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FIDUCIARY DUTIES

Walking the High Wire: Guidelines for Board of Director Designees Of Private Equity Funds, Activist Stockholders and Other Investors

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In *Shocking Technologies Inc. v. Michael*,[1] the Delaware Court of Chancery recently reaffirmed its longstanding rule that a director appointed by one class of stockholders owes the same fiduciary duties to the company and all of its stockholders as any other director. The case, which considered the extent of a director's ability to work at cross-purposes to the rest of the board, highlights the challenges faced by so-called "constituency directors," such as those designated by private equity funds and "activist" stockholders, to balance the interests of the constituency with the director's duty of loyalty to the company and all of its stockholders.

In this article we provide a framework for a constituency director of a Delaware corporation when balancing her duties to the company and all of its stockholders with the interests of, or her obligations to, the constituency. We begin by describing the duty of loyalty issues that typically arise for a constituency director. We then look at issues concerning the flow of information between the constituency director, her appointing stockholder, and the company. Next, we examine a constituency director's ability to dissent from the rest of the board without violating her fiduciary duties. Finally, we provide guidance for constituency directors in discharging their duties and for investors contemplating the appointment of a constituency director.

[1] C.A. No. 7164-VCN, 2012 BL 257554 (Del. Ch. Oct. 1, 2012).

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Duty of Loyalty Issues Concerning Constituency Directors

An activist stockholder or other significant investor that appoints a designated director may have different interests than the other stockholders of the company. For example, it may hold preferred stock having a liquidation preference to the common stock but with limited equity upside; it may want the company to make an immediate large dividend to stockholders rather than pursue a long-term growth strategy; or it may prefer to sell its ownership position after rapid, short-term gains rather than hold for the long-run.

This divergence of interests is problematic for a constituency director because, while a stockholder generally has only limited, if any, fiduciary duties to the company, a constituency director has the same fiduciary duties as any other director.[2] Therefore, as the Court of Chancery noted in *In re Trados*, while "an individual stockholder that is not a controlling stockholder can generally vote in its individual interest, the same cannot be said of directors designated to the board by such a stockholder."[3] For example, even if the constituency director serves as the representative of a particular class of stock, "it will be the duty of the board [including any constituency directors], where discretionary judgment is to be exercised, to prefer the interests of the common stock . . . to the interests created by the special rights,

[2] *In re Trados Inc. Shareholder Litigation*, No. 1512-CC, 2009 BL 162187 (Del. Ch. Jul. 24, 2009).

[3] *Id.* at *9, n.49.

preferences, etc. of preferred stock.''[4] In this vein, the Court of Chancery has held that a board does not breach fiduciary duties when it ''allocates [merger] consideration in a manner fully consistent with the bottom-line contractual rights of the preferred,'' even where the board could read the contract more favorably to the preferred and the preferred stockholders have no voting rights to protect themselves in connection with the merger.[5] As a further example, a constituency director who is also employed by her appointing stockholder is likely to be considered an interested director with respect to a transaction between the company and her constituency, denying the constituency director the protections of the business judgment rule in connection with such transaction. This outcome not only subjects constituency directors' actions to a higher standard of judicial review (often the ''entire fairness'' standard), but it also increases the likelihood that a constituency director may breach her duty of loyalty in circumstances in which the company cannot indemnify the director.[6]

Preferred stockholders might argue that their right to appoint a director entitles them to that director's loyalty. While it is true that directors owe fiduciary duties to the holders of preferred stock where the right at issue is a ''right shared equally with the common,''[7] the preferences of preferred stock are only ''contractual in nature.''[8] This means that in most situations a constituency director must ''pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred.''[9] However, a constituency director need not stay silent in the event that the company attempts to deny her constituency's rights of a contractual nature. Instead, directors ''must be given some latitude . . . to ensure compliance with corporate obligations, even when those directors comprise a minority of a corporation's board.''[10] Nevertheless, constituency directors seeking to require that the company meet such obligations should act carefully to avoid violating their fiduciary obligations.

Disclosure Issues Relating to Constituency Directors

While a constituency director is often perceived as her constituency's eyes and ears on the board of directors, the director's fiduciary duties raise two concerns about the flow of information between the director and the company. First, the duty of loyalty creates a duty of confidentiality that may prevent the director from sharing information about the company with her constituency. Second, the duty of loyalty creates a duty of disclosure that potentially requires the director to disclose information about her constituency to the company.

The duty of confidentiality prevents a director from disclosing sensitive business information that could be used by a party adverse to the company.[11] A director who provides confidential information to parties with interests adverse to the company violates her fiduciary duties, even when the adverse parties are significant stockholders.[12] A director may have greater leeway to provide information to her constituency when the constituency is not adverse to the company, as in *Kortum v. Webasto Sunroofs, Inc.*, where the Court of Chancery indirectly permitted a director to provide confidential information to his appointing stockholder on the grounds that the stockholder was not adverse to the company.[13] The greater the actual and potential conflicts between the company and the constituency, the more cautious a director must be in delivering information to her constituency. It is clearly a violation of a director's duty of loyalty, for example, to provide confidential information to her constituency to assist the constituency in preparing an unsolicited bid for the company or otherwise negotiate a transaction with the company.[14]

An equally problematic issue involves the director's duty of disclosure. Although the exact scope of this duty is unclear, if a constituency director recommends corporate action to the stockholders of the company, the director has an obligation to inform the stockholders of all material facts that she knows.[15] Further, the duty of full and open disclosure to the company, and therefore to the other directors, may be a subset of the duties of loyalty and care even when not soliciting stockholder action.[16] This outcome can be problematic for a constituency director when knowledge of the plans of the director's constituency would be relevant to the company. For example, if a company needs additional cash to repay a debt facility and a director's constituency is interested in providing the cash to further its investment, the constituency might prefer that this information be delivered to the company later in time to increase its leverage in negotiating the terms of the cash infusion. If the constituency director is aware of her constituency's plans, she has a fiduciary duty to use this information for the benefit of the company even if it will harm the constituency.

Ability of a Constituency Director to Dissent

A constituency director is not required to march lock-step with the rest of the board. Indeed, the Court of Chancery has noted that ''it is . . . important that directors be able to register effective dissent.''[17] However, this dissent must not cause the director to violate her duty to ''refrain from any conduct that would harm the

[4] *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997).

[5] *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 438 (Del. Ch. 2010).

[6] DGCL § 145.

[7] *In re Trados*, *supra* note 2, at *8 (internal citations omitted).

[8] *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593 (Del. Ch. 1986).

[9] *LC Capital Master Fund*, *supra* note 5, at 452.

[10] *Venoco, Inc. v. Eson*, No. CIV. A. 19506-NC (Del. Ch. Jun. 7, 2002).

[11] For a detailed discussion of a director's duty of confidentiality, *see* Charles Nathan, Stephen Amdur & Colin Bumby, *Corporate Governance Commentary on Board Confidentiality*, Latham & Watkins Corporate Governance Commentary, Dec. 2009.

[12] *Venoco*, *supra* note 10.

[13] 769 A.2d 113, 121 (Del. Ch. 2000).

[14] *Venoco*, *supra* note 10.

[15] *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).

[16] *See Pfeffer v. Redstone*, 965 A.2d 676, 684 (Del. 2009); *see also Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989).

[17] *Sherwood, et al. v. Chan Tze Ngon, et al.*, No. 7106-VCP, 2011 BL 322740, at *9–10 (Del. Ch. Dec. 20, 2011).

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corporation.''[18] An ''activist'' investor will often appoint a director who has a perspective that differs from the rest of the board and who may oppose plans and policies supported by the other directors, particularly where the rest of the directors are heavily influenced by a company's management.

Shocking Technologies provides a useful framework for analyzing what actions a director may take in opposing the rest of the board. In that case, Simon Michael, a director appointed by the holders of the Series B and Series C stock, became concerned about the company's corporate governance and executive compensation at the same time as the company found itself in dire need of additional funding. Michael, who believed that the corporate governance issues should be resolved before securing additional funding, called a special meeting of the stockholders, where he strongly criticized the other directors and the performance of the company. Michael also informed a stockholder who at that time was the company's only potential source of additional funding that the company had no other available sources of funds, in the hopes that the stockholder would use his negotiating leverage to demand another board seat as a condition for his investment.

The Court of Chancery held that Michael's calling the stockholder meeting to air his grievances against the other directors did not violate his fiduciary duties.[19] However, Michael's delivery of confidential information and bargaining advice to a party with interests adverse to the company violated his fiduciary duty of loyalty, even if he acted in subjective good faith. Michael's actions harmed the company's efforts to secure crucial financing and even risked its solvency. The court rejected Michael's argument that his actions were in the long-term best interest of the company, stating:

> Michael has referred to this as short-term pain for long-term gain. Perhaps it is a matter of degree. Advancing a policy where short-term adverse effects are outweighed by future benefits may be the product of a prudent and dutiful fiduciary. In theory, there may be something of a continuum on which actions, such as Michael's, should be measured. Where the line is between the acceptable and the unacceptable is not readily pinpointed. The circumstances of this case, however, leave little, if any, room for doubt.[20]

The court found two such circumstances that made Michael's case a clear breach of his duty. First, Michael's actions could have ''caused the demise of [the company].'' Second, Michael disclosed confidential information to an adverse party, knowing that such disclosure would benefit the adverse party to the detriment of the company.[21]

The court's discussion leaves open the possibility that a director could act to cause short-term harm to the company if she believes in good faith that this action would benefit the company in the long-term. Because the Delaware courts have rarely explored this area, directors should tread carefully before taking such actions. Actions involving only the company's stockholders in their capacity as such, including calling special meetings or lobbying the stockholders against other directors, are forms of dissent least likely to violate directors' fiduciary duties. Although the *Shocking Technologies* court did not prohibit dissenting actions involving third parties, such actions clearly carry a greater risk of a fiduciary duty violation, and actions involving a substantial risk to the company's existence would appear to almost certainly be violations. Further, a director's subjective good faith in taking an action in dissent is not sufficient to avoid a finding of breach.

Conclusion—Considerations for Constituency Directors and Investors

Constituency directors should consider the following in navigating their precarious position:

Always remember that a constituency director's fiduciary duties are for the benefit of the company and all of its stockholders, and not solely for the benefit of her constituency. When conflict arises between the holders of various classes of a company's stock, a director's fiduciary duties will usually require her to protect the interests of the common stock. A director may, however, act to facilitate the company's compliance with its contractual obligations to a particular class of stock.

Be keenly aware of interested transactions. Significant connections between a constituency director and her constituency substantially increase the likelihood that she will be regarded as an interested party with respect to a transaction between the company and the constituency. A constituency director should disclose to the other directors all ties to her constituency before the board considers a transaction involving the constituency. Consideration should be given to whether voluntary recusal is appropriate, and, where recusal is not practical, the director should bear in mind that her actions with respect to an interested transaction may not be protected by the business judgment rule.

Consider a written confidentiality policy. Courts consider written confidentiality policies in evaluating whether particular corporate books and records are confidential.[22] A good confidentiality policy can facilitate a director's provision of permissible information to her constituency by establishing clear and unambiguous guidelines as to what information is confidential and the process for providing it to stockholders.

Dissent through formal corporate processes rather than through individual actions. A director working ''within the system'' to effect a change on the board, so long as such change is in the best interest of the company and all of its stockholders, is the least likely form of dissent to constitute a breach of fiduciary duty. Calling a stockholder meeting to discuss problems with the board may be the act of a dutiful fiduciary. Leaking information to the press or the constituency seldom is.

Investors should likewise think critically about the constraints that fiduciary duties place on constituency directors when determining whether to demand rights to appoint board members, particularly because a stockholder may act in its own self-interest and a director, whether appointed by the constituency or not, cannot. In addition, although constituency directors are often seen as the eyes and ears of their constituencies, a

[18] *Shocking Technologies v. Michael*, *supra* note 1 (quoting *In re Walt Disney Co. Deriv. Litig.*, No. Civ. A. 15452 at *6 n.49 (Del. Ch. Sept. 10, 2004) (quoting BelCom, Inc. v. Robb, No. Civ. A. 14663 (Del. Ch. Apr. 28, 1998))).

[19] *Id.* at *5–6.

[20] *Id.* at *10–11.

[21] *Id.* at *11.

[22] *See, e.g.*, *Disney v. The Walt Disney Co.*, No. Civ. A. 234-N, 2005 BL 16634, at *3 (Del. Ch. Jun. 20, 2005).

director's fiduciary obligations will significantly constrain the flow of information between the director and the constituency. A constituency director's vote may be of minimal value in light of these countervailing factors, particularly if her views are held by only a minority of directors on the board.

An investor may determine that its interests are better served by bargaining for specified contractual rights to act as a stockholder rather than to appoint directors. For example, the stockholder may negotiate to prohibit a wide array corporate actions without its consent as a stockholder. Observer rights at board meetings can also permit an investor access to information, while retaining leeway for the investor to use that information for its own account. While the right to appoint a director can be a useful tool for certain investors, an investor should take into account the restrictions created by a director's fiduciary duties when it bargains for that right.

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