When Do Venture Capitalists Owe Fiduciary Duties To Their Portfolio Companies?

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May 2012

In the typical venture-backed company, the Board often includes some members designated by the venture capital firms who are investors in the company. When things go awry, lawsuits often follow, and litigators are left to figure out the contours of the duties that the venture-appointed directors owed to the company and others. Problems for the VC director often arise from the fact that their interests can differ from those of the company in subtle and not-so-subtle ways.

For the most part, of course, the VC firm, its appointed director, and the company all share a common goal: for the enterprise to make enough money for everyone to do well. It's when the enterprise starts to falter that interests may diverge. For example, preferred shareholders (often the VC investors) may want to cut their losses and get some portion of their capital back, while common shareholders usually prefer to hang in there until the bitter end. This puts the VC-appointed director in a tough spot: as a director of the company, s/he likely has fiduciary duties to the entity and the shareholders as a whole (depending on the type of entity and the applicable state law), but as a partner or stakeholder in the VC firm that appointed him, s/he may be inclined to do what works best for the VC firm.

VC-appointed directors in these circumstances may be tempted to rely on the entity agreements (such as the Operating Agreement in a Limited Liability Corporation or LLC) that set forth "contractual rights" (for example, to a liquidation preference) that might appear to trump any fiduciary duties they might have. That may not be as safe a haven as one might think. In a recent case that I handled, for example, a former Justice of the Delaware Supreme Court and a distinguished law professor disagreed, as competing experts, over whether a majority shareholder owed fiduciary duties that constrained his exercise of a contractual "blocking right" over new financing. The case settled before a judge or jury could decide the issue, but the point is that it was open to debate on the facts of that particular case.

So what is a VC-appointed director to do when facing a potential conflict between their role as a director of the portfolio company and their role as a member of a VC firm? The first step is simply to appreciate the situation. Whenever you find yourself making an important decision and wondering "which hat" you are wearing in considering alternative courses of action - the company's or the VC firm's -- it is time to pause. The second step is get advice, preferably legal advice covered by the attorney-client privilege.

Making the right decision often requires sorting through a variety of considerations, such as the type of entity involved and what law applies. LLCs under Delaware law - a common structure for VC investments -- are generally creatures of contract, but the Delaware Court of Chancery held in two recent cases (*Auriga Capital* and *Bay Center Apartments*) that fiduciary or fiduciary-like duties may be implied. Thoughtful consideration of the specific facts is often warranted: for example, the situation may be different if the VC-appointed director is also a majority shareholder, or if the director has effective control of the Board.

Most problems can be solved by disclosure, compromise, or by building a paper record that shows diligence and fairness in making a decision...but it can take some thought to get there.

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