

Venture Capital Directors – The Heightened Risk of Serving More Than One Master

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Introduction

The world of venture capital and private equity was once considered relatively free from litigation. However, common business practices of venture capital and private equity funds are under increasing attack in the post-Enron and Sarbanes-Oxley era. This new landscape has forced directors of both private and public companies to reexamine their fiduciary duties and corporate governance practices in an era of increased liability exposure.¹ Venture capital and private equity fund managers serving as directors of portfolio companies are not immune from liability exposure and have unique conflict issues that may increase such exposure under certain circumstances. These conflict of interest issues arise as the venture capital director has fiduciary duties to the limited partners of his or her fund, as well as fiduciary duties to all shareholders of the portfolio company, among others. These conflict issues are further exacerbated when the venture capital appointed director serves as a director of multiple portfolio companies in the same industry. Situations that can raise these conflicts include financing transactions (especially “down” rounds), mergers and sale transactions, insolvency situations, executive compensation, and conflicting interests of multiple portfolio companies.

This article provides a general discussion of a director’s fiduciary duties, lists potential conflict of interest situations for venture capital designated directors, and provides certain recommendations for venture capital and private equity fund managers serving as directors of portfolio companies.

Fiduciary Duties of Directors

In General

Delaware corporate law² imposes two primary duties on directors of corporations: (i) a duty of care and (ii) a duty of loyalty.³ The duty of care generally requires a director to use the amount of care that an ordi-

narily careful and prudent person would use in similar circumstances.⁴ This duty has sometimes been described as requiring the requisite level of “process” (i.e., diligently keeping oneself sufficiently informed of material information and seeking the advice of experts to the extent necessary to make an informed decision). Any deficiencies in a director’s process generally are only actionable on a showing of gross negligence or “reckless indifference.”⁵ The duty of loyalty generally requires a director to exercise his or her powers in the best interest of the corporation and not for personal benefit or gain or for the benefit or gain of another person or organization.⁶ Although the duty of loyalty does not prohibit related party transactions,⁷ because venture capital appointed directors often may face divided loyalties, such directors must be aware of their responsibilities, particularly in light of the heightened liability risk.

Directors may be held personally liable for breaches of these fiduciary duties. Although a corporation’s governing documents usually provide indemnification protection for such directors or otherwise eliminate or limit the director’s liability to the corporation or its shareholders, the Delaware corporate law expressly limits the ability of the corporation to indemnify a director or limit a director’s liability in certain circumstances.⁸ No director should assume that the indemnification provisions of a corporation’s governing documents and the corporation’s director and officer insurance policy will sufficiently cover this risk.

Business Judgment Rule and Entire Fairness Test

In assessing whether a director has complied with his or her fiduciary duties, Delaware courts generally apply the business judgment rule in disinterested transactions. Under this rule, Delaware courts resist substituting their own judgment for that of the directors. Rather, Delaware courts presume that “in mak-

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ing business decisions, the directors...acted in good faith and in the honest belief that the action taken was in the best interests of the company.”⁹ The business judgment rule places the burden of proving that a director violated his or her fiduciary duties on the plaintiff.¹⁰

However, if a transaction involves an “interested” transaction (i.e., the director stands on both sides of the transaction, commits fraud, or personally benefits), Delaware courts will employ a heightened level of scrutiny referred to as the entire fairness test. Under this test, in assessing a director’s compliance with his or her fiduciary duties, the director has the burden of proving fair dealing and fair price of the transaction.¹¹

Conflicts of Interest and Other Risks

Venture capital firms often require that representatives of such firms be appointed to the board of directors of the portfolio company to provide, among other things, expertise and to monitor the investment. However, such directors must be aware that the fiduciary duty obligations applicable to directors are equally applicable to venture capital appointed directors.¹² Compliance with such fiduciary duties may raise concerns for venture capital appointed directors because of unique conflict of interest scenarios and divided loyalties, and it may require venture capitalists to reconsider previously accepted business practices. The following are certain conflict of interest situations facing venture capital appointed directors.

Confidentiality of Portfolio Company Information

Often a venture capital appointed director is expected to report confidential information of the portfolio company to the venture capital firm. At the same time the venture capital appointed director owes fiduciary duties to the portfolio company, and it is often inferred that the duty of care or the duty of loyalty, or both, require such director to keep such information confidential.¹³ This issue becomes particularly acute when the venture capital firm has investments in multiple portfolio companies in the same industry.¹⁴

Follow-on Financing Transactions.

Typically new investors owe no fiduciary duties to the portfolio companies. However, a venture capital firm that is already an

investor in the portfolio company and is providing subsequent rounds of equity or debt financing must be aware of the fiduciary duties of the venture capital appointed director to the portfolio company and all of its shareholders and cannot just focus only on the protection of the initial venture capital investment.

Acquisition Transactions

In a transaction in which the portfolio company acquires another portfolio company of the venture capital firm, the venture capital appointed director may find himself or herself on both sides of the transaction.

Merger, Sale, or other Exit Transaction

In connection with any sale or disposition of all or a portion of the portfolio company, a venture capital appointed director must be comfortable that the transaction is in the best interest of the portfolio company and all of its shareholders and not solely to protect the venture capital investment in the portfolio company and/or to solely provide an exit for the venture capital firm.

Insolvency Situations

When a company is insolvent, a director’s fiduciary duties may require taking into account the interests of creditors, in addition to the company and its shareholders. Navigating this issue (including when a corporation is insolvent) becomes more complex when the venture capital firm itself is a primary and/or secured creditor. Also, there is some risk that a venture capital funded loan may be “equitably subordinated” to other debt of the company.

Aiding and Abetting Risks

A venture capital firm must be careful not to subject itself to potential liability for breach of fiduciary duty claims. Such a claim has been asserted directly against the venture capital firm, as well as the venture capital appointed director, where the plaintiff alleged that the venture capital appointed director was overly controlled by the venture capital firm.¹⁵

Executive Compensation

Although executive compensation transactions do not necessarily present conflict of interest issues, venture capital appointed directors should be mindful that such transactions have seen a significant increase in litigation.

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There has been recent litigation involving all of the circumstances described above.

Recommendations

Because of the unique conflict of interest situations and the heightened liability risk that may face venture capital directors in the post-Enron environment, a venture capital director should consider the following recommendations to minimize the risk of liability.

Consider Board Observer Rights

In response to the inherent conflict of interest issues and the increased liability exposure, some venture capital and other private equity firms have opted to forego board seats. Instead, such firms have required board observation rights, which provide the right to attend and otherwise participate in all board meetings and receive all board package materials. However, board observers do not have the right to vote. Board observers should require a portfolio company to cover them under the company's director and officer insurance policy.

Understand Your Duties

A venture capital and private equity director who also is a director of a portfolio company must always be aware of which hat he or she is wearing — venture capital hat whereby fiduciary duties are owed to the venture capital firm and its limited partners, or portfolio company hat whereby fiduciary duties are owed to the portfolio company and all of the shareholders of the portfolio company.

Review/Modify Governing Documents of Portfolio Company

A venture capital and private equity director should review the portfolio company's governing documents to ensure that these documents provide the maximum protection available under applicable state law. The director should also review the governing documents to ensure that advances on expenses are available to directors. Finally, the director should consider whether these governing documents (or the investment documents) also contain provisions whereby the portfolio company acknowledges and agrees that the director and the venture capital/private equity fund may also invest in and sit on the board's of competing companies and disclose confidential information regarding the portfolio company to the venture capital firm and its other management team members.¹⁶

Review/Modify Fund Formation Documents

The venture capital fund formation documents should expressly include provisions addressing conflict of interest situations involving venture capital appointed directors. For example, the fund formation documents could provide that a fund manager is permitted to comply with his or her fiduciary duties to the portfolio company, even if exercising such duties would conflict with his or her fiduciary duties to the fund.

Enter into a Separate Indemnification Agreement

A director should require a separate indemnification agreement before agreeing to serve on the portfolio company's board. These indemnification agreements typically provide broad-based indemnification protection, as well as provisions related to advancements of expenses. Although a separate indemnification agreement may be duplicative of the governing documents, it would provide the individual director with a separate contractual right for advancement of expenses. The value of such a contractual right is even greater now given a recent decision of the Delaware Chancery Court, which upheld amendments made to a company's bylaws eliminating the right to advancement of expenses for a former director facing litigation.¹⁷

Obtain and Review D&O Insurance

Venture capital funds generally will require portfolio companies to obtain and maintain D&O insurance. A portfolio company will often argue that the cost of such insurance is not worth the benefit, particularly if the portfolio company is at a relatively infant stage. In this situation, the venture capital fund should consider board observer rights (see above) in lieu of a full board seat. Also, the director should review the D&O policy as to scope and amount of coverage, limitations, "tail" coverage, director choice of counsel, and whether such coverage includes a duty to defend as opposed to a duty to reimburse.

Where Appropriate, Adhere to Corporate Governance "Best Practices"

A venture capital appointed director's actions and inactions will likely be judged against today's corporate governance "best practices" and "norms." A director complying with such practices and norms would, among other things (i) devote adequate time

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and effort to discharge duties, (ii) comply with corporate governance rules, (iii) review and document compliance with fiduciary duties (e.g., the minutes should reflect careful consideration and due deliberation), (iv) seek independent third-party advice where appropriate (e.g., valuations or fairness opinions), (v) document alternatives explored, (vi) obtain disinterested board and shareholder approval where appropriate, and (vii) recuse himself or herself from board discussions where appropriate.

Summary

A venture capital appointed director cannot eliminate all liability exposure for serving on the board of portfolio companies. However, a venture capital fund and its designated directors should be sensitive to the changing landscape and re-examine previously accepted corporate governance practices in light of heightened liability risk in the current environment.

transaction are disclosed and the contract or transaction is specifically approved in good faith by a majority of the shareholders; or

(iii) the contract or transaction is fair as to the corporation as of the time it is approved by the board of directors or the shareholders.

8. See DGCL, Sections 102 and 145.
9. See *Smith v Van Gorkum*, 488 A2d 858 (Del 1985).
10. See *Emerald Partners v Berlin*, 787 A2d 85 (Del 2001).
11. See *Weinberger v UOP, Inc*, 457 A2d 701 (Del 1983). See also DGCL Section 144.
12. *Id.*
13. Because the case law and commentary is not well developed in this area, the authors are aware of portfolio companies considering or requiring all directors to execute separate confidentiality agreements. Similarly, because of the fiduciary duty exposure, the authors are also aware that venture capital firms are requiring portfolio companies to amend their governing documents to specifically permit disclosure of such information to the venture capital firm.
14. See *CCBN.com v Thomson Fin, Inc*, 270 F. Supp.2d 146 (D Mass July 2, 2003).
15. See *Khanna v McMinn*, No Civ A. 20545-NC, 2006 WL 1388744 (Del Ch May 9, 2006) (unpublished opinion).
16. See DGCL, Sections 102(b)(7) and 122(17).
17. See *Schoon v Troy Corp*, 948 A2d 1157 (Del Ch 2008).

NOTES

1. See *General Partner/Director Position Poses Dual Fiduciary Duty Danger*, Corporate Officers & Directors Liability Litigation Reporter, Vol. 19, Issue 9, and cases cited therein.

2. The fiduciary duties of a director of a portfolio company are governed by the state of incorporation of such portfolio company. In part, because of the more developed case law in Delaware, this Article discusses a director’s fiduciary duties under the Delaware General Corporations Law (DGCL). In the absence of clear Michigan law on corporate law matters, Michigan courts often refer to the DGCL. See, e.g., *Glancy v Taubman Centers, Inc*, 373 F3d 656 (6th Cir 2004) (quoting *In re Consumers Power Co Derivative Litig*, 132 FRD 455, 461 (ED Mich 1990); *Russ v Federal Mogul Corp*, 112 Mich App 449, 455 (1982).

3. There has also been some discussion of a duty of good faith, which may or may not be subsumed in the duty of loyalty. See *In re Caremark Int’l, Inc Derivative Litig*, 698 A2d 959 (Del Ch 1996); *Stone v Ritter*, 911 A2d 362 (Del 2006). See also *In re World Health Alternatives, Inc*, 385 BR 576 (Bankr D Del 2008).

4. See *In re Walt Disney Co Derivative Litig*, 907 A2d 693 (Del. Ch. 2005).

5. *Id.*

6. *Id.* at 751.

7. Section 144(a) of the DGCL provides that a contract or transaction is not void or voidable if:

(i) the material facts as to the director’s relationship or interest and as to the contract or transaction are disclosed and the contract or transaction is approved in good faith by a majority vote of the disinterested directors;

(ii) the material facts as to the director’s relationship or interest and as to the contract or



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