

## *Voting Rights of Shareholders Versus Directors*

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*Question:* If a board of directors wants to take a significant action such as selling a corporation's business or real estate or acquiring the assets or stock of a competing business, can the directors approve such an action by themselves or must it be approved by the shareholders?

*Answer:* The shareholders must approve the action if it falls within the specific voting rights of the shareholders. Otherwise, the directors can approve the action without shareholder approval. In certain circumstances, the directors may want to obtain shareholder approval even if such approval is not required by California law.

Most private corporations have a relatively small group of shareholders that are also directors. However, some private corporations may have many shareholders that are composed of extended family members or shares that have passed down through one or more generations. In general, it will be more difficult to have any significant actions approved by a large group of shareholders as opposed to being approved by the board of directors. In addition, certain corporations may have a board of directors that does not have any shareholders sitting as directors. For these reasons, it is important to clearly define those actions that can be taken by the board of directors on its own versus those actions that require the approval of the shareholders.

California law gives shareholders the right to vote on specific corporate actions, such as:

1. The annual election of the directors and the appointment of any replacement directors;
2. Any amendment to the articles of incorporation;
3. Adopting, amending or repealing certain portions of the bylaws;
4. A sale of all or substantially all of the corporation's assets;
5. Any merger or reorganization of the corporation;
6. A voluntary dissolution of the corporation;
7. Any transaction in which the directors or officers have a financial interest, including loans to any officers or directors and any contracts or transactions in which a director or officer has a material financial interest; and
8. Any other voting rights that are specifically given to the shareholders in the bylaws.

Except for these specific items, the shareholders have no further voting rights with respect to a corporation's activities. The shareholders only have veto power over actions taken by the board of directors if such veto power is expressly given to the shareholders in the Articles of Incorporation.

As a general rule, the board of directors directs and controls all matters involving the "business and affairs of the corporation." This means that whenever a corporate action is required, the board of directors has the authority to take any actions and make any decisions that it believes are appropriate and in the best interests of the corporation (subject to any mandatory shareholder

approval for those items detailed above). This gives the board of directors broad discretion and authority to handle a corporation's business.

Directors have a fiduciary duty of care to the corporation and its shareholders, which means that each director must serve "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances" (Corporations Code Section 309(a)). The fiduciary duty of care is also known as the "business judgment rule." Under this rule, a court will not review directors' business decisions, or hold directors liable for errors or mistakes in judgment, so long as the directors were:

1. Disinterested and independent;
2. Acting in good faith; and
3. Reasonably diligent in informing themselves of the facts.

The business judgment rule requires that the directors must reasonably ask all questions and make all inquiries reasonably necessary in order for the directors to make an informed decision with respect to a matter. If they do so, then a court will not "second guess" any decision made by the board of directors. However, the business judgment rule will not protect directors for taking any action that infringes on shareholder voting rights.

The directors also owe a duty of loyalty to the corporation and its shareholders. The duty of loyalty means placing the corporation's and stockholders' interests ahead of any other business or personal interests. This duty is generally encountered in connection with defining actions that the directors must not do, such as competing with the corporation, taking personal advantage of corporate opportunities or taking any action in which they have a conflict of interest.

If the board of directors is proposing to sell all or substantially all of a corporation's assets, then the board must obtain shareholder approval of any such sale. If the board of directors intends to sell off a portion of the corporation's business, then it is unlikely that it would need the shareholders approval to take such an action. In addition, if the sale was so significant that it would effectively change the purpose of the corporation (ie. from being an operating business to simply a holding company for cash or stock), then this would likely need shareholder approval. But if the sale would not change the corporation's primary business, then it is unlikely that the board would need to obtain prior shareholder approval.

This example shows that it may not always be clear if a particular action requires shareholder approval. If the board of directors is uncertain about whether shareholder approval is required, the board can vote on a recommended course of action and then submit the proposed action to the shareholders for approval. This allows the shareholders to make the final decision on any course of action and limits the directors' potential liability for making such a decision. It also has the added benefit of significantly reducing the likelihood of a shareholder lawsuit against the directors for taking a course of action without shareholder approval.

If you have any questions on this article, please contact Patrick Casey, who is an attorney at Lombardo & Gilles, at (831) 754-2444.