FIDUCIARY DUTIES FOR DIRECTORS AND OFFICERS

Corporate officers and directors, and certain managers in non-corporate entities, have ultimate decision-making authority in their companies. But their decision-making is constrained by fiduciary obligations to shareholders, partners and LLC members. In volatile markets, there is increased focus on company decision-making and ever-present risk of conflict, litigation and liability. This is particularly true in the case of closely held companies. This program will provide you with a practical guide to the fiduciary duties of corporate and non-corporate officers, directors and managers, discuss the application of these standards to non-corporate entities, identify common areas of dispute, litigation and liability, and discuss best practices for avoiding liability.

- Framework of fiduciary standards for officers and directors
- Understanding which duties most frequently give rise to litigation and liability
- Application of fiduciary standards to non-corporate entities and closely held businesses
- Duty of loyalty and identifying common areas of self-dealing
- Corporate opportunity doctrine
- Good faith and fair dealing in transactions

Speakers:

Thomas W. France is a partner in the Tysons Corner, Virginia office of Venable, LLP, where his practice focuses on corporation transactions, securities law, financial and banking regulatory matters. He has substantial experience in mergers and acquisitions, public and private offerings of equity and debt, franchise transactions, joint ventures and corporate reorganizations. Mr. France received his B.A., summa cum laude, from Oregon State University and his J.D., cum laude, from Washington and Lee University School of Law.

Tara L Dunn is an attorney in the Denver office of Morrison & Foerster, LLP, where represents public and private enterprises in corporate financial transactions. She has substantial experience in public offerings and private placements of equity and debt securities, bank credit financings, and venture capital financings. Ms. Dunn published “The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket after Disney IV?” which was cited in In re The Walt Disney Derivative Litigation, 906 A.2d 27, 64 (Del. 2006). Ms. Dunn earned her B.A. and M.A. from the University of Colorado and her J.D. from the University of Denver College of Law.
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Fiduciary Duties for Directors and Officers

December 8, 2011

Thomas W. France, Venable LLP
Tara L. Dunn, Morrison & Foerster LLP
Overview

- Framework of fiduciary duties and standards of review (Dunn)
- Duties that frequently give rise to litigation (France)
- Duty of loyalty and self-dealing (Dunn)
- Corporate opportunity doctrine (France)
- Good faith and fair dealing in transactions (Dunn)
- Fiduciary standards and non-corporate entities (France)
Framework of Fiduciary Duties and Standards of Review

(Tara Dunn)
Duty of Care

• Directors must fully inform themselves of all material information reasonably available to them
  • May rely (reasonably/in good faith) on experts and advisors (DGCL §141(e))
• Must act with care in discharge of their duties – in a manner in which they would act if they were conducting their own affairs
• Considering whether directors met their duty of care in taking action:
  • Amount of deliberation
  • Time to and review of materials
  • Documentation
• Gross negligence – “reckless indifference” or “deliberate disregard”
• DGCL §102(b)(7) exculpatory charter provision – shields directors against monetary damages for breaches of the duty of care
Duty of Loyalty

• Directors must have the interest of the corporation/its stockholders ahead of their own personal interests
  • Is the director interested?
  • Is the director independent?
• Good faith – not a standalone fiduciary duty but a subset of the duty of loyalty
  • Subjective bad faith – an actual intention to do harm
  • Intentional/conscious disregard for your duties (often in a compliance/monitoring situation)
    • Challenge to directors’ oversight is an assertion that the directors failed to act in the face of a known duty to act
  • Oversight duties do not include ordinary business risks (*In re Citigroup Shareholder Litigation* (Del. Ch. 2009))
Standards of Review

• Business Judgment Rule – presumption that the directors were informed, acted in good faith, and in the best interests of the corporation
  • To rebut the presumption, plaintiffs must claim
    • Self-dealing
    • A conflict has not been expunged
    • A lack of good faith
    • Fraud
    • Gross negligence
  • DGCL §102(b)(7) – bars claims for money damages for breaches of the duty of care

• Entire Fairness – duty of loyalty claims or when the business judgment rule has been rebutted
  • Burden shifts to defendant directors to prove entire fairness
  • Fair dealing + fair price
    • Fair dealing – looks at process
    • Fair price – is the price one that would be obtained in an arms-length transaction?
Enhanced Scrutiny

• Additional fiduciary duties in a sale of the corporation/sale of control
  • *Revlon* – in a sale of control transaction, the directors must act *reasonably* to get the highest price *reasonably available* if the board is considering a sale of the corporation or change of control transaction (*Revlon v. MacAndrews & Forbes Holdings, Inc.* (Del. 1986))
  • *Unocal* – in evaluating defensive measures, the defensive measures taken must be *reasonable* in relation to the threat posed and in the context of the situation (*Unocal v. Mesa Petroleum Co.* (Del. 1985))
Duty of Loyalty and Self-Dealing

(Tara Dunn)
Conflicts and Loyalty Issues

• Privately-held corporations’ ownership, oversight and management structures
  • The conflict itself ≠ a breach of the duty of loyalty
• Officers – have the same fiduciary duties as directors
  • Inherent conflict of interest – job security
  • DGCL §102(b)(7) does not apply to or afford protection for officers
Self-Dealing

• A director must put the best interest of the corporation ahead of and above any personal interest
  • Interested directors
  • Directors that are not independent

• In a conflict of interest situation, directors can protect themselves by utilizing the statutory protections contained in DGCL §144:
  • By having the transaction approved by fully informed members of the board who are disinterested and independent (or a fully informed committee of disinterested and independent directors)
  • By having the transaction approved by fully informed, disinterested stockholders
  • §144 gets defendant directors back to the protection of the business judgment rule

• Private company challenge – board interest/independence issues and difficulty obtaining a majority of the minority – may lead to settlements
Disclosure

- Duty of disclosure applies when directors or stockholders are being asked to act
  - Information issues
  - Communications must be complete and accurate
- Action – vote, appraisal rights
Good Faith and Fair Dealing in Transactions

(Tara Dunn)
Good Faith & Fair Dealing

• Common good faith and fair dealing issues
  • Approval by the majority of the minority
  • Special committees in a controlling stockholder transaction
Majority of the Minority

• In situations in which the board uses a vote of the majority of the minority to address a conflict, once that vote is made a condition to the approval or acceptance of an offer for a sale or change of control, such condition cannot be waivable, even by the special committee, in order to be deemed to have expunged the taint of the conflict (*In re John Q. Hammons Hotels Inc. Shareholder Litigation* – (Del. Ch. 2009))
  • Defendants could not prove entire fairness because the majority of the minority provision was waivable by the special committee
  • Even though the majority of the minority vote was *not* waived, it was not a sufficient procedural protection – not a fair process
• In counting a majority of the minority, all minority stockholders entitled to vote are counted (*In re PNB Holding Co. Shareholders Litigation* (Del. Ch. 2006))
Special Committees in Controlling Stockholder Transactions

- In transactions with a controlling stockholder, use of a well-functioning, independent and informed special committee with a clear and adequate mandate, including an express right to negotiate and the condition of a fully-informed and upfront supermajority vote may allow defendants to shift the burden of proving entire fairness to the plaintiffs and/or avoid liability (In re Southern Peru Copper Corporation Shareholder Derivative Litigation (Del. Ch. October 14, 2011))

  - The defendants were unable to shift the burden of proof of entire fairness to the plaintiffs because:
    - 1) the special committee, although independent and informed, was not “well functioning” because it was only authorized to evaluate the proposed transaction and did not have express authority to negotiate
    - 2) the transaction was not conditioned at the outset on a supermajority vote to approve the deal and the vote was not fully informed

  - The transaction could not meet the entire fairness standard and the court awarded the plaintiffs just under $1.3 billion in damages
Procedural Considerations

• A board should consider:
  • Forming a “well-functioning” special committee of disinterested and independent directors
  • Authorizing the special committee to consider alternatives, expressly authorize it to negotiate and to hire independent and competent advisors
  • Requiring a non-waivable vote of a majority of the minority or a supermajority vote as a condition to the deal
  • Obtaining/updating a fairness opinion from independent third-party advisors
  • Documenting its rationale for the transaction
  • Documenting the specific background of the transaction
  • Ensuring the board meets its disclosure obligations - whether that be to a special committee of the board or the stockholders (including counterproposals, if appropriate)
Thank you.

Tara L. Dunn
Morrison & Foerster LLP
Denver, Colorado

December 8, 2011
Fiduciary Duties for Directors and Officers

Tara L. Dunn, Morrison & Foerster LLP
Thomas W. France, Venable LLP

December 8, 2011
Fiduciary Duties: Overview of Potential Litigation and Liability

Thomas France
Venable LLP
Fiduciary Duties: Potential Litigation and Liability

Functions of Board of Directors: Directors have two principal functions:

- **Decision-making** – approving or rejecting corporate actions
- **Oversight** – supervising the business and affairs of the corporation

When is Litigation and Liability Most Likely to Arise?

- Change of Control transaction
- Failure to Act/Oversee
- Self Dealing/Conflict of Interest/Corporate Opportunity
- Insolvency

Limitation of Director Liability

- Articles of Incorporation may limit liability of directors for money damages, with certain exceptions (e.g., breaches of duty of loyalty, receipt of improper financial benefits, intentional violations of law, etc.).
Fiduciary Duties: Potential Litigation and Liability

- Change of Control Transactions – Implicates duties of care and liability

- Standards of Review: Under Delaware law, there are generally three standards against which the courts will measure director conduct in a change in control transaction:
  - *business judgment rule* -- for a decision to remain independent or to approve a transaction not involving a sale of control;
  - *enhanced scrutiny* -- for a decision to adopt or employ defensive measures or to approve a transaction involving a sale of control; and
  - *entire fairness* -- for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumptions of the business judgment rule.
Fiduciary Duties: Potential Litigation and Liability

- Rejecting an Offer - the business judgment rule applies
  - The Board must determine in the exercise of its business judgment whether the offer is in the best interests of the corporation and its stockholders.
  - Directors must have a reason for rejecting the offer – even in a closely-held corporation.

- Defensive Measures – enhanced scrutiny will be applied if the Board employs defensive measures in response to a takeover bid
  - Directors must satisfy two tests before the business judgment rule applies: (1) did the directors have reasonable grounds for believing that a danger to corporate policy or effectiveness existed, and (2) was the action reasonable in relation to the threat posed.
  - May not be likely in the case of a closely-held corporation.
Fiduciary Duties: Potential Litigation and Liability

- Sale of Control – Revlon Duties
  - In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court imposed an affirmative duty on the board of directors to seek the highest value reasonably obtainable to the stockholders when a sale of the company becomes inevitable.
  - The duty established in Revlon was restated in *Paramount Communications Inc. v. QVC Network Inc.*, in which the Delaware Supreme Court further explained the extent of enhanced scrutiny:
    - The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.
Fiduciary Duties: Potential Litigation and Liability

- Sale of Control – Revlon Duties (cont.)
  - If a change of control transaction is challenged, the care with which the directors acted will be subjected to close review. For this review there will be no “bright line” tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances.
  - A recent Delaware case noted that no “court can tell directors exactly how to accomplish [the goal of getting the best price for the company] because they will be facing a unique combination of circumstances.”
  - In the absence of bright lines and blueprints that fit all cases, the process to be followed by the directors will be paramount.
Fiduciary Duties: Potential Litigation and Liability

- Limitation of Liability
  - State law may permit the corporation to eliminate or limit the personal liability of directors
    - Section 102(b)(7) of Delaware General Corporation Law – for duty of care
    - Section 2.02(b)(4) of Model Business Corporation Act
- Duty of Loyalty in Change of Control Context
  - Did the directors fail to act in good faith – assuming no conflict of interest
  - May be the dispositive issue if no personal liability for breaches of duty of care
Fiduciary Duties: Potential Litigation and Liability

- In *Lyondell*, the Supreme Court discussed its analysis of good faith in the Disney case, in which it had identified three types of bad faith conduct by a director:
  - intentionally acts with a purpose other than that of advancing the best interests of the corporation;
  - acts with the intent to violate applicable positive law; or
  - intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

- The Supreme Court found that:
  - “Directors’ decisions must be reasonable, not perfect. ‘In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.’ The trial court denied summary judgment because the Lyondell directors’ ‘unexplained inaction’ prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. **Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.** The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been **whether those directors utterly failed to attempt to obtain the best sale price.**”
Fiduciary Duties: Potential Litigation and Liability

- Oversight Liability – Claims for failure of oversight generally require showing that directors breached duty of loyalty by failing to attend to their duties in good faith.

- *In re Caremark Int'l Inc. Derv. Litig.*, 698 A.2d 959 (Del. Ch. 1996) was the first case in which a Delaware court articulated the fiduciary duties of directors in an oversight context. That case involved breach of fiduciary duty claims against defendant directors based upon their alleged failure to monitor actions in violation of the federal Anti-Referral Payments Law.

  "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."
Fiduciary Duties: Potential Litigation and Liability

  - “the Caremark standard for so-called ‘oversight’ liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent Disney decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence).”
  - *Caremark* claims fall within the third type of bad faith described by the Court in Disney—director intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

- **In re Citigroup Shareholder Derivative Litigation**, 964 A.2d 106 (Del Ch. 2009):
  - Delaware Chancery Court found that *Caremark*-type duties were not designed to impose oversight liability for business risk in case that involved potential liability of directors under Delaware law for losses suffered by the corporation as a result of exposure to sub-prime debt
Fiduciary Duties: Potential Litigation and Liability

- Self Dealing/Conflicts of Interest/Corporate Opportunity
  - This is another area ripe for fiduciary duty claims
  - Will be discussed in the next segments

- Insolvency
  - General rule is that directors and officers do not owe fiduciary duties to creditors of the corporation
  - Depending on the applicable state law, this may change if the corporation is insolvent or in the “zone of insolvency”
Corporate Opportunity Doctrine

Thomas France
Venable LLP
Corporate Opportunity Doctrine

- Corporate Opportunity Doctrine

- Subset of the duty of loyalty

- General rule is that a director, officer or controlling stockholder may not appropriate an opportunity rightfully belonging to the corporation without full disclosure to the Board and a decision by the disinterested directors to reject or decline to pursue the opportunity

- Fact specific determination
Corporate Opportunity Doctrine

- **Standard of Review** – A corporate fiduciary may not pursue an opportunity if:
  - The corporation is financially able to exploit the opportunity;
  - The opportunity is within the corporation’s line of business;
  - The corporation has an interest or expectancy in the opportunity; and
  - By taking the opportunity, the fiduciary will be in a position adverse to his duties to the corporation.
Corporate Opportunity Doctrine

- Exceptions – A corporate fiduciary may pursue an opportunity if:
  - The opportunity is presented to the director in an individual and not corporate capacity;
  - The opportunity is not essential to the corporation;
  - The corporation holds no interest or expectancy in the opportunity; and
  - The fiduciary has not wrongfully used the resources of the corporation in pursuing or exploiting the opportunity.
- May also be pursued if full disclosure is made to the Board and it is approved by disinterested directors – this may present challenges in the case of a closely-held corporation
- Depending on jurisdiction, there may be statutory safe harbors for pursuing certain corporate opportunities (Section 122(17) of Delaware General Corporation Law; Section 870 of Model Business Corporation Act)
Fiduciary Duties and Non-Corporate Entities

Thomas France

Venable LLP
Fiduciary Duties and Non-Corporate Entities

- Application of fiduciary duties - While states vary on the nature of the obligations, there is general agreement that partners in a partnership, and members and managers of an LLC owe fiduciary obligations to the entity, as well as their co-participants.
  - Care, loyalty, good faith
  - Competing business opportunities

- In some states (e.g., Delaware, Virginia), the operating agreement of an LLC can expand, restrict or eliminate the fiduciary obligations of the members and managers.
  - Not permitted in all jurisdictions
Fiduciary Duties and Non-Corporate Entities

- LLC Agreement – Precise drafting is critical:
  - Scope of fiduciary duties
    - Inclusive/modified/blanket waiver
  - Parties to which duties are owed
  - Indemnification
  - Pursuing competing business opportunities

- Interpretive Issues
  - Will a court “read-in” fiduciary duties where the statute and operating agreement are silent – depends on the jurisdiction
    - Delaware – yes
    - Virginia - no
  - Implied covenant of good faith and fair dealing – court may “read-in” implied terms to the contract if the contract is silent – not applied when the express terms are clear
Questions

Thomas France
Venable LLP
Tysons Corner, Virginia
December 8, 2011
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Speaker Contact Information

Fiduciary Directors for Directors and Officers

Tara L. Dunn
Morrison & Foerster LLP – Denver
(o) (303) 592-2217
tdunn@mofo.com

Thomas W. France
Venable LLP – Vienna, Virginia
(o) (703) 760-1657
twfrance@Venable.com