Dual Fiduciaries: A Cautionary Tale for Nominee Directors

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Following almost five years of litigation, the Court of Chancery of Delaware recently dismissed a fiduciary breach claim brought against nominee directors of a private equity fund in connection with the sale of a company in which the fund had a controlling interest. *Manti Holdings, LLC v The Carlyle Group Inc.* is a reminder to Canadian boards and nominee directors of the importance of identifying and managing conflicts of interests (both actual and perceived) that may arise from a nominee's relationship with their nominating shareholder.

Nominee Directors: Fiduciary Obligations and the Limits of Information Sharing

For a more general guide addressing considerations that nominee directors, nominating shareholders and companies should bear in mind when implementing a nominee director arrangement, refer to our Governance Insights article *Nominee Directors: Fiduciary Obligations and the Limits of Information Sharing*.

Background to *Manti Holdings*

The investee company in question, Authentix Acquisition Company, Inc. (Authentix or the company), operated a business of developing and selling product "tracers" to prevent fraud and counterfeit. In 2015, the Authentix board resolved to run an auction for the sale of the company. Shortly before launching the process, the company's largest customer (which represented a material portion of the company's sales) decided it would not be renewing its existing contract and entered into a short-term agreement that discounted prices by 30%. Nonetheless, the board decided to proceed with the auction to determine whether buyers could appropriately value the company in the absence of this renewal. A total of 127 potential buyers were contacted.

The offers that materialized proved underwhelming. Although the company's bankers provided a preliminary low-end valuation of US$200 million (before learning of the non-renewal of the key contract), the auction generated bids for about half of that, with bidders citing the risks of contract renewal and customer concentration among their concerns.

As negotiations narrowed to one final bidder, the company's largest customer agreed to a multi-year contract on diminished terms and another key customer notified the company of its intention to extend its contract. With these updates in hand, Authentix finalized negotiations with the remaining bidder and secured a final offer of US$87.5 million with a US$17.5-million earnout.

The board approved the deal in a four-to-zero vote, with one director (a nominee of another investor in the company) abstaining. As reasons for his abstention, the lone director criticized the sales process for failing to market Authentix's potential to launch new upstream processes; suggested that a 12-month deferral of the auction would increase the sale price; and argued that the final bid still undervalued the company. The deal closed on September 13, 2017.

End of Fund Life Cycle: Was the Fund Conflicted?

Following closing, the shareholder that nominated the dissenting director brought a suit alleging that, among other things, two of the board members suffered from a conflict of interest in connection with the sale. The two impugned directors were managing directors of a prominent private equity firm that held a controlling interest in Authentix and were the fund's nominees on the company board.

The plaintiffs alleged that the fund, through its nominees, prematurely forced the sale of the company at a depressed price in order to offload its investment in the company prior to the expiration of the fund's 10-year term (which was set for September 30, 2017). At the time of the sale, the company was the largest of the fund's three remaining investments. The court noted that the fund's governance agreement included customary end-of-term flexibility that permitted the fund to hold its investments past the expiration date at its discretion or to formally extend the term of the fund with the approval of either an advisory committee (comprising the fund's largest investors) or a majority of the fund's limited partners. The dissenting director gave evidence that one of the fund nominees explained to him during the sales process that the nominee was under pressure to sell the company "because it was one of the last investments still open in the applicable fund, and it was time [for the fund] to monetize and close that fund so the money could be returned to investors."

The court ultimately concluded that the fund had not acted under any real or perceived necessity to sell the company in 2017. The plaintiff was not able to provide any evidence that the fund's investors were explicitly pressuring the fund to wind up its investments by the 10-year deadline, and, significantly, following the sale of the company, the advisory committee approved a two-year extension of the fund's term.

In the end, the court found that the fund was aligned with the interests of other investors in seeking to maximize value and that, in pursuing the sale, its nominees were not suffering from a conflict created by an alleged divergence between the needs of the fund and the interests of the company's other stockholders (the relevant test in this case under Delaware law). The board weighed the dissenting director's view of the benefits of deferring the auction against concerns that the momentum of the company's growth would be lost if the sale were postponed. "To sell now or wait for a better opportunity later? Absent a showing of a conflicted transaction, this is the very stuff of which business judgment is made," concluded the court.[1]

[1] The plaintiff's chief claim was that the transaction should be subject to the "entire fairness" standard of review, an exacting level of Delaware judicial scrutiny that requires the directors of the subject corporation to prove the fairness of both the price and the process of the transaction. Under Delaware law, a transaction in which a controller (such as the fund, in this case) receives a unique benefit (such as a timely exit from the fund's investee company, as the plaintiff's alleged) will generally be subject to entire fairness review, unless certain governance procedures are followed (such as independent board approval and majority of minority shareholder approval). Because the nominees were not independent of the fund, they themselves would have been subject to the entire fairness standard if the court found that the interests of the fund diverged from those of the investee company and its stockholders: "Here, [the fund] is a controller but does not have a disabling conflict of interest that triggers entire fairness. As such, the [fund's nominee directors] were not incentivized to sell [the company] at a less-than-fair price to the special benefit of [the fund], as no such benefit is demonstrated in the record."

Dual Fiduciaries in Canada: A Cautionary Tale

Although the Court of Chancery declined to rule that the directors in question were conflicted, the court was abundantly clear regarding the dilemma that would be faced by a director who owes duties of loyalty to their nominating shareholder:

> The [nominee directors] were dual fiduciaries of [the fund] and [the company], serving as directors of [the company] and as managing directors and officers of [the fund]. If the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict. But if the interests of the beneficiaries diverge, the fiduciary faces an inherent conflict of interest.[2]

Delaware law and Canadian law align in this respect. Canadian law has not recognized any distinction in responsibilities between a director nominated by a shareholder and a director nominated by management – a nominee director owes the same duties to the corporation as all other directors. In Canada, these duties include the fiduciary obligation to act in the best interests of the corporation, and such duties carry with them an expectation that in all circumstances the nominee exercise independent judgment and subordinate the interests of the nominating shareholder to those of the corporation.

Had there been evidence that the fund's interests diverged from those of the company's other stockholders (for example, if the fund had felt compelled to sell the company in 2017 "consequences (and price) be damned"), the nominees would likely not have had the benefit of receiving judicial deference to their business judgment, and it would have been prudent to ensure that the sale process was overseen by independent directors.

In this respect, *Manti Holdings* represents a cautionary tale: boards must ensure that sales processes are not tainted by the participation or influence of conflicted directors; and nominee directors must consider the propriety of their involvement in transactions in light of potential conflicts of interest (real or perceived) that may arise from their relationship with their nominating shareholder. Conflicts can materialize overtly or more subtly, and it is incumbent on the board and the nominee to identify and manage potential conflicts on an ongoing basis.

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[2] See the Court of Chancery's reasons in respect of the motion to dismiss brought by the defendants (internal citations omitted).

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