

M&A Alert

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Delaware Court of Chancery Finds Director Breached Duty of Loyalty by Trying to Dissuade Potential Investor from Investing in Company as Part of Strategy to Change Company Governance

*Court in **Shocking Technologies, Inc. v. Michael** holds that by taking steps that would foreseeably cause harm to the corporation, director breached his duty of loyalty, notwithstanding director's claim that he acted in subjective good faith.*

Implications for Our Clients

Guidance for Dissenting Directors

- Fair debate is an important part of a director's duties. However, even if directors believe in good faith that they are acting in the best interests of the corporation, they may not take steps that could foreseeably cause harm to the corporation.
- The Court suggested, without defining the line between acceptable and unacceptable conduct, that there may be a sliding scale test under which short-term harm to the corporation may be permissible in order to achieve greater long-term benefits. Actions that could cause the demise of the corporation, and the furnishing of confidential information to a potential investor to the substantial detriment of the corporation, clearly both fall on the wrong side of the line.

Implications for Private Equity and Venture Capital Funds and Constituency Directors

- This case serves as a useful reminder that while stockholders are generally free to pursue their own interests, if they have designees on the board, their designees owe fiduciary duties to the corporation and all stockholders, and are not free to act solely in the interests of the designating stockholders.
- While financings serve as a legitimate opportunity for funds to bargain for improved governance rights, their board designees may not harm the corporation by interfering with its financing efforts or using confidential information to assist a third party in an adverse negotiation with the corporation.
- In situations where there is a significant conflict between the interests of a shareholder fund and of the corporation, such as where the fund is the corporation's sole potential financing source and has a designee on the corporation's board, consideration should be given to walling off the fund and its designee from relevant discussions and materials.

Summary

Simon J. Michael is the manager of Balch Hill Capital, LLC, a significant stockholder in a venture-backed company, Shocking Technologies, Inc. (the Company) and was the Series B designee on the Company's board.

By the summer of 2011, the Company was in a precarious cash position and sought to raise funds from various sources, including a strategic investor, Littelfuse, Inc. The investment would include the exercise of outstanding warrants prior to their December 5, 2011 termination date, plus a potential investment in new securities.

At around the same time, Michael started to express concerns about the Company's governance, including with respect to compensation for Lex Kosowsky (founder, CEO and director), and the fact that the Series B and C investors were only entitled to one board seat despite having provided 60 percent of the Company's funding. Michael asserted that Kosowsky and two other directors (two seats were vacant on the Company's six-person board) formed a "control group" that was advancing the group's interests to the detriment of the Company. The Company viewed Michael as seeking to increase his power at the Company and his ownership on the cheap.

Michael's discussions with the remaining directors made no progress and turned acrimonious. He then tried to use the Company's need for financing as a way of coercing the other directors into agreeing to his demands. He contacted Littelfuse's representative and encouraged him to withhold additional funds from the Company unless and until Littelfuse got "better terms," including a board seat. Michael also revealed that Littelfuse was the only potential

Implications for Public Companies Facing Shareholder Activism

- This case has important implications for shareholder activism. (Defendant Balch Hill was an activist in a public company earlier this year.) Activists commonly attempt to advance their agenda by seeking representation on the Board. The case is an important reminder that activist nominees are subject to the same fiduciary duties as other directors and are not free to implement the activist agenda in derogation of these duties.
- This is particularly important for the large number of campaigns that involve small hedge funds (like Balch Hill). Small funds typically do not have the same resources and internal controls as large funds and thus could present a heightened risk of their nominees misusing company information and otherwise failing to act in accordance with their legal duties.
- All issuers (not just public companies) are reminded to ensure that their board members are subject to appropriate confidentiality policies. The scope of director confidentiality obligations was not discussed in depth in the decision, and it is not an area for which there is a significant body of case law. A well drafted director confidentiality policy can help fill in the gaps in the legal framework and provide important protection against misuse of confidential information.

investor in the upcoming financing, thus increasing Littelfuse's bargaining power vis-a-vis the Company.

Unpersuaded by Michael but concerned about board strife, Littelfuse exercised its warrant in December, but did not make an additional investment until April 2012, when it invested \$10 million and obtained a board seat.

A few weeks after the warrant exercise, the Company brought an action against Michael and Balch Hill, alleging that by providing Littelfuse with negotiating advice and confidential information about the Company's bargaining position, Michael breached his duty of loyalty to the Company. The Court of Chancery held that even if Michael at one point had good intentions to change the Company's corporate governance, his efforts to frustrate the Company's financing, which could have caused the Company's demise, constituted a breach of the duty of loyalty.

Discussion

In analyzing the Company's claim, the Court of Chancery described the duty of loyalty as an "affirmative obligation to protect and advance the interests of the corporation" which requires a director to "refrain from any conduct that would harm the corporation." It encompasses a duty to act in good faith. Acting in subjective good faith may nonetheless breach the duty of loyalty. A "director, even if he is a shareholder, may not engage in conduct that is adverse to the interests of his corporation."

The Court found that Michael was disloyal because he knew how financially vulnerable the Company was, but took steps to frustrate the Company's financing efforts. It then considered whether Michael's concerns about corporate governance could justify or excuse his conduct, noting that corporate governance changes may be a legitimate goal of shareholders and directors. Applying an objective good faith test, the Court held that in pursuing that goal, a shareholder-director may not take action that harms the corporation by, for example, interfering with crucial financing efforts, or by using confidential information to aid a third party which has a position adverse to the corporation. Even if Michael at one point had good intentions, "his taking steps that would foreseeably cause significant harm to [the Company] amounts to nothing less than a breach of the fiduciary duty of loyalty."

The Court discussed in dictum whether a director may ever cause short-term harm to a corporation in order to achieve greater long-term benefits. It noted that there may be circumstances where a director can advance such a policy in compliance with her fiduciary duties, and that there may in theory be a sliding scale on which such actions are measured. The Court did not give guidance on the line between acceptable and unacceptable conduct because Michael's actions constituted a clear breach of the duty of loyalty on two grounds. First, his actions could have caused the demise of the Company. Second, the disclosure of confidential information to a potential investor, especially when the director knows it would benefit the potential investor to the substantial detriment of the Company, is a breach of the duty of loyalty.

The Court also made clear that Delaware law does not prohibit legitimate director dissent. According to the Court, a board majority may not muzzle a minority board member because it does not like what she may be saying. In addition, criticism of a board majority does not equate with criticism of the corporation and its mission. However, the Court noted that internal disagreement will not generally allow a dissident to release confidential corporate information.

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