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Resigning From a Board of Directors: Considerations for VC Fund Designees

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When a venture capital fund invests in an emerging growth company, it typically seeks to protect its investment by obtaining the right to designate a member of the Board of Directors. While many of these individual designees are experts in their field and have vast networks of valuable relationships at their disposal, a newly designated director may be unfamiliar with the duties imposed on him should he want to resign.

Delaware law generally gives the Board of Directors broad authority to manage the business affairs of a corporation. Although this level of discretion is generally extended to the ability to resign, there are various factors that should be considered when weighing the value of keeping a seat against the potential turmoil and liability associated with resignation. Designated directors often reflexively consider resignation when the company has run out of money or is heading into the so-called "zone of insolvency" out of fear of personal liability. Resigning at this point, however, may actually give rise to the very liability the director was seeking to avoid. As a result, it is important for a director to know when he <u>can</u> resign versus when he <u>should</u> resign.

I. The Benefits of Sitting on a Board: A Seat at the Table

The best way for a venture capital fund to remain informed and maintain influence on a company's decision-making is to hold a seat on the Board. Directors have the power to vote on matters mandated by Delaware law, the certificate of incorporation, or the investment documents that affect material aspects of the business and its stakeholders. For example, Board approval may be necessary for: amendments to the certificate of incorporation and bylaws; equity grants or transfers (whether stock, options, or warrants); distributions to stockholders; borrowing or lending money; adopting an annual budget; hiring or terminating members of senior management (or amending their terms of employment); adopting employee benefit plans; a sale of material assets of the company; a dissolution of the company; and/or entering into agreements and transactions of material importance to the company (intellectual property licenses, mergers, or IPOs).

This remains true even if the investment has gone sour. Directors will continue to have say over bridge financings, the direction of DIP loan packages, and other key decisions that need to be made by a company in distress.

II. Should I Stay or Should I Go?

Under Delaware law, a director generally may resign at any time, unless the certificate of incorporation or bylaws require otherwise. Notably, however, a director may not resign when doing so would constitute a breach of the duty of loyalty.

A. Duty of Loyalty

Directors have a duty to act in the best interests of the shareholders—personal benefit is secondary, even if management is making questionable choices. For example, simply resigning upon discovery of flagrant crimes committed by corporate insiders, without attempting to rectify the issue, may constitute a breach of the duty of loyalty. In *In re Puda Coal Shareholders' Litigation*, a CEO was accused of theft through unauthorized transfers which went unnoticed for 18 months. A third party brought the suspected criminality to the attention of the independent directors, but the directors were "stonewalled" by management when they attempted to bring suit. So, the independent directors resigned from the Board. The Delaware court was critical of the directors' decision to resign rather than cause the company to join a related derivative suit, stating that simply resigning at that point (while the company was in hot water) might be a breach of the duty of loyalty.

Similarly, in *Rich v. Chong*, another Delaware case, the court determined that ignoring numerous red flags and resigning from the Board may have constituted an abdication of the directors' duties. In this case, the company completed its public offering in 2009. In 2010, it revealed discrepancies in its financial statements, and in 2011, auditors discovered a $130 million cash transfer to third parties in China. A 2010 stockholder suit urged the company's audit committee to investigate, but the investigation was abandoned in 2012 due to management's failure to pay the fees incurred by the audit company's advisors. The company also failed to hold an annual stockholder meeting for several years despite a 2012 court order to do so. The independent directors subsequently resigned. Chiding the directors, the court stated that "the conscious failure to act, in the face of a known duty, is a breach of the duty of loyalty."

Directors of companies with foreign operations, moreover, are subject to a heightened fiduciary duty. Delaware Supreme Court Chief Justice Strine's view on local companies with foreign operations is that a director's required engagement is even more strenuous (e.g., traveling to that foreign country, having language skills, and knowing the culture).

B. Reasons for Resignation

A director may want to resign from his position on the Board for several reasons. If the company breaks the law or materially breaches its bylaws or shareholder agreements, without immediate rectification, a director may consider resignation. In addition, a director may deem it necessary to resign over disagreements among the Board members. Deadlocks and discord can severely impede progress—a particular concern for growth companies. While discussion and debate is healthy for an effective Board, intractable differences of opinion about the company's future can stall innovation and stifle success. Similarly, a fundamental opposition to some of the company's major practices could be reason enough to step away.

Designees are often selected for board seats because of their expertise in a particular field and their vast network of connections. However, a conflict of interest may arise as a result. If conflicts of interest persist and become irreconcilable, a director's exit might be best for all parties involved. Still, a director's fiduciary duties to the corporation and its shareholders must be at the forefront of one's concerns, and if an exit may constitute a breach of the duty of loyalty, directors must think twice about resignation. In addition, while the director himself may not have a personal conflict, a designated director might wish to resign if the fund they represent is going to engage in certain debt financing transactions with the company.

Additionally, a director may want to resign if he is unable to obtain adequate protection against personal liability. A director should ensure that the company has a sufficient director and officer ("D&O") insurance policy and an indemnification agreement in place that protects individual directors. It is important to make sure D&O policies have a proper tail so that directors are still covered even after they leave the Board. A director is often best served staying on the Board as long as possible to make sure that the D&O insurance is kept in place at the expected levels and/or to best negotiate a tail on his exit. Without appropriate D&O insurance, directors may face liability for certain claims against the corporation. Notably, a recently enacted California law includes directors in the group of individuals that may be held personally liable for unpaid final wages. While a director may be covered by insurance or indemnification in this instance, it is important to be aware of state laws that may subject corporate agents to additional liability.

Finally, evidence that management is not acting in the best interests of the shareholders may be cause for a director's resignation. But again, a director has to be sure that his exit does not unduly harm the company or breach a fiduciary duty owed to the shareholders.

III. Practice Tips for the Director Pondering Resignation

When considering resignation, a director must act in the best interests of the company. Current or potential directors should research whether there are any unusual restrictions on resignation in the certificate of incorporation or bylaws or unusual internal procedures and policies.

Moreover, a director should take specific steps upon the discovery of illegality or malfeasance, namely:

1. A director's first duty is to take reasonable steps to stop any ongoing legal or ethical violations.

2. If met with stonewalling, the director should seek independent legal counsel.

3. A director who decides to resign may want to submit a written statement to the chairman for circulation to the Board and possibly to the shareholders.

Following these general steps will ensure that a director can leave a Board while guarding against potential liability. The decision to resign from a Board must not be made flippantly. Facts and circumstances will rule the day; regardless, a director must always mind his fiduciary duties to the company and its shareholders.

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