Duties of Directors of Emerging Growth Companies and Strategies to Mitigate Liability Exposure

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INTRODUCTION

- Recent Headlines – Enron, WorldCom and Walt Disney Derivative Litigation
- Business Judgment Rule
- Duties of Directors of Private Companies
  - Duty of Care
  - Duty of Loyalty
- Strategies to Mitigate Liability Exposure
  - Corporate Governance Best Practices
  - Indemnification
  - Directors' and Officers' Insurance

BUSINESS JUDGMENT RULE

- Presumption that, in Making a Decision, Directors of a Corporation Acted on an Informed Basis and the Action Taken was in the Best Interests of the Corporation and its Shareholders

- Unless the Presumption is Rebutted by a Plaintiff, the Board's Decision will be Upheld and the Directors will not be Liable

BUSINESS JUDGMENT RULE (CONTINUED)

- Plaintiff can Rebut the Business Judgment Rule Presumption if it can Demonstrate that the Board Violated one of its Fiduciary Duties in Connection with the Challenged Transaction.

- If the Presumption is Rebutted, the Burden Shifts to the Defendant Directors to Prove the Entire Fairness of the Transaction.

DUTIES OF DIRECTORS

- Duty of Care

- Duty of Loyalty

DUTY OF CARE

- Duty of Care – Use Due Care in Making Decisions as a Director and in Performing Oversight Responsibilities.
- California Corporation Code Section 309(a):
  - Good Faith
  - Reasonably Believe in Best Interests of Corporation and Shareholders
  - With the Care, Including Reasonably Inquiry, a Prudent Person in a Like Position Would Exercise in a Similar Situation

DUTY OF CARE (CONTINUED)

- Smith v. Van Gorkum
  - Van Gorkum (Chairman & CEO) negotiated sale of Trans Union for 50% above trading price to Pritzker.
  - Board approved the Transaction after a 20 minute presentation by Van Gorkum with only 2 hours of deliberation
  - No independent valuation analysis and no questioning of how price was set
  - No Review of Merger Agreement or Term Sheet
  - Transaction Approved by Shareholders with Board Recommendation
  - Board Did Not Meet its Obligations - Such a Material Transaction Required More Deliberation

DUTY OF CARE (CONTINUED)

- Walt Disney Company Derivative Litigation
  - Michael Ovitz hired by Disney for $24M per year and No Fault Termination resulted in $38M Cash Payment and $140M in Acceleration of Options
    - Eisner issued press release announcing hiring before board decision
    - Eisner stacked board with friends
    - Compensation Committee met for less than 1 hour
    - Court ruled business judgment rule applied because duty of care met
      - Materiality – less than amount head of film production could approve on its own so 1 hour of deliberation with a detailed term sheet sufficient (compare Van Gorkum sale of company)

DUTY OF CARE (CONTINUED)

- Meeting the Duty
  - Time Commitment, Attendance at Meetings - More Material Requires More Time and Diligence
  - Be Adequately Informed
    - Don’t Act Without All the Facts
    - Don’t be Afraid to Request More Time to Deliberate
  - Make Due Inquiries
    - Look for Red Flags – transactions with little business purpose, related-party transactions, unusual accounting changes, unusual one-time expenses
    - Question Management
  - Reliance on Experts
    - Must Exercise Due Care in Choosing Experts

DUTY OF LOYALTY

- Duty of Loyalty
  - Good Faith
  - Act in a Manner Reasonably Believed to be in the Best Interests of the Corporation
  - Not in Separate Best Interests of Director or Related Person

- Duty owed to:
  - Corporation
  - Shareholders
  - Creditors if Insolvent

DUTY OF LOYALTY (CONTINUED)

- Situations in Which Duty of Loyalty is Implicated:
  - Conflict of Interest Transactions
  - Usurping a Corporate Opportunity

- Conflicts of Interest Transaction
  - Types
    - Financial Interest
    - Personal Interest
  - Approval of Interested Transactions (Cal Corp. Code Section 310)
    - Material Facts Concerning Director's Interest Disclosed; and
    - Approved by Shareholders without Counting Interested Director's Shares; or
    - Approved by Disinterested Board <u>and Transaction was Just and Reasonable</u> (compare Delaware – Does not require fairness)
    - Alternatively, Can Prove the Transaction was Fair.

DUTY OF LOYALTY (CONTINUED)

- Controlling Shareholder Fiduciary Duties
  - Generally controlling shareholders can act and vote their economic interests
  - Have fiduciary duties to other shareholders when on both sides of a transaction or when receive something to the exclusion of the minority
    - Self-interest precludes application of the business judgment rule of the board even if directors are unaffiliated with controlling shareholder
    - Transaction must be entirely fair to the minority
      - Fair Price
      - Fair Dealing
- Example – Down Round Financings
  - Conflict of Interest – VC Board Member interested because fund is investing in round
  - Those who don't continue to invest are "washed out" while those who do participate are buying on more favorable terms than prior rounds

DUTY OF LOYALTY (CONTINUED)

- Alantec Corp.
  - $1.5M Series A - VCs got 1 Board Member
  - Series B Financing by VC and 2 other Funds on Condition that No Other Outside Money
    - Down Round Despite 100% Sales Growth
    - VCs get Majority of Board and 92% of Equity
  - Founders Terminated by VC Controlled Board with 8% of Equity
  - 2 More Down Rounds Leaving Founders with .007% of Equity
  - Company Went Public and Eventually Acquired for $770M, Founders received $600K
  - Founders Sued for $40M (amount would have received if had 8%)
    - VCs settled with Founders, giving them $15M
- Lessons from Alantec
  - Create Independent Committee
  - Offer Participation to All Shareholders
  - Secure Disinterested Shareholder Approval
  - Independently Validate Terms
    - Offer terms to third parties and fully negotiate
    - Full deliberation by independent board
    - Fairness opinion

DUTY OF LOYALTY (CONTINUED)

- Usurping a Corporate Opportunity
  - Factors
    - In Existing or Planned Business Area
    - How Director Learned of Opportunity
    - Significance to Corporation and Corporation's Interest in it
    - Reasonableness of Corporation's Expectation that Director Should Make Opportunity Available to it
  - Board Member Can Pursue Opportunity if:
    - Bring it to the Attention of the Board
    - Disclose Relevant Facts
    - Disinterested Board Disclaims Opportunity

STRATEGIES TO MITIGATE LIABILITY EXPOSURE

- Corporate Governance Best Practices
- Indemnification
- D&O Insurance

Corporate Governance Best Practices

- Attend All Board Meetings
- Review all Board Packages Ahead of Time
- Don’t Rush Decisions
- Evaluate Officers and Other Directors
- Review Charter Documents
- Engage Outside Experts – Investment Banks, Law Firms, Accountants
- Avoid Conflicts of Interest and Self-Dealing Transactions
- Elect Disinterested Committees if Necessary
- Review all Transaction Documents
- Review Board Minutes
- Keep Copies of Documents Decisions are Based Upon

INDEMNIFICATION

- Charter or Bylaw Provisions Providing for Indemnification or Indemnification Agreements and Even Elimination of Liability
  - California law only allows Indemnification or Elimination of Liability if Director Acted in Good Faith and in a Manner Reasonably Believed to be in the Best Interests of the Corporation and (for Criminal Actions), the Director had no Reasonable Cause to Believe the Conduct was Unlawful
  - Compare Delaware Law which Allows Indemnification if Acted in Good Faith in a Manner Believed to be in, <u>or not Opposed to</u>, the Best Interests of the Corporation

D&O INSURANCE

- Especially Necessary for Start-Up Companies w/ Limited Capital
- Must be Reviewed Carefully with Experienced Counsel to Determine:
    - Policy Limitations
    - Who is Insured
- Does not Cover Willful or Criminal Misconduct

D&O INSURANCE (CONTINUED)

- Usually Claims-Made
- Terminated for Non-Payment
- Indemnity versus Liability
- Terminated in a Change of Control
- Insured versus Insured Exclusion

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