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Deal Making A Practice Focus

A Hot Seat at the Table?

For venture capitalists, board membership entails certain legal risks.

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In exchange for their investment, venture capitalists typically seek the right to appoint a member of the board of directors. Their reasons are clear: VC firms use the board right to directly monitor their investment and to vote on board-level decisions.

Early-stage companies can certainly benefit from the venture capitalist's advice. VC firms offer invaluable expertise not otherwise available to the entrepreneur, guiding management in strategic decision making, advising on administrative matters, and providing contacts within the business community.

Unfortunately, that desirable business vision can sometimes lead to legal complications. VC firms need to be aware of some potential pitfalls in appointing a board designee and how to avoid them.

The interests of a VC firm and its portfolio companies are generally aligned—execute the business plan and maximize return. But stockholders can differ when it comes to how and when the company accomplishes these fundamental goals. In particular, when companies have to negotiate financing, merge, or liquidate, the VC firm may desire an approach that may not be aligned with the interest of all stockholders. When this happens, the VC firm's board designee must reconcile the VC firm's interests with those of the company and the company's other stockholders.

FIDUCIARY DUTIES

Recent heightened scrutiny of board actions requires VC firms to make certain they are prepared to maneuver through potential conflicts of interest. If VC firms ignore these issues, they risk litigation for possible breach of fiduciary duties. On the other hand, if they cater too much to the portfolio companies' stockholders at the expense of the VC firm's own investors, they may need to justify their actions to their own investors.

Delaware law charges directors of public and private corporations with overseeing the affairs of the corporation and, as a result, imposes fiduciary obligations on them. A director is required to act prudently and in the best interests of the company and its stockholders at all times. Failure to discharge fiduciary duties could lead to personal liability and monetary damages.

Among these fiduciary obligations is a duty of care. A director must make decisions on an informed and rational basis, with reasonable diligence, after appropriate deliberations. Generally, under Delaware law, a director will be found in breach of this duty if he or she acted with gross negligence.

Directors also have a duty of loyalty. They cannot appropriate a corporate asset or corporate opportunity or use their position to promote a transaction between themselves (or their affiliates) and the company. If an opportunity arises that would benefit a director, the director must disclose the material facts to allow the board to decide whether the company should pursue the opportunity.

INCREASED EXPOSURE

The choice a VC firm's board designee makes when potential conflicts arise can create potential liability for the VC firm and/or the board designee. Two relatively recent decisions by the Delaware Chancery Court, *In re Emerging Communications* (2004) and *In re Disney* (2003), have opened the door for imposing personal liability on directors for breaches of fiduciary duties by limiting the application of Delaware statutory protections for directors.

In the Emerging Communications case, an independent director was denied the protection of §102(b)(7) of the Delaware general corporation law, which allows companies to limit directors' liability for breaches of the duty of care. The court held that because the director should have known that the price of a merger transaction was unfair based on his financial and industry expertise, he breached both his duty of loyalty and his duty of care by approving such a transaction.

Because neither Delaware state law nor the exculpatory provisions of the company's certificate of incorporation protect a director against a breach of the duty of loyalty, the director was held personally liable for his actions.

The directors involved in the Disney case were also denied the protections of §102(b)(7) and the corporate charter's exculpatory provi-

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sion because the court held that the directors consciously ignored their duties to the corporation, thereby causing injury to its stockholders. It found that such actions were not taken in good faith and involved intentional misconduct.

Taken together, these two cases also seem to suggest that directors' indemnification insurance will not shield a board member from personal liability if he or she fails to exercise reasonable care or puts his or her interests ahead of the interests of the corporation or its stockholders.

In addition, the recent settlements in the Enron and WorldCom cases suggest a possible trend toward imposing personal liability on directors in settling class action claims.

The Enron settlement required 10 outside directors to pay an aggregate of $18 million. This amount represented 10 percent of the outside directors' pretax profits from sales of Enron stock.

In the WorldCom case, the plaintiffs wanted the directors to bear some of the cost of the settlement. Although the court eventually rejected the settlement, the outside directors of WorldCom had offered a settlement package that included personal payments of $13 million.

Whether this represents a trend is unclear, but according to a study conducted by Stanford University, directors previously had contributed their own money to settle class actions in only four cases between 1968 and 2003.

Indemnification of Directors

Section 102(b)(7) permits Delaware corporations to include a provision in their certificates of incorporation limiting a director's personal liability for breaches of the duty of care. However, this exculpatory language is not available for breaches of the duty of loyalty, or for acts or omissions not taken in good faith, intentional misconduct, and knowing violations of law.

In most cases, a company will indemnify its board against liability, and it may also purchase directors' and officers' liability insurance. However, directors' and officers' insurance policies usually exclude coverage for the types of acts that are not indemnifiable under applicable law. The recent decisions in *Emerging Communications* and *Disney* suggest that the types of acts where indemnification and insurance may be denied have been expanded to include a director's failure to exercise reasonable care or a director's putting his or her interests ahead of the interests of the corporation or its stockholders.

If the insurance at the portfolio company is not sufficient, VC firms typically provide additional coverage under their own insurance policies for the board designees they appoint. If insurance becomes less available, VC firms providing contractual indemnity to their board designees could end up paying settlement amounts on behalf of these designees.

A Workable Solution

Fortunately, the standard terms and conditions of VC investment agreements already provide a way to avoid the conflict-of-interest problem for board designees. Typical VC agreements provide the VC investor with significant other means to influence the operation of the portfolio company. They include the following:

- *Terms of preferred stock.* A VC firm will usually invest through preferred stock. Preferred stock provides certain priorities over common stock with respect to voting preferences, distributions of dividends, distributions upon liquidation, and anti-dilution provisions. The specifics of these preferences are negotiated on an arm's-length basis before the VC firm becomes an insider, thereby giving the VC firm a strong defense should a stockholder challenge these preferences.

Delaware courts have recognized that the rights of preferred stock are a matter of contract. As a result, board action taken to fulfill its contractual rights to the preferred stockholders does not trigger or violate a director's fiduciary duties.

- *Information rights.* VC firms typically demand a package of information rights as part of their investment. Through these rights, the VC firms receive budgets; monthly, quarterly, and annual financial information; prompt notice of litigation against the company; and prompt access to the company's books and records. This is the same information usually provided to the board of directors. Information rights may also include a right to attend all board or committee meetings and to confer with management on a periodic basis.
- *Voting and consent rights.* Typical investment terms require the consent of the preferred stockholders before the company proceeds with fundamental corporate events such as mergers and acquisitions. Consent is also required for actions otherwise only within the province of the board, such as approval of the budget, equity and debt financings, and dividend payments. The VC firm thus has a chance to approve or reject major corporate decisions before they are submitted to the common stockholders.

When structured properly, these information, access, and voting controls give the VC firm some of the power of a board seat but without the fiduciary obligations and potential liability of that position.

In these situations, state and common law responsibilities of controlling stockholders should not pose a risk to VC firms because VC firms generally do not acquire a controlling interest in a company and rarely meet the thresholds established for determining control.

The Conflict Situation

When a conflict of interest does arise, a VC firm can take some simple steps to avoid being exposed unnecessarily to the risk of litigation:

- Resign from the board. A VC firm's board designee can resign from the board so that the firm can then act solely in its capacity as a stockholder. In most cases, even without the board designee, the VC firm is able to continue monitoring its investment through the protections set forth in the investment agreement.
- Obtain approval of noninterested directors. Delaware law specifically acknowledges that an interested-party transaction can be approved if the interested director's conflict is disclosed and the non-interested directors approve the transaction. In cases where the directors are all interested parties, the board can handle such a transaction by adding independent board members (which may be difficult) or obtaining the direct approval of a majority of the minority stockholders.
- Keep a record. Perhaps the simplest approach, but one that is neglected at times, is to keep a thorough record of board deliberations. Most decisions are made after extensive analysis and discussion. If the record shows how a decision was reached, directors are better able to defend against a lawsuit.

With these measures, VC firms are well-poised both to protect their investment in the portfolio company and to share their financial expertise with the board.

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