

Quinn Emanuel Private Equity Litigation Practice Alert

Duty of Loyalty Issues for Designated Directors and the Boards of Portfolio Companies

I. Background

For the partners and managing directors of PE firms who have also been designated to serve as directors of one of the firm's portfolio companies ("designated directors"), navigating potential conflicts of interest is a fact of life. As businesses brace for the next economic downturn in the wake of the coronavirus pandemic, these conflicts are likely to become more prevalent and may expose directors to increased litigation risk. Designated directors need to be particularly cautious in circumstances where the investing firm's interests diverge from those of the portfolio company—and crises like the current pandemic, which has placed many portfolio companies under financial stress, often give rise to conflicts. In this Client Alert, we address these challenges in the designated director context, focusing primarily on the duty of loyalty under Delaware law.

II. Designated Directors and the Duty of Loyalty

Under Delaware law, all directors owe a duty of care and a duty of loyalty to the corporation. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). Thus, designated directors owe a duty of "uncompromising" loyalty to the corporation and, at least derivatively, to *all* of its stockholders. They cannot value the interests of their nominating firm above those of the corporation or any other stockholders. Delaware law is clear that there is "no dilution" of the duty of loyalty when a director "holds dual or multiple" fiduciary obligations; "there is no 'safe harbor' for such divided loyalties in Delaware." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Although Delaware law (8 Del. C. § 102(b)(7)) allows corporations to exculpate directors from personal liability for breaches of the duty of care, it expressly precludes such exculpation for breaches of the duty of loyalty.

The fundamental question for designated directors, then, is how to navigate the potentially competing loyalties they owe to the corporation on the one hand and their nominating firm on the other. The designated director may face competing pressures resulting from his or her role at the nominating firm. For example, the designated director's compensation at the nominating firm may be tied in part to the firm's investment returns associated with the corporation. Designated directors may also owe fiduciary duties or contractual obligations to the nominating firm and *its* partners or shareholders. Under certain circumstances, these duties could be seen to interfere with the designated directors' obligations to the portfolio company and its stockholders. "Because [constituency] directors are often affiliated with entities whose interests may differ from those of the stockholders as a whole, and because [constituency] directors are often dual fiduciaries who also owe a duty of loyalty to their differently situated entities, this standard poses particular risks to the [constituency] directors." J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 Bus. Law. 33, 49 (2015).

III. Conflict Transactions

We refer to a conflict transaction as one in which a majority of the board has an interest in the decision or transaction that differs from the stockholders in general (such as when a director receives additional consideration to the detriment of the other stockholders), or when the directors or a controlling stockholder "stand[] on both sides" of a transaction. The latter applies particularly in the case of designated directors because transactions will often involve the portfolio company and the sponsoring firm or other companies it owns. For example, as more companies struggle financially and may approach insolvency, directors may need

to decide whether a bankruptcy or out-of-court restructuring is necessary. As such situations materialize, nominating firms may decide they want to liquidate their positions in the portfolio companies quickly. But, a transaction or liquidity event that may have a short-term benefit for the nominating firm may not be in the best interests of the company or the rest of the company's shareholders. A designated director who "also serves in a fiduciary capacity for [the nominating firm] can face a conflict of interest: the [designated director's] duties to the corporation require that the director manage for the long term, while the [designated director's] duties to the [nominating firm] require that the director manage for an exit." Laster & Zeberkiewicz, at 50.

Conflicts of interest also may result from "down-round investments," in which a PE firm whose portfolio company is struggling loans the portfolio company money in order to keep it solvent. If and when the portfolio company turns things around, the loan converts into equity. This is a way for PE firms to hedge their bets with their portfolio companies during hard economic times, but these down-round investments create conflicts of interest both for the PE firm and for the directors it appoints to the portfolio company's board. Those directors have a duty to the portfolio company, but also may owe conflicting duties to the PE firm, which is negotiating the terms of the loan *against* the portfolio company.

Conflicts can also arise if the same designated director sits on boards of other portfolio companies, and those portfolio companies enter into transactions with each other. In those circumstances, the designated director could be privy to confidential information of one portfolio company that gives an advantage to the other portfolio company in negotiations. The director could also learn of a business opportunity that may be valuable to both portfolio companies, but available to only one of them. In addition, any transaction in which the PE firm receives consideration from the portfolio company, including the payment of a dividend to the PE firm and other stockholders, implicates the duty of loyalty because designated directors likely will be deemed to sit on both sides of the transaction: The designated directors are approving the transaction on behalf of the portfolio company and they are employed by or affiliated with the PE firm receiving the consideration. If they are investors in the PE firm's funds, they might also be personally receiving a portion of the consideration through their investment in the funds.

These types of situations create a risk that a designated director may face a claim for breach of fiduciary duty when he or she addresses these matters at a board meeting of the portfolio company.

IV. Potential Legal Defenses

Among the first issues courts must decide in fiduciary duty cases is whether to scrutinize the challenged transaction under the "business judgment rule" or the "entire fairness standard." The standard of review is critically important, as it is very difficult for a plaintiff to even make it past the motion to dismiss stage where the business judgment standard applies; by contrast, a defendant can be challenged to prevail even on summary judgment if the entire fairness standard applies.

The business judgment rule is the default rule in Delaware and is extremely deferential to directors' decisions. The business judgment rule is a presumption that directors acted in good faith, on an informed basis, and with a sincere belief that they were acting in the company's best interest. Where the rule applies, a transaction will stand unless it cannot be attributed to any rational business purpose. As this standard suggests, it's possible for director-defendants to lose under the business judgment rule, but the challenged decision must be egregiously bad—not attributable to any rational purpose. In *Smith v. Van Gorkom*, for example, the board approved a merger without consulting any experts or reviewing any documents that would allow it to assess whether the merger price was reasonable. The Delaware Supreme Court held that, given the board's complete failure to take steps to evaluate the proposed merger, the plaintiff rebutted the presumption that the board's judgment was an informed one.

The business judgment rule applies by default provided a majority of the directors are independent, informed about the subject of the challenged decision, and believe (rationally and in good faith) that the challenged decision is in the company's best interest. As long as those things are true, director-defendants will almost always prevail—and often at a very early stage of the lawsuit, saving time and costs.

The business judgment rule does not apply, however, when the majority of approving directors is conflicted, as in the conflict transaction examples previously discussed, or if the portfolio company is engaging in a transaction with an entity in which the PE firm is a controlling stockholder. *See Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994) (“A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness.”). Nevertheless, the board may still attempt to invoke the protection of the business judgment rule in several ways.

- First, the board could create a special committee of disinterested directors to consider and approve the transaction and, in the case of a transaction with the controlling stockholder, negotiate it. There is authority that the use of a special committee, combined with minority stockholder approval, will trigger business judgment rule protections, even with a transaction involving the controlling stockholder. *See In re MFW S'holders Litig.*, 67 A.3d 496, 526-27 (Del. Ch. 2013) (deciding the issue as a matter of first impression).
- Second, the conflicted directors could abstain from the discussion and the board vote, resulting in only disinterested directors approving the corporate action or transaction. In such a situation, the board action cannot be approved by written consent because of the unanimity requirement of DGCL § 141(f). *Solstice Capital II, Ltd. P'ship v. Ritz*, 2004 WL 765939, at *1 (Del. Ch. Apr. 6, 2004). If the approving disinterested directors comprise a majority of the board, the business judgment rule almost certainly applies. If they do not, legal authority is mixed, with some courts stating that the disinterested majority must be measured with respect to the *entire board*. *See Cumming v. Edens*, 2018 WL 992877, *22 (Del. Ch. Feb. 20, 2018) (“If a director-by-director analysis leaves insufficient [independent] directors to make up a board majority, then the court will review the board’s decision for entire fairness.” (citation omitted)). If the disinterested directors constitute a quorum of the board under the portfolio company’s bylaws, however, there should be a strong argument that the quorum represents the board and disinterestedness should be measured with respect to the quorum.
- Third, the board of a portfolio company organized under Delaware law could rely on the safe harbor in DGCL § 144(a), which provides that a transaction is not void or voidable solely because conflicted directors participate and vote, as long as (i) the conflicted directors disclose the conflict to the entire board prior to a vote; and (ii) the transaction is approved by a majority of disinterested directors. Again, however, legal authority is mixed as to whether compliance with the safe harbor triggers business judgment rule protection if the majority of the entire board is conflicted, with one court recently holding that it does not. *See Cumming v. Edens*, 2018 WL 992877, *21-22.

If the business judgment rule does not apply, the board action will be judged under the more difficult entire fairness standard. The entire fairness standard requires the directors to establish “to the *court’s* satisfaction that the transaction was the product of both fair dealing *and* fair price.” *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162-63 (Del. 1995) (emphasis in original). The procedures discussed above—use of a special committee, approval by the minority stockholders, abstention of independent directors, disclosure of conflicts, and approval by a majority of disinterested directors (even if it is one director)—are relevant to the fair dealing analysis.

What should the designated director do when faced with a conflict scenario? Given the serious potential reputational and financial consequences of breaches of fiduciary duty and the likely increased prevalence of these complex issues during the current economic crisis, all those with a vested interest—the corporations, the nominating firms, the designated directors, and the boards on which they sit—must grapple with how to avoid a potential violation of the duty of loyalty and best position themselves if there is litigation. We discuss these potential concerns below in the context of advocating for the nominating firm’s preferred

course of action, steps to take to “cleanse” potentially interested transactions, and various conflicts that can arise from the sharing of confidential information among nominating firms, designated directors, and portfolio companies.

V. Approaches for Specific Types of Conflict Scenarios

Advocating for the Nominating Firm’s Preferred Course of Action on the Board

Assume the corporation’s board is contemplating a course of action (say, beginning a debt restructuring for a company that, in the face of the current pandemic and resulting shutdowns, is struggling and nearing insolvency) that the nominating firm strongly supports because it believes it will improve value for all stockholders. May the designated director advocate in favor of the transaction before the board without breaching the duty of loyalty? The answer should be “yes”—but only if the designated directors disclose their interest and are fully informed and honestly and objectively believe the transaction is in the best interests of the corporation and *all* its stockholders. Thus, although designated directors cannot blindly (and to the detriment of the company’s other stockholders) represent the positions of a nominating firm, they *can* advocate for a position which the nominating firm would favor, if that position is based on the honest and objective understanding that such position is in the best interest of the corporation and all of its stockholders—whether or not the corporation’s other stockholders agree with their assessment. *See, e.g., In re Lear Corp. S’holder Litig.*, 967 A.2d 640, 655 (Del. Ch. 2008) (“directors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them”). To ensure that they are not accused of tainting the other directors, the designated directors must fully disclose any conflicts at the outset.

As discussed above, however, the standard for the business judgment rule is disinterestedness. Accordingly, if the directors approving the transaction are not a disinterested majority of the board, or if the transaction involves the controlling stockholder, the board vote can still be challenged as a breach of the duty of loyalty without the board receiving the protections of the business judgment rule. The next section discusses steps to “cleanse” a conflicted transaction.

Steps to Take to “Cleanse” Potentially Conflicted Transactions

Assume that another portfolio company is struggling during the current pandemic, and the PE firm wants to make a down-round investment—to loan the portfolio company cash up-front, with the loan converting into equity if the company weathers the storm. Also assume that the PE firm’s designated directors on the portfolio company’s board are also principals or employees of the PE firm, and thus owe fiduciary duties to both the portfolio company and the PE firm, creating a conflict of interest with respect to the down-round investment transaction. Assume the disinterested directors do not constitute a majority of the entire board.

What should the designated directors do? The safest course of action is for the board to appoint a special committee, comprised of only the independent and disinterested directors, with the full authority to negotiate, discuss, and ultimately approve the transaction. If the board combines the use of the special committee with approval of the transaction by the minority stockholders, it likely will be able to obtain the protections of the business judgment rule. *See MFW*, 67 A.3d at 526-27. But the board must be careful to ensure that conflicted parties are not involved in any way in the negotiation, discussion, or approval of the transaction because it could be deemed to taint the fairness of the process. *See Emerald Partners v. Berlin*, 2003 WL 21003437, at *28 (Del. Ch. Apr. 28, 2003) (noting under the entire fairness standard that “[t]he single flaw in the non-affiliated directors’ decision-making process was their failure to insist that [the conflicted directors] absent themselves entirely from that process.”), *aff’d*, 840 A.2d 641 (Del. 2003).

If a special committee is impractical or impossible, the conflicted directors should (1) fully disclose the conflict to the board; (2) remove themselves from any discussions concerning the matter; and (3) abstain from the board vote. As discussed above, however, if the disinterested directors do not constitute a quorum, the board cannot depend on the protections of the business judgment rule.

Without business judgment rule protection, the directors should be prepared for the entire fairness standard to apply if the board action ultimately is challenged. In connection with a transaction requiring board approval, directors can take certain steps to best position themselves for meeting the entire fairness standard. *First*, the board should make a written record of its consideration of the transaction, which should reflect careful and informed consideration of the material issues raised by the transaction. *Second*, the board should obtain a fairness opinion from independent financial advisors stating that the terms of the transaction are fair, from a financial point of view, to the company and its stockholders. *Third*, the board should rely on information from independent management or outside advisors when they can, rather than information from the PE firm. *Fourth*, the board should obtain approval from any fully informed disinterested directors. *Finally*, the board should consider requiring stockholders to approve the transaction after providing them robust disclosures that include a discussion of all conflicts.

Sharing of Confidential Information Between the Corporation and the Nominating Firm

Another set of possible conflict issues arises in connection with the sharing of confidential information. As a board member, the designated director is entitled to the same confidential corporate information provided to other directors—and directors have very broad rights to access the company’s books and records in order to perform their functions effectively. *Schoon v. Troy Corp.*, 2006 WL 1851481, at *1 n.8 (Del. Ch. June 27, 2006) (A director’s right to information is “essentially unfettered in nature”); *Intrieri v. Avatex Corp.*, 1998 WL 326608, at *1 (Del. Ch. June 12, 1998) (“[A] sitting director is entitled to ... receive whatever the other directors are given.”).

As one would expect, access to confidential information can create conflicts where a designated director has the dual-fiduciary concerns we have discussed above. Can the designated director share confidential company information he or she learned as a board member with the nominating firm? The answer is that it depends—largely on whether the director can share the confidential information without breaching his or her duties to look out for the welfare of the portfolio company and its stockholders. Unsurprisingly, it *is* a breach of the duty of loyalty for a designated director to share the corporation’s confidential information with the nominating firm if such sharing of confidential information would harm the portfolio company. *See Wayman Fire Prot., Inc. v. Premium Fire & Sec., LLC*, 2014 WL 897223, at *22 (Del. Ch. March 5, 2014). To continue the down-round investment example, a portfolio company director who disclosed to the PE firm confidential information that helped the PE firm in its loan negotiations against the portfolio company would almost certainly have breached his or her duty of loyalty to the portfolio company.

There are, however, circumstances where Delaware law permits the designated director to share the corporation’s confidential information with the nominating firm. For example, in *Kalisman v. Friedman*, the Delaware Chancery Court held that the corporation could not deny a designated director, who also served as the principal at a hedge fund that owned 13.9% of the public corporation, access to company information, including attorney-client privileged material, out of fear that the director would share the information with the nominating firm. 2013 WL 1668205, at *5 (Del. Ch. Apr. 17, 2013). In dicta, the court stated that “[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder’s representative, then the stockholder is generally entitled to the same information as the director.” *Id.* at *6. Of course, where the sharing of confidential information would be harmful to the corporation, the director’s duty of loyalty still prevents such conduct.

The confidential-information problem can also run in the other direction. Suppose the designated director gains confidential information relevant to the corporation *from* the nominating firm. Must the designated director disclose the information to the corporation? Again, it depends. If a designated director gains confidential information from his or her nominating firm that is relevant to an action being contemplated by the corporation’s board, the duty of loyalty may require disclosure of such information, particularly if the transaction would benefit the nominating firm more than the portfolio company. *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1184 (Del. Ch. 2006) (a director does not have a general duty to disclose but rather a duty to disclose in “circumstances in which the director is personally engaged in transactions harmful to the corporation, but beneficial to the director”). The analysis is thus similar to conflict of interest

analysis in general: If the designated director (or the nominating firm, if the designated director is a principal or employee) benefits from the designated director's failing to disclose the information to the corporation, the director is likely breaching his or her fiduciary duties to the corporation.

Of course, the conflict issues do not necessarily end there. If disclosure of the confidential information to the corporation's board is harmful to the nominating firm, would the designated director breach any duties to the nominating firm if the information is disclosed? The answer is that he or she may well have done so, but it depends on the specific facts. There is simply no way to avoid *all* potential conflicts of interest between nominating firms, designated directors, and the corporations on whose boards designated directors sit. And, as noted, the current crisis means that more and more of these potential or hypothetical conflicts of interest will develop into actual conflicts. Although PE firms reap many benefits from the presence of their designated directors on the boards of their portfolio companies, they should also consider the potential liability risks. Designated directors facing such potential or actual conflicts should follow the steps outlined above—fully disclose their conflicts of interest, appoint special committees and obtain approval by a majority of disinterested directors when they can, and position themselves to satisfy the entire fairness standard when they cannot—to help mitigate the resulting risk of liability.

As set forth above, the increasing prevalence of constituency directors on company boards, and designated directors in particular, requires careful and proactive navigation of potential conflicts of interest. These issues are likely to arise even more often as the economy struggles through a pandemic-generated recession. Following the steps outlined in this Client Alert should help PE firms and the directors they appoint reap the benefits of having designated directors on portfolio company boards while reducing the accompanying risk.

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