

Morgan Lewis

Fiduciary Duty of Board of Directors  
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# What is Corporate Governance

A combination of (1) principles, (2) policies and (3) procedures designed to enable the Board of Directors to manage the corporation in accordance with duties owed to stockholders.

The Delaware General Corporation Law (“DGCL”) provides that the “business and affairs of every corporation...be managed by or under the direction of a board of directors...”

# General Fiduciary Duties

- Each director is obligated to act in the best interests of the corporation and all of its stockholders
- Directors may face personal liability if they breach their fiduciary duties.
- Directors may also face personal liability if certain employee withholding payments are not made or tax returns are not filed

# General Fiduciary Duties

## 1. Duty of Care

- Each director must act on an informed basis, in good faith and in a manner he reasonably believes to be in the best interests of the corporation
- Each director must act with such care as a reasonable person would use under similar circumstances

# General Fiduciary Duties

## 2. Duty of Loyalty

- Each director must put the corporation's interests ahead of his or her personal interests
- Each director must refrain from conduct that would injure the corporation and its stockholders or deprive them of profit or advantage

## 3. Duty of Good Faith

- Broader concept (expands duty of care)
- Requires more active role of oversight by Board members

# Additional Fiduciary Duties

## 4. Duty of Disclosure or Candor

Directors have a duty to be truthful when disseminating information to the corporation's stockholders

## 5. Duty of Oversight – In re Caremark Int'l.

Directors have a duty to ensure that company management adopts an “effective” program to detect and prevent violations of law – particularly in regulated industries

# Business Judgment Rule

The “Business Judgment Rule” is case law created

- A presumption that directors acted on an informed basis, in good faith and believing that their action was in the corporation’s best interests
- Serves as safe harbor from “bad decisions” provided that directors fulfill their duties
- Courts generally will not substitute their own notions of what is or is not sound business judgment

# Charter Provision Re Exculpation

## Exculpation

- Section 102(b)(7) of the DGCL permits a charter provision eliminating the personal liability of a director for breach of fiduciary duty as a director
- 102(b)(7) does not apply to:
  - *any breach of the director's duty of loyalty,*
  - *Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law,*
  - *Unlawful payments of dividends or stock redemptions, or*
  - *any transaction from which the director derived an improper personal benefit*

# Indemnification

- Section 145 of the DGCL permits indemnification of directors for expenses and other losses incurred in connection with litigation and other proceedings relating to their services as directors
- Only allowed where the director acted in good faith and in a manner the director reasonably believed to be in or not opposed to the best interests of the corporation
- Contractual indemnification prevents later changes to charter or bylaws and can set forth procedures for advancing expenses.

# Sale of Control

- **Additional Duty-of-Care Issues**
  - Heightened duty to inform oneself and be active in all board discussions
  - May use outside experts, e.g. investment bankers and counsel; however, involvement of experts does not excuse the directors from actively informing themselves and exercising their own judgment

# Sale of Control

- Consideration of defensive measures (Unocal Standard)
  - *Voting Proxies*
  - *No-Shop or Window Shop*
  - *Break-up Fee and Expense Reimbursement*
  - *Restrictive Pre-Closing Covenants*
- No duty to sell, but if the Board determines to sell, obligation to seek the maximization of the company's value for Stockholders (Revlon Standard) using method of sale most likely to produce best value reasonably available for the stockholders (Barkan).

# Corporate Opportunity Doctrine

If a director, in his or her role as a director of a corporation, is presented with a business opportunity which:

- *the corporation is financially able to undertake*
- *falls into the line of the corporation's business, and*
- *is of practical advantage to it...*

the director is prohibited from taking the opportunity for himself or herself.

# Corporate Opportunity Doctrine

Section 122(17) of the DGCL permits a corporation to renounce, in its charter or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders.

# Interested Party Transactions

- Who is an interested director?
  - A director is “interested” when he or she, directly or indirectly, has a financial or personal interest in a transaction in which the corporation is a party
  - Thus, the duty of loyalty is implicated
  - Section 144 of the DGCL requires interested transactions to be approved by either:
    - *Disinterested directors; or*
    - *Disinterested stockholders; or*
    - *Deemed to be “fair” to all stockholders (may need to obtain a third party fairness opinion to rely on this standard).*

# Interested Party Transactions

- When will the Business Judgment Rule still apply?
  - If a disinterested majority of the board makes a decision, the BJR will apply
  - Beware of a “dominated” or “controlled” disinterested majority
  - If majority of disinterested stockholder approve decision

# Interested Party Transactions

- Demonstrating the independence of the disinterested majority
  - Form an independent board committee
  - Retain separate advisors, including investment bankers and counsel, if current advisors relationship is with party whom there is perceived conflict (i.e. management of majority stockholder)
  - Exclude the interested directors from the discussions of the independent committee, as well as the vote itself

# Interested Party Transactions

- If BJR does not apply, then “entire fairness” standard does

The “entire fairness” test is met where (1) the procedures followed by the directors in approving the transaction or making the decision were fair to the corporation and all stockholders (2) the substantive terms of the transaction were fair to the corporation and all stockholders

- Entire fairness often judged in retrospect

# Distressed Company Issues

- Expansion of duties to creditors as well as stockholders
- Increased risks of personal liability
  - For breach of fiduciary duties
  - For non-payment of wages (may include unused vacation and severance under state law) and trust fund taxes
  - D&O insurance may not protect directors from creditor claims
- Business Judgment Rule may not apply due to conflict of interest between stockholders and creditors

# Additional Duties for Directors of Public Companies

- Accurate and Timely Disclosures
- Regulation FD requiring consistent disclosure
- Insider trading restrictions required
- Additional internal controls required to be established by the Board

# Presentation Not Legal Advice

Although this presentation is not intended to be exhaustive, it provides the basic principles under Delaware law with which the board should be familiar in exercising its fiduciary duties in the present context. The relevant laws of other States may vary. This presentation does not address the great number of subtle nuances which may inevitably arise under a given set of factual circumstances. The analysis of directors' duties in particular circumstances is highly fact-intensive and fact-sensitive. This presentation should not be construed as, and does not constitute, legal advice on any specific matter, nor does this presentation create any attorney-client relationship

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