

CDX Ruling and The Independence of “Independent” Directors. This ruling has implications for family dominated private companies where there are outside investors.

What do YOU think?

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In *CDX Liquidating Trust v. Venrock Assocs., et al.*, 2011 U.S. App. LEXIS 6390 (7th Cir. March 29, 2011), the United States Court of Appeals for the Seventh Circuit, reversing the District Court’s ruling, held under Delaware law that a director’s disclosure of a conflict, in and of itself, is insufficient to protect that director from liability for breach of the fiduciary duty of loyalty arising from that conflict. Similarly, the other party to whom the conflicted director owes loyalty (under the right circumstances) can be held liable for aiding and abetting a breach of fiduciary duty. Nor does the mere existence of independent directors shield these parties from liability.

In *Venrock*, the debtor (“Debtor”) was a company which manufactured internet modems. The founders received common stock. Two venture capital firms (the “VCs”) received preferred stock in exchange for an investment made at the beginning of 2000. A principal of one of the venture capital firms (the “VC Principal”) became a member of Debtor’s five-member board of directors (the “Board”) upon the firm’s investment. In April 2000, the Board rebuffed a tentative offer to buy Debtor’s assets for \$300 million.

In the fall of 2000, Debtor found itself in severe financial difficulty. The VC Principal, on behalf of Debtor, began negotiating for a loan. Although there were two potential lender groups, the VC Principal steered the Board to accept a bridge loan from the VCs, which closed in January 2001. By that time, the Board had grown to seven members, four of which (including the VC Principal) were employed by the VCs and were thus interested. The remaining disinterested directors were not financially sophisticated and relied on the VC Principal for financial advice. Debtor ran through the loan quickly. In May 2001, the VCs made a second bridge loan to Debtor, again negotiated by the VC Principal. The loan agreement provided that in the event Debtor was liquidated, the VCs would be entitled to twice the outstanding principal plus any accrued but unpaid interest, thus greatly diminishing any return to shareholders.

Debtor quickly defaulted on the second loan. In extremis, it agreed to sell its assets to a third party (the “Buyer”) for stock in the Buyer worth \$55 million. There was some evidence that a similar company whose loan terms gave them more time to negotiate a sale was sold for \$300 million, the amount of the rebuffed offer. The sale was approved by the entire Board. The independent directors did not seek separate legal or financial advice. A simple majority of both Debtor’s preferred and common shareholders, voting as a single class, and of the preferred shareholders (the VCs) voting separately also approved.

The \$55 million was just enough to satisfy the claims of Debtor's creditors and preferred shareholders (the VCs were both). The Buyer's stock was Debtor's only asset after the sale. It declined in value and became worth less than the claims of the VCs and other creditors, completely wiping out the common shareholders. The common shareholders commenced an action against the four members of the Board who were employed by the VCs (the "Director Defendants"), alleging that they had breached their duty of loyalty to Debtor, and against personnel at the VCs, alleging they aided and abetted the breach.

The Director Defendants' argued that although they may have had a conflict of interest as a result of their dual loyalties, they had fully disclosed that conflict as required under Delaware's General Corporation Law. Under that law, if a board member's conflict is fully disclosed or known to the board, and the board, in good faith, authorizes a transaction by the affirmative votes of a majority of the disinterested directors, then a transaction between company A and company B, where the director has financial interests in both company A and company B, will not be void or voidable solely because of those dual interests. The Director Defendants also argued that the plaintiffs had not proven proximate cause.

The District Court was persuaded by the Director Defendants that disclosure of the conflict, in and of itself, excused the purported breach of fiduciary duty and dismissed after the close of plaintiffs' case in chief. The Seventh Circuit, however, disagreed. The Seventh Circuit drew a distinction between the existence of a conflict, and disloyal conduct predicated on such conflict, holding that disclosure excuses the existence of the conflict, not the act of disloyalty as a result of the conflict:

To have a conflict and to be motivated by it to breach a duty of loyalty are two different things – the first a factor increasing the likelihood of a wrong, the second the wrong itself. Thus a disloyal act is actionable even when a conflict of interest is not – one difference being that the conflict is disclosed, the disloyal act is not.

While it was the VC Principal who was the director principally accused of disloyalty to Debtor, the other three interested directors were equally liable. Sitting by and knowingly allowing a wrongful act to take place that benefits another party to whom one has loyalty, if proven, is also a breach of fiduciary duty. The other interested directors could be culpable for not putting safeguards in place, as could be the personnel at the VCs who encouraged the interested directors to put such institutions' interests first, thereby aiding and abetting breaches of fiduciary duty.

The more surprising aspect, however, involved the independent directors. In *dicta*, the Court suggests that they, too, were not free from blame because they failed to hire independent advisors and left themselves at the mercy of the advice given by the VC Principal and the other conflicted directors. The Seventh Circuit clearly suggests that the mere existence of independent directors is not enough to safeguard the decision-making process where the directors fail to act with independent judgment. One can conclude that the best corporate practice is to have a separate committee of independent directors with its own legal and financial advisors. Had the directors done so here, their actions would have been shielded by the business judgment rule. But since the entire decision-making process was tainted by the conflicted directors, that safe

harbor was unavailable, and the burden of proof shifted to the defendants to prove the entire fairness of the transaction.

There is a hard lesson to be learned from this case, particularly in light of today's world of special purpose entities and the like. First, mere disclosure of a conflict does not protect a director or a company. It behooves non-conflicted directors to put safeguards in place to ensure that conflicted directors are not in a position to act on such a conflict, or the remaining non-conflicted directors may find themselves with liability, as well.

Second, when forming the boards of even closely held-entities, there is a need not just for "disinterested" directors, but directors who are truly independent and function as such, with independent legal and financial advisors when appropriate. Care must be taken to ensure that the independent director fully understands all of the ramifications of actions the director is being asked to approve. On significant matters on which certain directors are interested, there should be a separate committee of disinterested directors. The interested directors, having disclosed a conflict, should not vote on the matter. There is no reason to test their loyalties unnecessarily. As Judge Posner noted in the opinion:

A director may tell his fellow directors that he has a conflict of interest but that he will not allow it to influence his actions as a director; he will not tell them he plans to screw them.

This case is not dissimilar to a recent Delaware Court of Chancery case, *In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011). In that case, the board was called to task for relying on a conflicted advisor. Here the reliance was on a conflicted director. Clearly the trend is for the courts to insist on independent judgment.

While hiring truly independent directors and arming them with the necessary advisors may seem costly, in the long run, it is significantly less expensive than the litigation and damages that can result from failing to do so. And one does not always have to pay huge sums to attract independent directors with integrity. National service providers can supply knowledgeable independent directors cost effectively. Here, the proper use of truly independent directors likely would have resulted in the Debtor securing better bridge financing thus giving it more time to find a more attractive offer than the Buyer, in which case everyone might have benefited. Instead, everyone lost due to a failure of good corporate governance.