SILICON VALLEY LAW GROUP

"DIRECTIVES ™" FOR DIRECTORS OF VENTURE-BACKED COMPANIES

"WHAT AM I NOT HEARING, SAYING & SEEING?"

By

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Directors are under increasing scrutiny and the public is demanding for greater accountability. The eyebrow-lifting case of *Smith v. Van Gorkom*[2] seems passé in light of such recent high profile cases as *Enron Corp*., *WorldCom*, and the *Walt Disney Derivative Litigation,*[3] and legislation, such as Sarbanes-Oxley Act of 2002 ("SOX").[4] While much of the media headlines have been focused on directors of public companies, the same lessons, standards and principles apply to directors of private companies.

In the past, directors of venture-backed companies, which traditionally have been more active in corporate management than their counterparts in publicly traded companies, have been somewhat immune from litigation due to (i) the prophylactic perception that entrepreneurs would be ostracized, (ii) lack litigation capital, (iii) plaintiff bar unwillingness to take on contingency cases, and (iv) lack of legal clarity. However, with the passage of SOX, the recent embolding plaintiff successes against public company, developing case law, the wealth generation of the Dot Com Era, the increased merger and acquisition[5] activity increased, and visible local cases of Epinions and Nishan

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[2] 488 A2d 858 (Del. 1985).
[3] 825 A2d 275 (Del Ch 2003).
[4] Sarbanes-Oxley Act of 2002 (Pub L 107 – 204, 116 Stat 745).
[5] According to Thomson Venture Economics & National Venture Capital Association the number of Venture-Backed Liquidity Events have increased and disclosed deal valuations have nearly doubled. VentureOne reported the number of acquisition events of Venture-Backed Companies have increased since 2003.

Systems,[6] both board of directors and executive officers of venture-backed companies need to be much more attentive to these trends, and cognizant their actions today will be held to greater scrutiny and adjudicated in a more accountable environment in the future.

This trend has also been seen in the insurance industry. According to the 2004 Tillinghast Directors and Officers Survey Report ("Tillinghast Survey"),[7] claims frequency in 2004 increased approximately 11% from the previous year, including a 12% increase in shareholder type claims, and the average claim payment size had increased.[8]

The purpose of this "Directive" is to educate the venture capital community of this litigation trend and inform Venture Capitalists of their legal duties as Board of Directors.

IN GENERAL

Directors of venture-backed private companies have the same fiduciary duties and responsibilities as directors of public companies. When directors take the helm managing American corporations, they assume legal and fiduciary duty of loyalty, which prohibits the directors from serving their own interests at the expense of the corporation, and duty of care, which requires competency, diligence and exercise of good faith in their decision-making and supervisory functions.

BUSINESS JUDGEMENT RULE

Traditionally directors have sought the comforting blanket of the business judgment rule in which the directors will not be "second guessed" by the courts on a particular business decision if all of its requirements are met. The business judgment rule requires directors act ***on an informed basis, in good will and in honest belief that the decision was in the corporation's best interest***. It encourages directors to take calculated risks when making business judgment calls. The rule forces the plaintiffs to overcome the presumption that a director's decision was valid by showing either that the decision was a product of fraud or self interest or the director failed to exercise due care.

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[6] Settlement in 2003 between Amir Latif (founder of Nishan Systems) and Lightspeed Ventures, ComVentures and others were undisclosed.

[7] The Tillinghast Survey included 2,445 US and Canadian participants. Of the 2,445 participant companies 1,478 of the participants had less than $10,000,000 in revenue and 1,254 participants had less than $10,000,000 in assets, 821 were technology companies and 336 were biotechnology & pharmaceutical companies.

[8] Tillinghast Survey reported the average claim payment size for repeat survey participants from $10.6 million to $11.9 million.

Given the developing case of law, the recent decisions and settlements, and SOX, this shield of the business judgment rule has become porous. Directors need to ensure that they are adequately protected to the fullest extent under law, sufficient insured, adequately informed and insist that decision making is prudently conducted and documented. In short, a director makes a good faith business judgment to fulfill the duty of care if the director: (a) is not interested in this subject of business judgment; (b) is informed with respect to the subject of the business judgment to the extent the direct reasonably believes to be appropriate under the circumstances; and (c) rationally believes that the business judgment is in the best interest of the corporation.

The business judgment rule does not protect a director who inadvertently fails to exercise due care in the decision making or "directors who abdicate their function or, absent a conscious decision, fails to act."[9] However, a director who deliberately decides to refrain from acting with respect to a subject matter or consciously decides to delegate a decision to others.[10]

Smith v. Van Gorkom was an example where the directors failed to adequately inform themselves before making a decision. The Trans Union Corporation's board approved a merger of the corporation after a mere 20-minute oral presentation by its CEO and deliberations of less than two hours. The Board did not obtain a fairness opinion from an investment banker and did not even read the merger agreement before signing it. The court held that Trans Union directors were not sufficiently informed before approving the merger and thus was not protected by the business judgment rule. Furthermore, the board did not even secure more information than was presented to it by its CEO. In spite of the amendments of California and Delaware's personal liability statutes (CCC Section 204(a)(10) and 8 Del Code Ann Section 102(b)(7), directors should take an abundance of steps to ensure that they are adequately informed prior to making business decisions.

In the recent *Walt Disney Co. Derivative Litigation*, the motion to dismiss the shareholders complaint was not granted because the facts demonstrated that the board of directors of Walt Disney Company had failed to exercise any business judgment and

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[9] *Aronson v. Lewis* 473 A2d 805 (Del 1984)
[10] *Rosenblatt v. Getty Oil Co*. 493 A2d 929, 943 (Del. 1985)

make a good faith attempt to fulfill their fiduciary duties of due care in connection with hiring and termination of Michael Ovitz as Disney's president. The shareholders alleged the board allowed the current CEO, Michael Eisner, a close personal friend of Mr. Ovitz, to negotiate the terms of Michael Ovitz's employment agreement and subsequent termination, failed to even review the draft and final employment agreement of Mr. Ovitz, and failed to discuss the terms of his employment and termination, including the stock options and no-fault termination provisions that resulted in a $38,000,000 payment for only one year's work. The Court of Chancery observed the board overly relied upon the CEO, failed to inform itself, and failed to devote adequate attention. However, on appeal, the Delaware Supreme Court held the directors were protected by the Business Judgment Rule because (i) ordinary negligence is insufficient to constitute a violation of the fiduciary duty of care, and (ii) the nature of the transaction in Van Gorkom (merger transaction vs. executive compensation agreement) was fundamentally different, and order of magnitude more important.

In order for the business judgment rule to apply director must operate in the best interest of the corporation. In order to do so the director cannot have a conflict of interest with the corporation. If a plaintiff can demonstrate the director had interest in the subject matter, the business judgment rule will <u>not</u> apply.

Directors can seek protection immunization from conflict of interest if they obtain the approval of majority directors who are not interested in the decision. In the *Polk v. Good,*[11] the Delaware's Supreme Court found that an appointment of ten outside directors along with a receipt of an independent investment banking and legal advice constituted prima facie showing of good faith and fair dealing. Even though a decision by an independent board member gives the interested board member business judgment rule protection, it raises the question does the non-interested board members now have a heightened duty of scrutiny knowing that there is a director's conflict of interest. What if the interested director has material information and does not disclose it?

Good faith requires the judgment be made on some rational basis. In *Gimbel v. Signal Cos.,*[12] the court found that the board's decision was not rational and thus not

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[11] 507 A2d 531, 537 (Del. 1986)
[12] 316 A2d 599 (Del. Ch. 1974)

protected by the business judgment rule or sold when its subsidiary sold for $280,000,000 less than its $760,000,000 book value.

Although California and Delaware allow boards to delegate management of the corporation to the officers, corporate management must still be carried out “under the direction” of the board. Therefore, the board is allowed to delegate day-to-day decisions but clearly must maintain some supervisory control and review over its management.

The board can further seek comfort in relying on advice of management and experts in making decisions provided that they exercise the necessary oversight and inquire into the information in which their advice is based upon. Even though directors may rely on outside experts, the director has the responsibility to evaluate carefully any information supplied. Directors do not necessarily need to verify information supplied by management or discover along during which they have no reason to suspect exists. However, in *Graham v. Allis-Chalmers Mfg. Co*[13] a director who had actual knowledge of the problem should initiate discussions rather than wait for management to do so. Furthermore, the director needs to become basically familiar with the opinion or report before relying upon it. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.,*[14] the SCM Board of Directors failed to act appropriately when they allowed one of its competitors to purchase two of its important business units at under valued prices. The court found that the board failed to carefully review documents supporting the investment bankers opinions, inquired as to the range of fair value of the assets, ask about the value of the company without its two core assets, or seek a written opinion of the value of the two assets in question.

Finally, courts are less willing to allow directors to rely on the advice of independent bankers and advisors when such advisors compensation arrangement with the corporation creates conflict of interest. This issue often arises in connection with fairness opinions where the investment bankers are receiving contingent fees in connection with the sale of a business.

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[13] 188 A2d 125, 130 (Del 1963)
[14] 781 F3d 264 (2d Cir 1986)

DUTY OF CARE

The shield of the business judgment rule is only available when a director has exercised the standard of due care and has made a well-thought out, well-substantiated, conscience business decision. In order for a director to meet the duty of care standard and be shielded by the business judgment rule, the directors need to understand what the standard of care and business judgment rule requires.

In order for a director to understand what his duties are to the corporation and shareholder, they need to understand what law governs their actions. A commonly held misnomer that the law of the state of incorporation, often times Delaware, governs the corporate directors' actions now appears to be true. Notwithstanding the state of incorporation, California imposes its director code of conduct on corporations chartered outside of California if more than 50% of the corporation's voting securities are held by persons with California addresses and underlying 50% or more of the average of the corporation's property, payroll and sales factors are derived from California. [15] However, the Delaware Supreme Court, citing *CTS Corp. v. Dynamics Corp. of Am.*,[16] ruled that CCC Section 2115 is unconstitutional and the "internal affairs doctrine" mandates that with the exception to the rarest of situation, the state of incorporation controls regarding director and shareholder relationships and liability matters.[17]

Among the provisions California imposes on foreign corporations is its standard of duty of care in California Corporation Code § 309(a) which provides:

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including ***reasonable inquiry***, as an ordinarily prudent person in a like position would use under similar circumstances.

California's specific reference to duty of "reasonable inquiry" highlights the requirements for directors, particularly non-management directors, to oversee the corporate operations, diligently questioned management and to require further

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[15] CCC § 2115. Publicly traded companies are not subject to CCC § 2115
[16] *481 U.S. 69 (1987)*
[17] *VantagePoint Venture Partners 1996 v. Examen, Inc.* (Del Sup Ct. May 5, 2005, Case No. 127,2005)

information when making major decisions. It clarifies that a director may not avoid liability merely by closing his or her eyes to a situation.

Both California and Delaware have permitted boards to delegate certain activities to board committees and allowed directors to rely on certain specific reports. But, the delegations to committees of reliance on reports, does not relieve the director of common law duty of care.

A director must be able to determine, assess and analyze the risks and exercise a quality business decision making, and expend sufficient time, skill and effort to examine and weigh the relevant facts, and if necessary, uncover require facts in order to make a prudent decision, and manage and supervise the conduct of the business.

The standard of liability of a director is whether the director has performed his or her specific responsibilities, including the evaluation of other directors and management.

As articulated now in SOX, committee members are now being held more frequently to a higher standard of care with respect to its delegated scope of duties because they have more specific knowledge regarding those transactions, and the underlying facts, and those duties have been specifically delegated to such members.

Finally, the Delaware Supreme Court has held that in a change in control, the directors are held to a greater standard than the general standards of the business judgment rule.[18]

DUTY OF LOYALTY

Directors have the duty of loyalty of not advancing such director's own interest at the expense of the corporation. This duty arises even when the interested director may not have personally profited.

[18] See *Paramount Communications, Inc. v. QVC Network,* 637 A2d 34 (Del 1994).

One of the challenges of a venture capital firm partner becoming a director is immediately upon becoming a director finding out you have a practical, if not legal, conflict of interest. One of the reasons for becoming a director is protecting the significant fund investment that requires you to become a director. By monitoring the company and ensuring it is managed properly. However, once one becomes a director, one takes on responsibilities of developing and monitoring strategic planning, selecting management and overseeing management.

In California and Delaware the duty of loyalty and care is generally owed only to the corporation and its shareholders; however, directors have been found to owe a fiduciary duty to creditors when a corporation becomes insolvent or is approaching insolvency.[19] In addition, directors have been held statutorily liable to both the Internal Revenue Service and Franchise Tax Board for failure to withhold or pay the trust fund portion of payroll taxes, and can be liable for failure to file tax returns in California. .

The duty of loyalty arises in (a) transactions directly between the corporation and one of its directors or officers, (b) corporate opportunity situations, (c) corporate control contests, (d) transactions between corporation and interlocking board of directors, (e) executive compensation arrangements, (f) situations in which a director or officer competes with the corporation, and (g) defective disclosure to shareholders. California's codification of duty of care in CCC § 309(a) also applies to directors of foreign corporations by virtue of CCC § 2115.

California has provided a safe harbor for interested director transactions in CCC § 310(a)(1)-(3) in which an "interested director transaction" is not void or voidable if the transaction is approved by the shareholders in which the material facts concerning the director's interests is fully disclosed, the shareholders approve the transaction in good faith, <u>and</u> shares held by the interested directors are not entitled to vote, <u>or</u> is approved by the disinterested directors. CCC § 310(a)(2). If all material facts concerning director's interests are fully disclosed, the board approves, authorizes, approves or ratifies the transaction in good faith, the interested director's vote is not counted and the transaction must be "just and reasonable for the corporation" at the time of the board meeting

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[19] See *Credit Lyonnais Bank Netherland, N.V. v. Pathe Communication Corp*. 1991 WL 2776 13 (Del. Ch. Dec. 30, 1991). *Product Resources Group, LLC v. NCT Group, Inc*. 863 A.2d 772 (Del. Ch. Nov 17, 2004).

approving the transaction. These safe harbor provisions do not protect a transaction that involves the lack of good faith, waste or fraud. See *Gaillard v. Natomas Co.*[20]

Once an interested director transaction is approved by the majority of the board's disinterested directors, the burden of proving that it is not just and reasonable shift to the plaintiff and the board will seek the protection of the business judgment rule if those conditions are satisfied. However, given the nature of the transaction the board is best advised that the board seeks independent valuation of the transaction being just and reasonable to fulfill its duty of care.

If the shareholders approve a disinterested transaction, the court is not required to inquire whether it is fair and reasonable. However, if the transaction is not fair and reasonable, the court may look to the proxy statement or disclosure statement to determine whether their unfair aspects were sufficiently disclosed.

Delaware also provides a safe harbor for interested directors transactions in 8 Del Code Ann § 144. Unlike California's safe harbor, Delaware's safe harbor does not require a fairness determination by the court when the contract or transaction is approved by the majority of disinterested directors.

When there is a disinterested director transaction California law provides that an interested or common director may be count in determining a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves and ratifies a contract or transaction.[21] For shareholder voting purposes, the shares owned by an interested director are disqualified from voting and are not counted because they are not considered as outstanding.[22] Therefore, only a majority of the shares eligible to vote in a meeting are counted to establish a quorum under CCC§ 153.

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[20] 208 CA 3rd 1250, 256 Cal. Rptr. 702 (1989)
[21] CCC Section 310(c)
[22] CCC Sections 310(a)(1) and 112

WAYS TO MITIGATE DIRECTORS' LIABILITY EXPOSURE

Directors should consider viewing their liability protection less one dimensional and more a multi-dimensional layering of defenses through Indemnification, Investigation, Corporate Governance Best Practices, Education, and Directors' & Officers' Liability Insurance ("D&O Insurance").

Indemnification. Directors should take full advantage of Company's right to indemnify board of directors to the fullest extent permissible under law; however, Directors should be keep in mind (i) indemnification is only as good as the company's financial ability to honor its commitment (i.e. future financial events could make the indemnification practically ineffective) and (ii) under California law and Delaware Code involving intentional or knowing misconduct are not indemnifiable.

Investigation. Directors should evaluate and determine the impact of the state of incorporation, policies of the company, its procedures, the board composition, the board committees and board compensation. Directors should insist on implementing steps for mitigating risk, require checklists and investigations, and annually review ("D&O Insurance").

Corporate Governance Best Practices. According to the ABA Corporate Directors Guide Book, directors need to secure adequate information in sufficient time for them to study and reflect upon the contemplated transaction. If the directors believe the information is insufficient or inaccurate, or is not made available to them in a timely manner, a director should request that the action be delayed until desired information is made available and can be studied with sufficient time. If the director believes that the board is repeatedly not provided with adequate information to enable the director to vote in a formed matter, the director should entertain the need for the board to change management or failing such change should consider resigning.

In making business decisions, directors should at a minimum:

1. Attend all Board meetings and document reasonable reasons for absence;
2. Insist on timely delivery of board packets and reports so directors can have adequate time to review, analyze and investigate;
3. Keep informed about areas of Company's business;
4. Investigate report protocols and procedures;

5. Be generally aware of management provisions in Articles of Incorporation and Bylaws, and be informed about the company's authorized capital[23];

6. Be attentive to the selection and oversight of principal officers;

7. Evaluating effectiveness of officers and board members;

8. Conduct an independent assessment of the Board of Directors;

9. Allocate reasonable time to read, review, and analyze the reports;

10. Engage outside experts independent of management;

11. Determine what information was the basis for management and experts reports. It is important the information supplied to the management and experts are sufficient, accurate and not misleading;

12. If necessary, establish a disinterested committee for review of the transaction;

13. Review all material documentation for the transaction, including reading, review, and analyze all major final agreements;

14. Have at least one or more meeting to extensively discuss the transaction at length;

15. If appropriate secure fairness opinion from the outside consultants, such as investment bankers or appraisers;

16. Carefully record the board's actions and decisions;

17. Register and insist objections be documented in the board minutes;

18. Preserve all documentation on which the director's decision is based upon; and

19. Analyze carefully any troubling issues.

Education. Directors should enroll and attend educational seminars covering directors' duties & liabilities, best in class corporate governance practices, D&O Insurance.

D&O Insurance. Directors should take full advantage and thoroughly analyze D&O Insurance given the recent Enron and Worldcom cases should also consider the possibility of Independent Director Insurance ("IDL Insurance") in addition to the indemnification.

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[23] Sanders v. Wang, 1999 Del Ch Lexis 203, 1999 WL 1044880 (Del Ch Nov. 8, 1999)

DIRECTORS AND OFFICERS LIABILITY INSURANCE

D&O Insurance is essentially a form of malpractice insurance designed to protect directors from personal liability (and from incurring defense costs) in lawsuits brought against them in their capacity as directors. Although D&O Insurance insures against claims for honest mistakes and/or negligence, it generally does not cover willful or criminal misconduct.

According to the Tillinghast Survey, the D&O market has improved. D&O insurance is available, albeit at some cost, and coverage restrictions have begun to ease. The Tillinghast Survey reported premiums have decreased approximately 10% from 2003.[24] This premium decrease was the first since 1999. The survey also noted that retentions/deductibles options had improved, with 65% of the participants indicating no change in their retention/deductible, as opposed to 44% in their 2003 survey.

Given corporate indemnification of directors and officers is limited by the financial credit of the corporation and is explicitly limited by both California and Delaware statutes[25], directors need to look to D&O Insurance and a main line of defense against exposing their personal assets. D&O Insurance coverage should be viewed as a compliment to corporate indemnification, filling some of the holes of the indemnification provisions and financial limitation of the corporation. California permits indemnification of a director only if they acted in good faith and a manner that they believed to be in the best interest of the corporation, and with respect to criminal actions, the director had no reasonable cause to believe the director's conduct was unlawful[26]. Delaware statute is slightly different in that it provides the standard of indemnification as acting in good faith in a manner a person believed to be in or "not opposed to" the best interest of the Corporation[27]. Oftentimes D&O Insurance excludes certain acts from its protection, either by virtue of the written policy, public policy, or statute.

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[24] However, the 2004 Tillinghast Survey also noted that the claims frequency had increased approximately 11% for the participants the average claim payment size had increased, including shareholder claims which increased 12% from their 2003 survey and employee claims had increased 138%.
[25] See CCC Section 317 and 8 Del Code Ann Section 145.
[26] CCC Section 317(b).
[27] 8 Del Code Ann Section 145(a)

Even D&O Insurance cannot cover or provide 100% protection. Here are a few reasons for purchasing D&O Insurance:

1. D&O Insurance can provide protection in the event the corporation fails to honor its indemnification subject that an indemnification presumption is provided in the language in the policy.

2. If the corporation is unable to indemnify, such as when the corporation is insolvent or bankrupt, D&O Insurance can provide protection.

3. D&O Insurance can provide coverage when public policy deems indemnification unenforceable as a matter public policy, such as the SEC's position that indemnification is unenforceable for liabilities arising out of the Securities Act of 1933.

In order for D&O Insurance to be effective, directors and legal counsel should play an active role in securing such policy and determining its limits. Directors should pay close attention to who is insured (i.e. directors and officers, corporation, or both), what the actual losses are covered, understand the limitations of coverage available, understand the retention and co-insurance levels, determine whether subsidiaries are covered, and ascertain whether the policy is claims made or occurrence policy and determine who should get notices of cancellation.

Directors should be aware that D&O Insurance:

1. Does not cover informal governmental proceeding and investigations.

2. It only covers them for acts in their official capacity as a director.

3. Generally, they are "claims-made" policies. Claims made policies only insure against claims-made against the director and corporation <u>during the period of coverage</u>, regardless of when the actual action or inaction occurred. This type of policy is problematic because the alleged action or inaction may occur during the coverage period, but the actual claim may have been filed after the coverage period due to a plaintiff's ability to file a claim within the statute of limitations or after a change in control transaction.

4. Policy cancellation for nonpayment of otherwise is generally upon notice. D&O Insurance could be terminated without the knowledge of the board of directors.

5. Policies can be either liability basis or indemnity basis. Liability policies provide the insurance company <u>will pay</u> on behalf of the insured as opposed to indemnity

policies that agree to only reimburse. This distinction is very important because it may impact whether the corporation can adequately fund a defense.

6. Usually covers wrongful acts, or a negligent or mistaken action or inaction nature, but excludes coverage for "willful, intentional or criminal misconduct by directors."[28]

7. Policies usually excludes fines and penalties, punitive, exemplary or treble damages, unauthorized or illegal compensation received by directors or officers or money wrongfully acquired, personal injury and property damage claims, libel and slander, and certain, hazardous substance and employment claims (although, employment litigation coverage can be secured through endorsements).

8. An event of the change of control, whether by merger or acquisition, can terminate coverage.

9. Policies can be rescinded due to restatements.

10. The "insured versus insured" exclusions are the exclusion for claims made by one of the insured against another (e.g. corporation brings claim against director to avail itself of coverage, or in-fighting among shareholders and directors). Initially this exclusion was to prevent corporation's from making a claims in an effort obtain reimbursement from D&O Insurance. It usually does cover bonafide stockholder derivative actions.

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[28] See California Insurance Code Section 533.