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## Who Do Directors Represent?

In companies with venture capital financing, the venture investors usually have a right to designate one or more directors. Indeed it is not uncommon, when companies have gone through multiple rounds of venture financing, to see boards where a majority of the directors are elected by the venture capital investors.

Many entrepreneurs, and even a few VCs, assume that “VC Directors” represent the interests of the venture capitalists who elected them. An understandable assumption, perhaps, but in fact that is not the case. All directors, no matter who elected them, are legally obligated to represent the interests of all of the equity owners of the company. (In fact, when companies are in severe financial distress, directors can find that their fiduciary obligations extend to creditors as well, but I’ll leave that for another time.) By way of analogy, just as the President of the United States represents all American citizens – those who voted for him as well as those who voted against him; indeed, those who did not or could not vote at all – a director of a company represents all of the owners of the company.

Most of the time, this legal principle has little practical import. Directors elected by the venture capital shareholders will tend to see issues brought to the board the way the people who elected them view those issues: presumably, that was why they were elected. Ditto, of course, for directors elected by common shareholders. But while there is nothing inherently wrong with that there is more to the story. Directors can take many actions the effect of which is to favor one group of shareholders over another. But a director who takes an action the purpose of which is to favor one group of shareholders over another, she is treading on dangerous ground.

Let’s look at an example and see how this plays out. Newco has gone through a round of venture financing, and Jane Doe, a general partner of the lead investor, Acme Ventures, represents the venture investors on the Newco board of directors. Newco is running low on cash, and Beta Ventures has offered to lead a new round of financing at \$2.00 per share, a healthy premium over the previous financing. Director Doe votes against taking Beta’s offer, and, the following week, Newco’s board of directors, at director Doe’s suggestion, accepts an offer at \$1.00 per share from Acme Ventures. Has director Doe done anything unlawful?

Well, in this case, the facts provide a lot of smoke, but do not go far enough to say, with certainty, that director Doe has done anything wrong. What we don’t know, on these facts, is why director Doe opposed the Beta Ventures offer. If, in fact, Doe thought the Beta offer was the “best offer” for the collective owners of Newco but voted against it with the purpose of forcing Newco to take a less attractive offer that favored the existing investors, Doe’s action would have been, well, actionable. On the other hand, if Doe, even knowing that turning down Beta’s \$2.00/share proposal would result in Acme being able to do the deal at \$1.00, had a good faith reason to believe that Beta’s offer was not, considering all terms of the offer, not just price, not the best deal for the company’s collective owners, Doe’s action would not be actionable.

None of this means that “who controls the board” is not an important variable for founders and investors alike. In most situations, the policy differences between directors elected by one group of shareholders and those represented by another group of shareholders are not going to rise to the level of compromising the fiduciary position of a director. Board control does matter. But at crunch time, when decisions are being made that will impact different ownership groups differently, every director should

remember that her actions should reflect her view of what is best for the collective owners of the company, and not for any subgroup that elected her.

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