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The basics of fiduciary duty of officers, directors and shareholders

by James G. Wargo

A fiduciary is a person or party who has an obligation to act in good faith and in the best interests of another individual or entity. The traditional fiduciary duties owed by officers, directors and shareholders under Illinois law include the *duty of care* and the *duty of loyalty.*

Duty of Care

The duty of care generally requires an officer, director or shareholder not to act recklessly. The business decisions of officers, directors and/or shareholders are protected by the business judgment rule. "The business judgment rule is a presumption that directors of a corporation make business decisions on an informed basis, in good faith, and with the honest belief that the course taken was in the best interests of the corporation."

However, a plaintiff may "rebut the presumption by presenting evidence that the director acted fraudulently, illegally, or without becoming sufficiently informed to make an independent business decision." *Ferris Elevator Company, Inc. v. Neffco, Inc.,* 285 Ill.App.3d 350 (3d Dist. 1996).

Duty of Loyalty

The duty of loyalty requires each officer, director or shareholder to always put the interests of the corporation above his or her own personal interests. The duty of loyalty most often involves situations of conflicts of interest, corporate opportunities, and competing with the corporation. In order to comply with the duty of loyalty, a fiduciary must not engage in self-dealing, gain secret profit belonging to the corporation, compete with the corporation, or seize corporate opportunity.

A conflict of interest will arise when an officer or director is directly or indirectly on both sides of a transaction. *Shlensky v. South Parkway Building Corp.,* 19 Ill.2d 268 (1960). It should be noted that in a conflict of interest situation, the business judgment rule is not applicable. The Illinois Business Corporation Act of 1983 ("BCA") recognizes that the fundamental concern in an interested transaction is to ensure that the transaction is fair to the corporation.

A corporate opportunity situation arises when a fiduciary appropriates a corporate opportunity for him- or herself as opposed to allowing the corporation to take advantage of the transaction. In one of the leading corporate opportunity cases, the Illinois Supreme Court held that a director has a duty to tender a corporate opportunity to the corporation before the director can personally take

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Navigating the home buying process

by Joshua B. Rosenzweig

The largest transaction, strictly from a dollars-and-cents standpoint, that most people will engage in during their lifetimes is that of a home purchase. After all, where else will you decide to spend $100,000, $200,000, or $500,000, and then agree to pay an additional $100,000, $200,000 or $500,000 to finance your purchase?

Since buying a home is the largest transaction most people will ever make, it would stand to reason that all people would make sure to understand the entire process from offer to closing. However, what is expected and/or prudent is not the norm when it comes to home-buying.

Why? Well, the home-buying process can be incredibly confusing and unclear. The confusion often leads people to put off worrying about the details. Instead, most people think, "Well, my realtor will handle this," or "my attorney will handle that."

In many instances, a realtor can handle the initial contract negotiations and the payment of an earnest money deposit. And, sure, an attorney will handle making inspection requests on her/his client's behalf. But, in the end, neither the realtor nor the attorney are financially responsible for this new monstrosity that you intend to call "home."

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If you are making a 30-year commitment to bricks and mortar, and siding and roofing, and windows and appliances, shouldn't you know what you are getting into beforehand?

As an attorney, I have several advantages over a typical homebuyer. First, I have handled dozens and dozens of real-estate transactions during my career, which provides me with a unique perspective on the home-buying process. Second, through all of the transactions in which I have been involved, I have reviewed hundreds of contracts, addenda to contracts, change requests, inspection reports and inspection-repair requests. Third, I have an experienced staff of professionals who have worked on more real-estate transactions than I have, which makes my role much easier. Fourth, I worked for a mortgage company prior to going to law school, so I have plenty of familiarity with the mortgage process (even though the process has changed over the last decade).

But a typical homebuyer does not have the same knowledge and experience as I do. I doubt a first-time homebuyer understands how to read a title commitment. I doubt an individual who bought her first home 19 years ago remembers how the process works from offer to acceptance to inspection requests to mortgage contingency to closing. And I doubt an individual that is selling the home in which he raised his family in is able to remove his personal feelings about the home so as to consider contracts to purchase and/or inspection requests without some sense of personal attack by the prospective buyer. The home-buying process is tough, and that is true even for someone with a law degree.

If you are buying a home, you have several considerations to take into account as you move through the purchase process. First, understand *why* you are buying the property in the first place. If you are buying the property as an investment property, you need to look at several issues. For example, what are mortgage rates for investment properties? An investment property represents a higher-risk loan than a typical home purchase for a primary residence. Therefore, you can expect that your mortgage rate will be higher than if you were applying for a mortgage to buy a new home.

Also, what is the condition of the property? If you are buying an investment property, every issue that comes up during your ownership and someone else's occupancy of the property is going to be your responsibility. Do you want to buy a house that needs a ton of work just to get it ready for someone to rent? If so, then make sure you know who you can rely on to do the work. Do not think for one second that the issues will take care of themselves – they won't.

Second, understand the process of offer and acceptance. As buyer, you control the terms of the offer. Remember, buying a house is not like buying a loaf of bread. There are contingencies – attorney-review, inspection and mortgage – and there can be closing credits and home warranties and tax prorations. Each of these details impacts your bottom-line whether it be at the closing table in determining the amount of money to bring to closing or down the road when your tax bill comes the following year(s).

When making an offer, do not rely on prior purchase experience because no other transaction is similar to purchasing real estate. You should do research to understand home prices in the area. You should know what your tax rate is, and you should understand whether you are buying property in a planned unit development with an association. All of these items should factor into your offer.

Third, once your offer has been accepted, you move on to inspection and attorney-review periods. Get a licensed inspector to look through the entire home, and again, ask questions. If there are issues with the house, you need to know what those issues are so you can ask your attorney to request repairs and/or concessions. And, don't hesitate to have a contractor come out to advise you what repair costs will be. Again, you are buying a house – not a loaf of bread. If it is going to cost you $5,000 to repair a plumbing issue, that is something you need to bring to the attention of your attorney so she/he can make an appropriate request.

Fourth, as I alluded to before, understand the impact of the type of property you are purchasing. As I said, a mortgage on an investment property is going to be higher than a mortgage on a property your purchasing as your primary residence. And, while the rate may change, one aspect of the mortgage process never will – it is frustrating! The best advice that I can give someone applying for a mortgage – based on my experience as a home-purchaser, a real-estate attorney and a former loan officer – is to be organized.

For the 45 days or so that it takes to get through underwriting for a loan, there

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Corporations - C vs. S: choosing the right type of entity

by Craig D. Hasenbalg and Alexandra Verven

One of the first decisions any business owner is often confronted with is just what type of entity to use when operating the business. These days, the law offers a number of somewhat overlapping alternatives. They include partnerships, limited partnerships, corporations, limited liability companies, and the list can go on. This article will analyze two similar but very different types of corporations – a "C" corporation and an "S" corporation, which are (and have been for years) very popular choices.

Capital Structure

The primary motivation for incorporating a business in the first place is to insulate the owner or owners from third-party liabilities. When business is operated through a corporation, and the corporate entity is properly maintained, third-party creditors may seize the corporation's assets to satisfy a liability, but the creditor cannot touch the personal assets of the business owner. Both C corporations and S corporations provide their owners this type of creditor protection. Apart from this basic similarity, however, the two types of corporations bear little resemblance to each other.

The capital structure of a C corporation is typically more investor-friendly than an S corporation. For example, C corporations can have common and preferred stock. C corporations can also have multiple types of common stock, each granting its owners different bundles of rights. The same can be true for preferred stock. S corporations, on the other hand, can have only one class of stock, although S corporations can have common stock as well as non-voting common stock under the current rules. That provides for some flexibility, but not nearly as much as with C corporations.

Taxability

The taxability of C versus S corporations is the most frequently mentioned difference between the two types of corporations. C corporations are subject to "double taxation." C corporations are separate, stand-alone taxpayers, meaning that when a C corporation earns a dollar of income, the C corporation itself must pay tax on that dollar. If the owners of the C corporation wish to put the remaining after-tax money into their pockets, the C corporation must declare a dividend. Shareholders, however, must pay tax when they receive that dividend. Because the same dollar of income is taxed at the corporate level and then again at the shareholder level, a C corporation is said to be subject to double taxation.

With S corporations, however, the corporate entity is not itself a separate taxpayer. Consequently, S corporation income is not taxed at the corporate level. Instead, a dollar of income (whether it is distributed to the shareholders as a dividend or not) "passes-through" the S corporation and is included in the taxable income of the shareholders, to be taxed at each shareholder's individual tax rate. Because a dollar of S corporation income is only taxed one time, absent unusual circumstances (and assuming the amount of income earned is equal), there is typically more income left over when the income is earned by an S corporation.

Small Businesses

For most small businesses, choosing to be an S corporation is preferable, but some emphasis must be placed on word "small." A business cannot operate as an S corporation if it has more than 100 shareholders. Additionally, there are limitations on the characteristics of a qualified shareholder in an S corporation. All shareholders of an S corporation must be U.S. citizens and, in general, the shareholders must be natural individuals, although there are certain types of trusts that are permitted to hold stock in an S corporation.

On the whole, most small businesses find the advantages of an S corporation (especially the single level of tax) to be preferable to operating as a C corporation. However, if the business owners have great plans to grow the business into a significant enterprise with complicated and diverse capital structure, there often is no alternative but to conduct the business as a C corporation. ■

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will be several requests for information from the underwriter and/or processor reviewing your loan application to make sure you are an appropriate applicant for the sought-after loan. Therefore, make sure you know where the following documents are, and make sure they are readily accessible: last two-years worth of tax returns; 60-days worth of bank statements; last two paystubs; letters of explanation for any deposit into your bank account that is not work-related; and copies of most recent 401(k) statements or IRA statements.

While it is important to be organized so as to ensure you don't blow the mortgage contingency deadline in the contract, another important issue is to make sure you understand the loan paperwork. Prior to closing and after your preliminary approval, the lender will send you copies of the loan documents to review and sign. These documents will identify the loan program, interest rate, payment amount and escrow amount. Make sure you understand what the paperwork says. And if you have a question, ask your loan officer. Remember, this is the biggest transaction you will likely ever enter into – if you are not comfortable asking for clarity, then you shouldn't be buying the property.

Finally, you have made it to closing. Congratulations – now you have to sign your name 100 times so you can get the keys to the property. Remember, closing is not a time to "tune out." Just because your attorney and realtor are present, questions still need to be asked. Understanding each document is important because each document is being signed for a specific purpose.

The home-buying process is not easy. It is confusing and frustrating and exciting and complicated. Make sure you ask questions so you understand each step of the process. And if you need representation, several members of Ottosen Britz can help you navigate the process. ■

Ottosen Britz Kelly Cooper Gilbert & DiNolfo, Ltd.'s newsletter, ***Legal Insights for Small Businesses and Individuals,*** is issued periodically to keep clients and other interested parties informed of legal developments that may affect or otherwise be of interest to its readers. Due to the general nature of its contents, the comments herein do not constitute legal advice and should not be regarded as a substitute for detailed advice regarding a specific set of facts. Questions should be directed to:

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Fiduciary duty

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advantage of the opportunity. *Kerrigan v. Unity Savings Assoc.,* 58 Ill.2d 20 (1974).

Competing with the corporation involves situations where a fiduciary forms a third party or joins with a third party to compete with the corporation. The issue often litigated in these situations revolves around determining when the fiduciary's duties terminate. Generally, fiduciary obligations terminate when the fiduciary relationship terminates, including when the officer or director is fired.

Also, Section 7.9 of the BCA allows a shareholder in a close corporation (corporation with a limited number of shareholders) to terminate his or her fiduciary obligations to the corporation by waiving his or her voting and management rights in the corporation. (805 ILCS 5/7.9)

Limitation of liability under the BCA

The BCA allows the articles of incorporation to limit the personal liability of a director or its shareholders for monetary damages associated with a breach of fiduciary duty with certain limitations. 805 ILCS 5/2.10(b)(3). Any such limitation of liability may not eliminate the liability of a director for any breach of the director's duty of loyalty, acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of the law, or any transaction in which the director derived a personal benefit. ■

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