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Fiduciary Duties in Distressed Situations

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Issues for the Venture Capital Director

Today's program focuses on the fiduciary duties of directors in the following circumstances:

1. Company is operating at or near insolvency
2. Down Rounds
3. Times when a director's loyalties may be divided during a distressed sale / wind-down

* Unless otherwise indicated, all statements are based on applicable Delaware law. Because of its popularity as a state of incorporation, Delaware's law is well developed and influential in other jurisdictions.

The Business Judgment Rule

- Decisions made on an informed basis, in good faith and with the belief that the action was taken in the best interest of the corporation will be protected by the “business judgment rule”
- The business judgment rule prevents business decisions / actions from judicial second-guessing
- DGCL § 141(e) – Protects board members who rely in good faith on the corporation’s records and information provided by officers or employees who have been selected with reasonable care

Duties of Directors of Solvent Corporations

Directors have two basic duties:

- Duty of care
 - Directors must exercise the care of a reasonably prudent person under similar circumstances and in the manner reasonably believed to be in the best interests of the corporation
 - Requisite level of “process” (keep oneself informed of material information, seek advice where necessary to render an informed decision)
- Duty of loyalty
 - Directors must refrain from self-dealing, usurping corporate opportunities and receiving improper personal benefits
 - Interested transactions reviewed under “entire fairness” standard
 - Burden shifts to interested directors to prove fairness

Who is the Beneficiary of a Director's Fiduciary Duties?

- Directors owe their fiduciary duties to the corporation
- When the corporation is solvent, the shareholders, as residual interest holders, are the beneficiaries
- Shareholders of a solvent corporation can bring a derivative action on behalf of the corporation to enforce breaches of such duties
- A corporation's articles of organization may contain an exculpation of directors for breaches of the duty of care – but **not** for breaches of the duty of loyalty (DGCL § 102(a)(7))
- In general, directors' fiduciary duties are not intended to benefit creditors, whose rights are generally protected by contract and other areas of law (avoidance actions, etc.)

Officers' Fiduciary Duties

- Do officers owe fiduciary duties?
 - Yes
 - May owe additional duty to adequately inform board members

Personal Liability

- Certain actions taken by a company may trigger personal liability for a company's directors and officers
- Varies state by state, but typically includes:
 - Withholding taxes (e.g., social security income taxes)
 - Wages
 - "Trust Fund" Taxes (e.g., sales and use taxes)



Fiduciary Duties Upon Insolvency

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Duties of Directors of Insolvent Corporations

- Same fiduciary duties owed: care and loyalty
- Creditors replace shareholders as the residual interest holders
- Creditors may bring derivative actions to enforce breach of fiduciary duty claims
- Business judgment rule and exculpation clauses still apply
- Zone of insolvency no longer triggers creditors' right to bring action; actual insolvency must occur, but hindsight is always 20/20

Fiduciary Duties: A Cheat Sheet

	Solvent	Zone of Insolvency	Insolvent*
<u>Fiduciary Duty</u>	Protect assets and maximize value for the benefit of shareholders	<p>In certain jurisdictions, expanded duties to all stakeholders</p> <p>In majority of jurisdictions, including Delaware, fiduciary duties remain to the corporation and its residual interest holders</p>	Duty to maximize value of corporation recognizing that creditors are the residual stakeholders
<u>Maintain Derivative Action</u>	Shareholders	Shareholders	Creditors

* Does not apply to Limited Liability Companies or Limited Partnerships

Overview of Fiduciary Duties: Limited Liability Companies and Limited Partnerships

Limited Liability Companies

Limited Liability Companies and Limited Partnerships are creatures of contract

- Express statutory authority to contract away most duties
 - Del. Limited Liability Company Act § 18-1101(c)
 - See *also* Del. Revised Uniform Limited Partnership Act § 17-1101(f)
- Implied contractual covenant of good faith and fair dealing can never be contracted away
- Duties owed only to members and assignees

Caution: If LLC agreement is silent, court may read default duties into agreement

Limited Partnerships

A general partner owes standard fiduciary duties to the partnership and its limited partners

Do the directors of a corporation that acts as the general partner of a limited partnership owe fiduciary duties to the *partnership's* limited partners?

- Yes!

Caution: In certain situations, lenders have asked to be admitted as limited partners in connection with a borrower's pledge of interests in a subsidiary LP. Admitting a lender as LP gives the lender the benefit of a direct cause of action for breach of a fiduciary duty.

Best Practices in Advising Directors

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- Ensure properly drafted organizational documents
- Adhere to good corporate governance practices
- Stay current on the company's financial condition / Pay attention to insolvency indicators
- Retain counsel and financial advisors
- Document, document, document

Issues for the Venture Capital Director

Down Rounds

- *The Risk:*
 - Below-market valuation approved by the board creates situation where VC directors may be on both sides of the transaction
 - New investment by VC firm creates clear conflict for VC directors
 - Where a majority of the board is “interested,” business judgment rule does not apply
- *Mitigating Strategies:*
 - Create independent committee
 - Consider appointing independent directors
 - Offer financing to all stockholders
 - Obtain disinterested stockholder approval
 - Shop the deal / market test

Down Rounds

- Prepare for “Entire Fairness” Review
 - Must ensure fairness of both negotiation and deliberation process
 - Fairness opinion

Divided Loyalties

Issue Spotting

- VC Firm vs. Portfolio Company
 - Director may be expected to report information to VC firm, yet still be subject to confidentiality obligations to portfolio company (e.g. performance issues, misconduct)
- VC Firm vs. Itself
 - Multiple funds own different securities, or combination of debt and equity
- Portfolio Company vs. Portfolio Company
 - Multiple VC investments within same industry

Divided Loyalties

What To Do

- Make sure governing documents permit disclosure where necessary
- Know your “hat” – voting as a director (best interests of portfolio company) or voting as a stockholder (probably best interests of the VC fund)
- Disclose where necessary
- Consider recusal if appropriate

Insolvency Situations

- Directors may need to consider the derivative exposure of creditors if the company becomes insolvent
- These issues can become more complex if the VC firm itself is a primary and/or secured creditor

Recommendations

- Consider Board observer rights as alternative
- Be aware of your role – are you acting as a director or investor?
- Review / modify governing documents of portfolio company

Thank You

- Questions
- Recorded webinar will be available online and emailed to all attendees

Contact Us

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