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'Fiduciary tailoring' of the duty of loyalty to a Delaware corporation is blessed by Court of Chancery

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"Fiduciary tailoring" may be the buzz words that permit Delaware corporations to control the exposure of their fiduciaries to claims of breach of fiduciary duty, including the duty of loyalty. At a minimum, Vice Chancellor Laster set forth an invaluable roadmap for dealmakers seeking to limit exposure to claims by certain disgruntled shareholders in *New Enterprise Associates 14, LP v. Rich*.[1]

VC Laster concluded that fiduciary duties of officers and directors were not "immutable" under Delaware law.

The decision provides guidance to parties about how to resolve prospectively the frequently thorny interaction between fiduciary duties and the inter-class incentives between private company founders, employees and early investors, and later round preferred stock investors (in their roles as both investors and, typically, controlling directors).

After reviewing Delaware law about trusts, principal-agency, the Delaware General Corporate Law, and the common law, VC Laster concluded that fiduciary duties of officers and directors were not "immutable" under Delaware law.

Drawing on the Delaware Supreme Court's 2021 decision that shareholders can forego their appraisal rights, VC Laster concluded that Delaware recognizes "more space for fiduciary tailoring" and "greater limits on fiduciary accountability than is generally recognized" in a contract between the company and some of its shareholders.

Specifically, although a corporate fiduciary's duty of loyalty cannot be eliminated, VC Laster concluded that sophisticated parties may contract to modify the orientation and scope of the fiduciary's obligation — to the point of eliminating the duty of care entirely and the duty of loyalty in all circumstances other than breaches in bad faith or from intentional misconduct.

The plaintiffs were the seed-round investors (Seed Investors), managed by "sophisticated" venture capital funds. They backed Fuege, Inc. for more than six years before demanding the company pursue a liquidity event. After a fruitless six-month search for a buyer, Fuege needed capital, so the company pivoted to a recapitalization. Management determined that a recapitalization led by George Rich was the best option.

Rich's terms were tough, including — among other points — converting the seed-round equity to common stock, issuing new preferred stock to Rich and his fellow investors, and an agreement by the Seed Investors to participate in a drag-along sale if approved by the new preferred stockholders, and to sign a covenant not to sue for claims arising from the drag-along sale. The Seed Investors declined to participate in the recapitalization but agreed to Rich's terms.

Within months of the preferred stock round closing, an opportunity to sell Fuege materialized. Rich and his fellow investors realized a return of nearly 750% on their investment, while the Seed Investors were heavily diluted. Notwithstanding their covenant not to sue, the Seed Investors sued Rich and the other directors for breaching their duty of loyalty.

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Among other claims, the Seed Investors asserted that the waiver of the duty of loyalty was facially invalid. VC Laster disagreed; his analysis provides guidance for future deals.

Here are the key lessons:

- Waivers and limitations on fiduciary obligations not permitted in charter documents (including bylaws) are allowed in shareholder-level agreements. The decision reflects more than 20 years of evolution in Delaware's understanding of fiduciary obligations in corporations; VC Laster's conclusion would have been unthinkable in 2000.
- For such "private ordering" among shareholders, "sophisticated parties" means something different than does accredited investor status. VC Laster noted that the drag-along sale provision was cribbed from a model agreement issued by the National Venture Capital Association — to which organization at least one of the Seed Investors belonged. The Seed Investors were "dominant incumbents" on the cap table. Employee

shareholders and retail investors may not "tailor" a director's fiduciary duties.

- The Seed Investors and Rich negotiated the terms of the recapitalization. Each term was material to one side or the other's agreement. The Seed Investors declined to participate in the recapitalization. VC Laster's decision recognized the benefits of resolving the potential conflict between the fiduciaries' responsibility to different classes of stockholders and concluded that Delaware law permits sophisticated parties to "tailor" and "limit" the fiduciaries' duties by private contract, notwithstanding DGCL's prohibition against doing so in the corporate charter or bylaws.
- The terms of the recapitalization listed eight criteria that had to be satisfied for the drag-along sale (and the covenant not to sue) to take effect. Drawing on Delaware trust law, VC Laster concluded that the more detail included, the better.
- Rich and his fellow investors participated as buyers in the drag-along sale, a point they had not included in the terms of the recapitalization. The Seed Investors could have better protected their interests had that point been included as a ninth criteria.
- A covenant not to sue operates differently from a release. The covenant is an agreement to forebear from exercising a right as opposed to a discharge of liability. In the recapitalization, the covenant covered only claims arising from the drag-along sale. The more narrowly tailored the covenant, the more likely it is to be considered reasonable.

VC Laster disclaimed the broad applicability of his decision several times; however, given the expense of suing for breach of fiduciary duty, we suspect VC Laster's roadmap will prove a formidable weapon for fiduciaries to limit their exposure to claims from the parties most likely to have the motivation and resources to bring such claims.

Notes

[1] C.A. No. 2022-0406-JTL (May 2, 2023).

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