

The Investor/Director Guide for Conflict of Interest Transactions

by

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1. Introduction

Members of a corporation's board of directors often consider transactions involving a conflict of interest with one or more members of the board. A common conflict of interest scenario presents itself when the corporation is a portfolio company of a venture capital investment firm and a venture capitalist serves on the portfolio company's board of directors. On the one hand, the venture capitalist is an investor seeking to obtain the greatest rate of return with respect to its investment in the portfolio company. On the other hand, the venture capitalist, as a member of the board of directors, is subject to the same fiduciary duties as all other directors of a corporation. For any transaction involving a conflict of interest, directors should consider taking certain actions to ensure that their decision, if challenged by company stockholders, is reviewed under the most favorable standard of review. While there is no single action that ensures that a board's decision will be reviewed under the most favorable standard of review, this paper outlines a number of actions that the board may take that, in the aggregate, may persuade the court to review the board's approval of a conflict of interest transaction in the most favorable light to the directors. Since this paper deals with venture capitalists and their portfolio companies, we will apply Delaware law for our analysis as this tends to be the most frequently encountered law for companies of this type.

2. Conflict of Interest Transactions Generally

A conflict of interest transaction arises in three circumstances: (i) a majority of the board of directors has a conflict of interest with respect to the transaction,¹ (ii) a minority of the board of directors (who has a conflict of interest with respect to such transaction) controls or dominates a majority of the board,² or (iii) such transaction involves a merger of the corporation with a controlling shareholder.³ Venture-backed corporations most often encounter conflict of interest transactions that fit squarely within category (i) or (ii) listed above. Directors must be particularly aware of transactions that involve a conflict of interest because directors owe fiduciary duties that require them to serve and promote the best interests of the corporation.

3. Overview of Fiduciary Duties

Generally, members of a corporation's board of directors owe fiduciary duties to the stockholders of the corporation. These fiduciary duties help regulate the considerable power directors have in influencing corporate actions. In Delaware, directors generally owe two primary fiduciary obligations to the corporation and its stockholders. These obligations are "the duty of care"⁴ and "the duty of loyalty."⁵

¹ See Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 N.((Del. 1994).

² See Cinerama Inc. v. Technicolor Inc., 663 A.2d 1156, 1168 (Del. 1995).

³ See Kahn V. Lynch Communications, Inc., 638 A.2d 1110 (Del. 1994).

⁴ See Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Kaplan v. Centex Corporation, 284 A.2d 119, 124 (1971)).

⁵ See Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

Duty of Care

The duty of care refers to the obligation of directors to perform their job competently. Directors must act in an informed and diligent manner and must not be negligent in the exercise of their responsibilities to the corporation. Delaware case law requires directors to act with due care by informing themselves of “all material information reasonably available to them.”⁶

In determining whether directors exercised an appropriate degree of care, Delaware courts have held that a presumption exists that in making business decisions, a corporation’s directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the corporation.⁷ This presumption is known as “the business judgment rule.” The courts are reluctant to second guess the business decisions of directors based on the belief that businessmen are more qualified than courts to make such decisions.⁸ In addition, there is a belief that exposing directors to liability for ordinary mistakes in judgment would discourage qualified individuals from serving as directors.

Duty of Loyalty

The duty of loyalty prohibits directors from using their position of trust and confidence to further their private interests.⁹ Accordingly, as between the interests of the corporation and a director, the interests of the corporation must always come first. In order to avoid self-dealing, directors are required to make other directors and the corporation aware of any conflicts of interest that such individual director may have with respect to any matter involving the corporation before any action is taken on that matter.¹⁰ In an interested director transaction, it is generally the duty of loyalty that is at risk of being challenged. Because of the constraints imposed under the duty of loyalty, a transaction may be deemed void or voidable by a court solely because it is an interested transaction unless the transaction falls within the statutory safe harbor provided under Delaware law.

Statutory Safe Harbor

In cases involving transactions in which one or more directors are interested, Delaware offers a statutory safe harbor that provides that such a transaction will not be voidable solely because it is an interested director transaction. The safe harbor provision applies where (i) the material facts as to the director’s interest and of the transaction are disclosed to the board of directors or board committee, and the transaction is approved in good faith by the disinterested members of the board or board committee; (ii) the material facts as to the director’s interest and of the transaction are disclosed to the corporation’s stockholders and such transaction is

⁶ Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Kaplan v. Centex Corporation, 284 A.2d 119, 124 (1971)).

⁷ Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds in Brehm v. Eisner, 746 A.2d 244, 4254 (Del. 2000).

⁸ See Sinclair Oil Corp. V. Levien, 280 A.2d 717 (Del. 1971).

⁹ Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

¹⁰ Rosenblatt v. Getty Oil Company, 493 A.2d 929, 944 (Del. 1985).

approved by a majority (unless otherwise required) of the stockholders in good faith; or (iii) the transaction is fair as to the corporation at the time it was authorized.¹¹

4. Standards of Review

While ensuring that a conflict of interest transaction will not be voidable, it is important to note that meeting the requirements of the statutory safe harbor does not automatically make an interested transaction immune to challenge. Assuming the transaction and the board's decision is subsequently challenged, the standard of review applied by the court in reviewing the board's decision becomes crucial. Delaware case law is divided with regard to the circumstances under which an interested transaction will be reviewed under the business judgment rule or under the entire fairness standard of review.

Business Judgment Rule

In order to fall within the presumptions of the business judgment rule, directors must make a decision to act, or a determination to refrain from acting, and may not ignore a situation or fail to make a decision.¹² The business judgment rule protects only informed, affirmative decisions and it cannot be used to justify mere non-action. Directors are required to inform themselves of all material information reasonably available to them prior to making a business decision. Once they have become so informed, directors must act with requisite care in the discharge of their duties.¹³

The business judgment rule benefits defendant directors by allowing them a presumption that they acted on an informed basis, in good faith and in the honest belief that the challenged transaction was in the best interest of the corporation.¹⁴ This presumption is valuable because the courts will respect a director's judgment in the absence of any abuse of discretion.¹⁵ The burden of proof is on the party challenging the director's decision to establish sufficient facts to rebut the presumptions of the business judgment rule.¹⁶ Generally, this means that in order for the defendant directors to be found liable, the plaintiff must prove that the directors acted with gross negligence or committed fraud in making their decision. This standard of review greatly favors the defendant directors and provides a presumption that is very difficult for a plaintiff to rebut. Where a majority of the members of the board of directors are disinterested directors and a fully-informed majority of disinterested directors or stockholders approved or ratified the transaction, courts will generally apply the business judgment rule.¹⁷

¹¹ See Del. Code Ann. 8 §144(a)(1)-(3) (2002).

¹² See Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

¹³ Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984), overruled on other grounds in Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

¹⁴ See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Citro v. E.I. Dupont de Nemours and Co., 504 A.2d 490, 499 (Del. Ch. 1990).

¹⁵ Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds in Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).

¹⁶ Id.

¹⁷ Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1170 (Del. 1995).

Entire Fairness

If a plaintiff stockholder can demonstrate that a majority of the directors were interested or that a controlling or dominating stockholder of the corporation stood on both sides of the transaction (*i.e.*, a current majority stockholder or stockholders who will be investing in the new financing), the standard of review will be “entire fairness.”¹⁸ Under the entire fairness standard of review, courts review a defendant director’s decision in question to determine whether the transaction was fair in price and dealing.¹⁹ In determining whether the price was fair, courts examine the economic and financial considerations of the transaction, including all relevant factors, such as market value, assets, earnings, future prospects and any other factors that affect the value of the corporation’s stock.²⁰ When considering whether there was fair dealing in a transaction, courts look at the process used by the board of directors by examining the timing of the transaction, how it was initiated, negotiated, structured and disclosed to the directors, and how the director and stockholder approvals were obtained.²¹ Although the entire fairness standard has two parts, courts examine the parts together as a single issue. In essence, the entire fairness standard of review requires that the evidence concerning fair price and fair dealing prove that the negotiated transaction was fair to the corporation and characteristic of an arm’s length transaction.

The entire fairness standard of review is very rigorous and frequently results in a finding of liability.²² This standard of review greatly favors the plaintiff and creates great difficulty for the defendant directors to prove that the transaction was fair. It is very likely that a case in which entire fairness is the initial standard of review will require a full trial to receive a determination.²³

5. Creating a Record of Fairness: A Down Round Financing

Under the entire fairness standard, defendant directors have the initial burden of proving the entire fairness of the challenged transaction to the corporation and its stockholders. Therefore, a board of directors faced with a transaction that poses a potential conflict of interest needs to create a record that illustrates that, when making its decision, the directors were fully informed and carefully considered the transaction and any available alternatives and determined in good faith that its decision was the best available to the corporation and its stockholders. While creating a record of fairness will minimize a board of directors’ litigation risks, it is important to recognize that the transaction will likely continue to be judged under an entire fairness, and not business judgment, standard of review. However, the more steps a board of directors undertakes to create a record of fairness, the more likely the burden of proof will shift from the defendant directors to the plaintiff. To illustrate the various actions a board of directors may take to create a record of fairness with respect to a conflict of interest transaction, the remainder of this paper focuses on a common conflict of interest transaction involving venture-backed corporations, a down round financing transaction.

¹⁸ Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).

¹⁹ Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

²⁰ Id.

²¹ Id.

²² Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

²³ Orman v. Cullman, 2002 Del. Ch. LEXIS 18, 22.

Venture Capital Down Rounds

Many venture-backed corporations seeking subsequent rounds of financing are able to obtain financing only on terms representing a decrease in the corporation's valuation from a prior financing transaction. This situation is often referred to as a "down round." If investors in a down round are venture capitalists who are already stockholders of the corporation and who have placed their own representative on the corporation's board of directors, they have created fertile ground for a divergence of interests and an interested transaction. A down round financing can create a conflict of interest for the venture capitalist serving as a director of the corporation between his duties to the venture capital firm and his duties to the corporation and its stockholders.

Since inevitably the venture capitalist director will represent a dominant, or controlling, stockholder of the corporation, a down round financing will almost always be subject to judicial scrutiny under the entire fairness standard of review, especially if a majority of the board members are interested directors or if board members are affiliated with venture capital stockholders who wish to participate in the down round financing. In anticipation of having to defend the fairness of the down round financing, the board of directors should strongly consider the following steps to minimize its litigation risks.

Disinterested New Investor

Ideally, the corporation will find a new and disinterested investor to negotiate the terms of and lead a down round financing. Even if existing investors participate in the financing, the new lead investor will likely re-negotiate the valuation with the corporation based on its own due diligence, and will negotiate on an arms-length basis to establish the price and terms of the down round. With new outside investors leading an arms-length negotiations, the board of directors could show that the transaction was bargained in good faith by seeking pro-corporation terms or by showing that investor-favorable terms or investor control of the new series of stock were imposed on the corporation by the new lead investors.

Outside Fairness Opinion / Valuation

If the corporation is unable to find a new outside investor to lead the proposed down round financing, the board of directors should consider seeking a written opinion of or a valuation from an independent financial professional, such as an investment banking firm, that assesses the fairness of the terms of the proposed financing. Any fairness opinion should address any stockholders not participating in the financing rather than the interests of the corporation as a whole.²⁴

The board of directors should also consider engaging an independent financial professional to assist it with conducting thorough market surveys to determine whether the terms of the proposed down round financing are the best value reasonably attainable in the market. The board of directors should solicit interest from as many reliable financing sources as feasible

²⁴ See Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, 803 A.2d 428 (Del. 2002).

to provide support for the terms and valuation and to offset claims that the directors failed to act prudently, on an informed basis or in good faith. The board of directors should also explore all alternatives to financing, including a liquidation or sale of the corporation, paying particular attention to alternatives which would maximize stockholder value.

Stockholder Rights Offering / Stockholder Ratification

The corporation should consider making a rights offering to extend participation rights in the proposed down round financing to all stockholders, including founders and employees, on the same terms as all other investors in the proposed down round financing. A rights offering is especially important to consider in any interested transaction where existing stockholders are likely to be significantly diluted or where only insiders participate in a down round financing. The rights offering can help support a record of good faith and fair and equal treatment of all stockholders of the corporation.

However, a rights offering is not always a perfect solution. A rights offering can be expensive and time consuming. Because some stockholders, especially founders and employees, may not have the financial resources to participate in a new round of financing on the same terms as a venture capital firm, a rights offering may not fully cleanse the transaction. The corporation may have non-accredited stockholders who must be excluded from the offering in order to comply with blue sky laws or to preserve an exemption from registration under the Securities Act of 1933, as amended.

Another way to receive stockholder approval of the transaction without implementing a rights offering is to obtain waivers and releases from major stockholders harmed by the proposed down round financing following full and timely disclosure of all potential conflicts of interest by existing investors and of the material terms of the financing. Also, obtaining the ratification of the down round financing by a majority of the disinterested stockholders will provide the board of directors with strong evidence for an affirmative defense to the transaction and may even shift the burden of proof for the transaction.²⁵

There is a risk that attempting to obtain stockholder approval of the financing could delay the closing or that the stockholders will not approve the transaction at all, especially if the transaction will negatively impact a substantial number of them. However, approval by disinterested stockholders can provide strong evidence of fairness to the transaction as a whole as a backstop to a challenge that the interests of a director were not adequately disclosed.

Preferred Stock Versus Common Stock

Preferred stockholders generally enjoy preferences and privileges over and above those granted to common stockholders. While directors are required to honor contractual obligations to preferred stockholders, as set forth in the corporation's charter or related stockholder rights agreement, directors are not bound by special fiduciary duties with respect to such obligations. Directors owe the same fiduciary duties to both common stockholders and preferred

²⁵ Solomon v. Armstrong, 747 A.2d 1098, 1115-1117 (Del. Ch. 1999); *see also*, Braunschweiger v. American Home Shielff Corp., 1991 Del. Ch. LEXIS 7, 22.

stockholders. If a right asserted relates to a right equally shared by the preferred stockholders and the common stockholders, such right “ought not be evaluated wholly from the point of view of the contractual terms of the preferred stock designations,”²⁶ but the directors should also act with a duty of care with regard to such right. As a point of clarification, if the venture capitalist that sits on the portfolio corporation’s board of directors takes actions in his capacity as a preferred stockholder based on the preferred stockholders’ protective provisions set forth in the corporation’s charter, his actions will not affect the exercise of his fiduciary duties as a director since the protective provisions are stockholder rights that are protected by virtue of the corporation’s certificate of incorporation.²⁷

In Orban v. Field,²⁸ the board of directors exercised corporate power to assist preferred stockholders in exercising outstanding common stock warrants in order to win common stockholder approval of a merger which would wash out the common stockholders.²⁹ The board of directors took such action after being forced to decide whether to support the common stockholders’ efforts to extract value from the preferred position by refusing to approve the merger or to support the merger negotiated at arms-length, “which it believed to be the transaction at the highest available price.”³⁰ The shares of common stock were already underwater and the board of directors believed that the arms-length merger transaction reasonably appeared to be the best available under the circumstances to obtain the most value for the corporation as a whole. The court held that the board of directors acted in good faith and reasonably even though the board of directors exercised corporate power to assist the preferred stockholders against the common stockholders.

Extensive Meeting and Recordation

The board of directors should adhere to strict compliance with proper corporate governance procedures and should document a clear record of the board’s deliberations concerning the down round financing. During the meeting of the board of directors at which the proposed down round financing is presented for approval, directors should thoroughly review and discuss the proposed transaction, analyze and question any reports prepared in connection with the board review, and record as part of the minutes the board of directors’ deliberations. The board of directors, especially the interested directors, must carefully weigh the alternatives that exist to the proposed decision or course of action that gives rise to any potential conflict of interest. However, the corporation and the board of directors should be cautious of what is included in the board minutes. Board minutes should contain a brief synopsis of the meeting, documenting that alternatives were considered and creating a record in support of the final valuation. Board minutes should contain a clear record of any market surveys or analysis, outside financial advice, evaluation of alternatives, efforts to protect diluted stockholders, special committees and other measures to counteract self-dealing and conflicts of interest, and other steps taken in the process of completing the proposed down round financing. Ideally, the board

²⁶ Jedwab v. MGM Grand Hotels, 509 A.2d 584, 594 (Del. Ch. 1986).

²⁷ See Superior Vision Services, Inc. v. Reliastar Life Insurance Company, 2006 WL 2521426 (Del. Ch. August 25, 2006).

²⁸ Orban v. Field, 1997 Del. Ch. Lexis 48 (Del. Ch. Apr. 1, 1997).

²⁹ Id. at 31-2.

³⁰ Id. at 31.

of directors should convey through the board minutes that the board of directors acted in good faith and in the best interests of the corporation, fully explored all other alternatives, and only diluted stockholders as a last resort in order to get the best deal reasonably possible under the circumstances.

Any interested director should fully disclose all material details of his conflict of interest to the full board of directors and should limit his role to the greatest extent possible with respect to the down round financing. Such interested director may choose to recuse himself from board discussions regarding the transaction, and he should abstain from voting on any issues relating to the transaction. The board minutes should detail any such recusals and abstentions. In order to avoid the appearance of impropriety, the board of directors may choose to establish a board committee consisting of independent and disinterested board members to evaluate the proposed down round financing, thereby excluding interested board members from the discussions and voting concerning the down round financing.

Special Negotiation Committee

The board of directors should promptly form a special negotiation committee. While most corporations are familiar with and rely upon state law provisions that enable board of directors to utilize standing committees, many fail to utilize ad hoc special independent board committees when faced with a conflict of interest. A special negotiation committee is formed to consider and negotiate a proposed transaction involving a conflict of interest between the corporation on the one hand and the board of directors, controlling shareholders and other fiduciaries on the other hand. Perhaps more so than any other action, the use of a special negotiation committee supports the assertion of fair dealing and places the directors in the best position for defending their approval of a conflict of interest transaction.³¹

When forming a special negotiation committee to consider a down round financing, the board of directors must take care that the committee's formation and operations also comport with fair dealing. The board of directors should consider the following steps when forming its special negotiation committee:

1. Sound Mandate. The board resolutions establishing the special negotiation committee should provide a clear and unambiguous mandate outlining the committee's objectives.
2. Unbridled Power. Similarly, the committee's mandate must provide the committee, and not the board of directors, with the authority to determine the transaction's ultimate fate.
3. Advisors to Special Negotiation Committee. The mandate should grant the committee the authority and necessary resources to select its own advisors to assist it in making its decision.

³¹ Weinberger v. UOP Inc., 457 A.2d 701 (Del. 1983).

4. Committee Composition. The board of directors should take care that all members of the committee are both independent and disinterested. Similarly, committee member compensation should never be made contingent on the decisions made by the committee.

6. **Practical Tips for a Board Considering a Venture Capital Down Round Financing**

In summary, since there is a high probability that any challenge made to an interested director down round financing will be examined by the court under the entire fairness standard of review, the board of directors of the corporation should consider taking the following actions:

1. Statutory Safe Harbor. Any interested director should disclose the material facts as to such director's interest in the transaction to the board of directors, a designated board committee, or the stockholders, and the transaction should be approved in good faith by the disinterested directors, the board committee, or a majority (unless otherwise required) of the stockholders, respectively.
2. Disinterested New Investor. If possible, a disinterested new investor should negotiate the terms of and lead the down round financing.
3. Outside Fairness Opinion / Valuation. The board of directors should consider seeking a written opinion of or a valuation from an independent financial professional or soliciting interest from credible financing sources particularly if the corporation is unable to find a disinterested new investor to lead the down round financing. Any fairness opinion should address any stockholders not participating in the financing rather than the interests of the corporation as a whole.
4. Stockholder Rights Offering / Stockholder Ratification. The corporation should consider making a rights offering to all stockholders, obtaining waivers and releases from all major stockholders harmed by the proposed transaction, or obtaining the ratification of the down round financing by a majority of the disinterested stockholders.
5. Meeting and Recordation. The board of directors should thoroughly review and discuss the down round financing, analyzing and questioning any reports prepared for the directors to review. The board minutes should record their deliberations in a clear but brief synopsis of the deliberations. Any interested director should recuse himself from the discussion of the down round financing, if possible, and should abstain from voting on the proposed transaction.
6. Special Negotiation Committee. The board of directors should form a special negotiation committee charged with the task of considering and negotiating the proposed transaction. When forming the special negotiation committee, the board of directors must take care in establishing the committee's mandate and choosing the committee's membership so as to reflect fair dealing.