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Of Burning Bridges and Liquidating Trusts: Enhanced Liability Risks for VCs and VC Funds Extending Bridge Loans

A federal appeals court recently handed down a chilling reminder of the risks inherent in failing to address conflicts of interest and process issues in distressed venture capital and private equity financings. In *CDX Liquidating Trust v. Venrock Associates,* No. 10-1953 (March 29, 2011), the U.S. Court of Appeals for the Seventh Circuit reversed a defense judgment and sent the case back for retrial, reviving the VC directors' exposure to fiduciary duty liability and their funds' exposure to aiding and abetting liability.

The basic contours of the story are all too familiar to anyone who navigated the shoals of the tech meltdown of 2000 – 2002:

Cadant Inc. was an early-stage company that developed cable modem systems for high-speed Internet access to the home. Venrock and J.P. Morgan ("the VCs") were among its backers, having provided preferred stock financing in early 2000. By the fall of 2000, Cadant, like many technology companies, was in distress. The board considered a financing proposal from an outside investor group as well as a joint proposal from the VCs. Cadant chose the latter. In January 2001, the VCs provided an $11 million bridge loan with a 90-day term and a 10-percent annual interest rate. Cadant consumed those funds in a matter of months, and the VCs provided a second, $9 million bridge that included a 2X liquidation preference.

At the time of the loans, Cadant had seven directors. Four had originally come from the VCs. There is no indication that the other directors were constituted as an independent committee or had independent legal or financial advice. Instead, they reportedly had Eric Copeland, a Cadant director and Venrock principal, handle negotiations on Cadant's behalf, even though Mr. Copeland had an inherent conflict of interest. The Court describes the three independent directors as "engineers without financial acumen … [who] were at the mercy of the financial advice they received from Copeland and the other conflicted directors."

Ultimately, Cadant defaulted. In dire straits, Cadant agreed to sell all of its assets for stock then worth $55 million — sufficient to satisfy Cadant's creditors and preferred stockholders, but insufficient to leave anything for the common stockholders. Cadant filed for bankruptcy, and a liquidating trust holding Cadant's common stock pursued claims against the VC directors and their funds. While the trial court granted the defendants judgment at the close of the plaintiff's case, the Court of Appeals reversed, sending the case back for a second trial — nearly a decade after the events at issue.

Putting to one side the trial practice aspects of the Court's decision, both VC and non-VC directors can draw a number of practical lessons from it.

- **Address Board-Level Conflicts of Interest.** First and foremost is the critical importance of identifying conflict of interest issues at the board level and implementing processes to address them — particularly in distressed situations, where resources and options are, by definition, constrained. An important point in the Court's analysis was the fact that the non-VC directors did not step forward to act independently for the corporation, in light of the presence of conflicted directors.

- **Avoid "Sitting on Both Sides" of the Transaction.** Of equal importance was the Court's view that the VC directors used their positions to "act disloyally" — sitting on "both sides of the table" and obtaining terms favorable to them and harmful to Cadant and its common stockholders. These acts included using their knowledge that the disinterested directors would accept smaller bridge loans with shorter terms than the VCs would have expected and obtaining a 2X liquidation preference. In the Court's view, these terms weakened Cadant's ability to bargain with potential buyers by keeping Cadant's runway short and reduced the likelihood that the common stockholders would receive anything.

- **Mere Disclosure of a Conflict Is Not Enough.** An important detail the Court emphasized is that the mere *disclosure* of a conflict of interest does not absolve a director from liability for a subsequent breach of duty. In this case, the VC directors' inherent conflict of interest was obvious and well known; the fact that the conflict was disclosed did not mean, however, that the VC directors could proceed to sit on both sides of the bargaining table and be immune from suit.

- **Prepare for Funds to Be Sued.** Increasingly, VC funds are sued as "deep pocket" defendants, especially in distressed situations where portfolio companies often lack funds to pay indemnification and lack adequate (or any) D&O insurance. Here, the VC funds were claimed to have "aided and abetted" the directors' breach of fiduciary duty. The twist is that the Court treated the funds as third-party lenders, not company insiders, and stated that they could be held liable if they, knowingly, either exploited the directors' conflicts of interest or extracted terms that required Cadant to prefer their interests at the stockholders' expense. Funds should consider how they will approach and handle such exposure, including the possibility of obtaining insurance or establishing reserves.

- **Prepare to Prove Fairness.** Much of the Court's decision involves a tangle of issues having to do with what initial proof a plaintiff must make before the burden shifts to the defendants to prove transactional fairness — that is, fair process and price. Putting the details aside, the core point is that in fiduciary duty cases, there is always risk that defendant directors and funds could, at some point, be saddled with the burden of proving fairness, and the time to lay the groundwork for that is when the deal is happening and the process can still be shaped. In such cases, the goal is to emulate an arms' length negotiation process, with disinterested directors making decisions on the corporation's behalf.

- **Watch Out for "Inside-Out" Economics.** A final observation is that the claims in this case are being pursued by a liquidating trust, a creature of bankruptcy formed just for this purpose, without which the claims may not have been pursued at all. These trusts are typically funded by assets transferred from the bankrupt company's estate — assets the VCs might have thought to be theirs, at least in part. In the absence of insurance coverage or indemnification, VCs may find that they are effectively funding, in whole or in part, both sides of an otherwise non-viable lawsuit against them.

The decision in *CDX Liquidating Trust* marks another point in the trend toward increased judicial scrutiny of deal terms and processes in venture capital and private equity transactions. Like the much-publicized decision of the Delaware Court of Chancery in *In re: Trados Incorporated Shareholder Litigation*, No. 1512-CC (July 24, 2009), *CDX Liquidating Trust* reinforces that special care should be taken in distressed financings and subsequent exits, particularly where the VCs may stand to recover their investment (albeit with little or no gain — scarcely the business they are in), but the common stockholders may take nothing.

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