What To Do About Informational Conflicts Involving Designated Directors

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When a stockholder obtains director designation rights, the key to avoiding or mitigating potential informational conflicts involving the designated director is to consider these issues and balance allegiances at the outset of the transaction.

DELAWARE CASE LAW has long discussed the directors' fiduciary duties of care and loyalty to the corporation and its stockholders in absolute terms. An often-cited passage from the Delaware Supreme Court describes:

"A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty

to the corporation demands that there shall be no conflict between duty and self-interest."

Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

A director's fiduciary duty of loyalty to the corporation is unremitting and is not diminished by a director's appointment to multiple boards or appointment by a particular stockholder or class of stockholders (hereinafter referred to as the "designating stockholder"). *See Weinberger v. UOP, Inc.,* 457 A.2d 701, 710 (Del. 1983), *aff'd* without opinion, 497 A.2d 792 (Del. 1985) (there is no dilution of a director's duties where that director holds dual or multiple directorships); *Phillips v. Insituform of N. Am., Inc.,* 1987 WL 16285, at *10 (Del. Ch. Aug. 27, 1987) (the law does not recognize "a special duty on the part of directors elected by a special class to the class electing them").

This presents an interesting dynamic for boards whose members include directors appointed by various corporate constituencies and poses an important question under corporate law — how does a designated director balance his duty of loyalty to the corporation and all of its stockholders with his allegiance to those who appointed him to the board? While the interests of the corporation and its stockholders generally may be closely aligned with those of the designating stockholder in many instances, their interests and objectives are also likely to diverge in a number of circumstances. This creates a variety of issues that designated directors, who may owe fiduciary duties to both entities, must face — including the appropriateness of the designated director sharing confidential information between the corporation and the designating stockholder and of advocating for the interests of the constituency he represents. With the appointment of designated directors to corporate boards becoming more commonplace, corporations and their designating constituencies would benefit from addressing these issues early, before inevitable conflicts arise.

SHARING CONFIDENTIAL INFORMATION WITH DESIGNATING STOCKHOLDERS • The first question that arises is whether designated directors may share confidential information of the company with the designating stockholder. Corporate directors are typically privy to a wide range of confidential corporate information. There is, moreover, a presumption that a director "is entitled to unfettered access to the books and records of the corporation for which he sits and certainly is entitled to receive whatever the other directors are given." *Intrieri v. Avatex Corp.,* 1998 WL 326608, at *1 (Del. Ch. June 12, 1998); *see also Hall v. Search Capital Group, Inc.,* 1996 WL 696921, at *2 (Del. Ch. Nov. 15, 1996) ("When management communicates with the directors on matters of concern to the Board collectively, it cannot pick and choose which directors will receive that information. Absent a governance agreement to the contrary, each director is entitled to receive the same information furnished to his or her fellow board members"); 8 Del. C. §220(d) (providing that any director "shall have the right to examine the corporation's stock ledger, a list of its stockholders and its other books and records for a purpose reasonably related to the director's position as a director"). Thus, one issue that boards and their designated directors must face is whether the designated director may provide the corporation's confidential information, obtained through his position on the board, to the designating stockholder. This issue becomes particularly acute if the designating stockholder is a competitor of the corporation or has interests that are different from, or adverse or potentially adverse to, those of the corporation and its stockholders generally.

As an initial matter, it is well-settled law in Delaware that directors have a duty to maintain the confidentiality of the information they obtain by virtue or on account of their position on the board. The general rule with regard to a director's use of confidential corporate information, which has been repeatedly reaffirmed, provides:

"A fiduciary is subject to a duty to the beneficiary not to use on his own account information confidentially given him by the beneficiary or acquired by him during the course of or on account of the fiduciary relation or in violation of his duties as fiduciary, in competition with or to the injury of the beneficiary … unless the information is a matter of general knowledge."

Brophy v. Cities Service Co., 70 A.2d 5, 7-8 (Del. Ch. 1949).

The Duty Of Confidentiality In The Designated Director Context

In the case of designated directors, does the duty of confidentiality prohibit a designated director from providing the corporation's information to the stockholder who designated the director?

As noted above, Delaware case law holds that there is no dilution of fiduciary duties for dual directors, *see, e.g., Weinberger,* supra; *Phillips,* supra, 1987 WL 16285, at *10, and this principle would suggest that there is no exception to or dilution of a director's duty of confidentiality that would permit a director to disclose confidential corporate information to a designating stockholder. In practice, however, the Delaware Court of Chancery has taken a more nuanced approach and, in at least one circumstance, has suggested that a director may be permitted to disclose company information to a designating stockholder.

In *Kortum v. Webasto Sunroofs Inc.,* 769 A.2d 113 (Del. Ch. 2000), Mr. Kortum, a director designated by one 50 percent owner of WSI, a joint venture corporation, brought an action pursuant to Del. Code Ann. tit. 8 §220 seeking access to the corporation's books and records. *Id.* at 115. WSI, managed by the other 50 percent owner, acknowledged that Kortum, as a director, had a right to inspect the company's books and records, but sought to condition the inspection on Kortum's agreement not to disclose any confidential information to the designating stockholder, which WSI viewed as a potential competitor. *Id.* at 118.

The Court ultimately held that it was unreasonable for WSI to condition Kortum's inspection rights on an agreement not to disclose any of the company's confidential information to the designating stockholder. *Id.* at 121. (The Court will use its power and discretion to limit a director's access to corporate information sparingly because it is the director, not the Court, who owes fiduciary duties to the corporation and its stockholders. *Id.*)

Is There A Conflict?

Because the designated director was a fiduciary of both entities — the joint venture corporation and the designating stockholder — the Court held that absent a conflict between those two roles, the designated director's fiduciary duties to the designating stockholder required him to disclose the corporation's information to the designating stockholder. *Id.* In contrast, a designated director — and, for that matter, any director — as a fiduciary of the corporation, may not disclose the confidential and proprietary corporate information to third parties, including potential competitors of the corporation. *Id.* at 121 n.17; *see also Holdgreiwe v. Nostalgia Network, Inc.,* 1993 WL 144604, at *6 (Del. Ch. Apr. 29, 1993) (finding a designated director's disclosure of confidential corporate information to an affiliate of the designating stockholder to be a violation of the director's obligations to the corporation).

The Court's decision that the director could freely share information obtained in the Section 220 proceeding appeared to turn on the stockholder's status as a 50 percent joint venturer, the past history of open information sharing among the parties, and the Court's conclusion that there was insufficient proof of the stockholder's intent to compete with the joint venture corporation. *Kortum,* supra, 769 A.2d at 121.

Is The Designated Shareholder Competitor?

Thus, in at least some circumstances, it appears that the Delaware Court of Chancery would recognize that a director may disclose confidential corporate information to a designating stockholder. The Court of Chancery also recognized, however, that a corporation could impose conditions or limit the scope of the confidential information that may be provided to the designating stockholder if it were established that the designating stockholder was a competitor to the corporation. *Id.* at 124. More recently, in *Schoon v. Troy Corporation,* 2006 WL 1851481, at *1 (Del. Ch. June 27, 2006), the Court denied a designated director's request to inspect corporate records on the ground that the request was made at the behest of, and in order to assist, the designating stockholder in pursuing a sale of the corporation's stock and not for a proper purpose related to the director's directorial duties. *Id.*

Although the director's request to inspect corporate records was denied, the designating stockholder's direct request to inspect corporate records was granted, subject to limitations upon the stockholder's ability to disclose the information to competitors of the corporation. *Id.* at *2. Thus, in *Schoon,* the Court recognized that in considering the disclosure of confidential corporate information to a designating stockholder, the Court must balance the stockholder's right to obtain information about the company with the company's interest in safeguarding its confidential information from potential competitors. ("In determining the proper inspection relief, the court must balance the stockholder's statutory right to inspect the corporation's books and records with the corporation's legitimate interest to safeguard its highly confidential information from its competitors"). *Id.*

This at least suggests that the Court would not sanction the unfettered flow of confidential corporate information from a designated director to the designating stockholder. *See also eBay Domestic Holdings, Inc. v. Newmark.,* 2010 WL 3516473, at *28 (Del. Ch. Sept. 9, 2010) ("Preventing a competitor that is also a minority stockholder from unilaterally placing a director on the board so that confidential corporate information will not be freely shared with that competitor is a legitimate and rational business purpose").

Unclear Boundaries

As these cases demonstrate, under existing case law in Delaware, the boundaries of where a director's disclosure of confidential corporate information crosses from permissible disclosure to a breach of fiduciary duty are far from clear, leaving designated directors with little useful guidance as to when — or what — information can be shared. One would expect that whether a designating stockholder is a competitor or has other interests adverse to the corporation would frequently be a contested issue, as it was in the *Kortum* case. For a director considering his fiduciary obligations prospectively, or for a corporation concerned about potential misuse of its confidential information, the judgment as to whether and when the designating stockholder's interests come into conflict may therefore be a difficult one to make.

Spell It Out

One way to avoid or lessen the potential conflict between a director's duty to maintain the confidentiality of the corporation's information and the designating stockholder's desire to obtain appropriate corporate information is to define the designating stockholder's informational rights in advance by contract, and to couple the stockholder's contractual informational rights with confidentiality and use restrictions to limit the purposes for which the designating stockholder may use the information it receives. This approach allows the parties to negotiate at the beginning of their relationship the appropriate balance between the designated director's duty to protect confidential corporate information and

his ability to provide information to the designating stockholder, by defining the issue in contractual, rather than fiduciary, terms. For the designated director, this reduces the risk that sharing of information would be viewed as a breach of fiduciary duty (with the potential of personal liability and reputational damage) and gives greater certainty as to the boundaries of proper information sharing. From the corporation's perspective, a contractual provision defining the stockholder's information rights is beneficial because it provides clear guidance as to what materials can freely be shared and for what purpose the information may or may not be used, and because it provides an enforcement mechanism against the stockholder directly in the event of any misuse of the corporation's information by the stockholder. On the other hand, contractual information rights defined at a time when the parties presumably expect their relationship to be a mutually beneficial one could be overly permissive if the relationship later sours, and the corporation may be unable unilaterally to reduce the stockholder's access to confidential information if the stockholder's information rights are defined by contract. It may therefore be desirable to negotiate a "fiduciary out" to any information right, granting the corporation's board the right to limit the designating stockholder's access to confidential corporate information if the board determines that providing such information is no longer in the best interests of the corporation.

SHARING CONFIDENTIAL INFORMATION WITH THE CORPORATION AND ITS BOARD • The second question that arises is whether designated directors may share confidential information of the designating stockholder with the corporation and its board. Designated directors also face the converse of the foregoing problem: May or must a designated director disclose to his fellow directors confidential information regarding the designating stockholder or its plans and strategies that are known to the designated director by virtue of his relationship with the designating stockholder?

The Duty Of Disclosure

One of the "elementary principles of fair dealing" under Delaware law is the duty of candor, which imposes an unremitting duty on fiduciaries, including directors and officers, to "not use superior information or knowledge to mislead others in the performance of their own fiduciary obligations." *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989); *Weinberger,* supra, 457 A.2d at 711 ("one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy"). Moreover, the duty of disclosure to other directors has been described as an "unremitting obligation to deal candidly with their fellow directors." *HMG/ Courtland Properties, Inc. v. Gray,* 749 A.2d 94, 119 (Del. Ch. 1999).

The duty of disclosure requires a director to disclose material and relevant facts known to the director, regardless of the source, related to a transaction that is being considered for approval by the board. *Big Lot Stores, Inc. v. Bain Capital Fund VII, LLC,* 922 A.2d 1169, 1184-85 (Del. Ch. 2006); *see also Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1174 (Del. 1995) ("The duty of disclosure is based on a materiality standard."). This standard is similar to the board's duty of disclosure to its stockholders related to a transaction where the board is seeking stockholder approval. *See David P. Simonetti Rollover IRA v. Margolis,* 2008 WL 5048692, at *13 (Del. Ch. June 27, 2008) ("The directors' disclosure duty is premised upon the stockholders' right to be informed of all material facts when casting a vote on a proposed transaction, and the standard for determining the materiality of an undisclosed fact turns on whether it would have altered the total mix of information available to the stockholders in considering how to vote on the proposed transaction").

Limits Of The Duty

The duty of disclosure, however, does not require a director to disclose everything he knows about a transaction in which the corporation is involved, nor does it require directors to disclose confidential information related to issues that are not before the board. *Big Lot Stores,* supra, 922 A.2d 1169, 1184 ("duty to disclose is not a general duty to disclose everything the director knows about transactions in which the corporation is involved").

Thus, when a corporation's board is considering a matter as to which a designated director has material information obtained by virtue of his relationship with the designating stockholder, the designated director may face two diametrically opposed duties. On the one hand, the director is obligated to disclose to his fellow directors all material information he possesses, regardless of the source. On the other hand, the director's duties to the designating stockholder require that the designated director maintain the confidentiality of information obtained by virtue of the director's relationship with the designating stockholder. In the face of these directly conflicting duties, the designated director may be unable to fulfill his fiduciary obligations to both entities. If he discloses the information to the corporation's board, he violates his duty of confidentiality to the designating stockholder; if he remains silent, he violates his duty of disclosure to the corporation's board and his fellow directors.

A similar issue was addressed by the Court of Chancery in *Weinberger*. In that case, six directors on the 13-member board of UOP, Inc. (UOP) were representatives of UOP's majority stockholder, The Signal Companies, Inc. (Signal). *Id.* at 704. Two of Signal's officers, who were also directors of UOP, conducted a feasibility study to evaluate the possible acquisition of UOP's remaining outstanding shares. *Id.* at 705. This study, which concluded that the acquisition of UOP would be a good investment at any price up to $24 per share, was prepared using UOP's information by two UOP-Signal directors, but was never shared with the entire board of UOP. *Id.* at 707. Despite the conflicts faced by the UOP-Signal directors, these directors participated, at least to some extent, in UOP's decision-making process with regard to Signal's offer to purchase its remaining shares without disclosing the potential conflict or the existence of the valuation study to the rest of the UOP board. *Id.* Even though the UOP-Signal directors ultimately abstained from approval of the transaction, the Court found that Signal could not avoid the effects of the conflict, especially when the UOP-Signal directors did not totally abstain from participation in the matter. *Id.* at 710. The Court noted that once a conflict arises, the director should disclose the conflict and abstain from participation in the matter. *Id.* at 710-11.

The Abstention Option

As discussed by the Court in *Weinberger,* a designated director facing a conflict arising from his allegiances to the designating stockholder should certainly consider abstaining from all participation in any transaction involving a potential conflict. *Id.* at 711. Delaware courts have held that directors who abstained during the process of approving a particular transaction will not be held liable for the board's decision to approve the transaction. While there is no per se rule relieving a director of liability for a transaction solely due to his abstention from voting, Delaware law prescribes that a director who plays no role in the process of approving a transaction, and had no fiduciary duty not to abstain from voting, cannot be liable for the board's decision to approve the transaction. *See In re Tri-Star Pictures, Inc. Litig.,* 1995 WL 106520, at *2-3 (Del. Ch. March 9, 1995) ("Delaware law clearly prescribes that a director who plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board's decision to approve that transaction was wrongful"). However, it is not clear whether abstention will be sufficient for the designated director to avoid liability

for breach of duty, especially where informational conflicts are at issue. For example, where a director possesses material information obtained by virtue of his dual fiduciary status, merely abstaining from the transaction may be found to be akin to remaining silent during the discussions of the transaction, withholding the confidential information and thus violating the director's duty of disclosure to the corporation. *Weinberger,* supra (finding that directors who participated in various aspects of the process but abstained from voting could not "escape the effects of the conflicts it faced...when its designees on UOP's board did not totally abstain from participation in the matter"). On the other hand, the designated director's disclosure of the information motivating his decision to abstain may violate the director's duty of confidentiality to the designating stockholder. Thus, in some circumstances, the designated director may truly be unable to reconcile his fiduciary duties to both entities.

Advance Agreement

Some commentators have suggested that this potential conflict could be addressed by an advance agreement between the parties providing that no confidential information of the designating stockholder will be shared with the company and that the designated director will recuse himself from participation in any transaction involving a possible conflict without any further disclosure, including the reason for the recusal. *See* David M. Morris et al., *Designated Directors and Designating Investors: Early Planning is Key,* 16 The Corporate Governance Advisor 5, 7 (May/June 2008). The validity of such a provision is doubtful, however, because it would have the effect of limiting the designated director's fiduciary duty of loyalty to the corporation, and such limitations are not valid in the corporate context.

The idea of contractual limitations on fiduciary duties derives from the limited partnership or limited liability company contexts, where limitations on fiduciary duties are expressly approved by statute. *See* Del. Code Ann. tit. 6 §18-1101(e); Del. Code Ann. tit. 6 §17-1101(d). However, the concept of contractually limiting fiduciary duties, particularly the duty of loyalty, does not extend to Delaware corporations. *See Sutherland v. Sutherland,* 2009 WL 857468, at *4 (Del. Ch. Mar. 23, 2009) (noting that a provision eliminating a director's duty of loyalty, while possibly permitted under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, is expressly forbidden by the Delaware General Corporation Law). *But see* Del. Code Ann. tit. 8 §122(17) (permitting a corporation to renounce its interest or expectancy in specified corporate opportunities). Moreover, even in the limited partnership and limited liability company contexts, courts have been somewhat reluctant to embrace the concept of contracting around core fiduciary duties and have required that any such limitation be clear and unambiguous. *See Kelly v. Blum,* 2010 WL 629850, at *10 n.70 (Del. Ch. Feb. 24, 2010) ("Having been granted great contractual freedom by the LLC Act, drafters of and parties to an LLC agreement should be expected to provide parties and anyone interpreting the agreement with clear and unambiguous provisions when they desire to expand, restrict, or eliminate the operation of traditional fiduciary duties"); *Miller v. Am. Real Estate Partners, L.P.,* 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) ("it is fair to expect that restrictions on fiduciary duties [in limited partnership agreements] be set forth clearly and unambiguously"); *Sonet v. Timber Co., L.P.,* 722 A.2d 319, 322 (Del. Ch. 1998) ("principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain"). It therefore seems unlikely that a contractual provision could validly eliminate a corporate director's fiduciary duty of disclosure.

ADVOCATING INTERESTS • The third question that arises is whether designated directors may advocate for the interests of the constituency they represent. It is fairly clear that a designated director would breach his fiduciary duties by advocating for the interests of the designating stockholder without disclosing the designating stockholder's interests or the potential conflict, even if the designated director abstains from voting. *See Weinberger,* supra (board members who held dual directorships between the buying majority shareholder and the selling company and participated in various aspects of the board meeting approving the transaction but ultimately abstained from voting were found to have breached their fiduciary duties to the selling company due to conflict of interest). Additionally, if the designated director has a financial interest in the designating stockholder, taking an action at the expense of the corporation to benefit the designating stockholder may be found to have been taken in bad faith. *See Kahn v. Portnoy,* 2008 WL 5197164, at *7 (Del. Ch. Dec. 11, 2008) ("Intentionally acting to benefit oneself at the expense of the Company is a quintessential example of failing to act in good faith, which requires a director to act with the good faith belief that his actions are in the best interests of the company"). It is much less clear, however, whether a designated director who advocates for the interests of the designating stockholder with full disclosure of his interests to the rest of the board will breach his fiduciary duties to the corporation.

Advocacy — With Disclosure

Several commentators who have written on this issue have suggested that a designated director can freely advocate for the interests of his designating stockholder without breaching his fiduciary duties. *See, e.g.*, E. Norman Veasey and Christine T. DiGuglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors,* 63 Bus. Law. 761, 770-72 (May 2008). The key, according to these commentators, is full disclosure of the designated director's interest in the transaction. Thus, as long as the designated director has fully disclosed his representation of the designating stockholder to the entire board and the stockholders, he may be permitted to advocate for the interests of the designating stockholder in order to convince the board that the interests of the designating stockholder are aligned with the interests of the corporation and all of its stockholders. *Id.* at 772. Whether the designated director then must abstain from voting on the transaction is less clear, but the prudent course would be for the designated director to abstain from voting on the transaction in order to avoid allegations of lack of independence or interestedness if the board's decision is later challenged. Even interested directors are authorized to vote on the matter, regardless of any conflict, and be counted for quorum purposes. The issue is not one of corporate authority. Rather, abstention is intended to protect the interested director from liability, and to protect against any attempt to invalidate the transaction on the grounds that it was entered into in breach of the board's collective duties.

What Constitutes Full Disclosure?

But stating that full disclosure is required merely begs the question of what constitutes full disclosure of a director's interest in the transaction, particularly in the context of a designated director who is privy to confidential strategies of the designating stockholder. One assumes that, in most circumstances, a designated director's fellow directors will be at least generally aware of the relationship between the designated director and the designating stockholder. Mere disclosure of the fact of the relationship, standing alone, would thus add little to the discussion. But what the fellow directors may not know — and would likely want to know — are the designating stockholder's plans and strategies as they relate to the matter under consideration. If the requirement of full disclosure of the conflicting interest is interpreted to require this more fulsome

disclosure as the price a designating stockholder must pay to have an advocate for the stockholder's position in the boardroom, then the rule that allows advocacy only on full disclosure makes sense doctrinally. One wonders, however, how willing a designating stockholder will be to pay that price.

CONCLUSION • Much attention has recently been paid to the conflicts faced by designated directors in the transactional context. *See* Catherine G. Dearlove & Jennifer J. Veet, *Loyal to Whom? Recent Delaware Decisions Clarify Common Stockholders are Primary Beneficiaries of Directors' Fiduciary Duties*, 4 Deal Lawyers 1 (May-June 2010). But the informational and disclosure-related conflicts faced by designated directors are equally vexing, if not more so. Corporations, designating stockholders, and the individuals who serve as designated directors, should carefully consider these issues at the outset of any transaction in which a stockholder will obtain director designation rights.