Loyalty in the boardroom

A court decision affirms what a bad idea it is for directors to share confidential information without authorization.

BY DOUG RAYMOND

A RECENT DELAWARE CASE reminds directors of the risks involved in speaking out of school at the expense of the corporation on whose board they serve. The case, *Shocking Technologies, Inc. v. Michael*, was brought by a privately held Delaware corporation against one of its directors. The company alleged that this director had breached his duty of loyalty to the company by revealing confidential information to a third party and interfering with a critical financing transaction.

The director, who was the sole board representative of a series of preferred stock, had for some time expressed deep concern about Shocking's corporate governance, principally that while the investors in the preferred stock had provided 60% of the company's capital, they were only able to designate one of six directors. He was also concerned that a "control block" of directors was too cozy with management, particularly around issues of compensation.

Motivated by these concerns, the director, who knew that the company was in a "precarious cash position" and that its survival depended on obtaining new funding from a single crucial investor, lobbied the investor to hold off on investing in Shocking and to instead use its negotiating leverage to expand the board seats for the holders of preferred stock. In doing so, the director told the investor that Shocking had no other source of financing other than the investor, which dramatically shifted the playing field for negotiations.

When his actions were challenged, the director asserted that he had acted in good faith to try and improve the company's governance structure and to re-align its compensation practices. The court's analysis essentially assumed that the director had acted in good faith and that this was not merely a grab for power.

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Nonetheless, Vice Chancellor John Noble was unpersuaded that the director's good faith could justify actions that would foreseeably cause significant harm to the company. The court therefore found that the director had breached his duty of loyalty by frustrating a crucially needed source of financing and disclosing to the third party the extremely sensitive and confidential information that the company had no other available alternative.

The fiduciary duty of loyalty, together with the duty of care, are the most fundamental obligations of corporate directors. At its core, the duty of loyalty prohibits a director from engaging in conduct that is adverse to the company. Directors have an affirmative obligation to protect and advance the interests of the corporation and to absolutely refrain from engaging in conduct that harms it. Generally, the measure of loyalty is the good faith of the director: so long as she acts in good faith to advance the interests of the company, and avoids self-dealing, she would not breach her duty of loyalty.

The court recognized that individual directors have the right, and may sometimes even have the obligation, to oppose actions supported by a majority of the board. However, in the context of these particular facts, the court had little trouble concluding that the actions by the director — even if taken in his subjective good faith — crossed the line from dissent to disloyalty.

The opinion in *Shocking* lays out a continuum along which an action with adverse short-term consequences may nonetheless be proper if its eventual benefit outweighs the short-term costs. The court did not try to identify the divide between acceptable and unacceptable conduct and acknowledged the difficulty in doing so with any precision. However, based on the result in *Shocking*, directors should be aware that that this continuum exists, and they should proceed very cautiously in taking actions that are reasonably likely to cause significant risks to the company. And it is never a good idea to share confidential information learned in the boardroom with outsiders unless appropriately authorized.

Directors need also be doubly careful when they are elected by a specific shareholder class. These directors, like all directors, owe their loyalty to all shareholders and not just to the class by which they were elected. These directors must be careful not to breach their duty of loyalty to the company when seeking to advance the interests of that particular class of shareholders.

Violating the confidence of the boardroom is almost never appropriate. And even good faith is no defense to taking action that itself is reasonably likely to significantly injure the corporation. These are good principles to remember. And it is also important to note that nothing in this opinion, or elsewhere in the Delaware law, restricts the freedom of directors to vigorously argue and object, so long as the debate remains in the boardroom and is not carried to third parties who may be adverse to the company. ■

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