

Hayes Oyster Co. v. Keypoint Oyster Co.

Duty of Loyalty

Background rule

Corporate law provides that a director or officer owes a “fiduciary duty” to the company. That is, each director and officer are under a legal obligation to act in the best interests of the firm and not to act in their own self-interest (that’s what it means to be a fiduciary). Thus, they shouldn’t benefit at the firm’s expense. As a result, directors and officers have a duty not to misappropriate the firm’s property, information, or business opportunities.

This general rule gets tricky when directors and officers do business with the firm – buying something from the firm or selling something to the firm. Allowing a director to buy something from the firm might be a good idea because the director could pay a high price for the thing being sold. That helps the firm and shareholders -everybody wins. On the other hand, if the director doesn’t pay the going price, other shareholders will be harmed. In this case, courts may find that this violates the director’s fiduciary duty, that the deal was unfair to the firm, and the director would be held liable.

Given that, what do you think of this case?

Facts

Verne Hayes was CEO, director and 23 percent shareholder of Coast Oyster Company, a public company that owned large oyster beds. Coast was badly in need of cash to satisfy creditors. Verne did two things to help. First, he arranged for new bank financing. As part of that loan, he promised the Bank could seize his shares in Coast if Coast firm did not repay the loan. In essence, he was offering to pay off the firm’s debt with his own money.

Second, Verne proposed that Coast sell some of its oyster beds to raise funds. Verne asked Engman, a Coast employee, if he might be interested in buying the beds. Engman was willing to buy the beds and on August 11, Coast’s board approved Verne’s plan to sell the oyster beds to Keypoint Oyster Co., a corporation to be formed by Engman, for \$250,000, thus improving Coast’s cash position and relieving it of the expenses of harvesting the oysters in those beds.

After the board approved the sale and the terms, Engman asked whether Verne could help him find a way to finance the purchase. Engman asked whether Hayes Oyster could help -- Hayes Oyster Co. was a family corporation owned by Verne (who owned 25%) and his brother Sam (who owned 75%). On September 1, Verne and Engman agreed that Keypoint’s shares would be owned half by Engman and half by Hayes Oyster. *See the chart below for the ownership structure.*

On October 21, Coast shareholders approved the sale. Verne voted his own shares in favor of the transaction. Verne never disclosed his involvement with Keypoint Oyster to either Coast's board or shareholders.

A few years later, Verne sold his Coast shares and left the company. Coast's new managers later learned of Hayes Oyster's involvement in Keypoint and sued both Verne and Sam Hayes. They asked the court to give them Hayes Oyster's shares in Keypoint and as well as all of Verne's profits from the deal. Coast managers did not ask the court to undo the sale of beds (they did not want the beds back) and they did not claim that Verne had sold the beds too cheaply nor that Coast had suffered any loss or damage as a result of the sale to Keypoint. They just asked the court for the profits that Keypoint made on the grounds that Verne had violated his fiduciary duty to Coast.

The relevant law provides that a contract between a company and a fiduciary is not invalid just because the fiduciary is on both sides of the table if:

- a. The material facts about the director's or officer's involvement in the transaction are disclosed to the board of directors and the board approves;
- b. The material facts about the director's or officer's involvement in the transaction are disclosed to shareholders and they approve; or
- c. The contract or transaction is fair to the corporation.

Questions

1. Did Verne breach his fiduciary duty to Coast?
2. Should the ruling depend on whether the deal was good for Coast (whether the beds were sold for a fair price)?
3. What would you say in Verne's defense?
4. Assume that Verne (by virtue of his position) can influence the sales price of the oyster beds. What are his incentives? Will he have an incentive to increase the price or to reduce the price?
5. Does Sam have a legal duty to act in Coast's interests? If so, why? Could Sam be in trouble? Why or why not?

Ownership Structure

