

The board of directors of a commercial real estate development corporation consists of the corporation's chief executive officer (CEO) and three other directors, who are executives at various other firms.

The corporation owns a commercial office tower, the value of which is approximately 10 percent of the corporation's total holdings. The corporation uses one floor of the tower as its corporate headquarters, but it wants to vacate that floor as soon as it locates suitable replacement space.

Two years ago, the board obtained an independent appraisal of the tower, which indicated a fair market value of between \$12 and \$15 million. After considering that appraisal, the board authorized the corporation's CEO to seek a purchaser for the tower.

The CEO immediately showed the tower to several sophisticated real estate investors and received offers ranging from \$8 million to \$13 million. The CEO decided that these offers were insufficient, and after he reported back to the board, no further action to sell the tower was taken.

Two months ago, the CEO and the other three directors of the corporation formed a limited liability company (LLC) in which each holds a 25 percent ownership interest.

One month ago, the corporation's board unanimously authorized the corporation's sale of the tower to LLC for \$12 million. The minutes of the board's meeting at which the tower sale was authorized reflect that the meeting lasted for 10 minutes and that the only document reviewed by the corporation's directors was the two-year-old appraisal of the tower.

The minutes of the board's meeting further state that the transaction was to be carried out with "a friendly company so that the corporation will have time to relocate to a new headquarters" and that the board "authorized the transaction because the \$12 million price is toward the high end of the range of offers received in the past from sophisticated real estate investors and is within the range of fair market values listed in the appraisal."

After the board's authorization of the tower sale, the corporation entered into a contract to sell the tower to LLC. The board did not seek shareholder approval of the transaction.

A non-director shareholder of the corporation is upset with the board's decision authorizing the sale of the tower to LLC. The shareholder believes that the corporation could have obtained a higher price for the tower.

1. Does the business judgment rule apply to the board's decision to have the corporation sell the tower to LLC? Explain.

2. Did the directors breach their fiduciary duties by authorizing the tower sale? Explain.

Copyright © 2015 by the National Conference of Bar Examiners. All rights reserved

Question Presented

A corporation's board is its CEO plus three outside directors. Two years ago an independent appraisal valued the corporation's office tower at **\$12 to \$15 million**; the CEO sought buyers, got offers of \$8 to \$13 million, and **rejected \$13 million as too low**.

← stale \$12 to \$15M appraisal; a \$13M offer already rejected as insufficient

The CEO and the three directors then **formed an LLC, each owning 25%**. One month later the board unanimously authorized the corporation to **sell the tower to that LLC for \$12 million**.

← directors on both sides of the sale = conflicting-interest transaction

The authorizing meeting lasted **10 minutes** and the only document reviewed was the **two-year-old appraisal**. The board **did not seek shareholder approval**. A non-director shareholder objects, believing a higher price was available.

← 10-minute, stale-data decision; no disinterested or shareholder cleansing

Questions: (1) does the **business judgment rule** apply, and (2) did the directors **breach their fiduciary duties**?

← the BJR presumption is lost when a conflict is not cleansed

Issue 1: Director's Conflicting-Interest Transaction

Issue. Whether the sale of the tower to the directors' LLC is a director's conflicting-interest transaction.

threshold for the BJR question

Rule. G/R: A director's conflicting-interest transaction is one in which the corporation is on one side and a director, or an entity in which a director has a material financial interest, is on the other, and the director knows of the interest. Such a transaction is not automatically void, but it loses the ordinary business-judgment presumption unless it is cleansed.

self-dealing; interest on both sides

Analysis. Here, all four directors own 25% of the LLC that is buying the tower, so every director has a material financial interest and sits on both sides of the sale. This is a classic conflicting-interest, self-dealing transaction.

every director is interested

Conclusion. Therefore, the tower sale is a director's conflicting-interest transaction.

sets up loss of the BJR

Issue 2: Does the Business Judgment Rule Apply?

Issue. Whether the business judgment rule applies to the board's decision to sell the tower to the LLC.

Question 1.

Rule. G/R: The business judgment rule presumes that disinterested directors who act on an informed basis, in good faith, and in the honest belief the act serves the corporation are not liable for the decision. The presumption is unavailable for a conflicting-interest transaction unless it is cleansed by approval of disinterested and informed directors, approval of disinterested shareholders after disclosure, or proof that the transaction was fair to the corporation.

no presumption without cleansing

Analysis. Here, every director was interested, so there was no disinterested-director approval; the board sought no shareholder approval; and, as shown below, the deal was not shown to be fair. None of the cleansing paths is satisfied, so the protective presumption does not attach and the sale is reviewed for fairness.

all three cleansing routes fail

Conclusion. Therefore, the business judgment rule does not apply.

answer to Question 1

Issue 3: Duty of Loyalty and Fairness

Issue. Whether the directors breached the duty of loyalty by authorizing the sale.

Question 2, part one.

Rule. G/R: A director owes a duty of loyalty and may not use corporate dealings to profit at the corporation's expense. A self-dealing director bears the burden of proving the transaction was fair: a fair price comparable to an arm's-length deal, reached through fair dealing and an appropriate process.

burden shifts to the interested directors

Analysis. Here, the directors argue \$12 million was within the appraisal range and the old offer range and bought time to relocate. But the appraisal and offers were two years old, the board had already rejected a \$13 million offer as insufficient, it obtained no new valuation and solicited no other buyers, and it decided in 10 minutes. Neither a fair price nor a fair process is shown, so the interested directors cannot carry their burden.

stale price + no market test + rushed = not fair

Conclusion. Therefore, the directors likely breached the duty of loyalty.

loyalty breach

Issue 4: Duty of Care

Issue. Whether the directors breached the duty of care by authorizing the sale.

Rule. G/R: A director must act in good faith, with the care an ordinarily prudent person in a like position would use, and must become reasonably informed before deciding. Failing to inform oneself, that is, gross negligence in the decision process, breaches the duty of care.

Analysis. Here, the board relied only on a two-year-old appraisal, sought no current valuation or competing bids, and approved a multimillion-dollar related-party sale in a 10-minute meeting. That is an uninformed, grossly negligent process.

Conclusion. Therefore, the directors likely breached the duty of care as well.

Question 2, part two.

process-focused; gross negligence standard

no reasonable investigation

care breach

Step-by-Step: Reviewing a Self-Dealing Board Sale

First ask whether the deal is a conflicting-interest transaction; that determines whether the BJR applies.

1. Is it a director's conflicting-interest transaction?

→ All four directors own the buying LLC; they are on both sides. **conflicting-interest tx**



2. Was it cleansed?

→ No disinterested-director vote, no shareholder approval, not shown fair. **BJR does not apply**



3. Was the price and process fair? (loyalty)

→ Stale appraisal, a \$13M offer already rejected, no market test. **loyalty breached**



4. Were the directors informed? (care)

→ A 10-minute meeting on one two-year-old document. **care breached**



Bottom line

→ The BJR does not apply, and the directors likely breached both duties.