Client Alert

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Delaware Court Finds Dissident Director Breached Duty of Loyalty

In *Shocking Technologies, Inc. v. Michael*, the Delaware Court of Chancery held that a dissident director breached his fiduciary duty of loyalty by sharing confidential information with a third party and trying to discourage that third party from investing in the company. The court's post-trial ruling came in spite of the director's claim that he acted in good faith and believed his actions would address certain governance disputes that he had with the other directors. The court observed that "fair debate" is an important issue in corporate governance, but there are clear limits on director conduct in trying to resolve disagreements. Among other things, the court's decision serves as a reminder to stockholders who sit on boards or otherwise have board representation that directors' duties run to all stockholders.

Background

The decision involved a dissident director who was the sole board representative of two series of preferred stock. Over time, significant disagreements between the director and the other board members arose over executive compensation and whether there should be increased board representation for the preferred stock. The director argued that the company's governance problems needed to be resolved before it could attract additional equity funding. The company alleged, however, that these disagreements were pretext for the director's desire to increase his influence and control over the board at a time when the company faced financial difficulties.

As the disagreements escalated, the dissident director contacted a third party to discourage it from exercising warrants to purchase shares of the company's stock. The director also told the third party that the company was in a dire financial situation, that the third party was the only present source of financing, and that the third party should use this leverage to negotiate for more favorable terms, such as a lower price or board representation. The director argued at trial that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the board.

Court's Opinion

Following a trial, the court held that the dissident director breached his duty of loyalty by (i) trying to dissuade a potential third-party investment that would have provided much-needed cash to the company and (ii) disclosing confidential information relating to the company's financing alternatives to the third party. The director knew the company was in a "precarious cash position" with no alternative source of funding; he also knew that his actions would frustrate the company's objective of "finding enough cash to survive." Thus, because the director knew his actions were against the company's best interests, the court ruled that he breached the fiduciary duty of loyalty.

The court noted that shareholders and directors have a right to seek a change in "corporate governance ambiance" and board composition. Presumably, a minority stockholder is subject to few, if any, limits. The court held, however, that "[t]he steps that a shareholder-director may take to achieve objectives are not without limits" (emphasis added). The court explained that, even if the director believed his efforts could help the company in the long-term by improving its governance, "his taking steps that would foreseeably cause significant harm to [the company] amounts to nothing less than a breach of the

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fiduciary duty of loyalty." Because the third party exercised its warrants, however, the court denied the company's request for monetary damages.

Implications

Board Dialogue and Debate

The decision should be carefully considered by directors who are pursuing good faith disagreements with their fellow directors. Board dialogue is a critical aspect of corporate governance. In addition, while boardroom collegiality is important, directors may have significant differences of opinion with respect to issues of corporate governance or strategy. As the court noted, "fair debate may be an important aspect of board performance" and a "board majority may not muzzle a minority board member simply because it does not like what she may be saying." "[A] dissident board member," the court continued, "has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders."

The Court of Chancery also addressed board friction in the recent case of *Sherwood v. Chan Tze Ngon*, 2011 Del. Ch. LEXIS 202 (Dec. 20, 2011). There, a dissident director brought suit after the board decided not to renominate him for election at the company's annual meeting. The court found that the plaintiff had alleged colorable disclosure claims against the company where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the *only* reason that motivated the board to remove him from the Company's slate." The court explained that, while civility is a laudable goal, "it is also important that directors be able to register effective dissent." It continued that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion."

Dissenting directors, however, must act carefully in accordance with their fiduciary duties. In *Shocking Technologies*, the dissident director also called a special stockholders' meeting to air his governance concerns. The court rejected the company's argument that the dissident director's comments at the special meeting were a breach of fiduciary duty. It further noted that "this is the type of debate the courts are ill-equipped to referee." But the dissident crossed the line in communicating with the third-party investor with whom he shared confidential information about the company's financing needs and alternatives. "[I]nternal disagreement," the court wrote, "will not generally allow a dissident to release confidential corporate information."

"Short-Term Pain for Long-Term Gain"

The court recognized that some director actions could have adverse short-term consequences in the pursuit of long-term corporate benefits. As a result, it suggested a balancing act in which such actions are reviewed on a continuum that takes into account the potential harm and benefit to the company. *Shocking Technologies*, however, involved a clear-cut case of improper conduct in which the director's actions "could have caused the demise" of the company. In addition, the director's disclosure of confidential information to a potential investor was to "the substantial detriment of the Company" and thus "conduct which, in and of itself, is a breach of the duty of loyalty." "That there may be some theoretical improvement in 'corporate governance,'" the court reasoned, "does not alter this conclusion."

Unintentional Breach of the Duty of Loyalty

As a doctrinal matter, the court concluded that the director breached his fiduciary duty of loyalty even if he had legitimate goals. Typically, the duty of loyalty is viewed as a prohibition against certain kinds of self-dealing and a requirement to act in good faith. In this case, there was no self-dealing in the classic sense, and the dissident (who also was a significant stockholder) claimed to be acting in subjective good faith. There are a small number of Delaware cases, however, in which the courts have held that directors

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can unintentionally violate the duty of loyalty. These cases are important because directors cannot be exculpated from liability for a breach of the duty of loyalty.

Directors' Duties Run to All Stockholders

Shocking Technologies provides another reminder to directors who are elected by or represent a particular stockholder or class or series of stock that their fiduciary duties run to all stockholders generally. This is particularly important for large stockholders who serve on boards and for private equity and venture capital firms that designate principals to serve on the boards of their portfolio companies.

Generally speaking, a stockholder is free to act in its own self-interest. When that stockholder serves or is represented on the board, however, experience shows that it can be difficult to separate the two roles. For example, in *Schoon v. Troy Corp.*, 2006 Del. Ch. LEXIS 123 (June 27, 2006), the court found that a director did not have a proper purpose for inspecting the company's books and records where the request was "made in consultation with and at the direction of" the stockholder that appointed him. The court found that the request was outside the director's duties because it allegedly was made to help sell the stockholder's shares, which generally would be a permissible purpose had the stockholder made the request. Another conflict of interest was present in *In re Trados Inc. S'holder Litig.*, 2009 Del. Ch. LEXIS 128 (July 24, 2009), where the court refused to dismiss breach of loyalty claims against a board of directors in approving a merger. There, a majority of the directors were affiliated with preferred stockholders that benefitted from the merger, while common stockholders received nothing.

In *Shocking Technologies*, the dissident director's belief that the holders of the preferred shares with which he was affiliated deserved greater board representation did not justify his actions. Thus, directors with dual relationships need to be sensitive to their duties. In some situations, a director may need to be "walled off" from his or her affiliated stockholder or recuse himself or herself from the board's deliberations.

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