

THE VENTURE CAPITAL BOARD MEMBER'S
SURVIVAL GUIDE:
HANDLING CONFLICTS EFFECTIVELY
WHILE WEARING TWO HATS

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ABSTRACT

Venture capital investment terms typically include the right to elect a partner of the fund to the private company's board of directors, as well as provide the fund with preferential rights over holders of common stock in areas such as allocation of proceeds in an acquisition of the company, protection from future dilution, and special voting rights. The venture fund directors in this context are "dual fiduciaries," having fiduciary duties to the fund itself and its partners, as well as to the stockholders of the company on whose board they serve. Although there is an alignment of interest much of the time, transactions in which the interests of the preferred and common holders diverge, such as down-round financings and acquisitions resulting in disparate treatment of stockholders, can create difficult conflict of interest scenarios. When at least half of the board is conflicted and the deferential business judgment rule may not be available, boards that fail to understand and manage the process correctly, along with venture funds, can face the prospect of protracted litigation and personal liability. However, there are concrete process steps a board can take to help reduce this exposure.

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I. INTRODUCTION

The United States venture capital industry and the entrepreneurial companies it funds and supports are a crown jewel of America's capital markets. According to a 2011 National Venture Capital Association report, venture-backed companies had, as of that time, generated revenue equal to 21% of the national gross domestic product.¹ This industry has helped establish the United States as an innovation leader in a broad range of technologies and sectors and spawned companies such as Apple, Amazon, Netflix, Cisco, Google, Facebook, Genentech, Tesla, and Twitter.

Venture firms often invest very early in a company's life cycle and, as a result, own a sizeable percentage of the company at the outset. With these early investments, venture capitalists frequently negotiate for a position on the corporation's board of directors, as well as equity holdings that come with certain contractual and corporate charter-based preferences over the common stock in areas such as the divvying up of proceeds in a merger, protection against certain types of future dilution, and special voting rights.² Board positions allow the venture capitalist to provide oversight, helpful business advice, and mentorship for the benefit of the company and its stockholders, founders, and management team, and they also enable the venture board member to keep a close eye on the investment for the benefit of the venture fund and its general and limited partners. Membership on a corporate board also brings with it legal duties to the corporation and its stockholders and potential personal liability for a failure to meet those responsibilities in certain cases, as discussed below.

Much of the time, there is close alignment of objectives between and among the company, its common stockholders, and the venture capital fund: all parties are economically incentivized to help the company grow and be successful and to obtain a highly valued liquidity event down the road. With respect to these objectives, the venture board member's fiduciary duties to the company's common stockholders generally are not in conflict with his or her duties to the venture capitalist's primary employer, the venture fund, and his or her fiduciary duties to the fund's partners.³

¹NATIONAL VENTURE CAPITAL ASSOCIATION, VENTURE IMPACT: THE IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY (2011).

²See generally ENTREPRENEURS REPORT: PRIVATE CO. FINANCING TRENDS (Wilson Sonsini Goodrich & Rosati, Palo Alto, Cal.), Q3 2015, archived at <https://perma.cc/RU3R-HJR4>; William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815 (2013).

³See *id.*

However, conflicts of interest are never very far away in a venture-backed company. Most companies raise capital in stages, or "rounds," putting the interests of the company (to minimize dilution and obtain a high valuation and company-favorable terms) at odds with the interests of the existing funds and their partners (to obtain a low valuation and investor-favorable terms)—though of course less so if new investors comprise a significant portion of the round.⁴ Events such as down-round financings with punitive terms that are dilutive to common stockholders, recapitalizations, and sales of the company where separate classes of stock are treated differently are all examples of transactions where the interests of the preferred holders, of which the venture fund is usually the largest, can be in direct conflict with the interests of the common stockholders.⁵

These potential conflicts—paired with the lack of true independence on many venture-backed boards and, all too often, limited time and resources to provide the robust processes that judges tend to like—can make venture board members more vulnerable to lawsuits alleging a breach of fiduciary duty. A few recent cases discussed below vividly highlight the risks that confront directors in conflict of interest situations.⁶ Notwithstanding this vulnerability, there are concrete steps a venture-backed board can take to significantly reduce potential liability.

This article will review the current state of Delaware law as it relates to the duties of board members, with a special focus on those situations where a majority of the directors may not be "disinterested" and independent, as is often the case with venture capital-backed companies. The article will also touch on the manner in which plaintiffs may name venture funds in fiduciary duty lawsuits relating to such situations, either for aiding and abetting alleged breaches of fiduciary duty or as, potentially, controlling stockholders. We will then provide steps a board should consider in designing an effective process to address potential litigation risk and liability in these situations.⁷

⁴See, e.g., John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 150-51 (2014) (discussing the stages and rounds of financing in VC-backed companies).

⁵See, e.g., Joseph L. Lemon, Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, 39 TEX. J. BUS. L. 1, 13 (2003).

⁶See, e.g., *In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table); *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 56-57 (Del. Ch. 2013); Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618 (Del. Ch. 2013).

⁷This article does not discuss another issue, which is outside of this Article's focus, that often arises in venture-backed companies: The "corporate opportunity" doctrine and the related fiduciary duty implications for directors and officers if they are seen as "usurping" an opportunity for a particular corporation in order to benefit themselves or a venture fund (or

Although this article focuses on venture-backed companies, which commonly grapple with the issues covered in this article, this article is equally relevant to other similar contexts—including where a large portion of a board is appointed by private equity funds that hold preferred stock.

II. DIRECTORS' DUTIES AND CONFLICTS OF INTEREST

Corporate directors have fiduciary duties of loyalty and of care to stockholders of the company on whose board they serve.⁸ Significantly, these fiduciary duties tend to run primarily to the common stockholders, as the relevant case law views preferred stockholder rights as a function of, and protected primarily by, contract law—at least where the terms of preferred stock speak to a given issue, such as the allocation of proceeds to preferred stockholders in a sale of the company.⁹ Preferred stockholders do get the benefit of fiduciary duties when preferred stock terms are silent on an issue and preferred stockholders "share" a right with common stockholders¹⁰—although, as a practical matter, preferred

another of the fund's portfolio companies) with whom they are affiliated. *See, e.g.*, *Guth v. Loft*, 5 A.2d 503, 510-11 (Del. 1939). To attempt to avoid corporate opportunity problems, some funds ask for, and corporations might include, corporate opportunity renunciation provisions in a corporation's certificate of incorporation. DEL. CODE. ANN. tit. 8, § 122(17) (2011). Delaware case law has not fully explored the enforceability of such provisions, although they are generally permitted by the Delaware statute, such provisions should be carefully drafted. In any event, directors operating in the venture capital context should be aware of the corporate opportunity doctrine. The doctrine sometimes also coincides with fiduciary duty concerns relating to the private repurchase or sale of stock by directors or officers from or to stockholders who are not "insiders." In this context, directors should be aware that, under the existing Delaware case law, certain disclosure obligations can apply to directors and officers—and to the funds who appoint directors engaged in such private sales and repurchases. *See, e.g.*, *In re Wayport, Inc. Litig.*, 76 A.3d 296 (Del. Ch. 2013).

⁸*See, e.g.*, *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006) (discussing the duty of good faith as part of the duty of loyalty); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (discussing the duty of loyalty); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (discussing the duty of care).

⁹*See Trados*, 73 A.3d at 56-57 (internal citations omitted) (stating that "as a general matter, the rights and preferences of preferred stock are contractual in nature" and that a "board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights"); *Fletcher Int'l, Ltd. v. ION Geophysical Corp.*, 2010 WL 2173838, at *7 (Del. Ch. May 28, 2010) (stating that "rights arising from documents governing a preferred class of stock . . . that are enjoyed solely by the preferred class do not give rise to fiduciary duties, because such rights are purely contractual in nature").

¹⁰For example, both preferred and common stockholders can bring claims under the Delaware law "*Revlon*" doctrine, which provides that directors must, as a function of their fiduciary duties, seek to maximize value in a change of control transaction, because all stockholders as a general matter inherently share in that interest. *See LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Both preferred and common stockholders generally are

stock terms often do address the issue at hand. Taken together, this means that directors may at times be required to act in the best interests of the common holders—who Delaware law views as the residual owners of a company unprotected by contract—when directors have the discretion to do so, even when those interests collide with those of the venture fund that has invested in the company and compensates and employs the director appointed by the fund.¹¹ The duties of directors remain the same and run to all (common) stockholders generally, regardless of whether a director is appointed by a particular stockholder or class or series of stock.¹² The duties the venture director may have to the fund and its partners therefore are sometimes not only not helpful, but can be a liability when assessing whether the director fulfilled his or her fiduciary duties to the corporation and its stockholders.¹³

A director's duty of loyalty requires the director to act to further the interests of the corporation and stockholders as a whole and in good faith.¹⁴ The duty of care requires the director to act on an informed,

entitled to the benefit of fiduciary duties when directors provide disclosures to stockholders. HB Korenvaes Invs., L.P. v. Marriott Corp., 1993 WL 205040 (Del. Ch. June 9, 1993). Where preferred stock terms do not address the consideration that preferred stockholders are to receive in a sale, directors owe fiduciary duties to both the preferred and the common stockholders in allocating proceeds from a sale. *In re FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562 (Del. Ch. Apr. 2, 1993); see also Leo E. Strine, Jr., *Poor Pitiful or Potentially Powerful Preferred?*, 161 U. PA. L. REV. 2025 (2013).

¹¹Trados, 73 A.3d at 63 (internal citations omitted) ("The standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of the contractual claimants. In light of this obligation, it is the duty of the directors to 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.").

¹²*In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127, at *36 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table) (stating that "[d]irectors owe fiduciary duties to *all* stockholders, not just a particular subset of stockholders" and that the directors appointed by venture funds in that case had a "seriously flawed understanding of the nature of fiduciary duties under Delaware law" where the directors allegedly thought that only the independent member of the board owed responsibilities to the common stockholders).

¹³See *id.* at *29 (internal citations omitted) ("[S]ome [directors], especially with start-up companies, may have been appointed by a venture capital firm with whom they are in a fiduciary relationship. A director with a competing fiduciary relationship may face an inherent conflict of interest if, when considering the merits of a particular business decision, the interests of the beneficiaries diverge . . . [T]his court has described this issue as the 'dual fiduciary' problem.").

¹⁴See, e.g., *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006) (discussing the duty of good faith as part of the duty of loyalty); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not

careful basis, taking into account reasonably available information and alternatives.¹⁵ These duties oblige corporate directors to act in a manner to maximize value, generally for the long term.¹⁶ In making decisions, directors generally are protected by the business judgment rule, a judicially created doctrine in Delaware (and by statute in certain other states¹⁷) that presumes that in making business decisions not involving disabling conflicts of interest or self-dealing, corporate directors act in good faith and in the honest belief that their actions are in the company's best interests.¹⁸ Where the business judgment rule applies, a Delaware court will not second-guess rational decisions made by the board, even if those decisions turn out, with the benefit of hindsight, to be bad ones resulting in economic loss to stockholders.¹⁹ Under Delaware law,

trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

¹⁵ *E.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006).

¹⁶ *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 49 (Del. Ch. 2013) ("The duty of loyalty . . . mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital, as warranted for an entity with perpetual life in which the residual claimants have locked in their investment. When deciding whether to pursue a strategic transaction that would end or fundamentally alter the stockholders' ongoing investment in the company, the loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term.").

¹⁷ *See, e.g.*, NEV. REV. STAT. § 78.138 (2015) ("Directors and officers, in deciding upon matters of business, are presumed to act in good faith, on an informed basis and with a view to the interests of the corporation.").

¹⁸ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993) (citations omitted).

¹⁹ *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009) ("[I]nvestors, and others, want to find someone to hold responsible for . . . losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses.

directors are further protected by a Delaware statute, Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL"), that provides that directors who act in good faith and consistent with their duty of loyalty will not be held personally liable for money damages for a breach of their fiduciary duty of *care* if a corporation's certificate of incorporation so provides.²⁰ Taken together, this means that boards that are disinterested and exercise a reasonably basic amount of diligence are strongly protected from personal liability.²¹

The business judgment rule presumption does not apply where a majority of the board is not disinterested²²—where the board members have conflicts of interest and their loyalties may be divided—absent certain process steps described below. This is the situation in which boards of venture-backed companies often find themselves, where the interests of the preferred stock, held by the venture funds, and the common stock may conflict. The existence of a conflict is not a given. In a very favorable sale of the company or an IPO in which the preferred stock and common stock are treated equally, there should be no conflict. But when directors decide to sell, wind down, or invest in a company, the preferred stockholders fare better than the common, and at least half of the board consists of principals of venture capital funds or otherwise has a potentially special interest, a conflict may exist. In these situations, the antithesis of the deferential business judgment rule—the difficult "entire fairness" standard of review—may apply, and the directors must prove that they engaged in a fair process and achieved a fair result.²³

This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.") (emphasis in original).

²⁰Companies should always be aware that officers do *not* have this protection, even though officers generally owe to stockholders the same fiduciary duties that directors owe. See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

²¹See, e.g., *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005) ("Because duty of care violations are actionable only if the directors acted with gross negligence, and because in most instances money damages are unavailable to a plaintiff who could theoretically prove a duty of care violation, duty of care violations are rarely found."); *In re Zale Corp. S'holders Litig.*, 2015 WL 6551418, at *9 (Del. Ch. Oct. 29, 2015) (internal citations omitted) ("To support an inference of gross negligence, the decision has to be so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion.").

²²See *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984).

²³*In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127, at *34 (Del. Ch. Sept. 4, 2014) (internal quotation marks omitted) ("Entire fairness is the most onerous standard of review in Delaware corporate jurisprudence. This standard has two well-known components—fair dealing and fair price, which at times are referred to as 'procedural fairness and substantive fairness'—from which the Court must reach a unitary conclusion on the entire fairness of the business decision or transaction at issue."), *aff'd sub nom. Fuchs v. Wren Holdings, LLC*, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table); J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV.

The shift to the entire fairness standard is a significant factor in litigation and puts enormous pressure on boards. When a conflict might exist, the issue is fundamentally whether the directors have breached their duty of loyalty. In the case of a breach of the duty of loyalty, as opposed to a breach of the duty of care, directors cannot be exculpated from personal liability for related damages—and plaintiffs nearly inevitably seek damages against directors in a claim alleging a breach of the duty of loyalty.²⁴ In addition, under Delaware law, corporations may not be permitted to indemnify directors against personal liability for breaches of the duty of loyalty.²⁵ Finally, because the entire fairness standard is inherently fact-intensive, requiring evidence about process and price, it can be very difficult in that setting for directors to have litigation terminated at an early stage when the factual record has not yet been developed.

The determination of director independence and disinterested status can be one of the more confusing areas in corporate governance. The listing standards of Nasdaq and the New York Stock Exchange (the "NYSE") have specific criteria with respect to independence requirements for a majority of the board, as well as separate independence criteria for service on a board's audit and compensation committees.²⁶ Under Delaware law, however, the question of

1443, 1447 (2014) ("At this level [of entire fairness review], the plaintiff has shown that the board could not act as a qualified decision-maker, so the court must use its own judgment").

²⁴Plaintiffs often focus on loyalty violations as opposed to care violations because the vast majority of corporations have Section 102(b)(7) exculpation clauses that shield directors from being personally liable for monetary damages arising from a breach of the duty of care. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 n.48 (2000) (citing Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160-61 (1990)).

²⁵See generally DEL. CODE ANN. tit. 8, § 145(b) (2011) (providing that in a derivative action asserting fiduciary duty claims by or on behalf of the corporation, a director or officer cannot be indemnified by the corporation if the director or officer is liable to the corporation unless a court decides otherwise); DEL. CODE ANN. tit. 8, § 145(a) (2011) (providing that in other types of "direct" claims, a director or officer can only be indemnified if the court determines that the director or officer "acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, the best interests of the corporation").

²⁶See NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL, § 3.03A.01 & § 3.03A.02(a)-(b) [hereinafter NYSE MANUAL] (requiring that a majority of a listed company's board be "independent" and stating that an independence assessment must take into account "all factors specifically relevant" but also specifically enumerating certain matters relating to, for example, employment, compensation, and family relationships that render a director not independent); NASDAQ STOCK MARKET RULES, Rule 5605(a)(2) [hereinafter NASDAQ RULES] (basing an independence assessment on whether a director has a relationship that would "interfere with the exercise of independent business judgment" and also similarly stating types of relationships or facts that render a director not independent); NYSE MANUAL, § 3.03A.02(a)(ii) (imposing additional criteria for the independence of compensation committee members); NYSE Manual § 3.03A.07(a) (same regarding audit committee members); NASDAQ RULES, Rule 5605(a)(2) & (d)(2) (imposing additional criteria for members of audit and compensation committees, respectively).

independence is fact-specific and is governed by an extensive body of Delaware case law.²⁷ The focus is not on whether the director is an outside board member (in other words, not a member of the management team) or whether the director meets any particular specified criteria, but rather whether in the context of the matter being reviewed, the director has a conflicting interest. As a result, a director can be deemed independent under the Nasdaq or NYSE criteria for board or audit or compensation committee purposes, for example, but not be independent for purposes of a particular decision in which the director has a personal interest and is therefore conflicted.²⁸

Early-stage, venture-backed companies often find it difficult to attract qualified, independent board members.²⁹ Young companies are typically unable to provide attractive cash compensation packages and a level of D&O insurance commensurate with public company boards, instead relying on business and personal relationships and equity compensation to attract board members.³⁰ However, business and personal relationships can undermine independence in ways that may not seem obvious: as discussed further below, a director's status as a general partner in a venture fund or other business or social relationships may prevent a finding of independence by the courts, resulting in an entire fairness review of a transaction.³¹ It is not unusual for an early-stage venture-backed company to have a board composed of the corporation's CEO and otherwise general partners from the corporation's funding venture firms—in effect potentially no independent and disinterested directors when it comes to matters in which the holders of the preferred have different or conflicting interests from the holders of the common.

²⁷See Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, 119 A.3d 44, 61 (Del. Ch. 2015) ("Unlike the NYSE Rules, Delaware law does not contain bright-line tests for determining independence but instead engages in a case-by-case fact specific inquiry based on well-pled factual allegations."); Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1022 (Del. 2015) ("[O]ur law requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence.").

²⁸In re MFW S'holders Litig., 67 A.3d 496, 510 (Del. Ch. 2013) ("[T]he fact that directors qualify as independent under the NYSE rules does not mean that they are necessarily independent under our law in particular circumstances . . .").

²⁹See Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH. L. REV. 461, 470-71 (citing D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 324-37 (2005)).

³⁰See Joseph S. Tibbetts, Jr. & Edmund T. Donovan, *Compensation and Benefits for Startup Companies*, HARV. BUS. REV., Jan.-Feb. 1989, archived at <https://perma.cc/UPZ4-VH9H>; Olav Sorenson & Toby E. Stuart, *Syndication Networks and the Spatial Distribution of Venture Capital Investments* 3 (Univ. of Chi. Graduate Sch. of Bus. Selected Paper 83) (discussing the "structure of relationships in the VC community" and the benefits of "personal and professional relationships"), archived at <https://perma.cc/6CRG-8YGP>.

³¹See *infra* Part II.

The business judgment presumption in these cases may not be available absent specific and robust (and potentially impracticable) process steps. As a result, entire fairness is the standard of judicial scrutiny that may be applied should litigation challenging the board's conduct be brought.

Making matters even more difficult, when a venture-backed company undertakes a transaction in which the interests of the preferred and common holders may conflict, time and financial resources are often in short supply. Procedural steps that the courts might be used to seeing, such as hard-working special committees with independent directors and separate counsel, market checks, detailed minutes documenting a robust board process, and fairness opinions from qualified, independent investment banking firms, may not be feasible or affordable. That the company is out of time and money with no available alternatives, although potentially relevant,³² may not fully offset the application of the entire fairness standard. It is in these situations that directors of venture-backed companies are most exposed to allegations of breach of fiduciary duty.³³ As a result, advising venture boards in these situations can be very challenging for counsel, as the rigors needed to successfully endure an entire fairness level of judicial scrutiny may seem highly impractical to a board and management team that feel enormous pressure to complete a time-critical transaction and make payroll. Nevertheless, counsel must help the board assess the level of risk involved, educate the board regarding its duties, and design a process that both enables the company to complete the transaction at hand in a timely way and protects the board and the transaction with an adequate process to the maximum extent possible.

III. THE RECENT DELAWARE CASE LAW

In several cases in recent years, the Delaware courts have addressed various conflict situations that are relevant to venture-backed companies, particularly in the most sensitive contexts: insider financings and sales of a company.³⁴ The cases highlight many important issues and serve as cautionary tales for boards of venture-backed companies.

³²See, e.g., *In re Hanover Direct, Inc. S'holders Litig.*, 2010 WL 3959399 (Del. Ch. Sept. 24, 2010) (finding, post-trial, that a merger in which the common stockholders were cashed out for a nominal amount was entirely fair, where the preferences of the preferred stock and the company's debt had left the company "struggling" for some time, with "no end in sight" and the value of the stock "under water").

³³The lack of formal process steps (e.g., the absence of a special committee of the board) in these situations not only makes it potentially more likely that a court will apply the entire fairness standard, but can also make it more difficult to show a fair process under that standard.

³⁴See, e.g., *In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del.

In *Trados*, the Court of Chancery held, first on a motion to dismiss in 2009³⁵ and later in its post-trial decision in 2013 cited above,³⁶ that the board of a venture-backed company was conflicted and the entire fairness standard applied in light of the following facts: the board decided to sell the company.³⁷ A majority of the board consisted of directors who were principals of venture funds that held preferred stock in the company or who otherwise were viewed as "beholden" to the funds or had some other conflict.³⁸ The preferred stockholders received all of the proceeds of the sale, although the sale satisfied only 90% of their aggregate liquidation preferences.³⁹ The common stockholders received nothing in the sale.⁴⁰ Approximately six months before the sale closed, the board approved a management incentive plan, which benefited, among others, the CEO who was also on the board.⁴¹ The plaintiff, a common stockholder, alleged that the company was on an upswing and should have been continued for the benefit of all stockholders, including the common, but was sold because the preferred stockholders wanted to exit their investment.⁴²

The Court concluded that the board had a conflict and that the entire fairness standard of review applied for several interrelated reasons.⁴³ Drawing on prior Delaware case law, the Court held that where the terms of preferred stock address a particular issue (e.g., a sale of the company, through the existence of liquidation preferences), the rights of preferred stockholders are contractual, rather than fiduciary, in nature.⁴⁴ In such a situation, preferred stockholders, with negotiated preferred stock terms, are like any "contractual claimant."⁴⁵ Where preferred stockholders are so protected by contract, and directors can exercise discretion, directors, the Court concluded, should prefer the interests of common stockholders if possible, because common stockholders are not protected by contract and are the residual owners of the company.⁴⁶ The Court determined, based on the facts before it, that

2015) (Table); *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 56-57 (Del. Ch. 2013); Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618 (Del. Ch. 2013).

³⁵*In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

³⁶*Trados*, 73 A.3d at 17.

³⁷*Trados*, 2009 WL 2225958 at *3-4.

³⁸*Id.* at *8-10.

³⁹*Id.* at *4.

⁴⁰*Id.*

⁴¹*Trados*, 2009 WL 2225958 at *3-4.

⁴²*Id.* at *3.

⁴³*Id.* at *9; *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 42 (Del. Ch. 2013).

⁴⁴*Trados*, 73 A.3d at 38-39.

⁴⁵*Id.* at 41.

⁴⁶*Id.* at 63.

the board had taken the discretionary step of choosing to sell the company, the sale benefited the preferred stockholders, and a majority of the board had a conflict that caused the board to favor the interests of the preferred stockholders over the common stockholders.⁴⁷ The Court noted its belief that venture funds sometimes desire to exit "zombie" companies performing in a "sideways" manner.⁴⁸

In particular with respect to the board's independence, the Court determined that six of the seven directors were conflicted.⁴⁹ Two were members of management who received material benefits in the sale, through the management incentive plan and post-acquisition employment with the acquiror.⁵⁰ Three of the directors were principals of funds that held predominantly or entirely preferred stock.⁵¹ The Court determined that these directors were "dual fiduciaries" who were inherently divided in their loyalties and faced "competing duties" to the company and their funds, which wanted to sell the company.⁵² As for the sixth director, who had been appointed by one of the funds but was not an employee of the fund, the Court determined that the director nonetheless had a conflict.⁵³ This was partly because the director himself owned preferred stock and had received over \$200,000 in the sale (an amount that the Court found was material to him) and also because of the director's relationship to the fund.⁵⁴ The Court cited the director's sense of "owingness" to the fund and "history" with the fund, in that the director was or had been an executive at two companies backed by the fund and had invested \$300,000 with the fund.⁵⁵ In the course of this discussion, the Court noted the "web of interrelationships" that characterizes Silicon Valley.⁵⁶

Ultimately in *Trados*, after a trial in which the Court sorted through the fairness of the process and the terms of the sale, the Court concluded that the directors had not breached their duty of loyalty because the sale was entirely fair and the common stock had in fact been worth nothing.⁵⁷ Significantly, in arguing in the litigation that the common stock was worth more than zero and the common stock was undervalued in the sale, the plaintiff pointed back to a 409A valuation that the company had relied on in 2004 (the year before the company was

⁴⁷ *Id.* at 51-52.

⁴⁸ *Trados*, 73 A.3d at 51.

⁴⁹ *Id.* at 45.

⁵⁰ *Id.* at 45-46.

⁵¹ *Id.* at 46-50.

⁵² *Trados*, 73 A.3d at 51.

⁵³ *Id.* at 55.

⁵⁴ *Id.* at 54.

⁵⁵ *Id.* at 55.

⁵⁶ *Trados*, 73 A.3d at 54.

⁵⁷ *Id.* at 78.

sold) for tax purposes in granting stock options to employees.⁵⁸ That valuation placed the common stock at 10 cents per share, lowered from a prior valuation of 25 cents per share.⁵⁹ The Court was critical of the board for using a valuation in 2004 that the board later disavowed for purposes of the issues in the litigation in contending that the common stock was worth zero, but the Court agreed that the valuation was not sufficiently sound for purposes of assessing the value of the common stock in the litigation.⁶⁰

Even though the Court in *Trados* held that the directors did not breach their fiduciary duties, the directors endured over five years of litigation to get to that point, and the Court was critical of the board's process. The Court criticized the board's adoption of the management incentive plan that eclipsed any consideration that, in the Court's view, could have gone to the common stockholders and that the preferred stockholders did not agree to fund.⁶¹ In particular, the aggregate deal consideration was \$60 million, the preferred stockholders received \$52.2 million in the sale and had preferences totaling \$57.9 million, and the management incentive plan consumed the remainder of the deal consideration that otherwise would have been available for the common stockholders.⁶² The Court determined that the directors did not actually understand that their duties ran to the common stockholders and did not give "serious consideration" to the divergence of interests in the sale.⁶³ The Court also observed that the board did not use an independent committee of the board or condition the sale on a vote of the disinterested stockholders.⁶⁴

Two other recent decisions—*Carsanaro v. Bloodhound Technologies, Inc.*⁶⁵ and *In re Nine Systems*,⁶⁶ mentioned above—each involved a challenge to a sale of a venture-backed company and insider rounds of financings that preceded the sale. In particular, once the company in each case was sold, the common stockholder plaintiffs

⁵⁸*Id.* at 71-72.

⁵⁹*Id.* at 39.

⁶⁰*Trados*, 73 A.3d at 72.

⁶¹*Id.* at 59 ("Not surprisingly, the MIP favored the interests of the conflicted fiduciaries who initiated, designed, presented, and approved it.").

⁶²*Id.* at 59-60 ("Once the deal price exceeded the liquidation preference, however, the MIP took value away from the common There is no evidence in the record that the Board ever considered how to allocate fairly any incremental dollars above the liquidation preference.").

⁶³*Id.* at 63.

⁶⁴*Trados*, 73 A.3d at 65.

⁶⁵65 A.3d 618 (Del. Ch. 2013).

⁶⁶2014 WL 4383127 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table).

learned that they had been diluted in prior financing rounds led by various venture funds with representatives on the board, and the plaintiffs then challenged those prior financings.⁶⁷ In both cases, the plaintiffs named various funds as defendants for aiding and abetting (i.e., "knowingly participating" in) the alleged breaches of fiduciary duty. In each case, the Court permitted a challenge to the previous conflicted financing rounds, the details of which the Court determined had not been adequately disclosed to stockholders.⁶⁸ In *Bloodhound*, the plaintiffs also challenged aspects of the ultimate sale of the company.⁶⁹

In both decisions, when the Court examined the prior financing rounds, process and conflicts were problems. The parties in *Bloodhound* ultimately settled the litigation before the Court reached a final judgment. However, in its decision denying the directors' motion to dismiss the litigation, the Court was critical of the board for, among other things, obtaining stockholder consent to approve financing-related charter amendments without providing the actual charter amendments to a "swing-vote" stockholder whose vote was critical and who did not have insider information.⁷⁰ The Court also was critical of a management incentive plan adopted in connection with the sale of the company that consumed 18.87% of the deal consideration, or \$15 million, as compared to the "puny" \$100,000 in proceeds paid to common stockholders.⁷¹

In *In re Nine Systems*, which was litigated for over six years, the Court held in a post-trial decision that the directors breached their duty of loyalty, but the Court chose not to award monetary damages to the plaintiffs, in part because the evidence showed that the company had been worth exactly the value the directors ascribed to the company in the financings.⁷² However, the Court, who was very troubled by the directors' decision-making process in the financings, ultimately ordered some of the directors and their funds to pay \$2 million to the plaintiffs in attorneys' fees.⁷³ Of particular concern to the Court were the following facts: that the directors appointed by venture funds allegedly did not understand their fiduciary duties ran to the common stockholders generally; that those directors allegedly "knowingly excluded" the company's lone independent director from the board's decision-making

⁶⁷*Bloodhound*, 65 A.3d at 628; *Nine Sys.*, 2014 WL 4383127 at *1-3.

⁶⁸*Bloodhound*, 65 A.3d at 646; *Nine Sys.*, 2014 WL 4383127 at *3, *18.

⁶⁹65 A.3d at 634.

⁷⁰*Id.* at 633, 647.

⁷¹*Id.* at 641-43, 665.

⁷²*Nine Sys.*, 2014 WL 4383127 at *47.

⁷³*In re Nine Sys. Corp. S'holders Litig.*, 2015 WL 2265669 (Del. Ch. May 7, 2015), reprinted in 40 DEL. J. CORP. L. 845 (2016).

process;⁷⁴ that the directors used "back-of-the-envelope" numbers in valuing the company in the financing rounds, even though they were paying other types of consultants at the same time (including relating to a potential name change for the company);⁷⁵ and that the directors did not communicate honestly with stockholders and provide material information to stockholders, even when Delaware law required them to do so.⁷⁶ In both *Bloodhound* and *In re Nine Systems*, the Court either refused to dismiss the aiding and abetting claims against certain directors' venture funds or held that the funds had aided and abetted the directors' breaches of fiduciary duties.⁷⁷

Aside from board-level conflicts, venture-backed companies and their directors should also be aware of a second type of conflict scenario that can arise: conflicts involving controlling stockholders. Under Delaware law, a stockholder possesses control either where the stockholder holds a majority of the voting power of the corporation or holds less than a majority stake but nonetheless possesses control over the decision-making of the company.⁷⁸ Delaware law also recognizes a control group concept—that stockholders who are sufficiently legally connected to each other can be said to amount to a control group.⁷⁹

⁷⁴There are some circumstances under which a director can potentially involuntarily be excluded from board deliberations, if the board undertakes that exclusion appropriately—for example, if the director in question has an openly adverse relationship to the company in a given situation. See *Kalisman v. Friedman*, 2013 WL 1668205 (Del. Ch. Apr. 17, 2013). But such situations are sensitive and should be discussed contextually with legal advisors. In addition, we do not, in this article, discuss voluntary recusals by directors. This Article focuses on a certain recurring fact pattern that has arisen in the recent case law: Where at least half of the board, or the entire board, has a conflict—a situation in which recusals by directors are not particularly relevant. In situations in which a majority of the board is disinterested, but some directors have a conflict, the board may want to discuss with its counsel the appropriate path forward: Having the conflicted directors recuse themselves, having the directors remain in the board's process and decision-making, or forming a board committee that excludes those directors. Depending on the nature of the conflict, certain approaches may or may not fully alleviate all of the implications of the conflict for the directors with the conflict.

⁷⁵*Nine Sys.*, 2014 WL 4383127, at *2.

⁷⁶*Id.* at *37.

⁷⁷The Delaware case law has not fully explored the issues addressed in this Article in the context of a board's decision to wind down or dissolve a corporation, but a bench ruling suggests the same concepts apply. See Transcript, *Harrington v. Curcio*, C.A. No. 4235-VCS (Del. Ch. Dec. 22, 2008) (granting a preliminary injunction and criticizing a board's conduct where the plaintiff alleged that a preferred stockholder fund and its designees wrongfully dissolved a corporation and sought to purchase its assets for less than the liquidation preference of the preferred stock and that the board allegedly wrongfully excluded one director from the board's discussions).

⁷⁸*In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 991 (Del. Ch. 2014), *aff'd sub nom. Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).

⁷⁹*Frank v. Elgamal*, 2014 WL 957550, at *18 (Del. Ch. Mar. 10, 2014) (internal citations omitted) ("A group of stockholders, none of whom individually qualifies as a controlling stockholder, may collectively be considered a control group that is analogous, for

Where a controlling stockholder uses its control over the corporation, the stockholder takes on fiduciary duties to the minority stockholders, on the rationale that the controlling stockholder is exerting control over "property" (the corporation) that is also owned by others (the minority stockholders).⁸⁰ Accordingly, the Court of Chancery and Delaware Supreme Court have held in multiple cases that a conflict exists, and the entire fairness standard of review will apply, if a company engages in a transaction with a controlling stockholder,⁸¹ or if, in a transaction between the company and a third party, a controlling stockholder or control group negotiates a special benefit for itself as compared to stockholders generally.⁸²

Two recent Court of Chancery decisions illustrate how these issues can arise in the private company context. In *In re Nine Systems*, the Court determined that in addition to the conflicts that existed at the board level as described above, three venture funds in that case constituted a control group—and the recapitalization and financing that they led were subject to the entire fairness standard of review.⁸³ The plaintiffs alleged that the funds had a long history of working in concert together to implement their goals at the company.⁸⁴ The Court focused on the manner in which the three venture funds in that case conducted the financing and recapitalization at issue: two of the funds decided among themselves that they would fund the dilutive financing and recapitalization; those two funds gave the third fund an option to participate in the transaction in exchange for its support of the transaction; and the independent director on the board was not included in much of these discussions.⁸⁵

In another case decided in early 2016, *Calesa Associates, L.P. v. American Capital, Ltd.*,⁸⁶ the Court of Chancery held, at least for purposes of the defendants' early-stage motion to dismiss, that the entire fairness standard of review applied to a complicated financing

standard of review purposes, to a controlling stockholder. Allegations of mere 'parallel interests,' without more, are insufficient to establish that the individual stockholders constituted a control group. Rather, the stockholders must be connected in some legally significant way—e.g., by contract, common ownership, agreement or other arrangement—to work together toward a shared goal to be deemed a control group.").

⁸⁰See *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016).

⁸¹*Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

⁸²See, e.g., *In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

⁸³*In re Nine Sys. Corp. S'holders Litig.*, 2014 WL 4383127, at *33-34 (Del. Ch. Sept. 4, 2014), aff'd sub nom. *Fuchs v. Wren Holdings, LLC*, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table).

⁸⁴*Id.* at *24.

⁸⁵*In re Nine Sys.*, 2014 WL 4383127, at *25.

⁸⁶2016 WL 770251 (Del. Ch. Feb. 29, 2016).

transaction between a private company and a private equity fund that held 26% of the company's stock, because the fund was potentially a controlling stockholder. In particular, the Court found that the fund controlled the company's seven-member board: one of the directors was an executive of the fund and had helped negotiate the financing with the company.⁸⁷ Another director was a director of the private equity fund and therefore a "classic dual fiduciary."⁸⁸ A third director was the CEO of the company who, the record showed, had come to understand over time that his livelihood depended on support from the private equity fund and that without its funding of the company, the company would face "collapse." The Court observed that the CEO was able to continue his employment and participate in a management incentive plan as a result of the transaction.⁸⁹ The fourth director in question was a CEO of another portfolio company in which the fund had made a \$66 million investment, and the company in question had conceded in an information statement to its stockholders that the director had "interests that are in addition to or different than the interests of the [company's stockholders] generally."⁹⁰ As a practical matter, these cases and principles have two fundamental effects: (1) they allow a stockholder, such as a fund, to be sued directly for a breach of fiduciary duties (likely alongside of directors), and (2) they provide a separate basis for a transaction to be challenged under the entire fairness standard of review. As discussed later in this article, there may be procedural steps a board can take in all of these types of conflict situations to return to the business judgment rule presumption.

IV. TRANSACTION PLANNING AND PROCESS CONSIDERATIONS

In short, certain recurring scenarios in the venture-backed company context can constitute conflicts and pose seemingly intractable problems. The recent case law leads to two natural questions. One, how exactly do directors know when and if they have a conflict? Two, if there is a conflict, what is a board to do when the only viable or desirable alternative is a transaction that implicates that conflict?

As for the first question, whether a director has a conflict for purposes of Delaware law is a fact-specific question, as noted above. Under Delaware law, a director is not conflicted simply because the director is appointed by a particular stockholder or class or series of

⁸⁷*Id.* at *11.

⁸⁸*Id.*

⁸⁹*Id.*

⁹⁰Calesa Assocs., L.P., 2016 WL 770251, at *12.

stock.⁹¹ Instead, Delaware courts look to the context and actual relationship between the director and a particular party to determine if the director is "beholden" to the party such that the director is unable to exercise independent business judgment.⁹² As the *Trados* and *American Capital* cases show, if a director is a principal, or an employee, of a fund, the director may be considered to have a conflict by definition with respect to certain decisions implicating the fund.⁹³ Even if a director is not such a "dual fiduciary," a court will, as *Trados* also illustrates, look at that director's relationship to the fund and the facts generally to determine if the director nonetheless has a conflict.⁹⁴ Delaware courts have held in other contexts that directors may not be independent for other types of reasons—e.g., a close family relationship between a director and a particular party,⁹⁵ a 50-year friendship paired with certain business relationships,⁹⁶ or a relationship between a director and a particular party when the director was a university president and had raised significant funds from that party.⁹⁷ Aside from beholdenness to another party, as the *Trados* and *American Capital* cases illustrate, a director may be conflicted in a transaction because the director is receiving special benefits—e.g., as a member of management who will share in a management incentive plan or have ongoing employment.⁹⁸

Further confounding matters is that various members of a board may have conflicts for different reasons, as the recent cases show. As Vice Chancellor Laster of the Delaware Court of Chancery recently observed, the key inquiry under Delaware law is whether a majority of the board is independent—a "head-counting" exercise—the purpose of which is to ascertain whether there was a business decision by an independent decision-making body that deserves deference.⁹⁹ In

⁹¹See *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 996 (Del. Ch. 2014) ("It is well-settled Delaware law that a director's independence is not compromised simply by virtue of being nominated to a board by an interested stockholder.").

⁹²See *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016); *Beam v. Stewart*, 845 A.2d 1040, 1049-50 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: Independent from whom and independent for what purpose?").

⁹³See *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 42 (Del. Ch. 2013); *Am. Cap.*, 2016 WL 770251, at *11.

⁹⁴See *id.* at 46-47.

⁹⁵*Chaffin v. GNI Group, Inc.*, 1999 WL 721569 (Del. Ch. Sept. 3, 1999) (finding that director lacked independence vis-a-vis his son).

⁹⁶*Del. Cnty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del. 2015).

⁹⁷*In re The Ltd., Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28 (Del. Ch. Mar. 27, 2002).

⁹⁸See *In re Trados*, 73 A.3d at 45-46; *Am. Cap.*, 2016 WL 770251, at *12.

⁹⁹Laster, *supra* note 23, at 1456 ("[T]o determine whether to escalate from the business judgment rule to entire fairness, a court counts heads. If a director-by-director analysis leaves insufficient directors to make up a board majority, then the board cannot act as

conducting that head-counting exercise, the Court looks at each director individually and can find different types of conflict (or a lack thereof) for each director.¹⁰⁰

As for the second question—what does a board do if a majority of the board is not disinterested in a transaction—there is a gating issue that directors usually confront in such a situation. That issue is whether a company is able to consider taking certain approaches that may, under Delaware law, "return" a transaction to the protection of the deferential business judgment rule. Although the Delaware case law has not completely explored some of these issues, the case law suggests that where a majority of the board is not disinterested in a transaction such that the entire fairness standard of review may apply, there are procedures a board can employ to get "back" to business judgment review.¹⁰¹ In particular, where a transaction is negotiated and approved by a committee of the independent members of the board or where a majority of the disinterested stockholders properly approve a transaction, the business judgment rule may apply.¹⁰² In a financing that is led by insiders, there has historically been suggestion in the case law that if the financing is offered to all stockholders of the company on equal terms—often referred to as a "rights offering"—then the conflict is neutralized and the business judgment rule may apply in the event the financing is challenged.¹⁰³ A recent case, however, raises questions as to whether a

the qualified decision maker, and the court will review the board's decision for entire fairness.").

¹⁰⁰Id.; Transcript, *In re PLX Technology Inc. S'holders Litig.*, C.A. No. 9880-VCL (Del. Ch. Sept. 3, 2015) (holding, in the context of litigation challenging the sale of a public company following activist agitation for a sale, that two independent directors appointed by the activist fund should be dismissed from the litigation, but that other directors could not be dismissed, based on, in the case of one director, his status as a "dual fiduciary" of the fund and the fund's desire for a sale; in the case of another director who was the CEO, his alleged steering of the sale process to ensure post-closing employment and benefits for himself; and in the case of four other directors, their alleged "flip-flopping" in deciding to sell the company).

¹⁰¹*In re MFW S'holders Litig.*, 67 A.3d 496, 504-18 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).

¹⁰²*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 36 (Del. Ch. 2013). ("The standard of review may change further depending on whether the directors took steps to address the potential or actual conflict, such as by creating an independent committee, conditioning the transaction on approval by disinterested stockholders, or both."); *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 1003 (Del. Ch. 2014) ("[E]ven if plaintiffs had pled facts from which it was reasonably inferable that a majority of [the] directors were not independent, the business judgment standard of review still would apply to the merger because it was approved by a majority of the shares held by disinterested stockholders of [the company] in a vote that was fully informed.").

¹⁰³See, e.g., Zimmerman v. Crothall, 2012 WL 707238 (Del. Ch. Mar. 5, 2012); Watchmark Corp. v. ArgoGlobal Cap., LLC, 2004 WL 2694894 (Del. Ch. Nov. 4, 2004); Stepak v. Tracinda Corp., 1989 WL 100884 (Del. Ch. Aug. 21, 1989); Savin Bus. Machines Corp. v. Rapifax Corp., 1978 WL 2498 (Del. Ch. Feb. 15, 1978).

rights offering can return a financing to business judgment review, at least if the financing is with a controlling stockholder.¹⁰⁴ Aside from the rights offering context, the Delaware courts have also held that when a company engages in a transaction with a controlling stockholder, or a controller otherwise receives a special benefit in a transaction between the company and a third party, in order for the transaction to be subject to the business judgment rule, two fundamental conditions must be satisfied: the transaction must be conditioned up front on the approval of a fully empowered independent committee that exercises its duty of care to obtain a fair price *and* on the fully informed approval of the minority or disinterested stockholders.¹⁰⁵ The idea behind these cases is that if the conflict is neutralized and an arm's-length process is simulated, then the business judgment rule should apply.¹⁰⁶ Of course, even when a company actually has the ability to use these types of procedural devices, courts also focus on whether companies use such devices properly; if they do not, entire fairness may apply anyway.¹⁰⁷

These are some of the methods available to a board in ensuring that a transaction gets the protection of the business judgment rule. But these methods may not be available as a practical matter. A company may not have any independent directors to form a special committee. We have occasionally heard commentators suggest that independent directors could be added to a board to enable the use of a committee, but such persons may not be available to serve on the board of a cash-strapped company, particularly when litigation is a potential risk. Even if a company has independent directors, a board may worry that the company does not have sufficient resources available for the committee to conduct the type of process that Delaware judges are used to seeing in the public company context. Similarly, obtaining approval by a majority of the disinterested stockholders simply may not be practical for a company if the disinterested stockholders are receiving nothing or very little in a transaction; stockholders may have no incentive even to

¹⁰⁴ *Cancan Development, LLC v. Manno*, 2015 WL 3400789 (Del. Ch. May 27, 2015).

¹⁰⁵ *M&F Worldwide Corp.*, 88 A.3d at 642-54; *Swomley v. Schlecht*, 128 A.3d 992, 2015 WL 7302260 (Del. Nov. 19, 2015) (Table) (upholding rule in the private company context); *In re Ecorp Inc. Consulting Agreement Derivative Litig.*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016), reconsideration granted in part, (Del. Ch. Feb. 23, 2016), appeal refused sub nom. *MS Pawn Corp. v. Treppel*, No. 84, 2016, 2016 WL 921933 (Del. Mar. 10, 2016), appeal refused sub nom. *Roberts v. Treppel*, No. 85, 2016, 2016 WL 921984 (Del. Mar. 10, 2016).

¹⁰⁶ See *M&F Worldwide Corp.*, 88 A.3d at 644-46.

¹⁰⁷ See *In re Dole Food Co.*, 2015 WL 5052214, at *1 (Del. Ch. Aug. 27, 2015) (awarding over \$100 million in damages against a controlling stockholder and his "right hand man" who was an officer of the company where, despite the board's use of a committee, independent advisors, and a majority-of-the-minority vote, the controlling stockholder and his "right hand man" allegedly undermined and defrauded the sale process).

respond to a request for their consent. Companies and their advisors should also keep in mind that ascertaining which stockholders are "disinterested" for purposes of obtaining a cleansing vote can be problematic, if not downright impracticable, in the private company context.¹⁰⁸ A company offering participation in a financing to all stockholders on a completely equal basis may not be practical as a timing matter (if a company urgently needs funds) or for other practical reasons (if the company needs to rely on a securities law exemption that does not permit participation by unaccredited stockholders). Judges may also be skeptical as to whether the financing truly was available on equal terms.

What if a company cannot pursue a path that would restore the protection of the business judgment rule? The company may be left with the unfortunate reality that if a stockholder brings a lawsuit challenging a particular transaction, the stringent entire fairness standard of review will apply. This is not comfortable advice to give or receive. But, even when this is the reality, there are still many measures a board in such a situation will want to consider, both as well-meaning fiduciaries and to minimize legal risk surrounding the transaction. Or perhaps better put, when directors *know* that there is a heightened risk of litigation arising out of a proposed transaction and that the difficult entire fairness standard may apply, it is all the more important for the board to build a good record about its process, motivations, and decisions.

Boards confronting the possibility of the entire fairness standard should bear in mind what the courts examine under that standard: the fairness of the process that the board employed in negotiating and approving the transaction and the fairness of the price and terms that the board achieved. The recent cases offer important insights into what helps and hurts a board in general and particularly under the entire fairness standard. The following are the steps and considerations directors should have in mind in protecting the transaction that they approve and in minimizing the risk of meaningful litigation and liability. Together, these steps and considerations can help directors design a defensible process based on an assessment of the potential litigation risks. We have also, for ease of reference, included at the end of this Article a short list that distills these various steps and considerations for directors in designing their process.

There is no one perfect formula to be applied in every situation, and, as we have noted, timing, financial resources, and other constraints

¹⁰⁸See generally *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010); *In re Pure Res. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002) (questioning the economic incentives and independence of stockholders based on the underlying facts for purposes of a majority-of-the-minority analysis in the public company context).

may make several of these considerations impractical depending upon the circumstances. Many insider rounds of financing, sales, and other types of transactions where one or more board members are conflicted are effected with only some of these considerations incorporated into the process. A decision to proceed in that manner may well be reasonable in certain cases, particularly where the risk of fiduciary duty litigation is perceived to be very low. However, where conflicts of interest are present and there is a perceived risk of litigation, boards would be well advised to consider incorporating into the process those of the steps we describe that are reasonable under the circumstances.

- Quality of decision-making. In all cases, directors should review and consider all reasonably available alternatives and information, act diligently and with deliberation, and be engaged. This is the essence of the duty of care and goes to the heart of the board's process.
- An understanding of the board's fiduciary duties and possible conflicts. In all cases, directors should understand their fiduciary duties—including that their duties run to common stockholders—and this understanding should motivate the board's actions. The alleged failure of the directors in *Trados* and *In re Nine Systems* to understand their duties was a problem for the directors and figured in the Court's criticism of the directors' process in both cases. Relatedly, the board should disclose, discuss, and understand the actual or potential conflicts that exist.¹⁰⁹
- Input from advisors. Directors should seek advice from both legal and financial advisors as appropriate. A common question that arises is whether directors must hire a financial advisor and obtain a fairness opinion, especially if a company has limited resources. There is no *per se* rule. In one decision, the Court of Chancery was sympathetic where a board made a deliberate, documented decision that the company could not afford a fairness opinion and the full array of a financial advisor's services (although it is worth noting that a majority of the board was disinterested in that case).¹¹⁰ But in *In re Nine Systems*, as discussed above, the Court of Chancery was

¹⁰⁹ See Strine, *infra* note 122 at 687-90.

¹¹⁰ *In re Houseman v. Sagerman*, 2014 WL 1600724, at *7 (Del. Ch. Apr. 16, 2014).

very critical when, in approving a financing, directors who were principals of venture funds participating in a financing allegedly used their own casual "back-of-the-envelope" calculations in valuing the company, particularly when the directors were at the same time paying consultants for other types of ancillary input (e.g., concerning a name change for the company).¹¹¹ Delaware judges are also very attentive to whether advisors have conflicts, whether directors have adequately asked about and handled their advisors' conflicts, and whether advisors are appropriately incentivized in their fee structure.¹¹² The proper use of advisors goes to process and can also go to the fairness of the terms.

- Appropriate reliance on officers, employees, and advisors. Directors are expressly permitted to rely on officers, employees, and advisors reasonably and in good faith, but directors still have fiduciary duties and should not "rubber stamp" decisions, fail to ask appropriate questions, or permit officers or others to steer a process in a way that infects the transaction to the detriment of stockholders generally. These issues all go to process.
- Consideration of alternatives; conduct of negotiations. Courts will examine how a board conducted its negotiations, particularly under the entire fairness standard of review. This is true both internally (e.g., whether all directors are given a chance to weigh in or whether any directors are inappropriately excluded from the process) and externally (e.g., whether any particular buyers or financing sources, for example, are unreasonably excluded from a process). Recall that in *In re Nine Systems*, the Court was critical of the board for allegedly excluding an

¹¹¹ *In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127, at *2 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table).

¹¹² *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54 (Del. Ch. 2014), *aff'd sub. nom.* RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816 (Del. 2015) (awarding over \$75 million in damages against a financial advisor for aiding and abetting breaches of fiduciary duties by a selling company's board); *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432 (Del. Ch. 2012) (criticizing a financial advisor who represented a selling company for, among other things, conflicts pertaining to the financial advisor's ownership stake in the buyer and seats on the buyer's board).

independent director elected by the common stockholders from its decision-making.¹¹³ This all goes to process. As for external negotiations, as a practical matter, courts often take comfort from a market canvass or market check when directors determine to sell a company, and this can help show both fair process and a fair price.¹¹⁴ But in recent cases, courts have been more willing, at least in the public company context involving independent boards without a conflict, to permit "single-bidder strategies" in which a selling company pursues negotiations with only one bidder.¹¹⁵ That said, it is still extremely important for the board to understand and document why it employed such a process—especially in situations where conflicts are present and decisions are likelier to be scrutinized. In the financing context, a market check and/or the use of an "outside" lead investor will generally be more defensible than a pure "insider" round with no attempt to determine whether an outside offer at a higher valuation is available. This will be particularly true in a financing round that appears highly dilutive of the common stockholders.

- Consideration of valuation bases and methodologies. A valuation of a company can go directly to the fairness of the ultimate price or terms achieved in a transaction. As noted above, a board should consider whether to hire a financial advisor or valuation expert, although the board may ultimately conclude that the company does not have sufficient resources to do so. If a board relies on the company's own financial analyses, the board should do so thoughtfully and avoid the criticism the directors faced in *In re Nine Systems* for using casual valuations.¹¹⁶ If a company, as in *Trados*, has prior 409A or other types of valuations that assessed the company's stock at a higher

¹¹³ *In re Nine Sys. Corp. S'holder Litig.*, 2014 WL 4383127, at *24 (Del. Ch. Sept. 4, 2014), *aff'd sub nom.* Fuchs v. Wren Holdings, LLC, 129 A.3d 882, 2015 WL 8528870 (Del. Dec. 11, 2015) (Table).

¹¹⁴ See, e.g., Merion Capital LP v. BMC Software, Inc., 2015 WL 6164771, *1, *18 (Del. Ch. Oct. 21, 2015) (holding, in an appraisal action, that following a robust auction process and given deficiencies in using other measures, the deal price paid was the best indication of fair value for stockholders).

¹¹⁵ See, e.g., C&J Energy Servs. v. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust, 107 A.3d 1049 (Del. 2014); Koehler v. NetSpend Holdings, Inc., 2013 WL 2181518 (Del. Ch. May 21, 2013), *reprinted in* 38 DEL. J. CORP. L. 1119 (2014); *In re Plains Exploration & Prod. Co. S'holder Litig.*, 2013 WL 1909124 (Del. Ch. May 9, 2013).

¹¹⁶ *See Nine Sys.*, 2014 WL 4383127, at *2.

price than the figure that is used in a financing or sale, the board and its advisors should be prepared to explain and distinguish the prior valuations (e.g., in light of changed circumstances).¹¹⁷

- Proper handling of management incentive plans. In both *Trados* and *Bloodhound*, the Court was critical of the use of management incentive plans that consumed funds that the Court viewed as otherwise available for common stockholders.¹¹⁸ A management incentive plan might be needed to retain certain key members of management and preserve stockholder value. But if a company adopts a management incentive plan, the board will want to carefully (1) document the reasons for such a plan, (2) handle related negotiations (including potentially by utilizing disinterested directors if possible), and (3) consider how to structure and fund the plan. The use of a reputable, independent compensation expert could be useful in these situations when resources permit.
- Appropriate disclosures to stockholders. In evaluating a board's process, courts care about whether, when the board makes disclosures to stockholders, the board communicates appropriately and discloses all material information when stockholders are making decisions. As noted earlier, in *In re Nine Systems*, the Court of Chancery was very critical of a board for failing to disclose various facts to stockholders in a notice that Delaware corporations are required to send to non-consenting stockholders under the DGCL after stockholders approve a transaction by written consent, as had occurred in that case with respect to the financing.¹¹⁹ Similarly, in *Bloodhound*, the Court of Chancery was critical of the company for seeking stockholder consent of financing-related charter amendments but not including the actual charter amendments for a stockholder (who did not have insider information) to see.¹²⁰

¹¹⁷ See *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 71 (Del. Ch. 2013).

¹¹⁸ *Trados*, 73 A.3d 58-59; *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 634 (Del. Ch. 2013).

¹¹⁹ See *supra* Part II.

¹²⁰ See *supra* Part II.

- Documenting a Defensible Record. In litigation, everything a board does will be cast in the worst possible light by a plaintiff's attorney. Moreover, if a board is conflicted, the resulting entire fairness review will be very fact-intensive.¹²¹ Accordingly, it is critical that the board, at the time of its decisions and with its legal advisors, build a record to show why the board did why it did and that it understood its fiduciary duties. Board minutes should be professionally drafted and reflect the care and deliberation that went into the decision-making process, including the information reviewed and the range of alternatives considered.¹²² If the company does not accurately tell its story at the time, there is room for a different story to be told in litigation in hindsight.

V. CONCLUSION

Decision-making should focus on maximizing value for stockholders, while also of course taking into account litigation risk and liability. When conflicts exist, and especially when resources and time are scarce, the board should have a realistic discussion with its legal advisors about the board's process in light of the practical concerns and litigation risks. The board should consider which measures are feasible in light of the company's resources, the composition of the board, and the company's stockholder base. If resources, time, and practical realities permit, the likelier the litigation risk, the more prophylactic measures a board may wish to take. Where at least half of the board has a conflict, the board will likely want to consider as an initial matter whether the use of an independent committee or a vote by disinterested stockholders is practicable (or whether, in the case of a financing, the financing can be offered to all stockholders on equal terms). If not, the board will all the more so want to consider the other process points discussed above. Any board, regardless of a company's size and situation, can build a good record. All directors can and should document why they made particular decisions, and all directors can show that they knew and understood their fiduciary duties. Especially where directors are "dual fiduciaries," they should use these basic tools to protect the transaction that they approve

¹²¹ See *supra* notes 23-25 and accompanying text.

¹²² See Leo E. Strine, Jr., *Documenting the Deal: How Quality and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone*, 70 BUS. L.W. 679 (2015).

for their stockholders and to guard against protracted, costly litigation that can lead to personal liability.

Board Considerations in Conflict Situations*

- ✓ Review on a director-by-director basis the independence of the board and disclose and discuss conflicts
- ✓ If a majority of the board is not disinterested and independent, consider the use of an independent committee or disinterested stockholder vote
- ✓ In the case of a financing, consider whether all stockholders could be offered the opportunity to participate pro rata
- ✓ Understand and document fiduciary duties and to whom those duties run
- ✓ Consider all reasonably available information and alternatives
- ✓ Build and document the record with legal advisors
- ✓ Consider the use of a financial advisor
- ✓ Particularly if the use of a financial advisor is infeasible, carefully consider the bases for the valuation used
- ✓ Rely on and deploy officers as appropriate, but do not rubber stamp their decisions or permit them to steer the process inappropriately
- ✓ Construct a process that allows all directors to be appropriately included
- ✓ Consider an appropriate market check in a sale or financing—or, alternatively, document why the board is using a more limited process and why that is in stockholders' best interests
- ✓ If a management incentive plan is necessary or desired, carefully consider and document the reasons for one, its structure, the negotiations over the plan, and who funds the plan
- ✓ As the need for communication with stockholders arises, communicate honestly and provide all material information relevant to the decision that stockholders are making

*This list represents various process steps a board should consider and select from based upon the reasonableness of a process step in light of the specifics of the transaction, an assessment of the likelihood of litigation, the nature and extent of conflicts that may be present, and other factors. Depending upon the context and particular facts surrounding a potential transaction, not all of these considerations may be practical, appropriate, or advisable.