Client Alert

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Constituent Directors: Court Allows Company to Impose Confidentiality Restrictions on Stockholder's Right to Designate a Director

In *Partners Healthcare Solutions Holdings, L.P. v. Universal American Corp.*, the Delaware Court of Chancery addressed a stockholder agreement entitling a large stockholder to designate a director. In the specific circumstances of this case, the court held that the company could require the director to execute a confidentiality agreement before he could be seated, even though the agreement did not provide for such a restriction.

Background

Partners Healthcare Solutions Holdings presented a dispute over a stockholder's contractual right to designate a director. The stockholder, which was a private equity fund, nominated one of its principals. The only contractual restriction on the stockholder's right was that the designee had to be "independent" under applicable stock exchange rules, an issue that was not in dispute.

Importantly, the company had sued the stockholder in an unrelated matter. That litigation created an issue as to whether the stockholder's board designee, in his capacity as a director, could be represented by the same law firms representing the stockholder. The company had insisted that the designee enter into a confidentiality agreement prohibiting him from sharing company information with those law firms. The designee refused, and the stockholder sued to enforce the agreement.

While the litigation was pending, the parties settled part of the dispute by agreeing that the designee could use the stockholder's law firms as long as an ethical wall was created to prevent the litigation lawyers from obtaining company information. The stockholder continued to seek damages, however, from the company's refusal to seat the designee immediately.

Court of Chancery's Decision

The court held that the company did not breach the stockholder agreement, even though the agreement did not require a confidentiality agreement or impose any similar restrictions on the designee. The court found that the company's board of directors responded to a legitimate concern:

> The Board, in a faithful discharge of its fiduciary duties, recognized a conflict in the Designee engaging as counsel, in his capacity as a director and on behalf of [the company], the same counsel that was adverse to [the company] in the Fraud Litigation.

The court also found the company's response to be reasonable, noting that the board of directors "did not outright refuse to seat [the designee], but instead agreed to seat him once the problem of conflicted representation was solved. That cannot be said to be a breach of the Board Seat Agreement." The court concluded that "the Board was responding to a legitimate concern when it addressed the conflict created by the proposed representation of a director by a law firm that was also representing a litigation adversary."

Take-Aways

Despite the unusual facts, *Partners Healthcare Solutions* is a notable decision for companies with so-called "constituent directors." This includes companies backed by private equity and venture capital investors, who often have contractual rights to board representation. It also includes companies whose boards include representatives of activist hedge funds and founding families.

If the director is employed by the stockholder, he or she will usually be deemed "interested" in any transaction between the stockholder and corporation. *See In re Trados Inc.* (Del. Ch. Aug. 16, 2013). If the director is not employed by or otherwise affiliated with the stockholder, however, Delaware law generally presumes that the designee is disinterested and independent. *Aronson v. Lewis* (Del. 1984). In other words, the fact that a director is elected or designated by a particular stockholder does not automatically strip such director of his or her independence. After all, the director owes duties to all stockholders and not just the one who designated him or her. Still, companies often have concerns about even a "nominally independent" constituent director's access to certain types of sensitive information, particularly if the stockholder is at odds with the board majority or management.

If nothing else, *Partners Healthcare Solutions* illustrates the highly contextual approach to these situations taken by Delaware courts. For example, in *Shocking Techn. v. Michael* (Del. Ch. Oct. 1, 2012), the court found that a dissident director breached his fiduciary duties by trying to dissuade potential investors from investing in the company and by sharing confidential information with those investors. Yet the court also declined to award damages. In *Kalisman v. Friedman* (Del. Ch. Apr. 17, 2013), the court rejected a claim that information (including privileged communications) could be withheld from a director because the corporation thought he would misuse it. The court presumed that the director would act in good faith and indicated the company would have a remedy if he breached his duty. To the surprise of some observers, the court also said the director could generally share board-level information with the stockholder who designated him. *See generally* J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33 (2015).

Partners Healthcare Solutions indicates that, at least in some situations, a board of directors can take preemptive action to address a specific and legitimate concern to the company. Here, the concern related to confidentiality, but a board of directors — in the proper exercise of its fiduciary duties — could identify other threats justifying similar action. The court's decision is particularly noteworthy given the specific agreement in place with the stockholder, which did not impose any conditions or qualifications. Though the level of detail in such agreements can vary significantly, it is not clear whether a board's fiduciary duties could trump a contract with more specific terms regarding a board designation right. Regardless, it seems clear that the company could have sued the director for breaching his fiduciary duty if information was improperly shared with the stockholder's litigation counsel, but the court found that the board did not breach the agreement by insisting on a confidentiality agreement before seating him. From the board's perspective, this is typically the preferred approach. After-the-fact litigation might be an inadequate remedy once confidential information has been leaked.

Contacts

Allen C. Goolsby
agoolsby@hunton.com

Steven M. Haas
shaas@hunton.com