REPRINT

CD corporate disputes

RESOLVING BOARDROOM DISPUTES

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corporatedisputes@financierworldwide.com

MINI-ROUNDTABLE

RESOLVING BOARDROOM DISPUTES

PANEL EXPERTS

Ethan A. Klingsberg
Partner
Cleary Gottlieb Steen & Hamilton
T: +1 (212) 225 2588
E: eklingsberg@cgsh.com

Ethan A. Klingsberg is a partner based in Cleary Gottlieb Steen & Hamilton's New York office. His practice comprises M&A, public company board of directors, corporate and SEC matters. Repeatedly named as a 'BTI Client Service All-Star' based on the survey of general counsels of the Fortune 1000 and 'Most Valuable Practitioner' in M&A by Law360, Mr Klingsberg is recognised as one of the country's leading corporate lawyers.

Ryan Mowat
Partner
Kingsley Napley LLP
T: +44 (0)207 357 1238
E: rmowat@kingsleynapley.co.uk

Ryan Mowat is a partner in Kingsley Napley's Dispute Resolution Practice. Mr Mowat has a broad litigation practice including boardroom disputes, commercial contract disputes, professional negligence, contentious trusts and probate, defamation and privacy and civil fraud. Mr Mowat is an accredited mediator and a member of the Alternative Dispute Resolution Group (ADR Group) panel.

Paul J. Lockwood
Partner
Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (302) 651 3210
E: paul.lockwood@skadden.com

Paul J. Lockwood engages in securities litigation in Delaware and throughout the country. He defends corporations, their directors or their advisers in derivative and class action lawsuits relating to accounting issues, mortgage-backed securities, proxy contests, public offerings, and mergers and acquisitions. Mr Lockwood has also litigated disputes concerning bond indentures, partnerships, joint ventures, trusts and LLCs.

CD: Reflecting on the last 12-18 months, could you explain some of the recurring causes of board disputes?

Mowat: Board disputes commonly arise in owner-managed companies, where directors are also shareholders. A party can wear different hats as a shareholder and a director, and they can act differently according to which hat they are wearing. This is bound to lead to conflicts within some companies, especially as a board can be made up of a group of diverse and independently minded people. We commonly find that board disputes also arise because of a lack of clarity about the roles of the board and management, and because of poorly drafted articles and shareholder agreements. In many cases, smaller and mid-sized companies do not even have shareholder agreements, which is a recipe for problems when disagreements arise. Disputes ought not to come as a surprise. In 2013, CEDR and the IFC Corporate Governance Group conducted a global survey of 191 directors and board members, which revealed that 29.6 percent of respondents had experienced a boardroom dispute which affected the survival of an organisation and 42.8 percent reported that conflict had reduced the level of trust between board members.

Lockwood: Board disputes most often arise when there are pre-existing factions within the board. For example, disputes can arise between board members representing a minority private equity investor and management. Another frequent source of board disputes is when an activist investor has obtained board representation. Disputes also arise when the board of a public company loses faith in the founder.

Klingsberg: In a long-term, low-interest rate environment, there is increased pressure on corporations from institutional stockholders, together with their friends at activist hedge funds, to force short-term returns. This backdrop leads to several developments that may have toxic chemistry – incumbent directors are compelled to deviate from the ordinary course strategic plan, boards refresh their own composition and their management teams more regularly, and there's an increased presence on boards of 'outsiders' recommended or nominated by, or sought out to pacify the potential threat of, activist stockholders. These developments can destabilise the dynamics within the boardroom if not managed correctly by management and advisers.

CD: Have any high-profile board disputes caught your attention recently? What does the nature of these cases tell us about boardroom culture and behaviour?

Klingsberg: The board of Morgans Hotel had an ugly situation. The board marginalised one director,

who was from an activist fund. The director not only asserted a successful claim, but was able to obtain court-ordered access to the internal communications of the board's counsel on the grounds that these lawyers were his counsel, even though, in fact, they were working with the other directors to exclude him from board processes. Another awkward one was the resignation of Justin King from the Staples board following the decision to add a new director in response to demands by the activist, Starboard. Psychoanalysing why these disputes arose is hard to do second-hand; but I can tell you, from first-hand experience, that such disputes are regularly avoided by making each director feel well-informed and integrated and by giving them sufficient time to engage in a constructive dialogue with management, outside counsel, and their fellow directors.

Mowat: Unfair prejudice petitions are frequently used as the weapon of choice for minority shareholders wishing to extricate themselves from a company on the best possible terms.

In *Arbuthnott vs. Bonnyman* and others the claimant owned shares in a company. Other shareholders formed a corporate vehicle, by which they sought to acquire all shares in the company. All members of the company except the claimant accepted the offer. The claimant brought proceedings, contending that unfair prejudice had occurred, including that the company had sought to appropriate his shares at a gross undervalue. His claim was dismissed. The Court of Appeal set out principles as to the conditions for an effective challenge to an alteration to a company's articles. The respondent shareholders were acting in the best interests of the company as a whole when changing the articles to make them clearer and more consistent. The changes had been for the benefit of the company, even if the shareholders did not benefit. In the case of *Judge vs. Bahd* an unfair prejudice petition was granted where a director-shareholder had been unfairly excluded from the management of two companies which had been run as a quasi-partnership, and there had been no offer to acquire the petitioner's shares at a fair value.

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CD: What are the benefits of establishing an orderly dispute resolution process in anticipation of a potential board disagreement?

Lockwood: An established dispute resolution process that all of the directors accept as fair can provide for greater confidentiality and allow the board to control the message delivered to shareholders and other members of the public about the dispute. The difficulty is persuading the party that 'loses' the dispute to maintain their belief in the fairness of the process. Developing a dispute resolution process before the dispute arises may increase the chances that directors will recognise the fairness and impartiality of the system. A process developed mid-dispute is more likely to be perceived as an exercise in blackballing the disfavoured directors.

Mowat: Having an ADR framework in place to resolve boardroom disputes can help the parties avoid adversarial litigation that is highly damaging to the company's performance, reputation and value. According to CEDR's survey, 61.2 percent of boardroom disputes were resolved by internal negotiation and 25.2 percent by mediation. This reinforces the view that litigation ought to be the last resort whenever a boardroom dispute arises. If there are dispute resolution provisions in the shareholder agreement or other documents which govern the company, those provisions should be followed.

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Ryan Mowat, Kingsley Napley LLP

Klingsberg: Dispute resolution processes are useful for joint ventures among a small number of parties. But for publicly listed corporations with lots of constituencies, you're in trouble if you are going to rely on a clunky, dispute resolution process. Management and advisers have to be proactive in dealing with directors, including one-on-one, in a flexible manner. Getting independent directors of a publicly traded company to coalesce is a delicate art.

CD: To what extent can potential board-level problems be identified early so that serious disputes might be avoided?

Klingsberg: Foreseeing the issues that may divide the board is the responsibility of management and outside advisers to the board. Even the sudden and aggressive presence of an activist stockholder can be anticipated. At the end of the day, if the board is united around a well-understood strategic plan, then everything in that boardroom is going to work more smoothly. Management and advisers have to be sensitive to the risks that the directors, as well as stockholders pressuring directors, will lose confidence in the strategic plan. The solution is for management and their advisers to keep doing their homework to improve the plan and work with the board to maintain their confidence.

Mowat: Boardroom disputes can often be avoided if the parties have defined the roles of the board and management clearly and have implemented an orderly board process. Many disputes arise because of a lack of information being supplied to all directors and shareholders, which again is avoidable with the proper measures in place. Companies can lay down a framework for resolving disputes to include any or all of internal negotiation, mediation or arbitration.

Lockwood: Giving each director an opportunity to voice concerns may help to head off potential disputes or at least bring them out in the open. Where a director is advancing the agenda of a group or faction with rights to board representation, often direct negotiation with that shareholder group can also head off a board-level dispute.

CD: Do any particular steps need to be taken if the CEO of a company happens to be the source of a dispute?

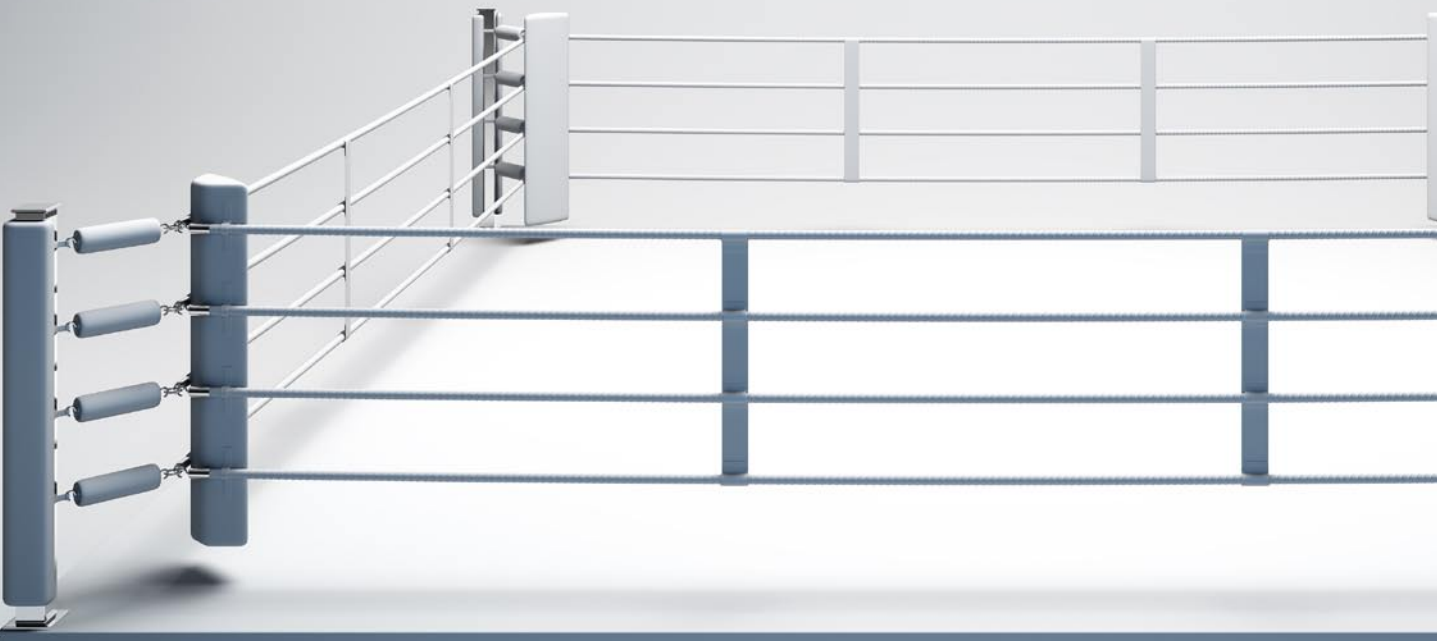
Lockwood: The case law of the Delaware Court of Chancery is filled with examples of boards which acceded to a dominant CEO and were thereafter subject to criticism and litigation. Where the CEO is a source of a dispute, the independent outside directors have to take a lead role in resolving the dispute. Where appropriate, the independent board members should form a committee and hire their own advisers to ensure their independence from the CEO. The independent directors also need to establish a means of acquiring information from other members of management without interference from the CEO.

Klingsberg: Every board of a US public company these days has regular 'executive sessions' where management is not present. This would be the right forum for working out issues where the CEO is causing unconstructive disruption in the boardroom.

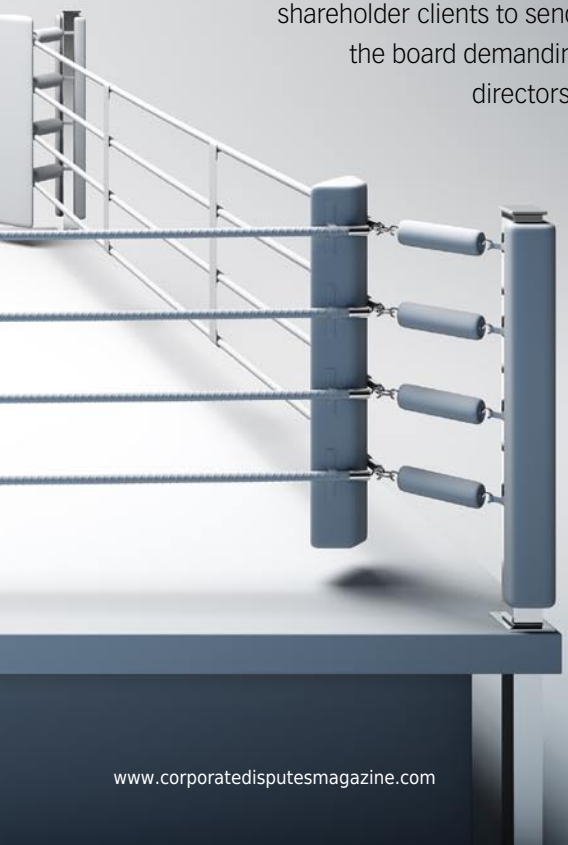
Whenever possible, we prefer to have executive sessions solve these types of issues, rather than forming special committees, the mere of existence of which signals that there is a problem or conflict that is irreconcilable and disabling.

CD: What should a company, or an accused individual, do if there is an allegation or suspicion of fraud at board-level?

Klingsberg: Serious allegations of fraud at the board-level will likely require a committee of disinterested directors to figure out what happened and the impact. The company needs to consider informing the auditor, public disclosure obligations, litigation risks and the impact on financial statements and relationships with lenders, commercial partners and regulators. Get the facts, act quickly and minimise uncertainty.



Lockwood: The board has an obligation to conduct an independent investigation of allegations of fraud at the board-level. Depending on the circumstances, an investigatory committee may be formed or, at the very least, the accused individual should recuse himself or herself from the investigatory process. But there is no 'one size fits' all response to accusations against a director. A board should take accusations of fraud by directors seriously, but the company need not spend millions of dollars and thousands of hours investigating every allegation. For example, it has become a common tactic for plaintiffs' lawyers and their shareholder clients to send letters to the board demanding that the directors investigate and sue certain directors or officers for purported wrongdoing. Oftentimes, these allegations are based on nothing more than poorly sourced media reports. In these circumstances, a review of the allegations by counsel to determine whether any purported wrongdoing is ongoing followed by a cost/benefit analysis of the requested litigation may be the sufficient information for the board to determine that the matter requires no further action.



Mowat: If there is an allegation or suspicion of fraud at board-level – or in the company generally, one of the first priorities ought to be appointing external lawyers. Ideally, the investigation and team of people dealing with the case at the company should be limited as far as possible, especially until such time as it is clear who in the company might have been involved in the fraud. The external lawyers will probably need to advise in respect of at least litigation, criminal and employment issues, and evidence will need to be preserved pending an investigation. It is likely that one of the first steps will be to review the email accounts and devices – if possible – of those under suspicion, but every case is fact specific.

CD: What advice can you offer to companies and individuals on managing their reputation in the face of allegations published either by the press or disseminated through social media?

Lockwood: It is important for counsel to be cognisant of publicity and the company's overall public messaging objectives, but not to displace the company's existing media relations expertise. Companies should strive to integrate their legal strategies with their media strategies while maintaining applicable privileges.

Mowat: The press have become increasingly interested in businesses and the individuals running them. Focusing on senior management individuals personally gives colour and spin to a story, and is no longer reserved for celebrities and politicians. Prevention is better than cure, so companies need to ensure that their internal policies protect them in the face of a crisis. Employees should be aware of good email and social media disciplines that are company friendly and staff should be trained to understand confidentiality even when using personal social media. Care should be taken particularly in contentious situations, especially if there is potential media appeal. Companies should have a crisis management system ready, and a good PR who can liaise with the lawyers, and never react to a press enquiry in a knee jerk way. In a pressured situation it is easy to make the wrong call. Before doing or saying anything, it is important to get professional external advice.

Klingsberg: Often the allegations in the press or social media are by a stockholder trying to force a change in the board's approach to balance sheet management or strategic alternatives and using claims of board entrenchment and self-dealing to intimidate the directors to make the changes that the stockholder is seeking. In these cases, the directors need to keep the focus on the substantive issues of whether they are doing right by the corporation from a strategic perspective and to make sure management is adequately explaining to the market the justifications for the board's substantive decisions and chosen direction for the corporation. By placing a greater focus on this substance, the potential damage caused by reputational mud-slinging is significantly diminished.

CD: In what circumstances should ADR techniques be considered when problems are identified?

Klingsberg: ADR can work for a closely-held, private joint venture, but a public company board needs to be managed delicately and artfully, not through ADR mechanics, to maintain stability.

Lockwood: Traditionally, ADR comes in two forms – nonbinding mediation and binding arbitration. The use of a skilled mediator is often helpful in resolving all types of corporate disputes, including board-level disputes. On the other hand, in my experience, arbitration for board-level disputes is rare. The primary benefits of arbitration are confidentiality

and speed. Confidentiality, however, may be hard to achieve for public companies because board disputes, or at least their outcome, will most likely need to be disclosed to shareholders. The advantage of speedy resolution through arbitration also applies less clearly to board disputes because courts, especially in Delaware, understand the need to promptly resolve these disputes.

CD: How should parties respond if a board-level dispute does progress to litigation? What factors might determine the best course of action to take?

Mowat: If the litigation is effectively a dispute between the shareholders, such as an unfair prejudice petition, the parties will need to fund the costs of the litigation themselves – and not through the company. This is often not understood by parties embarking on unfair prejudice litigation. As a priority the parties ought to be focusing on what they want to achieve from the litigation, personally and for the company. Typically, the aggrieved party is unhappy about being excluded from the management of the company or about the way that the company is being run. If those grievances cannot be resolved by agreement then, in most cases, the sooner the aggrieved party receives a financial settlement in exchange for leaving the business the better. Indeed, in a vast number of cases the aggrieved party's objective is to receive a financial settlement, and therefore the parties should focus on obtaining a fair valuation for that party's shareholding as early as possible. In our experience, parties can wait too long to get the nub of these issues.

Lockwood: An important step to take before a board dispute heads towards litigation is to determine, as far in advance as possible, which lawyers represent which clients. Without careful consideration of representation issues, privileges could be lost and lawyers may be forced to withdraw from representing everyone involved. Longtime counsel for the company, for example, may need to remain neutral. In addition, where a committee has retained its own counsel, that committee counsel's

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communications with lawyers for individual directors may not be privileged, especially if the individual is a subject of an investigation. The directors and their counsel also need to be cognisant that other constituents will eventually join in the dispute. Any board-level dispute that is serious enough to give rise to litigation among the board members will also give rise to a shareholder lawsuit challenging the conduct of the directors.

Klingsberg: Once a director is suing their fellow directors, as occurred in the Morgans Hotels cases, the director is in an overt, adversarial position and the best the rest of the board can do, at this point, is to leave it to the litigators to establish that the board had been working in good faith in the past and to turn all of its energy toward making sure the corporation has in place the best forward-looking strategic plan possible and that the market understands this.

CD: What advice can you offer to companies on creating a board culture that allows for effective discussion, debate and deliberation when a dispute arises?

Lockwood: A board culture should emphasise the shared objective to serve the best interests of the company and its shareholders. In addition, it is always important to give each director access to information and the ability to express his or her viewpoint. Respecting the role of each director is especially important in the context of a potential dispute.

Klingsberg: You've got to give directors opportunities to build bridges with each other. This happens by having lots of information available, having management and advisers sketch out these bridges for directors in advance of board meetings, and having management and advisers nurture the efforts by directors to figure out ways to get to the best interests of the corporation. Sometimes counsel needs to be firm with directors to get them into line. Other times, directors all have good questions and legitimate doubts and you help turn these into solutions.

Mowat: The Chartered Institute of Arbitrators (CIArb) has launched a set of dispute board rules for use on medium and long-term projects – whether construction, IT or commercial in nature. These rules encourage setting up a board at the outset of a contract with the aim of helping parties to resolve problems themselves. The board can then choose to have powers to make non-binding recommendations or binding decisions. Although dispute boards are a form of ADR, they are considered to be different from other methods of ADR in that by being appointed at the outset, the board members become familiar with the issues as they arise. This approach

might be suitable for some companies and in any event demonstrates that there is an increasing awareness that the challenges in resolving boardroom disputes can be unique. In any event, companies really ought to have in place a framework for resolving boardroom disputes to include any or all of internal negotiation, mediation or arbitration. CD