.[72] Thus, although a corporation would like to have an asset and is negotiating for it, the company does not have an opportunity capable of protection unless it has a defined use to which the property could be put. This is a very difficult standard for the corporation to meet, for it must show not only that it had the financial resources to acquire the opportunity but that it had a present intention to purchase, and that it could use the property once it exercised the opportunity.

The extent to which Colorado courts go to avoid the corporate opportunity doctrine is evidenced by *Carper v. Frost Oil Co.*[73] In this case, W.H. Malone, the corporation's attorney, one of its directors, and its general manager, was dispatched to Louisiana to negotiate for the

lenging the transaction) the transaction is ratified, following such disclosure, by the board, the shareholder, or the corporate decisionmaker who initially approved the transaction or his successor.

68. *Id.*; *see also* Gelb, *supra* note 66, for a full discussion of this topic.

69. Three G Corp. v. Daddis, 714 P.2d 1333, 1336 (Colo. App. 1986). Three G Corporation had brought an action against the former officer and controlling shareholder for recovery of damages and real property. However, as the court found, Three G Corporation had no intention to purchase the real property because of its financial condition. Thus, the corporation had no interest in the property. *Id.*

70. Colorado & Utah Coal Co. v. Harris, 97 Colo. 309, 313, 49 P.2d 429, 431 (1935).

71. *Three G Corp.*, 714 P.2d at 1336.

72. *See* Colorado & Utah Coal Co., 97 Colo. at 310-11, 49 P.2d at 430-31.

73. 72 Colo. 345, 211 P. 370 (1922).

purchase of oil lands for the corporation. During the trip, Malone purchased oil producing property for himself and the president of the corporation. When the corporation attempted to recover that property, the court determined that no corporate opportunity existed.[74] The court held that the evidence did not establish that the corporation could have acquired the same land at a reasonable price. Furthermore, the corporation could not be certain that it could have purchased the land even if Malone had not. Moreover, Malone was sent to Louisiana not as a purchaser of oil lands but as a general manager of the company. In that capacity, he was not authorized to purchase oil lands for the corporation. From these facts, the court determined that no corporate opportunity existed. Under current law in states other than Colorado, Malone would have been ordered to hold the oil property in constructive trust for the corporation.[75]

Under the widely accepted rule of corporate opportunity:

> [I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.[76]

Applying this standard to the *Frost Oil* case, the oil producing properties were in the line of business of the corporation, it had an interest in the property, and the interest of the corporation and the officer were in conflict because of the officer's purchase. Under the *Guth v. Loft, Inc.*[77] test, the interest of the corporation need not be actual and practical but need only be "reasonable."[78] Colorado, therefore, has departed from the general rules of the corporate opportunity doctrine, and will allow directors wide latitude in choosing the properties that they buy.

Colorado case law also prohibits the director from engaging "in enterprises directly in competition with, and necessarily having injurious, crippling, or detrimental effect upon, the corporation's business."[79] This duty is similar to the corporate opportunity doctrine since a competing business takes away opportunities that a corporation ordinarily would have. Only one Colorado case, however, has affirmatively imposed this duty upon a director.[80] It is unclear to what extent Colorado

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74. *Id.* at 348-49, 211 P. at 371.

75. *See* Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71 (Minn. 1974)(opportunity and any property acquired becomes subject to a constructive trust for the benefit of the corporation).

76. Guth v. Loft, Inc., 23 Del. Cas. 255, 263, 5 A.2d 503, 511 (1939).

77. *Id.*

78. *Id.*

79. Williams v. Stirling, 40 Colo. App. 463, 466, 583 P.2d 290, 292 (1978).

80. *Id.*; *see also* Colorado & Utah Coal Co. v. Harris, 97 Colo. 309, 49 P.2d 429 (1935) (if the director owes no duty to act or contract for the corporation with respect to property in question, he is at liberty to act for himself).

courts will enforce this fiduciary duty not to compete.

## III. Statutory Liability

In Colorado, under section 7-5-114, a director will be liable to the corporation if one of four circumstances are found to exist:[81] (1) if the director allows the corporation to pay dividends while it is insolvent; (2) if the director allows the corporation to purchase its own shares when it has no surplus to do so; (3) if the director allows the corporation to distribute assets to its shareholders in liquidation without providing for known debts; and (4) if the director allows the corporation to make a loan to the director of the corporation without the affirmative vote of two-thirds of the shareholders.[82]

Under section 7-5-114(1)(a), if a director votes for or assents to a dividend or other distribution to the corporation's shareholders "contrary to the provisions of this code or contrary to any restrictions contained in the articles of incorporation," he will be liable to the corporation jointly and severally with the other directors voting for the dividend or distribution.[83] A dividend would be contrary to the provi-

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81. Colo. Rev. Stat. § 7-5-114(1) (1986). Section 7-5-114, in part, states:

> *Liability of Directors on Certain Cases.* (1)In addition to any other liabilities, a director shall be liable in the following circumstances unless he complies with the standard provided in this code for performance of duties of directors:
>
> (a) A director who votes for or assents to the declaration of any dividend or other distribution of the assets of a corporation to its shareholders contrary to the provisions of this code or contrary to any restrictions contained in the articles of incorporation shall be liable to the corporation, jointly and severally with all other directors so voting or assenting, for the amount of such dividend which is paid or the value of such assets which are distributed in excess of the amount of such dividend or distribution which could have been paid or distributed without a violation of the provisions of this code or restrictions in the article of incorporation.
>
> . . . .
>
> (c) A director who votes for or assents to any distribution of assets of a corporation to its shareholders during the liquidation of the corporation without the payment and discharge of, or the making of adequate provision for, all known debts, obligations, and liabilities of the corporation shall be liable to the corporation, jointly or severally with all other directors so voting or assenting, for the value of such assets which are distributed, to the extent that such debts, obligations and liabilities of the corporation are not thereafter paid and discharged.
>
> (d) The directors of a corporation who vote for or assent to the making or guaranteeing of a loan to a director of the corporation (unless the voting procedure specified in § 7-3-101(1)(f) has been followed), or the making or guaranteeing of any loan to a director secured by shares of the corporation, shall be jointly and severally liable to the corporation for the amount of such loan or guarantee until the repayment thereof.
>
> (2) Any director against whom a claim is asserted under this section for the payment of a dividend or other distribution of assets of a corporation and who is held liable for such claims shall be entitled to contribution from the shareholders who accepted or received any such dividend or assets, knowing such dividend or distribution to have been made in violation of this code, in proportion to the amounts received by them.
>
> (3) Any director against whom a claim is asserted under this section is entitled to contribution from the other directors who voted or assented to the action upon which the claim is asserted and who could be liable under the circumstances stated in subsection (1) of this section.

82. *Id.* at § 7-5-114(1).

83. *Id.*

sions of the code if it were made when the corporation was insolvent, or when payment of the dividend would render the corporation insolvent, or when the declaration or payment of the dividend would be contrary to any restrictions in the articles of incorporation.[84]

The directors of the corporation are absolutely liable for violations of this and the other provisions of section 7-5-114.[85] The director's only method of avoiding liability is to prove one of the statutory defenses.[86] In the case of dividends, the director would have to prove that one of the exceptions to the proscription against dividends while insolvent was met.[87]

Under section 7-5-114(1)(b), a director who votes for or assents to a purchase by the corporation of its own shares "contrary to the provisions of this code" is liable to the corporation jointly and severally with the other directors voting for the purchase of any amount in excess of the amount that could have been paid in accordance with the provisions of the statute.[88] Generally, the corporation may purchase its own shares only to the extent that it has unreserved and unrestricted surplus.[89] No showing of fraud is required to impose liability under this section.[90] The liability of the directors, however, is limited. The directors are only liable to the extent that the amount paid upon the repurchase exceeds the amount statutorily allowed.[91] In fact, under all of the statutory liability sections, the directors are only liable to the extent that their actions exceed the provisions of the code. Under prior law, a violation of

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84. *Id.* at § 7-5-110(1) (1986). This statutory rule is subject to several provisions which limit its effect. First, corporations engaged in the business of exploiting natural resources may pay dividends out of depletion reserves, so long as those dividends do not reduce the net assets of the corporation below an amount required to pay preferred stockholders. *Id.* at § 7-5-110(1)(b). Second, the corporation may declare a dividend in its own treasury shares. *Id.* at § 7-5-110(1)(c). Third, any corporation may pay dividends in excess of its stated capital, so long as that dividend does not reduce the net assets of the corporation below an amount equal to stated capital plus any amounts other than stated capital sufficient to liquidate the interest of preferred shareholders. *Id.* at § 7-5-110(1)(d). Finally, the company may make a dividend of its own authorized but unissued shares out of any unreserved and unrestricted surplus, so long as the board assigns to the stated capital the par value or the assessed value of any shares so issued. *Id.* at § 7-5-110(1)(e)(I).

85. Security Nat'l Bank v. Peters, Writer and Christensen, Inc., 39 Colo. App. 344, 569 P.2d 875 (1977)(under the present statutes, damages are based directly upon injuries suffered by corporation as opposed to a liquidated measure without regard to injury).

86. *Id.*

87. *See supra* note 81 and accompanying text.

88. COLO. REV. STAT. § 7-5-114(1)(b) (1986).

89. *Id.* at § 7-3-102(1) (1986). Once again, this general restriction is subject to several exceptions. Section 7-3-102(3) states:

> Notwithstanding the limitation of subsection (1) of this section, a corporation may purchase or otherwise acquire its own shares for the purpose of:
> (a) Eliminating fractional shares;
> (b) Collecting or compromising indebtedness to the corporation;
> (c) Paying dissenting shareholders entitled to payment for their shares under the provisions of this code;
> (d) Effecting, subject to the other provisions of this code, the retirement of its redeemable shares by redemption or by purchase so as not to exceed the redemption price.

90. *Security Nat'l Bank*, 39 Colo. App. 344, 569 P.2d 875.

91. *See supra* note 81 and accompanying text.

provisions substantially similar to section 7-5-114 would have subjected the director to liability for *all* debts of the corporation.[92] The prior statute was considered penal in nature while the current statute is considered remedial.[93]

The third method of statutory liability is self-explanatory. If the directors allow the corporation to liquidate and distribute assets to the shareholders without first providing that all of the debts of the corporation are satisfied, then the directors will be liable for those debts not paid.[94] In essence, the directors must ensure that the corporation retains assets sufficient to satisfy all known obligations of the corporation.[95]

The final method by which the directors may become liable is when the directors allow the corporation to make or guarantee a loan to a director in violation of the statute, or make or guarantee a loan to a director secured by shares in the corporation.[96] Unless the articles of incorporation state otherwise, a loan to a director must be affirmed by a vote of two-thirds of the outstanding shares entitled to vote.[97] It is important to note that if the directors make a loan to another director secured by shares of the corporation, the directors are personally liable on the debt until it is paid, regardless of whether the shareholders voted in favor of the loan.[98]

When any of the above provisions are violated, creditors of the corporation, as a group, may sue to recover the funds.[99] While each of the above provisions state that the liability of the director is "to the corporation," the courts have reasoned that the creditors, as a group, may enforce the rights of the corporation so that they may have a fund from which to satisfy their obligations.[100] This does not mean that any creditor may sue for a violation of the above provisions. A creditor may not sue individually since such a suit would be to the detriment of other creditors.[101] While the creditors must sue as a whole, they need not prove that the violation actually caused their damages.[102] Liability is predicated solely upon violation of the statute, and not upon damages caused thereby.

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92. *See* COLO. REV. STAT. § 7-5-110 (1986), § 31-5-10 (1963), § 31-31-10 (1953 & Perm. Supp. 1960), § 31-2-12 (1953); Guarantee Reserve Life Ins. Co. v. Holzwarth, 148 Colo. 366, 366 P.2d 377 (1961); Fitzgerald v. Marshall, 161 F. Supp. 470 (D. Colo. 1958).

93. *Security Nat'l Bank*, 39 Colo. App. at 349, 569 P.2d at 879.

94. COLO. REV. STAT. § 7-5-114(1)(c) (1986).

95. Ficor, Inc. v. McHugh, 639 P.2d 385, 394-95 (Colo. 1982).

96. COLO. REV. STAT. § 7-5-114(1)(d).

97. H.R. 1142, 56th Colo. Gen. Assembly § 2 (1987) (to be codified at COLO. REV. STAT. § 7-3-101(1)(f)).

98. *See supra* note 81 and accompanying text.

99. *Ficor, Inc.*, 639 P.2d at 393.

100. *Id.*

101. *Id.* (distinguishing Rosebud Corp. v. Boggio, 39 Colo. App. 84, 561 P.2d 367 (1977)).

102. *Ficor, Inc.*, 43 Colo. App. 409, 611 P.2d 578 (1980), *aff'd*, 639 P.2d 385 (Colo. 1982).

## CONCLUSION

Corporate directors may face liability from several different angles. The four that have been discussed in this article — due care, conflict of interest, usurpation of corporate opportunity and statutory liability — are the most common. The new Colorado statute can give directors some security with regard to violations of the duty of due care. They now know that they may not be held personally liable for their negligent exercise of judgment. The question remains whether they will be protected if they are grossly negligent or reckless. In conflict of interest situations, the trend is towards favoring such transactions, provided that they are fair to the corporation. If there has been disinterested director or disinterested shareholder approval, the trend is to place the burden of proving unfairness upon the challenging party. Colorado seems to refuse to invoke the corporate opportunity doctrine unless the circumstances are particularly egregious. Directors should be aware that they must give the corporation a chance to purchase the property although they may proceed with their own acquisition if the corporation has no expectancy or interest, and the director need not pledge his own funds to aid the corporate acquisition. The statutory liability of directors is straightforward in prohibiting them from committing certain acts. The liability is absolute, if there has been an injury to the corporation.