BUSINESS LAW **TODAY**
The ABA Business Law Section's Online Resource

Small Business and the Corporate Opportunity Doctrine

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The corporate opportunity doctrine prohibits a corporate fiduciary from exploiting an opportunity related to the corporation's business unless he or she first offers that opportunity to the corporation. There is no question whether the doctrine applies to small businesses. Indeed, countless cases confirm that it does. The more interesting question is how it applies, given the unique characteristics of many small businesses. In the small-business setting, challenges may arise as to whom, if anyone, the opportunity must be disclosed; whether the holder of a distributional interest in the business can challenge the business' decision to turn down an opportunity; what happens when basic corporate formalities are not followed; and whether the persons taking the opportunity have violated any duty to the business' creditors. This article explores those issues.

Rule of Disclosure

The officers, directors, and shareholders of a small business owe a fiduciary duty to their company that includes the obligation to refrain from usurping so-called corporate opportunities that rightfully belong to the company. A corporate opportunity exists when a proposed activity is reasonably related to the company's present or prospective business and is one in which the company has the capacity to engage.

The corporate opportunity doctrine is, in essence, a rule of disclosure: When a company's fiduciary wants to take advantage of an opportunity that is in the company's line of business, "the fiduciary must first disclose and tender the opportunity" to the company. As the Supreme Court of Illinois explained in *Kerrigan v. Unity Savings Association*, 58 Ill. 2d 20 (1974), "[I]f the doctrine of business opportunity is to possess any vitality, the corporation or association must be given the opportunity to decide, upon full disclosure of the pertinent facts, whether it wishes to enter into a business that is reasonably incident to its present or prospective operations."

Despite the heavy emphasis the doctrine places on disclosure, the law of some states does not require the formal presentation of a potential opportunity when the company does not have any interest in pursuing the opportunity or the financial ability to engage in it. In *Broz v. Cellular Information Systems., Inc.*, 673 A.2d 148 (Del. 1996), for example, the Supreme Court of Delaware held that presentation is a form of safe harbor, "which removes the specter of a post hoc judicial determination that the director or officer has improperly usurped a corporate opportunity." The courts of other states, including George, Rhode Island, and Connecticut have adopted similar approaches.

But this "safe harbor" is not universal. Illinois courts, for instance, view the failure to disclose a corporate opportunity as undermining the "prophylactic purpose" of the rule. In such circumstances, the failure to disclosur "forecloses" the interested fiduciary from exploiting the opportunity, even in cases where he or she reasonably believes the company is incapable of claiming the opportunity. Thus, in *Kerrigan*, the court held that defendant-directors' belief that their savings and loan association was precluded by law from capitalizing on an opportunity in the insurance business could not "operate as a substitute for [their] duty to present the question" to the corporation for independent evaluation.

Application to Small Businesses

Disclosure of a corporate opportunity is, at least in theory, a simple process: The interested fiduciary tenders the opportunity to the company, fully discloses all pertinent information, and disinterested fiduciaries then evaluate whether the company should engage in the opportunity. The problem, however, is that this process does not always neatly apply in the context of a small business, where (1) each fiduciary may want to pursue the opportunity for himself; (2) distributional interests may be held by someone other than an owner; (3) corporate formalities are not always observed; and (4) the company may be insolvent or nearly insolvent.

Absence of Disinterested Fiduciaries

An interesting practical question can arise in small businesses when every owner knows about or is personally interested in the corporate opportunity. What happens when there are no disinterested officers, directors, or owners to evaluate an opportunity on behalf of the business? Must the opportunity be presented to a disinterested third party for independent evaluation?

In re Tufts Electronics, Inc., 746 F.2d 915 (1st Cir. 1984) (Massachusetts law), was one of the first cases from any jurisdiction to consider this issue in detail. There, the former president, director, and sole shareholder (Martin) of a bankrupt corporation appealed from the judgment of the district court that had affirmed the imposition of a constructive trust on property he personally owned. Martin had acquired the property in part with corporate funds, and then leased the property back to his corporation. The bankruptcy and district courts had found that, under the corporate opportunity doctrine, Martin had breached his duty to the corporation by using corporate funds to help purchase the property for himself rather than for the corporation.

The First Circuit Court of Appeals disagreed. Emphasizing that Martin was the sole shareholder, director, and president of the company, the appellate court held that the corporate opportunity doctrine was inapplicable because Martin's actions "necessarily involve[d] the knowledge and assent of the corporation." The court further recognized that even though Martin and the corporation were separate persons, "absent some element of defrauding, Martin was not obliged, in every action he took, to prefer the corporation's interests to his own. No one could operate a corporation solely on such a basis."

A number of courts in other jurisdictions have applied similar reasoning to reach the same conclusions. For example, in *L.R. Schmaus Co. v. Commissioner of Internal Revenue*, 406 F.2d 1044 (7th Cir. 1969) (Wisconsin law), the court found that "if an officer of the company owns all the stock, he may use the corporate assets as he sees fit and there can be no misappropriation of corporate assets by him." Likewise, in *Mediators, Inc. v. Manney*, Adv. 93 Civ. 2304 (CSH), 1996 WL 297086, at *10 (S.D.N.Y. June 4, 1996) (New York law), the court dismissed a corporate opportunity claim because the corporation had "necessarily consented" to diversion of its assets through the acts of its sole owners and officers, who were accused of usurping opportunity. To the same effect is *In Committee of Unsecured Creditors of Specialty Plastic v. Doemling*, 127 B.R. 945, 952 (Bankr. W.D. Pa. 1991), where the court reversed a usurpation finding because the corporate opportunity doctrine was "difficult to apply" to a small business where "there were no other shareholders to whom [the sole fiduciary] owed a duty of disclosure and loyalty." And in *Pittman v. American Metal Forming Corp.*, 649 A.2d 356 (Md. 1994), the court, upon surveying the law in other jurisdictions, held that the sole shareholder could not not liable for usurpation of a corporate opportunity in the absence of any harm to creditors.

The logic of these cases is compelling. After all, as the Seventh Circuit recognized in *In re Doctors Hospital of Hyde Park*, 474 F.3d 421 (7th Cir. 2007), a sole shareholder can "hardly . . . defraud[] himself or breach[] a fiduciary duty to himself." Other courts have reached the same conclusion, as in *In re Hearthside Baking Co., Inc.*, 402 B.R. 233 (Bankr. N.D. Ill. 2009) (a "sole shareholder does not owe a fiduciary duty against its own corporation and cannot breach a fiduciary duty to itself"); and *In re Gordon Car & Truck Rental, Inc.*, 65 B.R. 371, 376 (Bankr. N.D.N.Y. 1986) (corporate opportunity doctrine inapplicable where sole stockholders and officers "cannot be accused of withholding information from *themselves*").

A minority of courts have reached the same result through a different-but-related doctrine—ratification. For example, in *In re Safety International*, 775 F.2d 660 (5th Cir. 1984), the Fifth Circuit held that "even when [a] transaction is detrimental to the corporation, no cause of action will lie if all of the [interested] shareholders have ratified the transaction." According to the court, "[e]ven if [the directors/shareholders] breached their duty to [the corporation] by taking the purchase option in their own names, no party to this action can complain of the breach. There are no non-consenting shareholders."

In short, where the usurpation of a corporate opportunity from a small business necessarily involves the "knowledge and assent" of the corporation (*Tufts*) or ratification by the shareholders (*Safety International*), there can be no claim under the corporate opportunity doctrine. With the exception of insolvency, explained below, this rule is true even where the consenting or ratifying fiduciaries are personally interested in the opportunity.

Transfer of Distributional Interests

Many small businesses are structured as limited liability companies. A distributional interest in a limited liability company ordinarily is a transferable asset, and it is not uncommon for a member of an LLC to transfer his or her distributional interest to a person who has no ownership interest in the business, such as a creditor. That raises the question of how, if at all, such a transfer affects a fiduciary's disclosure obligations under the corporate opportunity doctrine.

The transfer of a distributional interest does not confer an ownership interest or a fiduciary relationship with the company's other members. The consequences of this are twofold. First, the transferee of a distributional interest is not entitled to exercise the rights of a member, which include challenging—either directly on its own behalf or derivatively on behalf of the company—the supposed usurpation of a corporate opportunity. Second, as a corollary, corporate fiduciaries are not obligated to disclose the opportunity to some independent third party for evaluation merely because a non-owner holds a distributional interest in the company.

In fact, the authors of this article recently defended the sole members of a limited liability company, a husband and wife, against a claim that the husband had usurped an opportunity of the LLC in precisely this situation. The usurpation claim was brought by a judgment creditor of the wife who had used part of its judgment to acquire her distributional interest in the company. The creditor argued that the husband could not take a corporate opportunity without first formally tendering the opportunity to the company and having it evaluated by some independent person. According to the creditor, if the husband had not taken the corporate opportunity for himself, the company would have profited from the opportunity and would have had assets to distribute, which would have benefitted the creditor. The trial court rejected the creditor's argument. It found that the husband had no fiduciary duty to a creditor holding his wife's distributional interest in the LLC and, further, that the husband and wife, both of whom knew of the corporate opportunity, had no obligation to formally present the opportunity to the corporation or to submit it to an independent third party for evaluation. Accordingly, the court dismissed the claim.

Failure to Adhere to Corporate Formalities

The failure to adhere to basic corporate formalities, such as documenting meetings of the board of directors or recording shareholder votes, unfortunately is commonplace among many small businesses. This oversight is often a product of the cost of compliance, the casual approach to operations taken by many small business owners, or simple ignorance of proper procedure. Whatever its cause, a lack of documentation can lead to significant problems where corporate opportunities are concerned.

For example, take a situation where every shareholder knows of a corporate opportunity, and agrees that the business should not pursue it. Some of the shareholders decide to take the opportunity for themselves, but they fail to document any sort of formal presentation of the opportunity to the business or official vote of the officers or directors. Sometime thereafter, perhaps because the business opportunity turns out to be better than expected or because the shareholders have a falling out over an unrelated issue, the shareholders who did not take the corporate opportunity bring a lawsuit against those who did claiming that the opportunity was not fully or properly disclosed to the corporation.

What might have been quickly resolved with proper documentation had corporate formalities been observed now presents a thorny factual issue. Was the opportunity actually tendered to the corporation? Were the pertinent facts fully disclosed? Did the board or shareholders in fact agree that the business should not pursue it? The fact that the answers to these questions cannot be found in board meeting minutes or shareholder ballots could mean the difference between a speedy resolution of the claims on a motion to dismiss and costly, time-consuming discovery. In short, the failure to adhere to corporate formalities that so often plagues small businesses can make a mountain out of a mole hill in the context of a usurpation claim.

Insolvency

An additional consideration is whether the small business was solvent at the time of the challenged transaction. This is important because, when a company is insolvent, the duties of its fiduciaries—including the duty to disclose corporate opportunities—extend to its creditors. As the Supreme Court of Delaware recently explained in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007):

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

And once an insolvent company files for bankruptcy, its creditors have standing to complain about the usurpation of corporate opportunities, and they often do. A small business is no different than any larger company in this respect.

In re McCook Metals, LLC, 319 B.R. 570 (Bankr. N.D. Ill. 2005), illustrates the point. There, the bankruptcy trustee of a closely-held aluminum processor (McCook) brought suit against McCook's principal (Lynch) for, among other things, transferring an opportunity to acquire a smelter away from McCook. As part of his defense, Lynch argued that he had breached no duty to McCook because he had disclosed the opportunity to purchase the smelter to McCook's other members, who agreed that a separate entity should make the acquisition. The bankruptcy court rejected this argument because the duty involved was to McCook's creditors, not its other members. According to the court, "That the other member owners agreed to transfer the [smelter] opportunity away from McCook makes them jointly and severally liable, with Lynch, for a breach of duty to the creditors; it does not excuse Lynch."

Similarly, in *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998 (3d Cir. 1973), the president and majority shareholder (Hoffman) of a family-owned business arranged to personally buy a mortgage at a discount when the opportunity to do so rightfully belonged to his corporation. The corporation filed for bankruptcy hours after the purchase was complete. The district court found that Hoffman had not breached a duty because the acquisition was agreed to with the "knowledge and approval of all of [the corporation's] officers, directors and shareholders," i.e., Hoffman and his sons. The Third Circuit rejected this logic, finding that it could not "countenance such a narrow view of the scope of Hoffman's fiduciary duty. As an officer, director and principal stockholder of an insolvent corporation . . . Hoffman was duty bound to act with absolute fidelity to both creditors and stockholders." The court explained that because Hoffman had arranged the transaction with knowledge of his corporation's insolvency, approval by the fiduciaries did not free him to appropriate corporate opportunities to the detriment of the corporation's creditors. Corporate assent did not, therefore, relieve Hoffman of his fiduciary duties, and the "opportunity should have been disclosed to the receiver as representative of the creditors."

Conclusion

The corporate opportunity doctrine can pose significant challenges to the owners of small businesses. These problems can be exacerbated by the failure to observe corporate formalities and, in particular, whenever the corporation is insolvent and the rights of creditors are at stake. Still, when insolvency is not an issue, there is case law support for the notion that small business owners have the right to treat their business as their own, including by taking corporate opportunities for themselves personally.

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