DISSIDENT DIRECTOR WHO HARMS CORPORATION TO FURTHER PERSONAL OBJECTIVES VIOLATES DUTY OF LOYALTY

By Byron F. Egan

I. Director Duty of Loyalty

Directors owe fiduciary duties to a corporation on whose Board of Directors ("*Board*") they serve and effectively to all of its stockholders.[1] The fiduciary duty of loyalty dictates that directors act in good faith and not allow their personal interests to prevail over those of the corporation.[2] Thus, a director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.[3] This principle is often memorialized in corporate policies.[4]

II. Duty of Loyalty Breached by Leaking Confidential Information

In *Shocking Technologies, Inc. v. Michael*,[5] a director ("*Michael*") of a privately held Delaware corporation in dire financial straits who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information to another preferred shareholder considering an additional investment in the company. The Delaware Court of Chancery found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a "better deal" which would include Board representation for such investor (thereby changing the balance of power on the Board in Michael's favor). In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

> "The fiduciary duty of loyalty imposes on a director 'an affirmative obligation to protect and advance the interests of the corporation' and requires a director 'absolutely [to] refrain from any conduct that would harm the corporation'. Encompassed within the duty of loyalty is a good faith aspect as well. 'To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation. **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The 'essence of the duty of loyalty' stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is 'adverse to the interests of [his] corporation**.' [Emphasis added]

The *Shocking Technologies* case involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there

should be increased Board representation for the preferred stock. Michael argued that the company's governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael's desire to increase his influence and control over the Board at a time when the company faced financial difficulties.

As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company's only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company's stock. Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation. The Court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,[6] or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

In rejecting Michael's argument that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the Board, the Court wrote:

> "Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance objectives aligned nicely with his self-interest.[7] When he and his fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking.[8] That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.
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> "Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.

> "Michael's conduct had a foreseeable (and intended) consequence: depriving the Company of a cash infusion necessary for its short-term survival. It turns out that a predictable result of his actions did not occur. In these circumstances, a director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, internal disagreement will not generally allow a dissident to release confidential corporate information. Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult. Here, the most logical objective of Michael's actions—strangling the Company with a potentially catastrophic cash shortfall—cannot be reconciled with his 'unremitting' duty of loyalty. Thus, Michael did breach his fiduciary duty of loyalty to Shocking."

III. Director Debate Has Limits

The Court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists:

> "Shareholders and directors, sometimes to the chagrin of a majority of the board of directors, may seek to change corporate governance ambiance and board composition. That is not merely permitted conduct; such efforts may be entitled to affirmative protection as part of the shareholder franchise. Michael's objectives as to his corporate governance agenda were not proscribed. They may have been prudent, or they may have been irresponsible. Nonetheless, it was his right to make such policy choices.
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> "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. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation."[9]

The Court in *Shocking Technologies,* however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

> "Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot

> outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty."

The Court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation. The Court appeared concerned that shifting fees may be too much of a penalty for a dissident director, and may make it too easy for the majority to use as a "hammer" to silence those members of the Board who dissent, explaining: "The line separating fair and aggressive debate from disloyal conduct may be less than precise."

IV. Lessons from *Shocking Technologies*

The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be. The case also shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives.

ENDNOTES

[1] Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law, Austin, TX, Feb. 8, 2013, http://www.jw.com/publications/article/1830.

[2] *Gearhart Indus., Inc. v. Smith Int'l., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831 (Del. 2011); *Solash v. Telex Corp.,* 1988 WL 3587 at *7 (Del. Ch. 1988).

[3] *Hollinger Intern., Inc. v. Black*, 844 A.2d 1022, 1062 (Del Ch., 2004); *Agranoff v. Miller*, 1999 WL 219650, at *19 (Del. Ch. Apr. 12, 1999), aff'd as modified, 737 A.2d 530 (Del. 1999).

[4] *See Disney v. Walt Disney Co.*, C.A. No. 234-N (Remand Opinion June 20, 2005), discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). *See* The Walt Disney Company Code of Business Conduct and Ethics for Directors available at http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors.

[5] C.A. No. 7164-VCN (Del. Ch. Oct. 1, 2012), *available at* http://courts.delaware.gov/opinions/download.aspx?ID=179010.

[6] The company alleged that Michael was seeking to force the company into a new down round share issuance in which Michael could purchase shares on the cheap and dilute the other stockholders.

[7] *See City Capital Assocs. Ltd. P'ship v. Interco. Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988) ("human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial").

[8] Michael believed that the B/C series investors had contributed 70% of the capital paid in to the company.

[9] *Cf. Sherwood v. Chan Tze Ngon*, 2011 Del. Ch. LEXIS 202 (Dec. 20, 2011), which involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting, and in which the Court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the board to remove him from the Company's slate." The Court commented that it is "important that directors be able to

register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion."

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