The Fiduciary Duties of Delaware Directors and the Impact of *Shocking Technologies* "Best Intentions"

BY JESSICA ACKERMANN & IRV BERLINER

Delaware has long been known for the broad protections it offers to corporate directors. The business and affairs of Delaware corporations are managed by, or at the direction of, the corporation's board of directors, and fiduciary duties are required of all directors while serving on the board. In fulfilling their managerial responsibilities, directors must uphold their fiduciary duty to both the corporation and the corporation's stockholders (and the corporation's creditors in certain cases, such as insolvency). The Delaware Supreme Court has explicitly expanded the scope of fiduciary duties to encompass the actions and decisions of corporate officers as well as directors. *Gantler v. Stephens,* 965 A.2d 695, 708-9 (Del. Supp. 2009). In recent years Delaware courts have clarified the standards for evaluating director and officer conduct but have not withdrawn their widely-cast safety nets which offer broad protections.

The primary fiduciary duties, those of care and loyalty, have not seen any dramatic changes. The duty of care requires directors "act in an informed and deliberate manner" and inform themselves of "all material information reasonably available to them" prior to making a business decision. *Smith v. Van Gorkom*, 488 A.2d 858, 872, 873 (Del. 1985). Gross negligence serves as the standard in determining if there has been a breach of the duty of care. *In re Walt Disney Co.*, 906 A.2d 27, 53 (Del. Ch. 2006). The duty of loyalty requires directors put the corporation's interests above their own personal interests and refrain from receiving improper benefits as a result of their relationship with the corporation. Directors have an "affirmative duty to protect the interests of the corporation, but also an obligation to refrain from conduct which would injure the corporation and its stockholders or deprive them of profit or advantage. In short, directors must eschew any conflict between duty and self-interest." *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987).

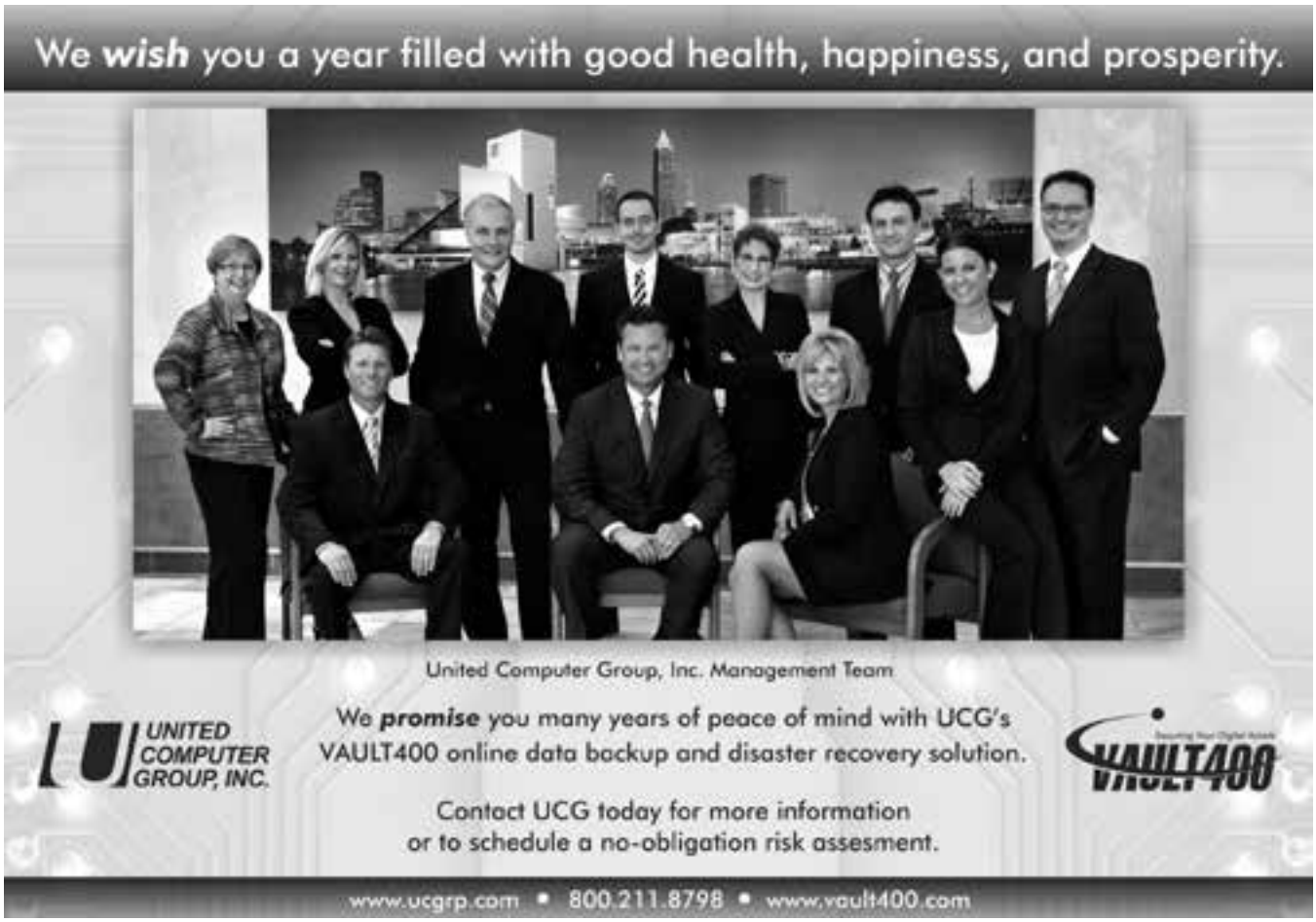
In addition to the "primary" duties, additional fiduciary duties exist. These "other" fiduciary duties include duties of oversight, disclosure and candor, and good faith. The duty of oversight requires directors assure a "reasonable information and reporting system exists." *In re Caremark*, 698 A.2d 959, 971 (Del. Ch. 1996). The duty of disclosure and candor require directors disclose all material information when soliciting stockholder action. *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992). Pursuant to those duties, directors must disclose to the board material information in their possession bearing upon a board decision, particularly where the directors have a personal interest in the outcome of the board decision. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989). Lastly, the duty of good faith, which some have described as a subset of the duty of loyalty, requires a director to act at all times with an honesty of purpose and in the best interests and welfare of the corporation. "Directors cannot consciously and intentionally disregard their responsibilities, or adopt a 'we don't care about the risks' attitude concerning a material corporate decision." *In re Walt Disney Co.*, 907 A.2d 693, 754-55 (Del. Ch. 2005).

In 2012, the Delaware Chancery court further refined the standards of fiduciary duties in the case of *Shocking Technologies, Inc. v. Michael*. C.A. No. 7164-VCN (Del. Ch. Oct. 1, 2012). *Shocking* was a derivative lawsuit brought by the shareholders of the company, Shocking Technologies, alleging that director Simon J. Michael breached his fiduciary duty of loyalty both by trying to dissuade the remaining potential investor from investing in the company and by sharing bargaining advice and confidential information with the remaining investor.

Michael, through affiliated entities and relatives, was a significant source of investment for Shocking Technologies. His concern revolved around the fact that he, along with other particular investors, had at one point, provided approximately sixty percent (60%) of the company's capital but were only entitled to designate one of the board's potential six directors. Of further concern was an issue relating to executive compensation. The president, founder, and CEO of the company, in addition to serving on the Board of Directors, was seeking additional compensation in the form of stock options double to what he had received in years prior. Michael believed this compensation was undeserved and sought to tie the compensation to performance triggers. Hostilities on the board relating to executive compensation led Michael to believe the other board members formed a "control group" acting to advance their own interests rather than the best interests of the company.

To further complicate matters, the company was in a precarious financial position and in serious need of funding. The company had only one potential investor, a previous investor. whose funds they badly needed. Michael knew the company's survival likely depended on the potential investment and knew the effects he could have on the investor. Michael proceeded to communicate with the potential investor. He described to the investor the possibility that they could coerce the CEO into meeting their demands, including the control of an additional board seat, through the application of financial pressure. In doing so, Michael linked his personal goal of a revised board structure with his ability to interfere with the company's short-term funding efforts.

Michael disclosed to the investor confidential information indicating that they were the



only potential investor likely to participate in the necessary fundraising which gave them a significantly enhanced strategic bargaining position. In finding that Michael's delivery to the investor of confidential information and bargaining advice constituted a breach of his fiduciary duties the *Shocking* court noted; "The best interests of the [c]ompany—finding enough cash to survive—were immediate and unmistakable. Michael, knowing the consequences if he was successful, acted against the [c]ompany's best interests. For that, he was disloyal." Further, notwithstanding Michael's claimed '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."

While the court does not define the line between acceptable and unacceptable conduct, they do seem to indicate there may be a sliding scale balancing factor test. "Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult." Pursuant to the balancing test, short-term harm to the corporation may be permissible to achieve greater long term benefits. However, the potential harm Michael could have caused fell outside the acceptable scale, thus resulting in his liability. "The steps that a shareholder-director may take to achieve objectives are not without limits. A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further such objectives." Any hope that the disclosure of confidential information would have ultimately resulted in better corporate governance practices cannot "outweigh or somehow otherwise counterbalance the foreseeable harm" it would cause. The court was unable to reconcile Michael's action in attempting to strangle the company with a potentially catastrophic cash shortage and his 'unremitting' duty of loyalty.

Additionally, *Shocking Technologies* serves as an important reminder for both directors and their counsel. "A director acting in subjective good faith may, nevertheless, breach his duty of loyalty." Even if Michael had the best of subjective intentions, it would be difficult to reconcile his conduct and its likely consequences of causing serious harm to Shocking with the fiduciary duty of loyalty he owed. Further, while fair debate is an important part of a director's duties, directors may not take steps that could foreseeably cause harm to the corporation, even if they believe they are acting in the best interests of the corporation. As a consequence, investors may want to reconsider whether a principal of the investor actually holds the director position. The investor may have more flexibility if it instead appoints an unaffiliated person as a board member.



Jessica A. Ackermann is an associate at Taft and is a member of the Business & Finance and Real Estate practice groups. She focuses primarily on mergers and acquisitions, real estate investments, private equity and venture capital. She represents public and private companies in asset, stock and merger transactions. Ms. Ackermann can be reached at (216) 706-3862 or jackermann@taftlaw.com org.



Irv Berliner is a partner in the Corporate Finance, M&A, Securities, Gaming and Private Equity practice groups at Taft. He represents public and private companies in a number of transactions and industries, assisting with mergers, spin-offs, IPOs, bank financings, going-private transactions, high yield offerings, proxy contests, restructurings and 144 offerings with A/B exchanges. Mr. Berliner can be reached at (216) 706-3889 or iberliner@taftlaw.com org.