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April 2011 www.ssd.com

Seventh Circuit Makes Life Tougher for Directors With Conflicts

In a decision released on March 29, 2011, *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 that a director's disclosure of a conflict, in and of itself, is insufficient to protect that director from liability for breach of fiduciary duty or disloyalty arising from that conflict. Similarly, the other party in which the conflicted director has an interest can, under the right circumstances, be held liable for aiding and abetting a breach of fiduciary duty.

While the facts of this case may seem like an old-fashioned morality play, they stand as a modern lesson for boards and shareholders who wish to fill out the ranks of their directors. They should be aware that a director's disloyalty can be fatal to a company's fortunes, particularly when independent, disinterested directors do not take an active role in corporate governance.

Cadant (borrower) manufactured modems. The borrower was initially incorporated in Maryland but was reincorporated in Delaware effective January 1, 2001, and this case was decided under Delaware law. The founders received common stock. Venrock Associates (Venrock) and a venture capital firm received preferred stock in exchange for an investment made at the beginning of 2000. Eric Copeland, a principal of Venrock, became a member of the borrower's five-

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member board of directors upon Venrock's investment. In April 2000, the board rebuffed a tentative offer to buy the borrower's assets for US$300 million.

Shortly thereafter, in the fall of 2000, the borrower found itself in severe financial difficulty. Copeland, on behalf of the borrower, began negotiating for a loan. Although there were two potential lender groups, Copeland steered the board to accept a loan from Venrock and the venture capital firm, which closed in January 2001. By that time, the board had grown to seven members, four of whom (including Copeland) were employed by Venrock or the venture capital firm. The remaining directors were not financially sophisticated and relied on Copeland for financial advice. The loan was a 90-day US$11 million "bridge loan" at an annual rate of 10 percent. The borrower ran through that loan quickly and in May 2001 received an additional US$9 million bridge loan again negotiated by Copeland. The loan agreement provided that in the event the borrower was liquidated, Venrock and the venture capital firm would be entitled to twice the outstanding principal plus any accrued but unpaid interest, thus greatly diminishing any return to shareholders.

Cadant, the borrower, quickly defaulted on the second loan. In *extremis,* it agreed to sell its assets to ARRIS Group in exchange for ARRIS stock worth US$55 million at the time of the closing in 2002. There was some evidence that a similar company whose loan terms gave them more time to negotiate a sale was sold for US$300 million, the amount of the rebuffed offer. The US$55 million was just enough to satisfy the claims of the borrower's creditors and preferred shareholders (Venrock and the venture capital firm were both). The sale was approved by the entire board. The "independent" directors did not seek separate legal or financial advice. A simple majority of both the borrower's preferred and common shareholders, voting as a single class, and of the preferred shareholders voting separately also approved.

The ARRIS stock received by the borrower was its only asset after the sale. It declined in value and became worth less than the claims of Venrock and the venture capital firm and other creditors, resulting in a complete wipeout of the common shareholders prior to any distributions. The common shareholders commenced an action against the members of the board who were employed by Venrock and the venture capital firm (the defendants), alleging that the defendants had breached their duty of loyalty to the borrower, and against personnel at Venrock and the venture capital firm, alleging they aided and abetted such a breach.

The director defendants' primary substantive argument was that while 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 (i) a board member's conflict is fully disclosed or known to the board, and (ii) the board, in good faith, authorizes a transaction by the affirmative votes of a majority of the disinterested directors, then (a) 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 defendants also argued that the plaintiffs had not proven proximate cause.

The district court was persuaded by the 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 disagreed with this decision. 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 Copeland who was the director principally accused of disloyalty to the borrower, 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 Venrock and the venture capital firm 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 Copeland and the other conflicted directors. The Seventh Circuit clearly suggests that the mere existence of independent directors is not enough. 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 extrinsic fairness of the transaction. As such, the plaintiffs did not have to prove proximate cause, which they would have to do if there had been a truly independent decision-making process.

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 the remaining directors to put safeguards in place to ensure that the conflicted directors are not in a position to act on such a conflict, or the remaining 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 in 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 at hand. 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.

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 if a company fails to do so. And it is not necessary to pay huge sums to attract independent directors with integrity. National service providers exist that can supply knowledgeable independent directors relatively cost effectively. In Cadant's case, the proper use of truly independent directors likely would have resulted in the original offer to buy its assets for US$300 million being accepted. Everyone would have made money. Instead, everyone lost due to a failure of good corporate governance.

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