

FIDUCIARY DUTY OF CORPORATE DIRECTORS

If you are a member of the board of directors of a Louisiana corporation, you must act as a fiduciary to the corporation and its shareholders. The fiduciary relationship exists between the directors of for profit corporations and nonprofit corporations.

Anyone who accepts the responsibility to serve as a director should understand the scope of a director's fiduciary duties to the corporation and its shareholders. As a fiduciary, directors must perform their duties in good faith, and with that diligence, care, judgment and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

Satisfying the obligation created by the fiduciary relationship can be quite simple. Common sense will prevent a director from entering into a self-dealing transaction which gives the director an unfair financial advantage to the corporation's detriment.

However, situations often arise where satisfying the fiduciary duties is difficult for a director. For instance, a corporation's directors are charged with the responsibility of overseeing the officers that control the corporation's day to day operations. If the officers are not managing the daily operations properly, the board has the responsibility to take affirmative action to address the problem. This may not seem difficult, but when the directors are sued for breach of their fiduciary duties, the judge and jury determining whether or not they acted properly have the benefit of hindsight.

Another common occurrence is for directors to rely on experts in making business decisions. The most common is relying on a CPA's report regarding the corporation's financial statements. Assuming the directors have no reason to doubt the CPA's competence, the director's may rely on the CPA's report without concern. However, if a corporation's board is considering entering into a new line of business, the board may rely on various business advisors. Although the board might be justified in relying on the advice it receives, the directors are obligated to question whether the business advisors are qualified. Making a determination regarding someone's qualifications is not always as simple as it seems.

The need for awareness of and adherence to the fiduciary duties has been exemplified by the numerous corporate scandals over the last few years. Whether the director of a large public corporation or a small closely held corporation, the duties owed to the corporation and its shareholders are the same and should not be taken lightly.

Brett N. Brinson
225.382.3457
brett.brinson@keanmiller.com



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ENFORCEABILITY OF PURCHASE OF STOCK ON CREDIT

When organizing a new corporation, limited liability company or partnership, one thing the organizers must address is how to capitalize the entity. A recent case¹ involving a corporation illustrates one problem that may arise if the requirements of Louisiana law for the capitalization of a new entity are not strictly followed.

This Louisiana 5th Circuit Court of Appeal case involved the enforceability of the purchase of shares of stock from a corporation via a promissory note. The organizers of the new corporation approached one Mr. Kuebel in an effort to get Mr. Kuebel to invest in the new corporation. Mr. Kuebel signed a promissory note to the corporation in exchange for shares in the new corporation. Later, Mr. Kuebel sold some of his shares and made partial payments of interest and principal on the promissory note. Later, the corporation failed and Mr. Kuebel stopped making payments on the note. The corporation then sued Mr. Kuebel on the balance due.

The Louisiana Business Corporation Law sets forth the permissible ways to pay for stock issued by a corporation. With limited exceptions, payment for shares must be made in cash, property or services actually rendered to the corporation, before the shares are issued. Cash consideration for shares may not be paid by the purchaser's promissory note or uncertified check; and in case of delivery of such a note or check in payment for shares, the shares shall not be issued until the note or check has been paid in full.

The question before the court was whether the transaction was void from the beginning, and therefore the promissory note would not be enforceable by the corporation, or whether the transaction was only "relatively null" and therefore enforceable by the corporation if the corporation desired to enforce it. A contract is absolutely null (*i.e.*, void) when it violates a rule of public order, as when the object of the contract is illicit or immoral. On the other hand,

a contract is relatively null when it violates a rule intended for the protection of private parties. The relative nullity may be invoked only by those persons intended to be protected by the statute in question. The court determined that the purpose of the statute is to prevent corporations from issuing stock without receiving full value and thereby diluting the holdings of innocent stockholders and causing reliance by creditors on false or nonexisting capital resulting from the issuance of watered down stock. The statute was not intended to protect a stock purchaser.

The court ultimately decided that the stockholder (Mr. Kuebel) did not have the right to claim that the transaction was invalid. Therefore, the promissory note was enforceable.

This case illustrates one difference between corporations on the one hand and partnerships and limited liability companies on the other hand. Interests in partnerships and limited liability companies may be issued in exchange for promissory notes, but stock in a corporation may not be issued in exchange for a promissory note.

Although in this case it was in the interest of the corporation to enforce the promissory note and the issuance of the shares, there may be cases in which the corporation elects to void the transaction and cancel the promissory note and the stock. Both organizers of corporations and persons investing in corporations should be aware of this rule of law so as not to be caught in the trap illustrated by this recent case.



Mack Gregorie
225.382.3411
mack.gregorie@keanmiller.com

1. *Hibernia National Bank, as Trustee vs. Kenneth Kuebel*, 03-CA-1131 (La. App. 5 Cir. 3/9/04)