

PRIVATE EQUITY IN 2009 – 9 tips for protecting your investment, your rights and your designated directors

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Many investment professionals are expecting a difficult and challenging 2009. According to the third annual National Venture Capital Association (NVCA) 2009 Predictions Survey, 93% of venture capitalists believe it will be more difficult to sustain existing portfolio companies in 2009 and 96% believe new companies will have a more difficult time raising equity financing.²

Many articles have been, and will continue to be, written on the current down market and global financial crisis from a private equity perspective, ranging in topics from causes of the crisis and its conditions to market trends and outlook for the future. This article is not intended to be a spotlight on the 2009 private equity market, but instead seeks to provide a timely sampling of some “back to basics” practice tips in the context of a typical private equity deal. The practical tips should be carefully considered and addressed in light of the current economy and market conditions. The challenging market conditions that private equity funds will face in 2009, in an already Darwinian industry, cannot be ignored. This article intends to give proper attention to some fundamentals or “best practices” that will help protect a private equity investor’s investment, its contracted-for rights and its designated directors.

During a down market such as the 2009 market, the tension between the interests of the various stakeholders in a company is typically at its greatest. For instance, the members of a portfolio company’s board and its stockholders may have to consider potential sale events

earlier than planned or a significant restructuring in light of the lack of financing opportunities. Also, the current market conditions may require a company, its directors and its stockholders to decide whether or not to pursue a “down round financing” (a financing completed at a pre-money valuation that is lower than the post-money valuation of the prior round -- a topic that will most assuredly receive a lot of attention this year). It is at these times of increased tension that the deal terms of the investor’s preferred stock are often put to the test. It should be expected that the other stakeholders will review the terms of an investor’s preferred stock very carefully with the intent of constructing an interpretation, or identifying loopholes, that will help these other stakeholders promote their own economic interests and achieve their desired outcome, in most cases at the expense of the preferred stock investor. An oversight or loophole can result in lengthy and expensive intra-company disputes. It may also have the unintended consequence of the company, or the other stakeholders in the company, actually having a better deal, and the investor having a worse deal, than the investor had thought it had negotiated at the time of its investment.

Below are nine “back to basics” tips to keep in mind when negotiating the terms of a private equity investment in the current climate. The tips below assume the portfolio company is a Delaware corporation and that the investor is a “venture capital” or “growth equity” type private equity fund (referred to in this article as an “investor”) that focuses on preferred stock investments with board

representation and not with the intent of acquiring such companies, although the tips in this article will likely prove useful for buyout, mezzanine and other types of private equity as well. Underlying all of the tips is the goal of drafting an investor’s powers, rights and protections clearly and with a healthy respect for the Delaware General Corporation Law (DGCL) and the well-developed private equity/preferred stock principles developed by the Delaware courts.

With a majority of the private equity investments in 2009 expected to be follow-on investments in existing portfolio companies (as noted in the NVCA survey), investors and their counsel should carefully review the existing provisions of their investments. A follow-on financing serves as an excellent opportunity to clean up any inconsistencies, ambiguities or loopholes in the existing deal terms in order to properly capture and protect the investment.

Tip #1: No One, Including Judges, Speaks “Legalese”: The written contract should be as clear and comprehensive as possible.

Typically, when a private equity fund makes an investment it does so in a form of preferred stock or in a strip of preferred stock and common stock. The contractual rights and protective provisions of the preferred stock negotiated for by an investor establish not only the economic attributes of its investment but also serve to protect the investment. A fundamental principle of Delaware law that is codified

in Section 151(a) of the DGCL is that “any rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated.”³ The Delaware courts have consistently applied this principle and have steadily maintained that any special rights afforded the preferred stock are rights of contract and will not be presumed.⁴ Preferred stock provisions should be drafted with this in mind.

Practice Point. Don't Rely on Anti-Impairment Clauses to Create Rights. In certain cases, investors have relied on an “anti-impairment” clause for protection of their rights. Typically, an anti-impairment clause states that the portfolio company will not seek to avoid or impair the rights of the preferred stock. Investors should not place significant reliance on this general provision as Delaware courts have typically construed anti-impairment clauses narrowly.⁵ In a recent decision, the Delaware Chancery Court has stated that “no independent right springs from [an anti-impairment clause].”⁶ In other words, an anti-impairment clause will only protect those rights and protections that are otherwise “expressly and clearly stated” in the documents. These Delaware decisions, along with not wanting to provide disgruntled minority shareholders with a basis, albeit a very weak basis, for a claim, are among the reasons the NVCA has not included an anti-impairment clause in its Model Certificate of Incorporation.⁷

Practice Point. Watch Out for Differences in Opinion. A main objective of a contract is to clearly and accurately reflect the understanding of the parties while avoiding ambiguity. When a contract provision does not clearly set forth its purpose and application within the four corners of the document, a court will look to extrinsic evidence to determine the meaning of the contractual provision -- a judicial exercise that is costly and subjective. A telltale sign of an ambiguous contract provision is when the other party has expressed, or has clearly signaled, a different interpretation.

In its recent decision in *United Rentals*, the Delaware Chancery Court applied what has come to be known as the “forthright negotiator principle,” an

extraordinary judicial tool that allows a court to impose what one party subjectively believed a disputed contractual provision to mean if the other party knew, or should have known, of such belief. This tool is available if the extrinsic evidence does not resolve an otherwise ambiguous provision.⁸ Interestingly, in *United Rentals*, the court found both parties’ arguments and interpretations of the disputed specific performance-related provisions to be reasonable. An argument can be made that Cerberus (the private equity sponsor of the buyer that walked away from the deal and who was trying to avoid application of the specific performance provision) and its counsel may have been lucky with the final judgment; however, Cerberus was not lucky enough to avoid litigation.

The lesson from this case is to be alert to a difference of interpretation of contract provisions by the other party. First, this is a sign the provision is not clearly drafted. Second, an investor’s silence in the face of a differing interpretation can be later used against the investor. Ideally, the contract provision should be revised to remove any ambiguity. If this is not possible, the investor should seriously consider expressing its disagreement with the interpretation of the other party and set forth its own interpretation of the provision.

Practice Point. Don't Rely Entirely on Redlines. You are less likely to catch an old mistake in the drafting when reviewing a redlined document as the legacy mistake will not be highlighted. This could easily lead to a “small” mistake involving a handful of words resulting in a significant impairment to the investment after the closing. In the recent case *Lapoint v. AmerisourceBergen Corp.*, there was a “small” drafting error in the earn-out provision where the final provision stated that the sellers could deliver an objection to the buyer’s calculation of the final earn-out payment “no less than” 20 business days after buyer’s calculation of the earn-out payment.⁹ Consistent with the literal meaning of the provision, the sellers delivered an objection 26 business days after the buyer’s calculation.

The buyer argued to the court that the earn-out objection was untimely since the term “no less than” was really intended to mean “no more than.” The court noted that the buyer and sellers were sophisticated parties and refused to reform the plain meaning of the final provision. In addition to “cold reading” revised documents, counsel should have a best practice of having a colleague also proofread selected draft versions, including the final version. The “no less than”/“no more than” mix-up may have been avoided with a fresh pair of eyes reviewing the agreement. When it comes to proofreading, four eyes are exponentially better than two eyes.

Practice Point. Don't be Afraid to Include Examples. Examples are a great way of documenting the parties’ intent, especially for complex provisions or provisions dealing with multiple variables. In particular, examples can prove to be helpful when the parties are reviewing a provision several years after the fact when their economic motives and agendas may not be aligned or the people originally involved in the deal are no longer around.

There appears to be hesitancy in the legal profession to include examples in legal documents. We can only assume this is due to legacy factors, including that old drafting habits are hard to break (absent, of course, a landmark judgment in case law). The hesitancy in using examples is representative of the larger struggle in the legal profession between the trend of reforming drafting techniques to use plain English and concise sentences, versus the traditional practice of honing and perfecting classic contract prose. The unfortunate reality is that a number of legal professionals believe plain English provisions, including the use of examples, “dumbs down” a legal document. While this topic is beyond the scope of this article, we would argue, as would Delaware case law, that it would be rather dumb not to “dumb down” a legal document if it results in clearer provisions.

Practice Point. If There is an Issue -- Address It. It is inevitable that deal-specific issues will arise after the term sheet stage and before the closing of an

investment. The most common issues arise from the due diligence review that typically takes place after the term sheet is executed. As a general rule of thumb, it is in the best interests of the investor to attempt to address these issues directly and clearly in the investment documentation. Without clear and express language addressing the issue, there is a significant risk that an ambiguous or a general provision will be interpreted to the detriment of the investor.

This practice point may be a difficult lesson to apply to deals, as there is a noticeable tendency in deal negotiations for the parties to dance around issues -- with potentially a misguided hope of the investor that the "general" rights negotiated for during the term sheet stage will equally apply to the specific concern or issue identified after the term sheet was finalized. While the general term sheet provisions may indeed cover this concern or issue, an investor should confirm this with its counsel. If the term sheet rights don't clearly and expressly address the issue or concern, the investor should seriously consider re-opening negotiations in light of the identified concern and require a specific protective provision that clearly addresses the concern.

Tip #2: You Get What You Drafted: Consent rights of the preferred stock need to be drafted with care and specificity.

Private equity investments in growth-oriented companies often involve a minority investment in the target company. In these situations, the investor typically has one or two board seats, but does not usually have the right to designate a majority of the members of the portfolio company's board of directors. In this type of a minority investment, the investor does not have the ability to affirmatively control the portfolio company, which places great importance on the protective provisions and other consent rights of the preferred stock (which are typically negotiated at the term sheet stage). These contractual provisions provide "negative control rights" over the company's actions. The inherent risk in "negative control rights"

is that there may be inadvertent loopholes or unanticipated situations after the closing that can be exploited by the company or other stakeholders after the closing.

As previously discussed above in *Tip #1*, these consent rights or "negative control rights" need to be drafted as clearly and comprehensively as possible. Delaware courts will not read rights into unclear or overly broad language and have been consistent in refusing to imply or presume preferred stock powers, rights or preferences from other provisions of the charter. In *Benchmark*,¹⁰ the Delaware Chancery court held that protective provisions of an investor providing for a class vote with respect to certain amendments to the company's charter do not protect the investor against alterations or modifications resulting from a merger unless expressly provided for in the charter. The court held that the changes to the existing preferred stock were a result of the merger, which the investor did not have a sufficient consent right for and would not be deemed to be an amendment of the charter of the company that was merged out of existence.

The *Benchmark* case is a great example of how Delaware court decisions can transform private equity drafting practices. From this case came the phrase "whether by merger, consolidation or otherwise," as suggested by the court in its holding to protect against indirect amendments to the charter.¹¹ It is typical today to see this magic phrase liberally inserted into an investor's protective provisions.

Similarly, in *WatchMark*, a company was faced with the necessity of completing a "down-round" financing that was opposed by an investor holding a series of senior preferred stock. The series of preferred stock held by the objecting investor had a protective provision with respect to adverse charter amendments. Similar to the *Benchmark* case, the protective provision did not expressly cover amendments to the charter effected through a merger.¹² Consequently, the court affirmed the ability of the company, which had the approval of the other investors who

supported the financing, to remove the separate protective provisions of each series of preferred stock by completing a merger of the company with and into a wholly-owned subsidiary.¹³

As a result of the merger, the certificate of incorporation of the surviving corporation (*i.e.*, the subsidiary) was nearly identical to that of the former parent, the only material changes being the elimination of the separate class votes of the former preferred stock and the insertion of a "pay-to-play provision." The pay-to-play provision provided that an investor's preferred stock would be automatically converted into common stock to the extent it did not participate up to its pro rata share of the financing. This is a sobering case for all investors and shows how a loophole can be manipulated into a gaping hole in the negative control rights resulting in severe, unintended consequences to the investor.

In *Watchmark*, the investor believed it had bargained for a water-tight consent right on adverse charter amendments, but, after an expensive trial process, was made painfully aware that there was a loophole in the contracted-for language that the company was able to take advantage of to not only deprive the investor of its ability to veto a financing but also, in a cruel twist of irony, subject the investor to a pay-to-play provision that would extinguish all of the investor's preferred stock rights if it did not participate in the financing it opposed.

It should be noted that each of the *Benchmark* and *WatchMark* cases involve disputes from the last down market of early 2000. These cases demonstrate that investors in preferred stock did not have the negative control rights that they believed they had bargained for due to loosely drafted protective provisions that created unintended limitations on the scope of the consent rights. Note that the merger-related loopholes described above are addressed in the Revised Model Business Corporation Act ("RMBCA") (adopted by a majority of the states -- Delaware not being one of them), which provides that a merger can't amend provisions in the charter without the proper consent that would have been

required had the changes been effected through an amendment.¹⁴

Practice Point. Be Careful When Relying on Statutory Consent Rights. Although Section 242(b)(2) of the DGCL provides for a class vote on any amendment that would “alter or change the powers, preferences, or special rights of the shares,” the Delaware courts have consistently held that the authorization, designation and issuance of a senior stock, by itself, does not trigger a consent right in the existing classes of securities because it does not “alter or change the powers, preferences, or special rights of the shares” of the existing classes and series of stock.¹⁵ This is not the case in New York and those states which have adopted the RMBCA, each of which provides for a class consent on the issuance of a senior security that is senior to the existing preferred in either dividend preference or liquidation right.¹⁶ With a Delaware corporation, if an investor wants the right to block a company from creating a senior class of preferred, specific language to that effect must be included in the documents. As a general rule of thumb, an investor should not rely entirely on statutory consent rights and should contractually provide for such rights as well. Statutes are notorious for poor drafting (much of this due to the Frankenstein approach of the legislative process) and are subject to changing interpretations by the courts and amendments by the legislative authority, some of which may be completely unexpected and detrimental to the rights of the investor.

Practice Point. Protect Against Junior Stock that is “Super Participating.” It is not uncommon that the protective provisions in favor of the investor’s preferred stock are limited to amendments to the charter that adversely affect the rights of the preferred and, separately, to the authorization, designation or issuance of senior or *pari passu* stock. Depending on the exact language used, this may inadvertently leave a loophole for the issuance of junior preferred with unusual provisions that wouldn’t trigger a consent right under either protective provision described above. For instance, a clever company, acting with supportive stockholders, could

attempt to issue a junior preferred with a multiple liquidation preference or increased participation rights that would eat away at the proceeds that would have otherwise gone to the investor’s senior preferred stock and common stock upon a liquidation or deemed liquidation event (such as a sale of the company). This is just one example of how a company can creatively take advantage of loopholes in negative control rights.

Practice Point. Reminder to Protect Against Pari Passu Securities. The practice tip above assumes that the investor has already negotiated for a consent right on the authorization, designation or issuance of *pari passu* securities. As is evident in the case law described in this article, assumptions can lead to trouble, so we believe this tip deserves its own practice point. The lack of a consent right on *pari passu* securities not only raises the same concerns as a “super participating” junior preferred stock described in the practice point directly above, but also creates the opportunity for the company to issue additional shares of the same series of preferred stock held by the investor with the effect of diluting or eliminating the series consent rights previously enjoyed by the investor.

For instance, an investor holding 55% of the Series A Preferred Stock of a company may have negotiated a list of protective provisions and one board seat that are vested in the holders of at least 50.1% of the issued and outstanding Series A Preferred Stock. If the investor does not have a consent right on the issuance of *pari passu* securities, and the investor either does not have preemptive rights or does not want to (or is financially unable to) exercise them, the company has an opportunity to dilute the investor below 50.1% by issuing additional shares of Series A Preferred Stock to other investors.

Of course, this practice point, as with most of the practice points in this article, assumes that the investor has the negotiating ability to obtain these contractual provisions. If the investor is unable to negotiate for comprehensive consent rights with respect to future issuances of equity, this will place even

more importance on the content of the investor’s preemptive rights. The investor should make sure it has sufficient preemptive rights that allow it to participate in the subsequent equity issuances -- an admittedly weaker form of protection that requires the investor to use new money in order to help protect its existing investment.¹⁷

Practice Point. Protect Against Actions Directed Through Subsidiaries. In *In re Sunstates Corp. Shareholder Litig.*, the Delaware Chancery Court held that a repurchase of shares of a junior stock of the parent company that would have otherwise required consent of the holders of a series of preferred stock was permitted because the purchase was made by a subsidiary of the corporation.¹⁸ Again construing rights of the preferred stock narrowly, the court held that the language in the charter requiring consent if “the Corporation” had purchased the shares would not apply to actions by a subsidiary thereof. The court did, however, suggest that the ruling may have turned out differently had the subsidiary been formed specifically for the repurchase and had it not had its own operations. This subsidiary loophole can affect many standard protective provisions. As a general rule of thumb, protective provisions should be drafted to specifically include actions by the portfolio company’s subsidiaries.

Practice Point. If the Intent of a Negative Control Right is to be All-Inclusive – Don’t Draft to the Contrary. All too often the intent of a negative control right is to be comprehensive and broad, but the language is drafted to the contrary, leaving unintended loopholes. Two classic examples are: (1) if the investor is looking for a negative control right on any change to the charter or bylaws – don’t qualify the consent right so it applies only to those changes that “adversely affect” the preferred stock, and (2) if the investor has negotiated a negative control right on the designation or authorization of any new class or series of capital stock – don’t limit it to senior or *pari passu* securities.

Tip #3: To State the Obvious: Don’t miss the obvious provisions.

An article focusing on “back to basics” tips would not be complete without a brief focus on some fundamental protections for investors expressly provided in Delaware law that should be incorporated into most private equity deal terms. The trap for unwary investors and their counsel is when a company is conducting its first institutional financing round with a sophisticated investor and the business parties have agreed to use existing investment documents as the template for the new financing round. What seems like a token gesture by the investor to move the new relationship in the right direction has the potential for meaningfully negative, unintended consequences. This situation calls for extreme vigilance in determining what, if anything, the existing documents may be missing and remedying provisions that are otherwise deficient.

Provision #1. *Section 102(b)(7) of the DGCL – Director Exculpatory Provision.* This provision (referred to in this article as the 102(b)(7) exculpation provision) protects directors from claims for monetary damages for breaches of the fiduciary duty of care (but not claims involving a breach of the duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law and certain other specified conduct). This is an “opt in” charter provision, but from an investor’s perspective, especially an investor who is appointing a director, it should be considered an unconditional “must have” provision.

Provision #2. *Section 122(17) of the DGCL - Waiver of Corporate Opportunities.* This provision permits a Delaware corporation to renounce, in advance, the corporation’s interest or expectancy in specified business opportunities. Directors and officers of a company have a fiduciary duty of loyalty to that company and its stockholders. Among other things, this duty prohibits self-dealing by directors and officers. The corporate opportunity doctrine requires that a director or officer, when presented with a business opportunity that could be advantageous to the corporation, make that opportunity available to the

corporation before pursuing the opportunity for his or her own or an affiliate’s account.

A concern for an investor is that a company may invoke the corporate opportunity doctrine to claim that a subsequent investment made by the investor should have been first presented to the company’s board of directors. Even if an investor was willing to agree to this principle, it can be very difficult to comply with in light of the many business plans and potential investments that an investor receives and the different personnel of the investor that may review these potential investment opportunities. In light of all of this, an investor should consider taking advantage of Section 122(17) and require the company to waive the company’s interest in corporate opportunities involving the investor or its director designees.

As noted in *Tip #1*, this charter provision needs to be carefully drafted and there does not currently appear to be any relevant case law setting forth how expansive this waiver provision can be while still being (i) enforceable and (ii) not a breach of a director’s duty of loyalty. The tension is that Section 122(17) refers to waiving “specified business opportunities” while most charter provisions provide for a “general” advance waiver of unspecified business opportunities. The NVCA Model Certificate of Incorporation attempts to address this apparent tension by excepting out of the general advance waiver those opportunities brought to a director “expressly and solely” in such person’s capacity as a director of the company. The notes in the NVCA Model Certificate of Incorporation caution that the model waiver provision is “very pro-investor.”

Provision #3. *Right to Designate Members of the Board of Directors.* An investor should consider securing its right to designate a director directly in the certificate of incorporation as well as setting forth a specific voting agreement for the election of directors in a stockholders agreement or voting rights agreement. By placing the designation rights into the charter, it truly becomes a “direct” designation right that attaches to the shares and not a contractual provision

as it would be if board composition matters were only included in a stockholders agreement or other similar voting agreement. The inherent weakness of a stand-alone contractual right is that a board appointment provision in a stockholders agreement simply acts as a voting agreement among the contracting stockholders. This results in a situation where an investor with a director designation right must rely on the other contracting stockholders abiding by their obligation to appoint the investor’s director designee in order to satisfy the required voting threshold for appointing directors, as set forth by the default DGCL rules or as otherwise set forth in the charter or bylaws.

In contrast, a clearly drafted direct designation right in the charter will allow an investor, or a class of stockholders, to have the ability to simply designate the director amongst the defined class and avoid reliance on the affirmative vote of other stockholders. The practical advice here is that it would be optimal to have complementary board composition provisions in both the charter and a stockholders agreement or voting rights agreement. First, a provision in a stockholders agreement or voting rights agreement, unlike a charter provision, that provides the investor with a clear, direct contractual right to designate a director is considered a safe harbor for claiming the venture capital operating company (VCOC) exemption under ERISA. Second, if there are multiple investors with the same series of preferred stock, the charter provision can provide for the number of board seats designated by the series of preferred stock, while the stockholders agreement or voting rights agreement can set forth the particulars of how the holders of the series of preferred stock will nominate and vote for the director designees.

Provision #4. *Section 202 of the DGCL – Make Sure Transfer Restrictions are Enforceable.* There are three notable potential missteps when it comes to transfer restrictions in private equity transactions. First, if the restrictions on shares of stock are not fully set forth on the company’s stock certificate, there must be a legend on the stock certificates referring to the

certificate of incorporation, stockholders agreement and any other agreements containing restrictions and obligations on the holders of the shares. This is consistent with the requirements in Section 202(a) of the DGCL and protects against a subsequent holder of the shares claiming that the shares are not subject to restrictions because they did not have actual knowledge of the restrictions. Second, the stockholders agreement should clearly provide that any transfer in violation of the transfer restrictions is not simply void but *void ab initio* – a legal nuance that has been developed over the years. The exact phrase used can be the difference between a transfer in breach that is upheld by the courts with damages as the remedy and a transfer that is treated as “invalid from the outset.” Third, if any new transfer restrictions are to be added to the charter, any existing stockholders that the company or the investor desires to be bound by such restrictions must vote in favor of the transfer provisions – otherwise any stockholder not consenting to the amendment will not be bound by the new transfer restrictions. Section 202(b) of the DGCL clearly states: “No restrictions so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.”

Provision #5. Section 242(b)(2) of the DGCL – Remove Class Consent Right of Common Stock on Increases (and Decreases) in the Number of Authorized Shares of Common Stock. Section 242(b)(2) of the DGCL provides that a separate class vote is required to increase or decrease the number of authorized shares of such class. Section 242(b)(2) goes on to allow a certificate of incorporation to expressly eliminate the class vote. Typically, investors would want this provision eliminating the class consent right with respect to the common stock included in the charter, so that if the company needs to approve more common stock, it would not be required to obtain the separate consent of the holders of common stock to do so. See related *Tip #4* below.

Tip #4: There Will be Blood: Anticipate dissident stockholders and disgruntled former employees down the road.

Typically, an investor making a minority investment relies on the existing management of the portfolio company. However, if the company fails to meet expectations, a change in management may be required. During difficult market conditions, the material weaknesses in the quality of management may be accentuated and significantly impact the financial performance of the company. As a result, the board of directors may decide it is in the best interests of the company to terminate the employment of members of senior management, some of which may be significant stockholders in the company.

Trap #1. Unintended Veto Rights on Amendments. Special attention needs to be paid to any consent or veto rights provided to the holders of common stock or the founders. For instance, it is not uncommon to see an amendment provision in the stockholders agreement and/or similar agreements which provides that the agreement may only be amended with the written consent of (i) the company, (ii) a majority in interest of the preferred shares held by the undersigned parties and (iii) a majority in interest of the common shares held by the undersigned parties.

In some deals, most likely those involving empowered founders, certain individuals will have an individual consent right to amendments. If holders of common stock or founders are empowered with a general consent right on amendments, there is a risk that one or more members of this consent group may be subsequently terminated by the board of directors, resulting in a group of dissident stockholders with the ability to “lock up” the provisions of the stockholders agreement. Depending on the terms of the stockholders agreement, the veto right possessed by former management may create a standstill on the ability to raise additional financing, especially from third party investors.

Trap #2. Lingering Rights to Board Seats. In addition to amendment provisions, the rights of the common stock to designate members of the board should also be carefully considered. Having disgruntled former members of management continue to be able to designate the common stock director designees would be a sub-optimal outcome, even more so if the designees appointed were the former managers themselves.

Practice Point. Consider “Pre-Nuptial” Arrangements with Management. As with marriage, an investor should hope for the best but plan for the worst. There are several ways to plan for the worst. One way would be to have shares of stock held by management be subject to stock restriction agreements with vesting provisions that allow the company to buy back any vested shares after the termination of employment and provide for the automatic forfeiture of any unvested shares. Another way to mitigate a messy divorce with members of management is to draft consent rights and designation rights of the common stock so that they are only vested in those holders who remain employed or otherwise engaged with the company. However, typically members of management, especially founders, are very sensitive to these type of provisions that address a possible future where they have been effectively removed from the company.

When this point becomes contentious or even emotional, it may come down to a business decision as to whether the investor is willing to make the investment and assume the potential risk of dealing with a disgruntled founder who is no longer involved with the day-to-day operations of the company having significant consent rights and board designation rights. Another way to address this risk is to not provide a general consent right on all amendments but rather provide a limited consent right to the holders of common stock (or founders) with respect to only certain types of amendments personally affecting the holders of common stock (or founders).¹⁹ There are several other ways to mitigate this risk, however, such detail is beyond the general scope of this article.²⁰

Practice Point. Remove Class Consent Right on Increases to Authorized Common Stock. As mentioned in *Tip #4* above, Section 242(b)(2) of the DGCL allows for a provision in a company's charter that removes the specific class consent right on increases or decreases of the authorized number of shares of a class of capital stock and instead allows the proposed increase to be approved by a majority of all voting shares. This is an important tool to allow increases to the authorized shares of common stock without triggering a separate class consent right in favor of the holders of the issued and outstanding common stock. Without this provision, a company can very easily be in a situation where it needs to conduct another preferred stock financing, and has the support of the investors, but needs the separate class consent of a majority of the issued common stock to increase the authorized common stock into which the preferred stock will convert. In such a situation, the holders of common stock may strategically withhold their class consent until certain concessions are made (*i.e.*, increase in the option pool, an additional or enhanced bonus plan, and/or employment agreements providing for severance, including change in control severance).

Tip #5: When a Charter or Bylaw Provision is Not Enough: The importance of director indemnification agreements.

Recent Delaware case law has highlighted the importance of protecting an investor's director designees. Before deal documents are executed, and the strength of an investor's bargaining position is weakened, an investor should ensure that its director designees and the investor itself have contractual protection from the portfolio company.

In most cases, the certificate of incorporation and bylaws of a portfolio company include the typical provisions providing mandatory indemnification for the members of the company's board of directors to the fullest extent permitted by law. A recent Delaware Chancery Court decision brought those provisions, and the

protection afforded the directors, into question. In *Schoon v. Troy Corp.*, a company was permitted to amend the indemnification provisions in its bylaws to eliminate the advancement of expenses provision for former directors.²¹ The court held that the right to advancement had not vested prior to its elimination and could be removed by the company without the consent of the former director.

Practice Point. Make Sure the Indemnification Rights Have Vested. When drafting indemnification provisions, including advancement provisions, to be included in a charter or bylaws, the language should clearly vest the right to indemnification immediately. For instance, the provision could state that the indemnification rights vest by virtue of the director serving at the time of the events giving rise to the claim - or even better - vest upon the director agreeing to serve as a director. However, no matter how well such a provision is drafted, a charter indemnification provision will always have some risk that the provision can be subsequently amended to the detriment of current and, especially, former directors. In response to the *Schoon* decision, the Delaware legislature proposed and supported, and the Delaware governor signed into law on April 10, 2009, amendments to Section 145(f) of the DGCL that overturns the standards set forth in *Schoon*. As amended (and which will be effective as of August 1, 2009), Section 145(f) of the DGCL now provides that the right to indemnification, or to an advancement of expenses, cannot be eliminated once the act or omission giving rise to proceedings have occurred, unless an amendment after the occurrence of the act or omission is expressly permitted in the certificate of incorporation or bylaws.

Practice Point. Seriously Consider Requiring Director Indemnification Agreements. The risk highlighted in the practice point directly above can be addressed in stand-alone indemnification agreements. Director indemnification agreements may be an important mechanism to (1) make the indemnification provisions a personal contract between the company and the director that requires any amendment or termination to be consented to by the

director; (2) make clear that the company has the burden of proof; (3) require an independent law firm or arbitrator to determine whether the director (or former director) is entitled to indemnification with respect to a claim that is brought after a change in control of the company (once there is a change in control of the company there is most likely a new board of directors that will have no interest in using company funds to indemnify prior directors); (4) address more technical points such as partial indemnification and the timing and process for advancement of expenses; and (5) address the priority of indemnification obligations (see next practice point below). In light of the inherent weakness of a stand alone charter or bylaw indemnification provision, an investor should seriously consider requiring director indemnification agreements for its director designee (and successor designees) as a condition to making the investment.

Practice Point. Set Forth the Priority of Indemnification. The Delaware Chancery Court sent a wake up call to the private equity world in 2007 with its decision in *Levy v. HLI Operating Company*.²² In *Levy*, the court held that, absent specific language to the contrary, if a director designated by a private equity fund is entitled to indemnification from the fund, the indemnification obligations of the fund and the portfolio company would be shared. Up until this point, many investors had assumed that the portfolio company would be responsible for indemnifying the director and that the fund's obligations would only kick in if the company did not have the ability to indemnify the director.

In response to the decision in *Levy*, investors should consider modifying their indemnification agreements to clarify that (i) the portfolio company is primarily responsible for indemnifying the directors and any obligation of the fund to indemnify is secondary²³; (ii) the portfolio company waives all rights of contribution, subrogation or other recovery against the fund for amount paid by the portfolio company; and (iii) the fund is able to recover any amounts paid on behalf of the director from the company. An example of such language can be found in Section

8(c) of the NVCA's Model Indemnification Agreement.²⁴

Related Practice Point. Don't Forget About Management Agreements. Private equity funds that typically enter into management agreements or other arrangements with their portfolio companies in exchange for management fees should review any indemnification provisions contained in those agreements. If a management agreement provides that a portfolio company will be obligated to indemnify those individuals providing services to the company on behalf of the fund, language similar to that suggested above should be included regarding the primary/secondary nature of the indemnification obligations. An investor may also wish to add language to the charter and/or bylaws of the portfolio company to the same effect.

Tip #6: When Director Indemnification Agreements are Not Enough: The importance of D&O insurance.

Down markets typically trigger increased litigation involving directors. Tough times force directors to make difficult decisions which are susceptible to claims -- such as a breach of the duty of loyalty claim²⁵ -- by upset stakeholders.²⁶ Even if an investor and its director designee follow *Tip #5* above and the company enters into a pro-director indemnification agreement, the benefit of such an agreement may become academic if the company becomes insolvent. Yes, the indemnification agreement may clearly provide an obligation for the company to advance expenses and indemnify the director designee; however, the indemnification rights only have meaning if the company has the resources to fund its indemnification obligations.

Surprisingly, there are many private companies without any type of D&O insurance.²⁷ For private companies with private equity financing, this could be due to a number of reasons, including (i) the private equity fund was comfortable relying on its fund-level policy for protection of its director designees, (ii) the topic was simply overlooked at the time of the investment or (iii) the private equity

fund did not require it and management erroneously believes that D&O liability insurance is really only for public companies.

While the fund-level policy is good assurance to the investor's director designee, assuming the policy provides proper coverage of board representation on portfolio company boards and proper notice of the directorship is provided to the insurer, the fund-level policy does not help the company with its indemnification obligations to the director designee or any of the other directors, or executive officers. A portfolio company without proper D&O insurance is susceptible to indemnification obligations that may drain the resources of the company resulting in an impaired, or even worse, lost investment for the investor.

Practice Point. Seriously Consider D&O Insurance and Provide for Proper Control of its Terms. As noted above, D&O insurance is not just beneficial for the directors and officers, it is also a benefit to the company by providing a separate source of funds, to the extent the claim is not excluded from coverage under the policy, to cover indemnification obligations up to the limits of the policy. It is not sufficient that the investor require the company to obtain and maintain D&O insurance, it is also important that the investor have proper consent rights on the terms of the D&O policy.

Practice Point. D&O Policy Terms can be (and Should be) Negotiated. Every insurer has its own standard D&O policy with distinct terms and conditions. Unfortunately, many companies and investors overlook the fact that these standard forms are negotiable and should be negotiated. Although beyond the scope of this article, careful attention needs to be paid to the exclusions set forth in the standard policy, especially the "insured vs. insuring" exception (exclusion for coverage for a claim brought by one insured against another which may effectively exclude all shareholder derivative actions or claims brought by a bankruptcy trustee or creditors committee).

Practice Point. Understand the Policy Coverage Options and Choose

Wisely. In general, an investor should require that the policy contain "Side A Coverage" (insuring the directors directly for certain claims and losses where the corporation did not indemnify them), as well as "Side B Coverage" (reimburses the company for its loss where the company indemnifies its directors and officers). There may be other coverages, such as Entity Securities Coverage (protects against securities claims), which should be considered based on the facts and circumstances of the company and the type of investment being made by the investor. In some situations, an investor may want to require the company to obtain a separate "Side A Only" excess policy that would complement the standard D&O policy. D&O insurance is a dynamic and increasingly complex field, so advice from qualified insurance and legal professionals will be important in obtaining a policy with appropriate coverage and acceptable exclusions and limitations.

Tip #7: The Best Indirect Insurance on the Market: The value of independent and disinterested directors.

An investor should give serious consideration to having at least one independent director on the boards of its portfolio companies. When there is a divided board of directors, the presence of an independent director can prevent a deadlocked board. If the investor has negotiated appropriate "negative control" protective provisions, the presence of an independent director can further enhance the potential for the board to make commercially reasonable and intelligent decisions on major company events and strategic choices. In this regard, the presence of an independent director is complementary -- and not toxic -- to the interests of the investor.

Practice Point. A Little (Disinterested) Approval Goes a Long Way. In addition to enhancing the ability of the board to make commercially reasonable decisions, the presence of one or more independent directors (who are disinterested directors, as explained below) can be invaluable for inoculating the board of directors from liability with

respect to transactions that are approved by the board of directors in good faith when one or more directors directly or indirectly have a personal interest in (commonly referred to as an “interested director transaction”). For instance, if the company is negotiating a down round financing with its major investor, the director designees of the investor will most likely be considered interested directors as a result of their relationship with the investor (typically the director designees are principals of the investor). In addition, the down round financing may have a “refresh” of the option pool, which results in the management team not suffering any material dilution. As a result, the management directors may also be considered interested directors in light of the new management options. In most interested director transactions, such as this example, the independent directors would be “disinterested directors” -- directors with no material direct or indirect interest in the transaction at hand.²⁸

The approval of the disinterested directors has three important benefits. First, the stamp of approval of the independent directors on an interested director transaction may deter stockholder claims, especially frivolous claims that were simply predicated on the presence of interested directors. Second, the approval of the disinterested directors triggers the statutory safe harbor under Section 144 of the DGCL, which provides that a transaction will not be void or voidable solely because it is an interested director transaction. Third, Delaware case law provides that the informed approval of an interested director transaction by the disinterested directors, coupled with proper board procedures²⁹, will most likely either implicate the “business judgment” standard³⁰ or will result in a shifting of the burden to the plaintiff under the “entire fairness” standard³¹, each of which can be an important factor in defending a claim. Whether the defendant directors obtain the greater protection of the “business judgment” or the burden of proof simply shifts to the plaintiff depends on many factors, including the particular allegations of the claim, the composition of the board and the type of interested director transaction.³²

In addition to the above-listed benefits, and putting aside the Delaware Chancery Court decision in *Lyondell*³³, other recent Delaware case law demonstrates the value of a 102(b)(7) exculpation provision (see *Tip #3* above) coupled with a board procedure where a majority of the disinterested directors approve a material corporate transaction.³⁴

Practice Point. Know Your Independent Directors. If one or more board seats are allocated to independent directors, an investor should have either the right to designate or elect the independent director, or have sufficient consent rights on the designation or election of any candidate. In addition, careful attention should be paid to the criteria of what constitutes an independent director. Two common approaches are to either: (i) provide that the independent director designee not be affiliated with the company or any of its members of management or stockholders with a definition for what constitutes being affiliated³⁵ or (ii) refer to the independent director requirements set forth in the Nasdaq or New York Stock Exchange rules and regulations.³⁶ An investor should also be mindful of adding additional requirements, such as requiring the independent director to have relevant industry experience, as this may unduly limit the pool of available candidates. This is especially important in today’s market where there is a critical shortage of participants who are willing and able to serve as independent directors of private companies.

Tip #8: There is no such thing as an Investor Director. Respect the overriding and separate duties of your director designee.

A classic oversight by investors is to allow their director designees to ignore proper director procedures and process and allow the designees to unconditionally promote the economic interests of the preferred stock held by the investor. This ignores well-developed Delaware case law that an investor director designee represent all stockholders of the portfolio company and not just the interests of the investor.³⁷ In

fact, Delaware case law supports the argument that the board’s fiduciary duties to preferred holders are more limited than the fiduciary duties owed to common stockholders.³⁸

While Delaware law is not clear on when fiduciary duties are owed to preferred stockholders, the sporadic case law suggests that it depends on whether the dispute arises from a right articulated in the contractual preferences of the preferred or if the right is associated with the duties of care and loyalty that are shared with the common stockholders. In light of the fiduciary duty mine field that investors and their director designees need to navigate under the DGCL and relevant case law, it is not surprising that more investors are making investments into limited liability companies and taking advantage of the freedom of contract principles under Delaware Limited Liability Company Act and the ability to contractually set forth what fiduciary duties are owed (if any).³⁹

Practice Point. Consult with Counsel on Proper Board Procedures When Considering a Significant Transaction. Not surprisingly, most stockholder claims alleging breaches of fiduciary duties by the board of directors are connected to the board’s review and approval of a significant transaction, such as a sale of the company, an equity financing or an interested party transaction. Especially during a down market, these significant transactions, even if they are in the best interests of the company, may result in unfavorable economic outcomes to many stockholders. For instance, a significant transaction may result in significant dilution to the common stockholders or may even render their shares worthless. An investor and its director designee need to be wary of these types of significant transactions and engage counsel to advise on proper procedures from the outset of the consideration of the strategic transaction by the board of directors. Unfortunately, the liability risk associated with significant transactions has been enhanced by recent Delaware cases in which the Delaware courts have muddied the waters as to what constitutes an appropriate sale process that satisfies a director’s *Revlon* duties (generally stated, *Revlon* duties

require the board to act reasonably to secure the best value reasonably available to shareholders).⁴⁰

An important lesson to be learned from each of these recent court decisions is that each sale process will be judged on a case-by-case basis with the benefit of hindsight and with a close review of the sale procedure followed by the board of directors. An investor director designee should be closely advised by counsel, ideally separate from company counsel, when the board of directors is considering a sale event or other significant transaction with serious consequences to the other stakeholders of the company. In light of recent case law, and the facts and circumstances nature of any dispute, it is not recommended that an investor director designees attempt to “go at it alone” armed just with textbook knowledge of how to fulfill a director’s duties. The ounce of extra caution from engaging counsel to advise during a significant transaction can result in more than a “pound of cure” by avoiding procedural mistakes that now provide fertile ground for stockholder claims against the board.

Practice Point. Disclose, Disclose, Disclose! With Delaware courts becoming more critical of board procedures, it is absolutely necessary that a director designee disclose all material interests and affiliations in the proposed transaction – anything less than full disclosure is an invitation for litigation. As noted in the practice tip below regarding the importance of full and proper records, the board minutes should include a full record of the interests being disclosed. In addition, these interests should be disclosed in full to the stockholders before any stockholder vote is taken with full disclosure being recorded in the stockholder minutes.

Practice Point. Know When to Abstain and to Establish Special Committees. Although not required under Delaware law in any circumstances, it is sometimes in the best interests of the director designee to abstain from a voting process. For instance, when a director is an interested party, what the director does not do can be just as important as what he or she actually does do. To properly abstain, the interested director should not

only abstain from voting but should also restrain himself or herself from attempting to control or influence the vote of the directors. A court will review the relationships and internal processes within the board when determining issues of law and fact, including whether the purported disinterested directors that approved the significant transaction were indeed disinterested.⁴¹

In certain circumstances, such as a sale of the company, it may be advised that the board take the additional precaution of establishing a special committee of disinterested directors to negotiate the terms of a significant transaction. As noted earlier, this option should be discussed with counsel in light of the facts and circumstances of the proposed transaction.

Practice Point. Record, Record, Record! As noted above, an investor director designee needs to be mindful of his or her fiduciary duties to all stockholders, especially the common stockholders, when reviewing and voting on material company decisions. However, recent Delaware case law indicates these fiduciary duties are only the first prong of a two prong test. While it is important that the investor director designee consider the best interests of all stockholders on material decisions, it is equally as important that the board minutes properly document this consideration. In light of recent Delaware case law scrutinizing a board’s process (see discussion in the above practice points and related footnotes), the entire board of directors should conduct itself under the premise that a discussion or review that is not properly documented or recorded in the minutes will not be respected by a court in hindsight if litigation arises from the action taken, or perhaps not taken. Failing to take proper minutes of board meetings is no longer a harmless, innocent oversight.

Practice Point. Consider the Effect of Placing Negative Control Rights With the Investor Director Designee. When negotiating the terms of an investment, a compromise that may be reached is that certain of the negative control rights are vested not with the investor but with the investor’s director

designee. It is important that the investor understand the implications of this seemingly innocuous shuffle of consent rights before agreeing to it. When consent rights are vested with the investor in its capacity as a stockholder, in most circumstances this will allow the investor to act in its own self interest. When consent rights are placed with the investor director designee, this consent right can be hollow because the director has overriding fiduciary duties owed to all of the stockholders (which come into play if there is a material conflict between the interests of the investor and the interests of the stockholders).

The combination of investment consent rights and fiduciary duties is a recipe for a potential Catch-22 for the investor and its director designee. If litigation ensues, a court may not view the exercise of an investment consent right by the investor director designee favorably. As with most of the practice tips in this article, we are describing optimal deal terms that may simply not be achievable during negotiations. Not to lose sight of reality, we note the obvious fact that it would be preferable for an investor to have consent rights vested with its director designee than not having any consent rights at all.

Tip #9: Your Portfolio Company is in Financial Trouble: Know to whom fiduciary duties are owed.

Members of the board of directors of a corporation generally owe fiduciary duties of care, loyalty and good faith to the corporation and its stockholders. Directors ordinarily do not owe fiduciary duties to the creditors of a corporation, as “creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.”⁴²

However, when a corporation becomes insolvent (generally assumed to occur when the corporation fails one of the following tests: (i) the balance sheet test - the corporation’s assets are greater than its liabilities, or (ii) the cash flow test – the corporation’s cash flow is enough to

meet its operating expenses as they come due) the scope of a director's duties expand to the entirety of the enterprise, which includes creditors. The greatest confusion, however, seems to arise when a company enters the "zone of insolvency" (although there is no identifiable test, most practitioners will tell you that "if you have to ask whether you're in the zone of insolvency, you probably are"). When in this zone of insolvency, there has been lingering uncertainty for over 15 years under Delaware law as to whether the board of directors owes a direct fiduciary duty to the corporation's creditors.⁴³

Alas, to the relief of directors and corporate counsel everywhere, in 2007, the Delaware Supreme Court largely clarified this issue. In its holding in *Gheewalla*,⁴⁴ the Delaware Supreme Court held that, regardless of whether the corporation is in the zone of insolvency or is actually insolvent, a corporation's creditors do not have a direct right to bring a breach of fiduciary duty claim against the directors of the corporation. The court held that "the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."⁴⁵ Instead, once a corporation is insolvent, the creditors may bring a derivative action against the directors on behalf of the corporation for breach of fiduciary duty – as once the corporation becomes insolvent, the creditors become the residual stakeholders in the corporation. Although the court did not address whether creditors can bring derivative actions for a solvent company in the zone of insolvency, most practitioners agree they cannot.

Practice Point. *Not so Fast - Directors Need to Proceed as Cautiously as Ever.* While the *Gheewalla* decision is a long-awaited clarifying decision that provides much needed discretion for directors to make critical and very difficult decisions when a corporation is approaching insolvency or is insolvent (which decisions should generally be protected by the business judgment rule), there remain many potential liability pitfalls and uncertainties

that require directors to continue to act with due caution. While the list of pitfalls and uncertainties is beyond the scope of this article (and indeed the list would be longer than this article), we generally summarize some of the more important pitfalls and uncertainties below, which concerns lead very nicely into the second practice point of this *Tip #9* – seek legal advice!

Cautious Tip #1: Engage the Stakeholders. While creditors may not be able to bring direct fiduciary claims, the directors still need to act with caution as their actions will most likely be closely scrutinized and subject to second guessing by the competing interests of the various groups of stakeholders in the corporation. Even if a director prevails in a derivative action, it is likely to be a protracted, fact intensive, expensive litigation with respect to a company that is insolvent and has no funds to honor its indemnification obligations owed to the defendant director (see *Tip #6* above regarding the importance of D&O insurance). In such times of financial distress, a director should exhibit an earnest and renewed dedication to making informed and thoughtful decisions, including exhibiting an awareness of the concerns and interests of constituencies beyond those of equity (*i.e.*, no swinging for the fences on behalf of the equity). Also, to the extent constituencies reach out to the directors, the directors should be receptive and open to constructive dialogue and new ideas. This thoughtfulness and open dialogue with the various stakeholders may not only significantly reduce the prospects of a lengthy and costly dispute, but it can also be persuasive evidence that the director fulfilled his or her duties by evidencing that the perspectives of the significant stakeholders (and creditors) were solicited and considered.

Cautious Tip #2: Regularly Evaluate the Company's Financial Situation. It remains very important for a director to take into consideration the company's financial condition when making critical decisions. A decision that is appropriate in good times may be less appropriate when the company is in financial distress. For instance, it may be prudent for a director of a solvent, financially healthy company to authorize

a significant, discretionary capital expenditure whereas a director of a company in the zone of insolvency may think differently of the proposed expenditure and may instead believe it is in the company's best interests to reduce overall discretionary expenses. Indeed, a director conducting "business as usual" when the company is in the zone of insolvency will have a difficult time defending his or her actions in hindsight if a dispute subsequently arises.

Unfortunately, due to the subjective nature of the insolvency tests, it can be very difficult to identify with any practical reliability the transition of a company from solvency to the zone of insolvency, or from the zone of insolvency to insolvency.

In down markets such as the current one, it is especially important for the board to regularly monitor the financial situation of the company as a key input for board review. Without an appreciation of the company's financial situation, it is very difficult for the board to make strategic decisions that are in the best interests of the corporation and its stakeholders.

Cautious Tip #3: It's a Minefield Out There: Other Types of Insolvency Claims Remain Possible. Delaware law regarding director duties for financially distressed companies is still developing and, notwithstanding *Gheewalla*, many claims against directors and officers of distressed companies remain viable. One such potential claim is the closely related, but critically different, concept of deepening insolvency. As with zone of insolvency, deepening insolvency (which essentially is the wrongful prolongation of a corporation's existence to the detriment of the corporation's stakeholders) continues to generate meaningful judicial and practical confusion. Although the Delaware Supreme Court's decision in *Trenwick* found that deepening insolvency is not a viable independent cause of action, a 2008 decision from the Delaware Bankruptcy Court found that it remained a viable theory of damages when connected to a viable cause of action (as a theory of damages caused by a breach of the duty of loyalty).⁴⁶

In *In re The Brown Schools*, the bankruptcy court refused to dismiss a claim by a bankruptcy trustee against a stockholder of a corporation (in this case a private equity firm), its director designees and certain of its affiliates alleging that the parties improperly benefitted from the repeated failed attempts at restructuring the corporation's debt. During the restructurings, the plaintiff alleged, the private equity fund received approximately \$1.7 million in fees for advisory services and improperly used sale proceeds to pay down the debt owed to the fund.⁴⁷ In calculating the damages, the bankruptcy trustee used the deepening insolvency theory to allege over \$22 million in damages (the amount by which the corporation's insolvency was increased or "deepened") although the alleged improper benefit to the defendants was less than \$5 million.

Although the viability of deepening insolvency as a theory of damages remains questionable (a subsequent Fifth Circuit decision⁴⁸ held that the *Trenwick* decision should be read as rejecting deepening insolvency as an independent cause of action, as well as a method for computing damages) the concept of damages that may exceed the amount of an investment in, or loans to, a portfolio company is enough to make any investor and its director designees tread lightly once the portfolio company becomes insolvent.

In addition to deepening insolvency, several other claims remain viable potential causes of action against boards and its members. Claims for aiding and abetting another party's unlawful conduct, for conspiracy to commit such unlawful conduct, or for outright fraud continue to receive some traction in the courts. Each has its own elements, defenses, and burdens, but, generally speaking, each can best be avoided with faithful and thoughtful conduct of duties by directors, with careful consideration of the financial and operational condition of a company, and with due care for preserving and maximizing the value of the corporate enterprise.

Practice Point. Most Importantly, Seek Legal Advice! While Delaware insolvency law has changed considerably

in the past three years, the practical advice to investors and their director designees remains the same. When a portfolio company is approaching the zone of insolvency, an investor and its director designee should seek counsel from an insolvency attorney. An insolvency attorney can advise on short term and long term actions that should be considered in light of the company's financial situation and can provide guidance to the investor director designee on how to best properly fulfill a director's duties in light of the competing interests of the stakeholders of the company. One important point to keep in mind is that while the creditors of a corporation may become beneficiaries of the fiduciary duties of an insolvent corporation as the residual stakeholders, the fiduciary duty remains the same: maximize value for the corporation and its stakeholders by acting in the corporation's best interests.

The nine tips offered in this article are timeless in that they are fundamental tips that apply to all market conditions and circumstances, however, they are especially important in a down market. Most investors are anticipating the current down market to continue through at least the end of 2009. Following the tips above may help avoid costly ambiguities and loopholes in the investment documents and protect against other stakeholders having unintended consent or veto rights. Deal documents that appreciate these "back to basics" tips and other practical advice should help protect the negotiated rights of an investor and its director designee in difficult times and allow the business parties to properly focus on the important and difficult business decisions at hand.

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This article is not intended to constitute a legal opinion or advice or to address any client's legal problems or specific situations.

April 27, 2009

¹ For more information on the newsletter, please see www.deallawyers.com.

² <http://www.nvca.org/pdf/09PredixRelease.pdf>.

³ *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A 19719, 2002 WL 1732423 (Del. Ch. 2002), *aff'd*, *Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp.*, 822 A.2d 396 (Del. 2003).

⁴ *Id.*

⁵ *Kumar v. Racing Corp. of Am., Inc.*, No. Civ. A 12039, 1991 WL 67083 (Del. Ch. 1991).

⁶ *WatchMark Corp. v. ARGO Global Capital, LLC*, No. Civ. A. 711-N, 2004 WL 2694894 (Del. Ch. Nov. 4, 2004)

⁷ NVCA Model Certification of Incorporation, http://www.nvca.org/model_documents/Certificate_of_Incorporation_V5.doc.

⁸ *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007).

⁹ *Lapoint v. AmerisourceBergen Corp.*, 2007 WL 2565709 (Del. Ch. Sept. 4, 2007), *aff'd*, 956 A.2d 642 (Del. 2008).

¹⁰ *Benchmark*.

¹¹ *Id.*

¹² It is interesting to note that the objecting investor unsuccessfully attempted to distinguish the case at hand from *Benchmark* by arguing that the broadly worded anti-impairment clause created a consent right on the subsidiary merger. Not surprisingly, in accordance with the caveats in *Tip #1*, the court refused to interpret the anti-impairment clause as granting additional rights not otherwise contained in the charter.

¹³ *WatchMark*.

¹⁴ See RMBCA §11.04(3)

¹⁵ Hartford Accident & Indemnity Co. v. W.S. Dickey Clay Mfg. Co., 24 A.2d 315 (Del. 1942)

¹⁶ NY Bus Corp Law § 804(a)(3) and RMBCA §§ 10.04, 11.04(3).

¹⁷ As a last bit of advice on this subject, an investor should consider having overallotment rights to the extent other stockholders don't participate, thus allowing an investor to increase its percentage interest in the company.

¹⁸ In re Sunstates Corp. Shareholder Litig., 788 A.2d 530 (Del. Ch. 2001).

¹⁹ Examples of specific common stock (or founder) amendment consent rights include (i) amending or removing the board designation rights of the holders of common stock – but be careful not to unintentionally provide a general consent right on an increase to the size of the board of directors and (ii) adversely amending the transfer restrictions on the shares of common stock – with a cautionary note that an increase or change in the investors who are entitled to rights of first refusal, co-sale rights or drag-along rights will not be deemed an adverse change.

²⁰ An amendment provision may also contain a “residual” amendment provision that provides that any stockholder who is material and adversely affected by an amendment that is disproportionate to the other similarly situated stockholders shall have a separate consent right on the amendment. Special attention needs to be paid to the exact language used to avoid this special consent right springing up (or being argued by stockholders as being applicable) in unintended situations.

²¹ Schoon v. Troy Corp., 948 A.2d 1157 (Del. Ch. 2008).

²² Levy v. HLI Operating Co., 924 A.2d 210 (Del. Ch. 2007).

²³ See Sodano v. American Stock Exchange LLC, No. Civ. A. 3418-VCS, 2008 WL 2738583 (Del. Ch., July 15, 2008) (enforcing a provision distinguishing between primary and secondary liability), aff'd, sub nom. American Stock Exchange LLC v. Financial Regulatory Authority Inc., No. 404,2008, 2009 WL 685162 (Del. 2009).

²⁴ http://www.nvca.org/model_documents/Model%20Indemnification%20Agreement-2008.doc

²⁵ A “Side A” D&O policy should not contain an express exclusion for breach of duty claims or an exclusion for claims that are not indemnifiable under applicable law, although a breach of duty claim may be excluded under the policy due to the claim being excluded under standard exceptions under the policy.

²⁶ Assuming the company has included a 102(b)(7) exculpation provision in its charter as mentioned in *Tip #3*, a stockholder would not be able to bring a breach of the duty of care claim against the directors.

²⁷ <http://www.chubb.com/corporate/chubb8596.html>.

²⁸ Note however that an “independent” director may not qualify as a “disinterested” director under Delaware law depending on the facts and circumstances of the transaction at hand.

²⁹ The board should consider appointing a special committee of disinterested directors, especially if the interested director transaction is a potential sale of the company.

³⁰ The business judgment rule is a presumption that the board of directors acted on an informed basis, without self-interest, in good faith, and in the honest belief that the actions taken were in the best interests of the company. The presumption imposes the burden on the plaintiff to prove otherwise.

³¹ The entire fairness standard is a heightened standard of review commonly used by the courts in certain interested party transactions. Unlike the business judgment rule, there is no presumption in favor of the action taken by the board of directors. In addition, the entire fairness standard of review which has two components: fair dealing and fair price, both of which are fact intensive. The defendant board of directors initially have the burden of proving entire fairness unless they are able to shift the burden to the plaintiff. When and how the court applies the different standards of review (including the intermediate “enhanced scrutiny” standard) is beyond the general scope of this article.

³² There are numerous Delaware cases addressing the effect of disinterested director approval on an interested director transaction. See Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) (“[S]ection 144

[of the DGCL] allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.”); Kohls v. Duthie, 765 A.2d 1274, 1285 (Del. Ch. 2000) (“the existence and functioning of the committee will result in the application of the deferential business judgment standard of review to the transaction at issue”) (footnote omitted); Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) (“[T]he exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . . [A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.”) (citations omitted).

³³ Ryan v. Lyondell Chemical Co., No. Civ. A. 3176-VCN, 2008 WL 2923427 (July 29, 2008) (Chancery court refused to grant summary judgment to defendants on claim that conduct by special committee of disinterested directors constituted bad faith). However, this decision was recently reversed by the Delaware Supreme Court and remanded the matter for entry of judgment in favor of the Lyondell directors (See Lyondell Chemical Co. v. Ryan, 2009 WL 1024764 (Del. 2009)).

³⁴ See McPadden v. Sidhu et al., No. Civ. A. 3310-CC, 2008 WL 4017052 (Del. Ch. 2008) and In re Lear Corp. Shareholder Litig., No. Civ. 2728-VCS, 2008 WL 4053221 (Del. Ch. 2008) (in each case the Chancery Court dismissed claims alleging that the conduct of the independent directors constituted bad faith).

³⁵ This is the approach adopted in the NVCA form of Voting Agreement.

³⁶ Recent statistics show an increase in the appointment of independent directors on private company board of directors, which provides another example of private companies adapting the best practices developed in public company regulations.

See http://www.businesswire.com/portal/site/google/?ndmViewId=news_view&newsId=20070913005020&newsLang=en.

³⁷ Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

³⁸ See WatchMark; Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997).

³⁹ Of special note, one of the fundamental differences between the DGCL and the Delaware Limited Liability Company Act (DLLCA) is that the DLLCA does not expressly set forth any fiduciary duties on the managers/members/directors of a limited liability company but instead provides, in furtherance of the underlying principle of freedom of contract of the DLLCA, that an LLC agreement may provide for the limitation, expansion or limitation of duties (including fiduciary duties) of a manager/member/director that may exist at law or in equity. As a result, the caveats in this *Tip #7* for an investor director designee can be addressed contractually in the LLC Agreement by expressly limiting or eliminating the duties of the investor director/manager designee owed to the members of the LLC. See Fisk Ventures, LLC v. Segal, No. Civ. A. 3017-CC, 2008 WL 1961156 (Del. Ch. 2008) (granting a motion to dismiss on a breach of fiduciary duty claim in light of provision in the LLC Agreement that effectively eliminated fiduciary duties).

⁴⁰ See In re Netsmart Technologies, Inc., Shareholders Litig., 924 A.2d 171 (Del. Ch. 2007); In re Topps Co. Shareholders Litig., 926 A.2d 58 (Del. Ch. 2007). See also discussion of Lyondell in footnote 33 above.

⁴¹ See In re Tele-Communications, Inc. S'holders, Litig., No. Civ. A. 16470, 2005 WL 3642727 (Del. Ch. Revised Jan. 10, 2006); Gesoff v. IIC Industries, Inc., 902 A.2d 1130 (Del. Ch. 2006).

⁴² North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (footnote omitted).

⁴³ The uncertainty is owed in large part due to dicta in the court's holding in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. 1991), which suggested that under certain circumstances directors may owe direct fiduciary duties to creditors when the company is in distress.

⁴⁴ Gheewalla.

⁴⁵ *Id.*

⁴⁶ Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438, at *1 (Del. 2007).

⁴⁷ Miller v. McCown De Leeuw & Co. (In re The Brown Schools), 386 B.R. 37 (Bankr. D. Del. 2008) (Walrath, B.J)

⁴⁸ In re S.I. Restructuring, Inc., 532 F.3d 355 (5th Cir. 2008).