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Venture capitalists as directors: challenges of serving on the board of an insolvent company

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Over the past few years, the private equity market has invested billions of dollars into seemingly promising ventures that are now on the brink of insolvency. As fund managers and private investors who sit on the boards of directors of such companies agonize over the potential loss of their investments, they must also wrestle with competing concerns as board members. This article analyzes the often conflicting positions of a venture capitalist who is faced with the stark reality of protecting an investment while serving on the board of a company that is slipping toward insolvency.

The scenario is painfully well-known these days. Venture Capital Fund ("VC") invests in an early round of financing. In exchange for its investment, VC obtains preferred stock containing a liquidation preference, warrants convertible into common stock (which are exercised to provide more cash to the company), and along the way VC may even be involved as a senior secured lender through a round of bridge financing or as a component of the series of preferred stock. In exchange for its investment in the company ("Cantwin Corp.") VC is given a seat (or more) on the board of directors. The IPO market collapses, Cantwin Corp. has trouble raising additional rounds of financing, and shrinks while pursuing a merger partner or alternative survival strategy.

What does our VC board member do? He or she has at least three conflicting roles that need to be reconciled. As a member of the board he or she has a fiduciary duty to the company and its shareholders as a whole; however, as the company slips toward insolvency, the law requires that the board's fiduciary duty shifts toward the creditors. Here is where it gets interesting. Remember, our VC is a preferred shareholder, common shareholder and senior secured lender. As the VC contemplates foreclosing on its collateral, our VC board member, who also has a fiduciary duty to the VC fund's investors, must reconcile these conflicts and must also consider the spate of lawsuits that are sure to follow, not to mention having the fund tagged as a vulture capitalist.

> *"…there are some protective strategies that should be considered…."*

Fiduciary duties of directors

One of the most basic tenets of corporate law is that directors who owe a fiduciary duty to the corporation and its shareholders hold such a duty in the nature of a trust. They are entrusted with the corporate assets and powers and are expected to maintain the utmost fidelity in their dealings with, and on behalf of, the corporation.

The fiduciary duties of directors fall into two broad categories—that of care and that of loyalty. The duty of care contemplates that a director will exercise reasonable care in gathering and considering relevant information prior to making decisions, as well as that he or she will exercise the same reasonable care in performing general responsibilities. The concept of "good faith" is inextricably bound to the duty of care. The duty of care has even been defined as complete good faith plus the exercise of reasonable intelligence. It encompasses good faith actions on the part of a corporate principal acting in the best interests of the company (revised Business Model Corporation Act). As such, a corporate principal is generally only held liable for gross negligence or recklessness. Examples of typical breaches of the duty of care include: failure to attend meetings; failure to learn about the company's business; failure to read reports and financial statements; and failure to obtain help for the business. A director may be held liable for mere passive negligence such as failing to discover wrongdoing by corporate employees. However, there is no affirmative duty to detect, absent notice of facts, that should suggest the occurrence of wrongdoing *(Graham v. Allis Chalmers Mfg. Co.)*.

For purposes of our example, the VC board member should not find any difficulty in satisfying his or her duty of care. The duty of loyalty, however, is likely to test the boundaries of comfort for our VC director of Cantwin Corp.

The duty of loyalty mandates that the best interests of the corporation and its shareholders take precedence over any interest imposed by a director, officer or controlling shareholder and not shared by the other stockholders generally. It includes a duty to avoid conflicts of interest that may subordinate the interests of the corporation to those of a competing constituency.

By the very nature of the fiduciary capacity, a board member, acting with the trust and confidence of the corporation, is prohibited from self-dealing. Of the duty of loyalty, the Delaware Supreme Court has stated:

> A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty. . . . The rule requires an undivided and unselfish loyalty to the corporation and demands that there shall be no conflict between duty and self-interest (Guth v. Loft, Inc.)

The threshold inquiry in ascertaining whether a director has violated the fiduciary duty of loyalty involves consideration of whether the director has a conflict of interest in the transaction. Directors are considered to be "interested" if they either "appear on both sides of a transaction" or "expect to derive any personal financial benefit from it in the sense of self-dealing," as opposed to a benefit which devolves upon the corporation or all stockholders generally. Unlike the duty of care, good faith does not preclude a finding that the duty of loyalty has been breached. Thus, a self-dealing transaction will be sustained only if the transaction is objectively or intrinsically fair.

The conflicting battle lines are now clearly drawn. The VC board member has the fiduciary duty to the company, and he or she has a duty to the VC to protect its investment. While the company fights for survival, the VC is considering foreclosing on its collateral, thus effectively shutting down the company and running away with its assets. At this point, can our VC board member realistically take part in any meaningful board decisions about moving the company forward or not, while the VC is simultaneously contemplating foreclosing on its collateral? Certainly any such vote by the VC board member would be tainted by his or her conflicting interests. Here we have a classic scenario whereby a director now seems to "appear on both sides of a transaction." It should be noted that the famed Business Judgment Rule, which protects directors from judicial second-guessing of their informed business decisions, would not apply when the director has a conflict of interest.

Insolvency

Some assistance may be available to our VC board member from the principle that when a company becomes insolvent, the director's fiduciary duty shifts to the creditors. However, for our VC director, who must wrestle with the VC's status as a senior secured creditor on the one hand and his or her directorship role on the other, some challenging questions begin to arise around the boardroom table. More likely, these questions are posed at the weekly portfolio review meetings at our VC director's office with the other fund managers:

- What definition of insolvency is used: the accounting definition, the bankruptcy definition or some other definition?
- At what point in this continuum does the duty to the creditors arise?
- Does the shift in the fiduciary duties toward the creditors mean that the director no longer has a duty to the corporation and its shareholders, or are the creditors now just added to the mix of a larger constituency?

Prior to insolvency, it is generally accepted that creditors of all types are creatures of contract, and as such the directors of the corporation owe no independent fiduciary duty to them. But now Cantwin Corp. is in the classic corporate purgatory. Cantwin Corp. has a skeleton staff and a slow, steady flow of revenue that continues to fall short of the cash needs of the company no matter how much it cuts expenses. However, Cantwin Corp. is also in serious discussions for a number of large contracts, any one of which will allow it to survive another six months while it searches for a merger partner or second stage investor, many of whom will consider the company attractive once it has proven its model by obtaining these larger contracts for which it was positioned since inception. Needless to say, Cantwin Corp. also has debts that far exceed its current ability to pay, and most certainly has a negative book value. Is this company insolvent? Is our VC board member now free to embrace his or her role as the representative of the senior secured creditor and foreclose on its collateral? Where does the duty lie at this point?

It is important to note that the Model Business Corporation Act defines insolvency as "the inability of a corporation to pay its debts as they become due in the usual course of business." The U.S. Bankruptcy Code, however, defines insolvency as "a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." The Delaware Chancery Court disregarded the Bankruptcy Code definition of insolvency in favor of the Business Corporation Act definition because it better fit with the reality of corporate culture wherein corporations incur significant debt in order to seize business opportunities *(Francotyp-Postalia AG & Co. v. On Target Technology).*

Does the Chancery Court's definition really help? As experienced venture capitalists know, one can always commit to fund a bit more money into a company to keep it on life-support just a bit longer until the landscape clarifies. So if the company can pay certain debts in order to survive, and the other creditors are not pushing hard for payment, is the company meeting its debts as they become due? If so, does this make it any clearer as to where our VC's fiduciary duty lies at this point?

The Delaware Chancery Court has rendered an opinion that should give comfort to directors who wish to ride out the storm and to keep their board seats. In *Credit Lyonnais Bank Nederland, N.V. v. Pathé Communications Corp.*, the Chancery Court held that the board of a corporation in the vicinity of insolvency is "obligated to act not in the best interests of the shareholders, but rather in accordance with the community of interests that sustain the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."

Survival strategies

The VC director who wishes to stay on the board must be extremely mindful of each of the conflicts posed by the multiple hats that he or she wears. Besides the obvious protection of directors' and officers' insurance, indemnity clauses and the like (many of which either might not exist in an undercapitalized venture or be worthless), there are some protective strategies that should be considered:

- Board minutes must be detailed and scrupulously maintained. The minutes should clearly reflect that the board took action based upon sound inquiry and with full knowledge of the available facts.
- The VC board member must keep constant watch on where the company stands in the continuum of insolvency and be mindful of the shift in fiduciary duties that arise with insolvency.
- As the company approaches insolvency, the VC board member must consider abstaining from votes that would be in conflict with his or her fiduciary duties to the company, the creditors or to the community of interests that sustain the corporation.
- Finally, the VC board member should consider resigning. Resignation is certainly the recommended course if the VC makes a decision to foreclose on its collateral before the company has voluntarily declared bankruptcy.

Inherent in this scenario is the potential for conflict. Knowing when and how these conflicts arise helps to avoid adding the insult of an expensive lawsuit to the injury of the investment losses. D

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