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The Quagmire of the 'Dual Fiduciary'

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In today's investment world, private equity firms, investment managers and other investors often acquire a substantial interest in a business and, as a consequence, earn the right to put "their people" on the company's board. That person then becomes a "dual fiduciary"—someone with fiduciary obligations to his or her investment firm and also to the "portfolio" company to which the person is appointed to serve. Of course, that person is often well-versed in the portfolio company's business precisely because of the work of the investment firm, and the person can therefore bring expertise and value to the portfolio company's board. But because the person owes duties to both entities, this scenario can present challenging issues on the proper exercise of fiduciary duty. In particular, the board member might be called upon to take action that does not benefit the investment firm.

For example, what expectations should we have when the fiduciary participates in decisions that affect both entities? Does the duty owed to one entity "outweigh" the duty owed to the other? How are the two simultaneously existing duties reconciled? How is the business judgment rule—which generally protects corporate directors' decisions made on an informed basis and in good faith—implicated? And what happens if the portfolio company faces financial distress that requires the board to make hard decisions affecting the investment made by the fiduciary's "parent" firm? Simply put, can a fiduciary in this position serve two masters?

Core Principles

Because Delaware is home to so many corporations, the Delaware law on this issue is particularly important (and well-developed). There is no per se rule barring a director of a Delaware corporation from also being a fiduciary for another beneficiary.[1] That said, the Delaware Supreme Court has held that "[t]here is no dilution of [fiduciary] obligation where one holds dual or multiple directorships, as in a parent-subsidiary context."[2] As a consequence, "individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations," which generally "is to be exercised in light of what is best for both companies."[3] If an act or decision by a dual fiduciary does not provide a special benefit to either the fiduciary or the second beneficiary, a court will not find an inherent conflict, and the lenient business judgment rule will apply. The rub, of course, is where it appears that the interests of the two beneficiaries diverge, posing a possible conflict of interest for the dual fiduciary.

This issue can be particularly acute where a dual fiduciary is acting for a corporation in financial distress. That is, an insolvent company confronts added burdens and expanded obligations. While creditors of a solvent corporation have various creditor-rights protections (such as contractual agreements, fraud and fraudulent conveyance law, general commercial law and the like), when a corporation is insolvent, creditors become the residual beneficiaries of any increased value of the corporation. Thus, under Delaware law, a creditor of an insolvent corporation, while not permitted to bring a direct claim, can sue the corporation's directors derivatively on behalf of the corporation for breach of fiduciary duty.[4]

A common scenario occurs where an investment fund has appointed its personnel to a portfolio company in connection with its investment, and that company's business goes south. The board must then confront "bet the company decisions" about how to deal with the deteriorating business. Should the company try to restructure its debt, which might affect the fund that has financed the company through notes? Should the company file for reorganization or even liquidation in bankruptcy (and if so, when), which will often adversely affect equity holders, again possibly harming the fund that invested by acquiring equity? These and similar decisions will come before the board, which of course must act in the best interests of the financially distressed company, and the company directors who come from the investor-fund might then confront competing duties. What are a dual fiduciary's obligations under these scenarios?

Leading Authority

The Delaware Chancery Court provided a detailed and thoughtful analysis of this dual fiduciary problem in a corporate-insolvency context in *Quadrant Structured Prods. v. Vertin*.[5]
Plaintiff Quadrant owned debt securities of an allegedly insolvent Delaware corporation—Athilon Capital Corp., a financial company that marketed credit derivative investment products. In 2010, another company, EBF & Associates, acquired all of Athilon's equity, as well as certain of its notes, and EBF then placed its personnel on Athilon's board.

Quadrant asserted that Athilon's board should have wound up the company when Athilon's business deteriorated, but instead the board improperly transferred value to the controller, EBF, doing so in part by adopting a business strategy that favored equityholders to the detriment of creditors. Quadrant brought derivative claims against the EBF-affiliated members of Athilon's board for breach of fiduciary duty premised on the transfers and, in particular, the new business strategy. Defendants moved to dismiss.

In support of its business-strategy claim, Quadrant asserted that "the board is changing [Athilon's] business model to make speculative investments for the benefit of EBF." Specifically, Quadrant alleged that by changing Athilon's investment guidelines to permit the company to invest in riskier securities and make speculative investments, "EBF benefits…because it will enjoy the upside if the strategy succeeds while suffering none of the downside if the strategy fails." Quadrant thus claimed that "faithful fiduciaries" would, instead, "pursue a conservative strategy and prepare for liquidation." In rejecting the claim as a matter of law, the Delaware Chancery Court explained that "[c]urrent Delaware law does not require the board to shut down Athilon's business and manage toward a near-term dissolution for the benefit of creditors. Notwithstanding a company's insolvency, [t]he directors continue to have the task of attempting to maximize the economic value of the firm." Importantly, the court held that the "dual fiduciary" status of certain board members did not eliminate the protection of the business judgment rule.

Thus, the court noted that while three of the directors "faced the dual-fiduciary problem," if "the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict of interest." This concept prevails even for dual fiduciaries of an insolvent company and its controlling stockholder, where "the interests of the primary residual claimants (the creditors) diverge from those of the equity." The court upheld applicability of the business judgment rule in this dual-fiduciary context when "business decisions…generally affect the value of the entity as a whole and…do not confer specific benefits on the directors themselves or, in dual-fiduciary situations, on the competing beneficiaries of fiduciary duties."

Unlike decisions that result in "direct and specific benefits" in a dual-fiduciary context, "when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others."

The court emphasized that generalized allegations of "conflict of interest" will not suffice. Rather, "[t]here must be specific allegations and later, actual evidence sufficient to permit a finding that the director faced a conflict or acted with an improper purpose on the facts of the case."

Applying these principles, the court held that Quadrant did not rebut the business judgment rule "by alleging that the board has decided to pursue a relatively more risky business strategy to benefit its sole common stockholder, EBF." Even though Athilon was "insolvent, and although the directors are dual-fiduciaries, the board does not face a conflict between the interests of the primary residual claimants (the creditors) and the interests of secondary residual claimants (the stockholders)….Under this court's precedents, the directors are not deemed conflicted on the theory that a riskier business strategy will benefit [controller] EBF and harm Athilon's creditors."
However, in contrast to the directors' adoption of a business strategy intended to benefit Athilon as a whole, the court declined to dismiss Quadrant's claims based on several direct and specific transfers to EBF. For example, the board decided not to defer certain interest payments owed to EBF, and because EBF owned 100 percent of Athilon's equity, this meant that "funds flowed from the company to EBF" and EBF squarely "stood on both sides of the transaction." Unlike an effort to benefit an entity as a whole, such a transfer "does not inure to the ratable benefit of all of the residual claimants." Athilon's payments of certain service and license fees to an EBF-owned entity also sufficed to state a claim because they too were a direct diversion of value to EBF.
On reconsideration of the dismissal, the Quadrant court adhered to its ruling.[6]

Implications

A person from an investment firm who is appointed to serve on the board of that investor's portfolio company needs to be especially cognizant of simultaneously wearing two fiduciary hats. A dual-fiduciary director must act in the best interests of both entities. Yet meeting that touchstone may be easier said than done.

The director must carefully consider decisions for the portfolio company through that dual lens. There should be concrete, specific and articulable reasons why a board decision or action serves the best interests of both entities and does not serve differing interests. For example, where a board is considering a merger for its company, the directors designated by a major stockholder could have conflicting interests where that stockholder's shares provide rights and benefits more favorable than those afforded the company's common stockholders.

Those diverging interests present a conflict, and decisions regarding the merger then might not be evaluated under the business judgment rule, instead coming under the much more demanding "entire fairness" test.[7] In short, while holding dual (or even multiple) fiduciary positions involving a Delaware corporation is not prohibited, the fiduciary must be especially attuned to any possible conflict that could arise from his decisions and actions.

Where a dual fiduciary faces an insolvency situation, scrutiny can be especially intense. It is perhaps too easy to point the finger at a dual fiduciary when finances go bad and difficult decisions must be made to keep a business afloat. Did the decisions truly advance the interests of the portfolio company in distress and not favor the fiduciary's investment firm? *Quadrant* at least provides a framework for evaluating decision-making in this murky world.

To assure that the best interests of the troubled portfolio company are really advanced, the key inquiry is whether a suspect decision affects the value of the entity as a whole—in other words, is it a bona fide effort to improve the financial condition of the entity for the benefit of all constituencies, not just one that will favor a specific stakeholder or one stakeholder-group? If the decision can be seen to benefit the fiduciary's other beneficiary, a conflict will be perceived, putting the fiduciary at risk and permitting the decision to be challenged. Significantly the protection of the business judgment rule might be lost.

While the conflict should be "clear" to be improper, clarity may be in the eye of the beholder intent on asserting a claim. The bottom line is that while a dual-fiduciary director can bring real value to a business, the director must take great care not to cross the line by making conflict-laden decisions that could be a basis for litigation.

Endnotes:

1. See *In re Nine Sys. Corp. Shareholders Litig.*, 2014 WL 4383127, at *29 (Del. Ch. Sept. 4, 2014).
2. *Weinberger v. UOP*, 457 A.2d 701, 710 (Del. 1983).
3. Id. at 710-11.
4. *North Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007).
5. 102 A.3d 155 (Del. Ch. 2014) (Laster, V.C.), reconsideration denied, 2014 WL 5465535 (Del. Ch. Oct. 28, 2014).
6. 2014 WL 5465535, at *1 (reiterating "the principle that when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others").
7. See, e.g., *In re Trados Inc. Shareholder Lit.*, 2009 WL 2225958 (Del. Ch. 2009).

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