

Board Positions and Competing Portfolio Companies

Focus on Conflicting Fiduciary Duties

Agenda

- Private equity fund managers who serve on portfolio company boards can find themselves with conflicting fiduciary duties to multiple portfolio companies
 - It happens more often than you think
- Key legal concepts relating to conflicting board positions
- Techniques and strategies for staying out of trouble

Sample Facts

- Joe VC, an expert in materials science, serves as a director of two portfolio companies:
 - FuelCell, an early stage company developing next generation fuel cells utilizing selectively permeable membranes
 - Dialysis, an early stage company developing next generation dialysis machines utilizing selectively permeable membranes

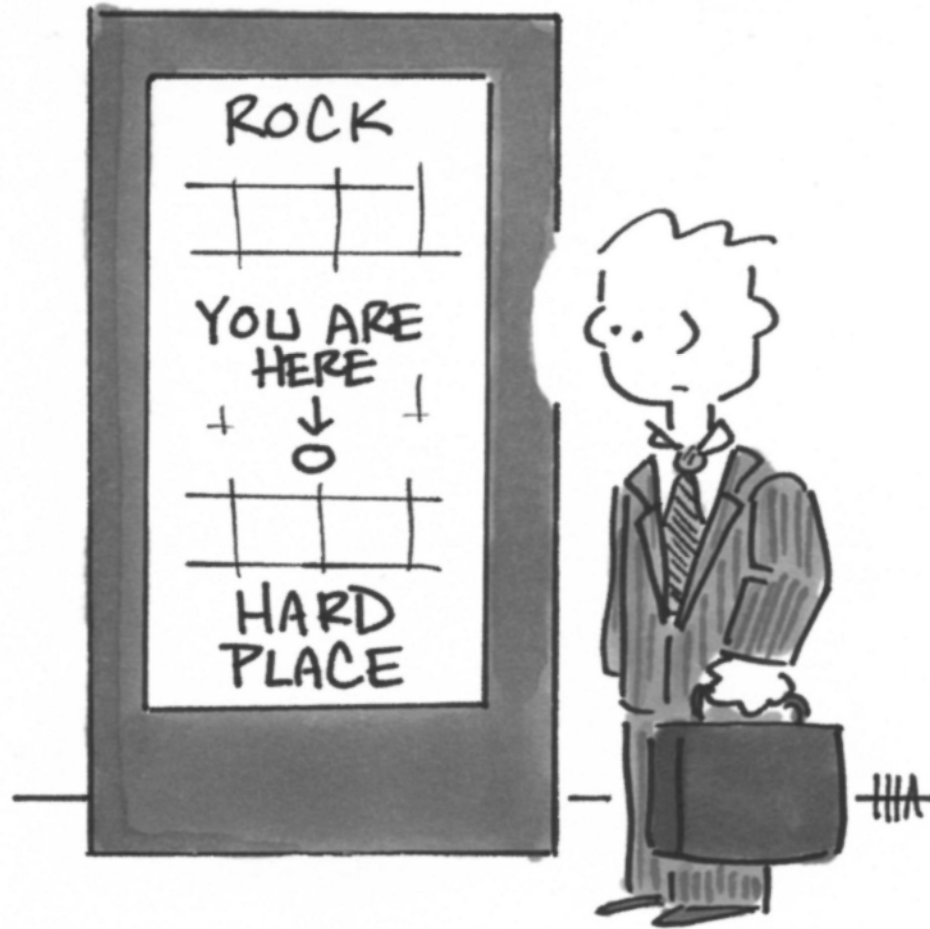
Sample Facts (cont.)

- At a board meeting, Joe learns that FuelCell has made a major breakthrough. After spending millions of dollars, it has determined that Catalyst X efficiently moves hydrogen through a membrane (essential for fuel cell operation), while Catalyst Y does not.
 - Based on this knowledge, FuelCell is poised to launch a very attractive fuel cell product
 - It's not clear that the choice of Catalyst X is patentable, but FuelCell has been advised that its use of Catalyst X is a protectable trade secret

Sample Facts (cont.)

- Dialysis has been having big problems. Their membrane appears useless for dialysis.
 - However, their scientists have accidentally discovered that their membrane appears to be permeable to hydrogen
 - If only they had an efficient catalyst, they could use their membrane to produce fuel cells
 - They have sufficient cash on hand to research only one catalyst. Preliminary study suggests that Catalyst X and Catalyst Y are the most promising candidates.
 - The CEO calls an emergency board meeting. The primary topic: Should Dialysis devote its limited R&D cash to Catalyst X or Catalyst Y?
 - ▶ Going into the meeting, she says to Joe, “I’m counting on you to participate in the discussion. With your background in membranes and catalysts, your insights will be invaluable. If we make the wrong choice, we’ll probably go bankrupt.”

- The following slide summarizes Joe's position from a technical legal perspective



Duty of Loyalty

- As a director, Joe has a fiduciary duty of loyalty to each of FuelCell and Dialysis
 - Duty of Loyalty: A director must act in good faith to promote the best interests of the corporation and its shareholders
 - ▶ The duty of loyalty generally prevents a director from placing his/her own interests (or the interests of a third party with whom he/she is affiliated) ahead of the interests of the corporation
 - A director generally also is required to offer to the corporation all business opportunities within the corporation's scope of business
 - ▶ The duty of loyalty is not diluted or narrowed just because the director has conflicting obligations to another corporation

Duty of Loyalty (cont.)

- In our example, Joe has conflicting duties
 - Dialysis desperately needs information about Catalyst X and Y that is in Joe's possession
 - ▶ As a practical matter, it will be impossible for Joe to fully participate in board discussions, and vote on the direction of the company's R&D program, without triggering a duty to disclose and/or use that information
 - But Joe obtained that information in his capacity as a director of FuelCell (and it's a trade secret)
 - ▶ Thus, he has a duty not to disclose it to, or use it for the benefit of, Dialysis

Duty of Loyalty (cont.)

- Because disclosing the Catalyst X and Y information to Dialysis clearly would be a breach of Joe's duty of loyalty to FuelCell, Joe should decline to participate in the Dialysis board meeting as well as any other Dialysis discussion of the issue
- However, the analysis doesn't end here

Duty of Care

- As a director, Joe also has a fiduciary duty of care to each of FuelCell and Dialysis
 - Duty of Care: A director must diligently perform his/her duties with such care as an ordinarily prudent person would use under similar circumstances
 - ▶ Under limited circumstances, such as where the board is considering a particular director's compensation, courts have held that it is appropriate for the director to recuse him/herself from board meetings/discussions
 - ▶ However, consistent failure to attend meetings or participate in discussions regarding issues that are central to the corporation's business may constitute a breach of the duty of care

Duty of Care (cont.)

- ▶ Under Delaware law, a corporation generally can limit a director's liability for breaches of the duty of care, but cannot limit the liability of a director in circumstances where the director "derived an improper personal benefit"
 - As a practical matter, it may be difficult, if not impossible, to demonstrate that no such benefit arose where there are competing portfolio companies
 - A detriment to one competing portfolio company generally will be a benefit to the other, giving indirect benefit to the investing private equity fund and, therefore, to the fund manager/director

A Special Arrangement?

- Delaware law also allows a corporation to renounce any interest in an entire class or category of business opportunities, which could eliminate problems resulting from “improper personal benefit”
 - Theoretically, it appears that a corporation could “surgically” abandon a narrow slice of business opportunity which consists solely of information/opportunities presented to a single board member in his/her capacity as a board member of a competing company
 - Such a surgical approach could become enormously complex as the director and the corporation essentially negotiate to develop a custom-crafted set of fiduciary duties that allow the director to participate in selected board meetings but not to actively harm the corporation

A Special Arrangement? (cont.)

- A director seeking a surgical approach must act in good faith when negotiating terms and conditions
 - ▶ The director would be required to disclose the nature of his/her conflicts so that the corporation could negotiate on a fully informed basis
 - ▶ In some cases, it may be difficult or impossible to make such disclosure without breaching duties to the other (competing) corporation
- These types of arrangements also present a variety of practical business problems, potentially creating distrust, suspicion or resentment among board members, etc.

Side Note: Avoiding Duplicate Problems at the Fund Level

- It is much easier for a fund manager to limit his/her fiduciary duties to the limited partners of his/her fund (via the fund's partnership agreement) than to limit fiduciary duties as a director
- In general, a fund's partnership agreement should contain a provision which allows each fund manager to satisfy fiduciary duties to portfolio companies, even if such behavior conflicts with fiduciary duties to the fund
- Thus, it generally should be possible for a fund manager to avoid an additional layer of "getting stuck between a rock and a hard place" in the form of conflicting fiduciary duties to a fund and a portfolio company

A Bigger Picture

- Note that Joe may be constrained by fiduciary duties in a variety of circumstances that have little to do with the direct conflict between FuelCell and Dialysis
 - Example: Dialysis decides to focus its R&D on Catalyst Y (which Joe knows won't work) so that bankruptcy is likely
 - Dialysis then receives notice that BigCo would like to purchase the entire company for \$100 million in cash
 - The rest of the board is inclined to reject the offer, because they think that the company may make a fortune in fuel cells
 - Can Joe participate in the discussion? What could he say that wouldn't violate his duty of loyalty to FuelCell? (Hint: very little)
 - Thus, fiduciary duty problems may be more significant than they initially appear

A Bigger Picture (cont.)

- Other situations involving conflicts between portfolio companies
 - Targeting same customers
 - Doing business with one another
 - Seeking business relationships or joint ventures with same counterparties
 - Seeking to recruit same key employees
 - Etc.
- In some cases, particularly where competing portfolio companies are doing business with one another, any recusal must be supplemented with disclosure of the conflict (e.g., Joe should tell the members of each board about his position on the other board)

What Should Joe Do?

- While Joe may avoid a breach of the duty of loyalty by recusing himself from the meeting/discussion relating to Catalyst X and Y, and may not be deemed to violate the duty of care for this one-time recusal, he must consider the possibility that FuelCell and Dialysis are now in such direct opposition that many future conflicts are inevitable
 - Some conflicts, like a competing obligation under the duty of loyalty to offer the same new business opportunity to both companies, may not be resolvable even through recusal
 - This increases the likelihood that Joe ultimately will be forced to breach either the duty of loyalty or the duty of care
 - If he can't negotiate a special arrangement, he'll need to do something else to be protected

What Should Joe Do? (cont.)

- Should Joe resign from one or both boards?
 - Resignation from a corporation's board generally will terminate a director's fiduciary duties
 - ▶ However, resignation generally will not terminate his/her obligation to maintain the confidentiality of information previously received in his/her capacity as a director
 - ▶ By completely separating himself from board activities, Joe may not be acting in the best interests of his fund, since it would lose its representative at board meetings

What Should Joe Do? (cont.)

- Should Joe become a board observer?
 - ▶ A board observer may add value by attending, and participating in discussions at, board meetings
 - ▶ A board observer generally does not have fiduciary duties to the corporation
 - ▶ However, a board observer typically will be subject to a contractual duty to preserve the confidentiality of information received as a board observer

What Should Joe Do? (cont.)

- Should Joe turn the board seat over to a colleague?
 - ▶ If Joe is lucky, his firm includes another fund manager (Ann), who would be qualified to serve as a director of FuelCell or Dialysis
 - ▶ If Joe and Ann serve on separate boards, and don't indirectly breach a duty of care or loyalty by improperly communicating confidential information to one another (i.e., by maintaining an "Ethical Wall"), they may be able to collectively represent their fund's interests without violating fiduciary duties
 - There is insufficient case law to know exactly when courts will respect the validity of an Ethical Wall
 - ▶ Note that maintaining an Ethical Wall can be very difficult in the collegial environment of many venture capital and other private equity firms, where open discussion and sharing of information is the norm
 - It may also require modifications to voting and other procedures within the General Partner entity

Additional Issue: Antitrust

- Section 8 of the Clayton Act generally prohibits “interlocking directorates” among competing corporations
 - Section 8 covers situations in which the same individual serves as a director of two or more competing corporations
 - It may also cover situations in which different individual members of the same venture capital or other private equity firm serve as directors of two or more competing corporations (the law in this area is evolving)
 - ▶ Note that the FTC has applied Section 5 of the FTC Act, broadly prohibiting “unfair methods of competition,” to uphold the “spirit and purpose” of Clayton Act Section 8 even where its technical requirements are not satisfied

Additional Issue: Antitrust (cont.)

- In general, Section 8 applies where:
 - The combined capital, surplus and undivided profits of each corporation exceeds \$21.3 million;
 - Each corporation is engaged in whole or in part in U.S. commerce; and
 - The corporations are “by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws”

Additional Issue: Antitrust (cont.)

- Under a *de minimis* rule, Section 8 generally does not apply where
 - The competitive sales of either corporation are less than \$2.13 million;
 - The competitive sales of either corporation are less than 2% of that corporation's total sales; or
 - The competitive sales of each corporation are less than 4% of that corporation's total sales
- Private claims for damages under Section 8 are allowed, but have been rare – a handful have been made in the last few years. Otherwise, enforcement consists of forced removal of the “interlock” by resignation from one or both board positions.

Conclusions

- Serving on the boards of competing portfolio companies may generate irreconcilable conflicts that place a fund manager “between a rock and a hard place”
- Declining to participate in meetings/discussions relating to issues of conflict may work occasionally, but may violate duty of care if it impairs general effectiveness as a director
- Specially negotiated arrangements may allow a director to avoid breaching fiduciary duties (essentially, by modifying those duties), but such arrangements can be difficult or impossible to negotiate/implement
- Splitting board seats among members of the same firm (and maintaining an “Ethical Wall”) may resolve conflicts, but the law is not entirely clear and the practical difficulties are significant
- Resigning/becoming a board observer may resolve conflicts, but only at the expense of reducing a fund’s representation vis-à-vis the portfolio companies
- Even diligent fund managers who seek to avoid investing in competing portfolio companies may find themselves in a difficult situation when business plans morph/evolve into competition
- Where portfolio companies actually compete in the marketplace, antitrust issues also should be considered
- Venture capital and other private equity firms should periodically review their portfolios, and information sharing procedures, to identify and resolve potential conflicts as early as possible

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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