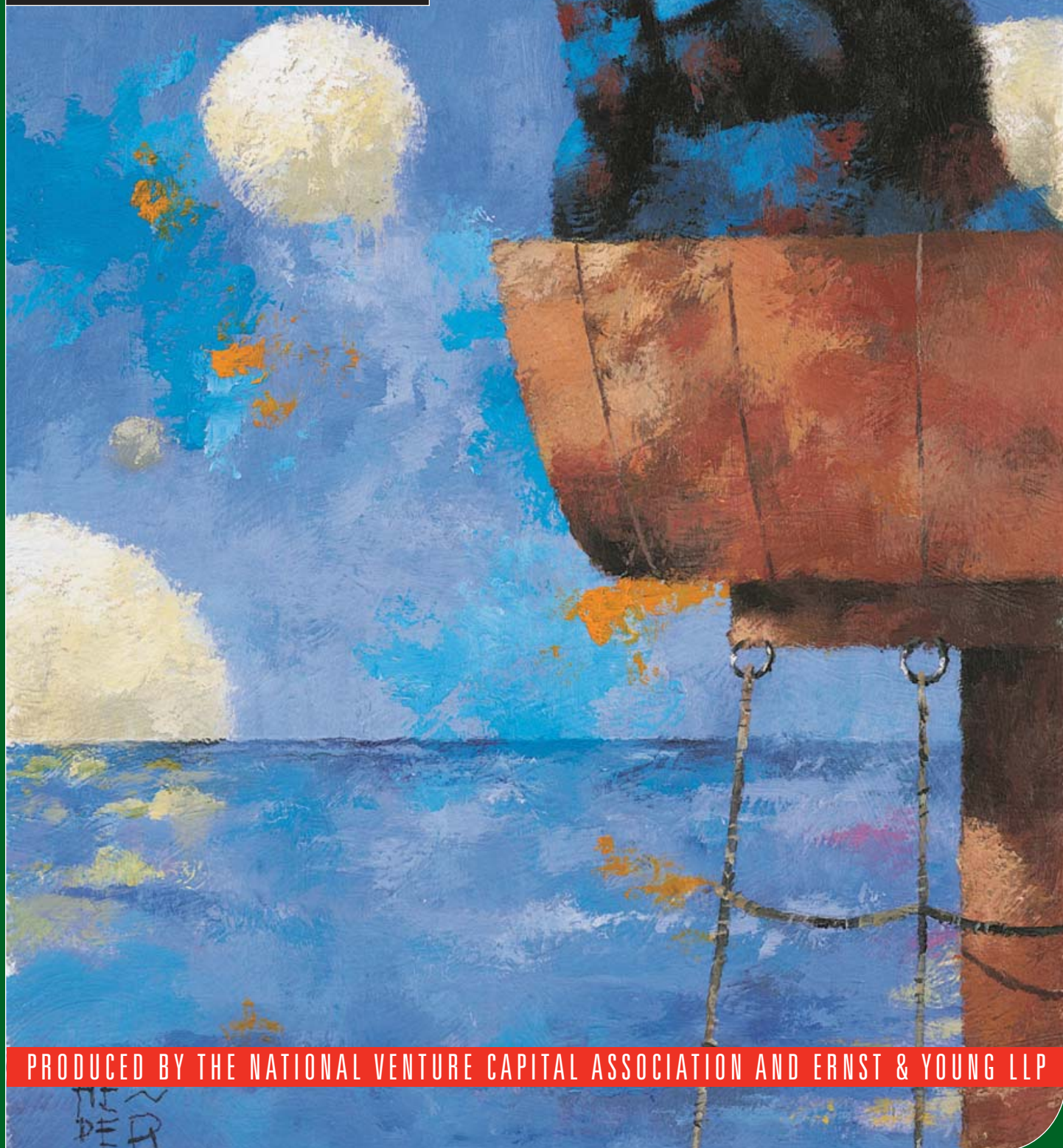


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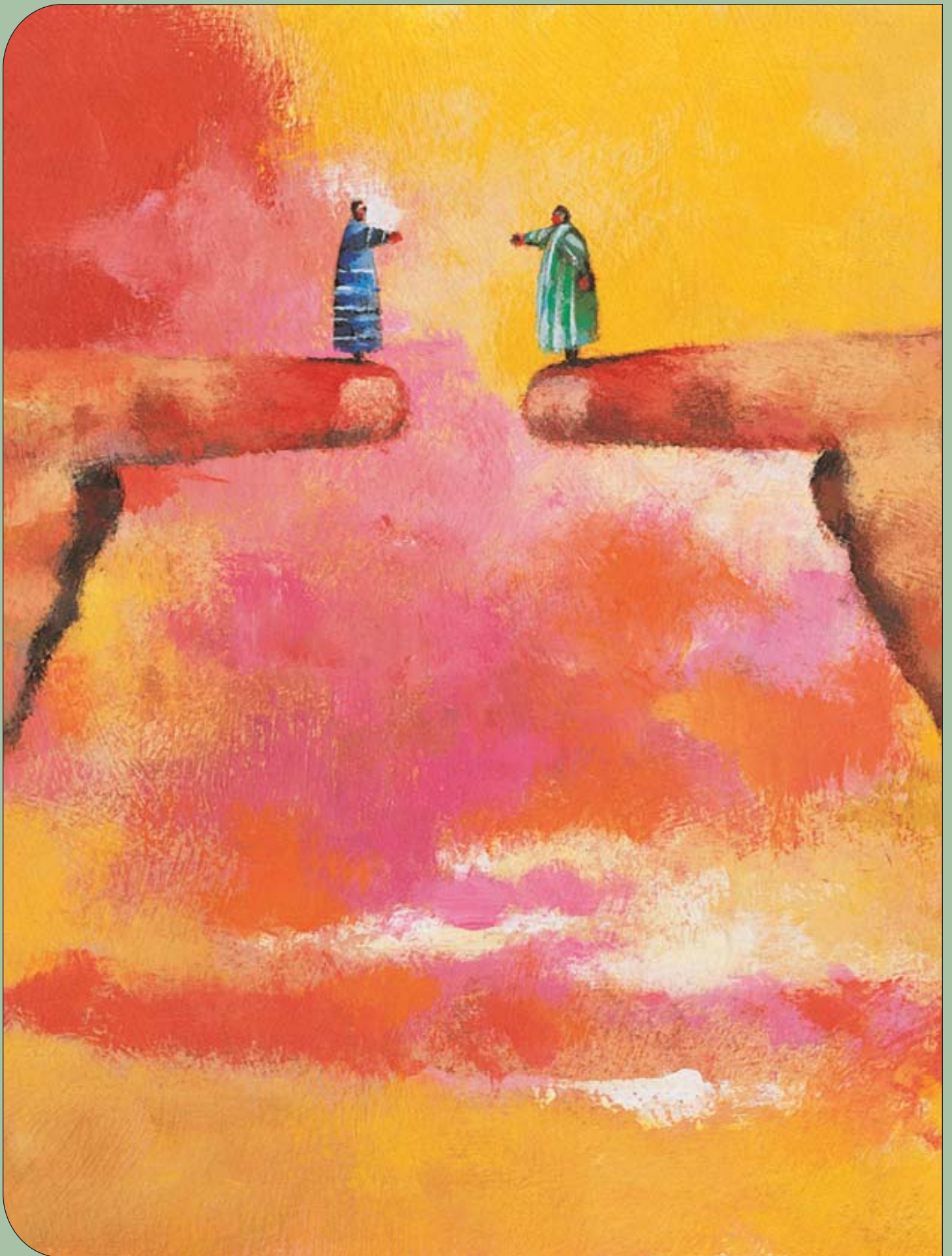
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# Distressed Companies In Distressing Times: Managing Board Risk

BY  
TREVOR J. CHAPLICK  
AND  
MICHAEL J. ALBUM

The current credit crisis has triggered a global recession of a magnitude not seen in decades. A cycle of deleveraging has severely depressed aggregate demand and economic activity. While a significant number of businesses have been forced to restructure or liquidate, the severity of the downturn unfortunately may claim many more companies. The board of a financially troubled company faces difficult decisions in this environment including terminating employees, recapitalizing equity, restructuring debt, financing or selling the business, or in the worst case, filing for bankruptcy or liquidating the business. Directors should proceed with caution as these decisions can precipitate litigation from a number of different parties. A clear understanding of the risks and appropriate process can dramatically minimize the personal exposure of directors.

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The purpose of this article is to provide a primer for directors of companies that are experiencing financial distress. The article summarizes the fiduciary duties and obligations under Delaware law<sup>1</sup> owed by directors of corporations that are insolvent and nearly insolvent, as well as the practical risks that can exist in such context. The article then suggests certain best practices for directors to satisfy their duties and limit their personal exposure, including in connection with (i) insolvencies, and (ii) dilutive financings and recapitalizations. Finally, the article discusses employment-related risks in the foregoing context and suggests certain measures to limit risk.

## Duties and Obligations of Directors to Shareholders and Creditors.

### Fiduciary Duties of Directors – The Basics.

Directors owe fiduciary duties to the corporation they serve and to its stockholders. The primary fiduciary duties are the duty of care and the duty of loyalty.<sup>2</sup> To satisfy the duty of care, directors must exercise the requisite degree of care in the process of making decisions, and when delegating authority. Taking adequate care to become sufficiently informed and taking sufficient time to deliberate before making decisions are central to the duty of care.<sup>3</sup> Courts have generally not found breaches of the duty of care absent gross negligence.<sup>4</sup> The duty of loyalty requires that a

director act in good faith in the best interests of the corporation.<sup>5</sup> The duty of loyalty forbids directors from standing on both sides of a transaction and prohibits personal benefit from self-dealing.<sup>6</sup>

In general, a board that satisfies its fiduciary duties should have the protection of the business judgment rule. The requisite elements of the business judgment rule apply to business decisions of directors who perform their duties (i) in good faith, (ii) on an informed basis and with due care in the decision-making process, and (iii) with the honest belief that their action is in the best interests of the corporation.<sup>7</sup> As both a substantive rule of law and a procedural determinant of the burden of proof,<sup>8</sup> the business judgment rule is a judicially-created presumption that directors will not be held liable and a court will not otherwise second guess the business decisions of disinterested directors.<sup>9</sup> The initial burden of proof in such litigation will be on the plaintiff.<sup>10</sup> Conversely, a board that fails to satisfy the required elements loses the benefit of the business judgment rule. The burden of proof in such circumstances shifts to the board to prove the fairness of its actions, and this can be difficult for directors to overcome.<sup>11</sup> In reality, whoever bears the burden of proof in fiduciary claims litigation usually loses absent a strong case.<sup>12</sup>

#### **Fiduciary Duties in the Context of Insolvency.**

The concept of insolvency has historic legal significance in Delaware. Delaware courts generally apply two tests to determine whether a corporation is insolvent: (i) an inability of the corporation to pay its debts as they become due, and (ii) when a corporation has liabilities in excess of the reasonable market value of assets held. If either of these tests is met, the corporation will generally be deemed insolvent.<sup>13</sup>

As discussed in greater detail herein, directors of a corporation do not owe fiduciary duties to creditors under Delaware law. Creditors are generally afforded protection through their contractual rights, such as financing or other agreements, and through certain laws such as fraudulent conveyance and bankruptcy law.<sup>14</sup> Accordingly, the general rule is that directors

do not owe creditors duties beyond the terms of their contractual rights.<sup>15</sup>

#### **The Zone of Insolvency – Does it Matter?**

Until recently, professionals generally advised their clients that the fiduciary duties of directors of a Delaware corporation expand to include creditors when the corporation enters into what had been referred to by lower Delaware courts as the “zone of insolvency.”<sup>16</sup> It was also an open question whether creditors could bring a direct cause of action for breach of fiduciary duty against directors once a corporation actually becomes insolvent. The law in Delaware has recently changed, but as we discuss below, the behavior of boards should not.

In *N. Am. Cath. Ed. Programming Found., Inc. v. Gheewalla*, the Delaware Supreme Court, in a case of first impression, rejected the “zone of insolvency” concept in favor of a bright-line test: creditors of a corporation that is either insolvent or solvent but operating in the “zone of insolvency” cannot as a matter of law assert a direct claim for breach of fiduciary duty against directors.<sup>17</sup> The *Gheewalla* court rejected earlier lower court decisions that implied that duties of directors expand to include creditors when the corporation enters into the “zone of insolvency.” The court held that “[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interest of the corporation for the benefit of its shareholder owners.”<sup>18</sup>

The *Gheewalla* court emphasized that when a corporation is solvent, shareholders can sue directors directly for breach of fiduciary duty, or alternatively, have standing to sue indirectly on behalf of a corporation to enforce derivative claims as the ultimate beneficiaries of any increase in value. When a corporation becomes insolvent, however, its creditors take the place of shareholders as residual beneficiaries, and therefore have standing to maintain indirect claims against directors for breach of fiduciary duties pursuant to a derivative action on behalf of the corporation. A



derivative action is an indirect claim that is brought on behalf of the corporation for the benefit of its stakeholders. Any damages awarded in a derivative suit are paid back to the corporation for the benefit of its stakeholders. The court was careful to note that insolvency does not convert derivative claims into direct claims against directors but merely provides creditors standing to assert claims against directors on behalf of the corporation.<sup>19</sup>

In short, as a result of *Gheewalla*, creditors have no direct right of action against a corporation's directors for breach of fiduciary duty, only an indirect right of action. This in turn subjects creditors to provisions in a corporation's charter that limit the liability of directors for breaches of the duty of care.<sup>20</sup>

### **Deepening Insolvency – Is It Still a Threat?**

A related issue in the context of insolvency is whether directors are vulnerable to claims that their actions caused a corporation's financial condition to worsen under a theory of "deepening insolvency." While there is no uniformly accepted, precise definition of the term, deepening insolvency is generally referred to as an injury to the corporation from the fraudulent expansion of corporate indebtedness and prolongation of the corporate existence.<sup>21</sup> The concept of deepening insolvency has been used in two ways: as an independent cause of action and as a theory of damages.<sup>22</sup> As a cause of action, claimants can seek a separate tort recovery from directors and officers, professionals such as auditors, and lenders who are alleged to have fraudulently or negligently prolonged the life of the corporation, and thereby increased the corporation's insolvency and exposure to creditors.<sup>23</sup> As a theory of damages, a claim of deepening insolvency is designed to enable a plaintiff to claim an injury beyond the amount invested in the corporation.<sup>24</sup> In other words, the practical risk to directors is increased exposure to plaintiffs who allege that the conduct of directors made a corporation's plight worse, and therefore greater damages should be awarded against the directors.

Recently, there has been much debate among the courts as to whether deepening insolvency is an independent cause of action, simply a theory of damages, or neither.

A majority of courts that have recently considered this issue have rejected the theory of deepening insolvency.<sup>25</sup> For example, the Delaware Supreme Court in *Trenwick Am. Litigation Trust v. Ernst & Young LLP* rejected deepening insolvency as an independent cause of action.<sup>26</sup>

Despite the trend against deepening insolvency as an independent cause of action, some courts are still willing to consider the concept of deepening insolvency as a theory of damages.<sup>27</sup> As a result, claims against directors for deepening insolvency may likely continue, albeit asserted pursuant to a more traditional breach of fiduciary duty claim. The specter of this potential claim, whether or not a particular court will allow it, further underscores the importance of process to ensure the availability of the business judgment rule.

### **Lessons Learned – The More Things Change, the More They Stay the Same.**

Although the Delaware Supreme Court in *Gheewalla* eliminated the concept of a "zone of insolvency" and clarified that creditors cannot pursue direct causes of action against directors for breach of fiduciary duty, these changes in the law should have little practical effect on best practices with respect to the exercise of fiduciary duties by directors of companies that are on the verge of insolvency.

First, it is often impossible or, at least impractical, to determine contemporaneously when a corporation actually becomes insolvent. Analogous to when economists identify the precise inception of a national recession, insolvency is more accurately identified after the fact. In reality, no one can know whether a company experiencing financial distress will ultimately become insolvent, and when it actually crosses that line is at best uncertain. In the context of litigation, the actions of directors are judged with the benefit of hindsight. Second, while a claim for breach of fiduciary duty by a creditor will not be allowed in Delaware against directors of a solvent corporation, it will be allowed against directors of insolvent corporations if the litigation is brought *indirectly* as a derivative action for the benefit of the corporation, assuming creditors meet their burden of proof in alleging breach.

Since directors can still be vulnerable to a claim for breach of fiduciary duty by a creditor upon actual insolvency, albeit pursuant to a properly drafted complaint in a derivative action, has anything really changed in reality that would suggest altering best practices of directors in the context of financial distress? While the law in Delaware has changed, in practice the behavior of directors should not. The practical reality is that as a company experiences greater financial distress, the risks for boards increase, whether that risk is from claims by shareholders, creditors or other parties such as employees. True, it may be harder for a creditor to maintain an action against boards for breach of fiduciary duty following the *Gheewalla* holding, but such litigation can occur in the event a corporation becomes insolvent, and it is often impossible to know in advance whether a corporation will ultimately become insolvent. Upon insolvency, creditors can still take aim against boards if such litigation is structured properly as an indirect, derivative claim. It is also important to note that the “zone of insolvency” concept, while rejected by Delaware, may still be applied by courts for corporations incorporated in certain jurisdictions outside of Delaware.<sup>28</sup>

Accordingly, in the context of insolvency, we recommend that directors should carry out their duties for the benefit of the enterprise as a whole pursuant to the requirements of the business judgment rule and as appropriate under the circumstances. Once a corporation appears to be in financial distress, directors should focus on maximizing value for the enterprise as a whole rather than for the benefit of any specific group such as shareholders. This means considering the impact of a board’s actions on creditors and other constituencies including employees. This expanded focus from shareholders to include other parties such as creditors may seem somewhat inconsistent with the language of the *Gheewalla* court. However, the practical risk of ignoring the impact of a board’s actions on creditors is that in the event of actual insolvency, such creditors can still sue directors for breach of fiduciary duty, albeit indirectly pursuant to a derivative claim. These creditor-plaintiffs will have the benefit of hindsight in second-guessing the board’s decisions.

Considering the interests of the enterprise as a whole does not mean that directors must necessarily move to shut-down mode when insolvency is imminent. The Delaware Court of Chancery recently emphasized the importance of board process in focusing on increasing overall value: “[i]t is settled Delaware law that an insolvent company is not required to turn off the lights and liquidate when that company’s directors believe that continuing operations will maximize the value of the company.”<sup>29</sup> The board should consider the circumstances and take the action it believes will benefit the entire organization. If this means taking action to continue operations, so be it. The business judgment rule will still protect directors against breach of fiduciary duty claims provided the directors act on an informed basis, in good faith and in the best interests of the corporation.<sup>30</sup> If a board can demonstrate that it met its principal fiduciary duties, the burden of proof will be on the plaintiff to overcome the presumption of the business judgment rule, regardless of whether such plaintiff is a shareholder or creditor.

To help directors navigate the current environment, we outline below specific, practical action boards should take generally to secure the benefit of the business judgment rule as well as other actions that can be taken to limit personal exposure. We then discuss best practices in two specific contexts: (i) financial distress, and (ii) dilutive financings and recapitalizations. It is important to remember that best practices will inevitably be situational. One size does not fit all, nor should it. The optimal board process must adapt to the actual circumstances and demands of the situation.

### **General Best Practices for Directors.**

It is hard enough generally to be a director, but particularly so in these challenging times. We outline in this section general best practices that directors should consider notwithstanding the state of the economy or the financial condition of the company.



### **Don't Fall Asleep at the Switch.**

If there is one single lesson from the last decade of governance failures such as Enron, it is the importance of engagement. Nothing good can come from passivity. Collegiality among board members is certainly laudable, but not at the sacrifice of direct, active involvement at the board level. While there are no fixed guidelines, certain practices are universally associated with strong boards, and in fact, are so obvious and based on common sense, that it is remarkable when boards lose sight of these practices. For example, directors should do their homework in advance of meetings to be prepared. This means they should demand that board packages not be sent out at the last minute. Directors should reserve enough time to do the work rather than skimming materials on the morning of a meeting. Following such preparation, directors should take a proactive, thoughtful role during board meetings, and if appropriate, outside of meetings. This may mean disrupting the flow of management presentations during the board meeting. It also may mean management members may not get the "air time" they want at board meetings. In fact, directors should insist that the board format not be so compacted that no cushion is available for questions and discussions. Directors should also have a clear understanding of the corporation's general business, financial performance and general liquidity such as cash flow and indebtedness. Many directors insist that management prepare "dashboards" of key metrics of company performance that can be used as a tool for comparative analysis and board discussion at each board meeting. In these currently challenging economic times, directors should establish an early warning system to detect the first signs of financial distress so that preemptive action can be taken well in advance of crisis. The general theme of all of the foregoing suggestions is that a director should not be a bystander at board meetings. Active, personal involvement by board members is essential to accountability and effective oversight. It may mean being perceived as impolite and disruptive, but that is the role directors need to play.

### **Rely on Qualified Experts but Don't Outsource the Duty of Care.**

Directors have a fundamental duty to become adequately informed before making material decisions. In an increasingly complex world, no one can know everything. Directors are entitled to, and in fact, should seek the advice of experts, including qualified bankers, counsel and other specialists such as compensation consultants. Reliance on qualified third parties is a necessary part of strong governance. Delaware even provides a safe harbor for proper board reliance on reports by management or outside experts under Section 141(e) of the Delaware General Corporation Law ("DGCL").<sup>31</sup> Although a board may rely on the advice of its advisors, it should not abdicate decision-making responsibility. Boards should treat such advice as simply that. Boards should feel free to question the reports of management or third parties, and should not necessarily feel shackled to the recommendations of experts. However, recognizing the reality that a departure from the advice of experts may create litigation risk, boards should ensure that in such circumstances there are rational and reasonable reasons for the departure. Getting a second opinion from a qualified expert is certainly a time-tested, although not exclusive, way to build such a record.

### **Remember That Process Matters.**

Good process is both a structural discipline and a wise defensive measure to demonstrate the exercise of fiduciary duties. In today's challenging environment, boards may be pressed to make strategic decisions quickly. Successful defense against fiduciary challenges requires a sound decision-making process. An unduly rushed or careless process creates exposure by increasing the risk of bad decisions. Taking the time to get relevant information, including through knowledgeable advisors, is critical for sound decision-making. Boards must also take the time to adequately deliberate once they have the right information. The materiality of the matter and the gravity of the consequences should inform the process.<sup>32</sup> Directors should also never forget that conflicts of interest may undermine if not completely jeopardize a court's willingness to defer to a board's business judgment. In addition, a duty of loyalty breach from a conflict of interest can

preclude indemnification from the corporation. Setting up structural protections such as a special committee of independent, disinterested directors in the event of a conflict of interest can avoid such landmines. The objective of managing litigation risk through a well-counseled process, however, should not overshadow the fact that following sound process is essential to making good decisions.

#### **Create an Intelligently Drafted Record.**

We live in a world where directors unfortunately have to assume that all actions will be scrutinized and second-guessed after the fact. Intelligent documentation of the record is always important. Generally “less is more” is the best approach for memorializing the written record. However, counsel should be involved to ensure sufficient detail is reflected in an intelligent manner, particularly for certain matters of significance. It is a careful balance. The record should clearly show that the directors were adequately informed and deliberated in a disinterested manner, but should exclude gratuitous information that can be manipulated in litigation.

#### **Include Indemnification Provisions in the Charter.**

In order to encourage individuals to serve as directors, Section 102(b)(7) of the DGCL permits a corporation to adopt a charter provision that limits or eliminates the personal liability of directors to the corporation or its stockholders for monetary damages for breach of a fiduciary duty.<sup>33</sup> The scope of this protection, however, is not available to limit or eliminate liability for (i) breach of a director’s duty of loyalty, (ii) acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law, (iii) willful or negligent conduct in paying dividends or repurchasing stock other than from lawfully available funds, or (iv) for any transaction in which the director derives an improper personal benefit.<sup>34</sup> Directors should confirm that the corporation’s charter includes such a provision.<sup>35</sup> Remember, however, that while the negligent director may be indemnified from personal liability, the disloyal director may not.

#### **Review Director Indemnification Agreements and Insurance Policies.**

Every director should enter into a well-drafted director indemnification agreement prior to becoming a board member.<sup>36</sup> While charter and bylaw provisions can be carefully drafted to protect current and former directors, a contractual indemnification right is prudent supplemental protection from personal monetary liability for board actions taken in good faith. These types of agreements should be coupled with adequate D&O issuance coverage, including Side A coverage, to mitigate enterprise bankruptcy risk. The corporation’s D&O policy should be reviewed annually by a qualified insurance broker and legal counsel to ensure that it is up to date and reflects market provisions.

#### **Practical Guidelines for Directors of Insolvent or Near-Insolvent Companies.**

As stated above, a board’s fiduciary duties do not change when a corporation becomes insolvent. Nevertheless, directors of financially distressed companies face certain unique problems, complicated decisions and heightened litigation risk. The following are practical guidelines for directors to minimize risk and personal liability in the event of potential insolvency.

#### **When in Doubt, Assume Insolvency.**

The determination of whether a corporation is actually insolvent is difficult. A court will assess in hindsight whether a corporation was insolvent at the time board action was taken and will judge the board’s actions from this perspective. It is therefore prudent for directors to adopt a conservative approach in their evaluation of the corporation’s current financial health and to assume that the corporation is insolvent if there is a reasonable question about the corporation’s solvency.

#### **Focus on Maximizing Value for the Corporation as a Whole.**

Once a corporation is in financial distress, directors should focus on maximizing value for the enterprise as a whole rather than for any specific group such as shareholders. This does not mean that directors must necessarily move to dissolve the corporation when insolvency appears imminent. Reduction of expenses

and efforts to raise financing may be prudent steps. However, if a business model has failed and financing is simply not realistic, directors should be intellectually honest. Reckless disregard of the realities to pursue survival at any cost is inconsistent with the directive of maximizing the value of the entire enterprise during insolvency, and can increase risks from other constituencies such as employees, as discussed below.

#### **Retain Professionals.**

Directors of financially distressed companies face unique risks and issues that are not encountered in the ordinary course. These issues can include determinations of solvency, turnaround strategies, bankruptcy, employment matters and fiduciary obligations with respect to such issues. In extraordinary circumstances, directors need to consider engaging qualified professionals with appropriate skill sets. In the event of insolvency, hiring bankruptcy counsel for initial advice is prudent. Additionally, engaging a workout consultant may also help avoid rapid deterioration of the business. It also is important for the board to receive advice on its fiduciary duties from qualified counsel, and for the record to reflect such advice.

#### **Increase the Frequency of Board Meetings.**

The prospect of insolvency should lead to greater board involvement on a more frequent basis. As a matter of good business practice, directors should embrace more active involvement under such critical circumstances. Financial distress is precisely the time when a director's experience and seasoned judgment can help a corporation. Furthermore, litigation risk inevitably increases with financial difficulties. People do not generally sue directors when a business succeeds – they sue when they lose money. In situations of insolvency, directors should recognize the heightened risk. Both as a matter of substance as well as in the interest of creating a more defensible record, boards should meet with much greater frequency during financial distress, even if such meetings need to be by teleconference or be of a shorter nature.

#### **Reserve Sufficient Cash for an Orderly Wind-down.**

In the event a corporation's business cannot be saved, directors should ensure sufficient resources are available to effect an orderly wind-down of the business and/or file for bankruptcy protection. An orderly wind-down and/or filing for bankruptcy may be necessary to minimize risks that can be magnified in the event of insolvency. The identity of such expenditures will depend on the nature of the business and the individual circumstances. Budgeting for such expenditures may avoid aggravating a situation and lessen the personal liability of directors. For example, as discussed in the final section of this article, directors can become personally liable for certain employment-related costs in the event of business failure.

#### **Remember the Business Judgment Rule Still Applies.**

The business judgment rule applies whether or not a corporation is insolvent. As long as directors are disinterested, act on a fully informed basis, in good faith and in the best interest of the corporation, their business decisions should be protected by the business judgment rule. If a board can demonstrate that it met its principal fiduciary duties, the burden of proof will be on the plaintiff to overcome the presumption of the business judgment rule, regardless of whether such plaintiff is a shareholder or creditor.

#### **Practical Guidelines For Dilutive Financings and Restructurings.**

The rapid descent of the economy will decrease the availability of capital for the foreseeable future. Even when available, funding may be on terms that are very dilutive, particularly in the case of a company that has experienced financial difficulty. The aggregate amount of debt and liquidation preferences of a troubled business may also necessitate a recapitalization, often in connection with a dilutive financing. These corporate actions may be necessary but can create litigation risk due to many factors including a disparate, negative impact on certain stockholders. In addition to the general guidelines outlined above, a board should consider the following guidelines as a non-exclusive way to further minimize board risk in such circumstances.



### **Avoid the Mistakes of Alantec Through Fair Treatment.**

Fairness is a theme that should guide the actions of boards when considering a dilutive financing or restructuring. Not particularly well-known outside of certain circles in Silicon Valley, a lawsuit against the directors of Alantec Corporation is considered by many attorneys as a cautionary tale for what not to do in the event of a dilutive financing. Its lessons also apply to any recapitalization.<sup>37</sup> At a time of financial distress, the Alantec directors were alleged to have acted in a unilateral manner that benefited a group of investors in control of the company to the detriment of minority shareholders. Experienced practitioners cite this case as one in which the board did not follow appropriate process and thereby left themselves vulnerable to collateral attack by aggrieved shareholders once the company's fortunes improved. The plaintiffs' allegations included self-interested behavior by investor directors, process defects and a record rife with inflammatory facts that jeopardized the availability of the business judgment rule protections. The case ultimately settled for an amount that likely reflected the plaintiffs' leverage from such mistakes. The guidelines outlined below are suggested to avoid such an outcome. Fair treatment and sound process underlie these recommendations.

### **Identify and Eliminate Potential Conflicts of Interest.**

Control is a privilege that carries certain burdens and associated exposure. Directors need to be especially vigilant when their actions may be to their direct or indirect benefit, or in the event that a director appears to be on both sides of a transaction. There is nothing inherently improper about transactions between a corporation and its major shareholders, officers or directors. However, director self-interest can completely defeat the availability of the business judgment rule and a right to indemnification. If a director has an interest in a matter, or is on both sides of a transaction, the board should remove him or her from deliberations and voting. For example, if a director represents a fund that will participate in a financing, he or she has an interest that could debilitate the integrity of the board process. In such circumstance, the board should require

interested directors to recuse themselves or establish a special committee consisting of independent, disinterested directors to review, negotiate and approve the financing. In Delaware, a special committee of even one independent, disinterested director can protect the entire board from a claim of breach of the duty of loyalty.

### **Conduct a Market Check.**

The terms of a dilutive financing or restructuring will be more difficult to challenge if a board can demonstrate that the terms were fair and market-based. If the only investors available to sponsor a transaction are existing investors, it is particularly important to demonstrate fairness. This can be done by instructing management to seek offers from third parties to lead a transaction. The terms of the financing will be much less susceptible to attack if they are negotiated at arm's length between such third party and the corporation. If the insiders ultimately finance the company themselves but the terms materially track the terms offered by a third party, it will be more difficult to claim that the insiders took advantage of their position. Hiring an independent bank or financial advisor to evaluate the fairness of a valuation and terms can also be an important supplemental protection in such circumstances. In the context of a restructuring, coupling a recapitalization with new funding based on market terms establishes valid consideration to support a change in the capitalization. If nothing else, the record will reflect that the board attempted to inform itself impartially on the availability of offers from third parties and the fairness of the terms given the company's circumstances.

### **Consider the Feasibility of a Rights Offering.**

A board should make every attempt to be inclusive of shareholder participation in any transformative transaction. Excluding shareholders from a financing or restructuring that will severely dilute their existing interests is a sure way to generate stockholder ire and suspicion. Allowing participation up to at least a stockholder's pro rata interest can dramatically lessen stockholder estrangement and subsequent lawsuits. Such offers in effect act as an estoppel – how can

minority stockholders claim injury if they were offered the same opportunity to participate in a transaction on the same terms and conditions as insiders? Other considerations will also be relevant including providing stockholders with sufficient time to evaluate the transaction and make an investment decision, and complying with securities laws (e.g., unaccredited investors may need to be excluded, but in many circumstances they often account for a small portion of the capitalization). As a caveat, discussed below, provision for broad participation will not limit risk if disclosure is not complete and accurate.

#### **Transparency Through Full and Accurate Disclosure.**

Transparency through full and accurate disclosure inevitably cures a lot of ills. As with democratization of participation, open and full disclosure can discourage, if not completely defeat, a lawsuit based on allegations of fraud or misrepresentation. Boards should require management to disclose the material terms (including any conflicts of interest) of a transaction to all stakeholders and take care to adhere to all statutory and contractual requirements including requisite notice and consent. Full and accurate disclosure will preclude allegations that stockholders did not give informed consent or have an adequate basis to make an investment decision. Such disclosure is also a required element for securities law compliance and for certain statutory protections discussed below.

#### **Disinterested Director and Stockholder Approval.**

Prior to consummating any dilutive financing or recapitalization, a board should seek approval by both a disinterested board and by as many stockholders as feasible, including ideally a majority of disinterested stockholders. In the event a majority of directors are interested, a special committee can serve such function as discussed above. Delaware also offers a statutory protection under Section 144 of the DGCL that provides an additional layer of protection. Under Section 144, an interested-director transaction will not be void or voidable merely because those approving the transaction are conflicted if it is approved, on a fully informed basis, either by a majority of the disinterested directors or by stockholders, or if such transaction is fair to the

corporation.<sup>38</sup> Section 144 in effect operates as a safe harbor that will, upon demonstration that its elements have been met, shift the burden of proof to plaintiffs. Adequate disclosure is important for the availability of the safe harbor, particularly as to the nature and extent of any director self-interest. Additionally, while technical approval by only a majority of stockholders is required by the statute, many litigators believe approval by a majority of *disinterested* stockholders will improve the strength of a board's position in litigation under this safe harbor.<sup>39</sup>

#### **Create a Careful Record.**

Prior to authorizing a transaction, create a strong record that reflects the best practices outlined above. The minutes should reflect sufficient frequency of meetings, and an informed, deliberate process that is not compromised by inadequate information or self-interest. An evaluation of reasonable alternatives, the creation of structural protections that ensure the integrity of process, consideration of the impact on the entire corporation, and an articulation of defensible rationale for board action will help minimize risk.

#### **Do the Right Thing.**

Litigation can often turn on atmospherics in the record. Plaintiffs can get past a motion to dismiss and leverage settlement value by unearthing inflammatory evidence often referred to as a "smoking gun." As a corollary to creating a good record, boards that frame their decisions by asking what is good for stockholders and the corporation and then document such intention position themselves more effectively. This also means avoiding dumb mistakes such as hastily drafted emails and random notations that could be recast as selfish, unilateral behavior. Consider the practical effect of how communications and decisions could be taken out of context and mischaracterized. In the context of a dilutive financing or recapitalization, it is generally advisable to hire separate, outside counsel to help investors navigate effectively through a complex process. But at the end of the day, there is no substitute for acting with common sense to ensure that the record reflects that directors acted with good faith and integrity.

*Continued on page 34*

## **Distressed Companies in Distressing Times: Managing Board Risk**

*Continued from page 13*

### **Managing Employment-Related Risks.**

#### **Exposure Arising from Labor and Employment Matters.**

Federal and state labor and employment laws provide a patchwork of legal obligations that can ensnare an unsuspecting director and perhaps the venture capital or private equity firm that he or she represents. In many instances this liability is most likely to arise when the business is distressed and efforts are undertaken to restructure operations and save money. Actions that can lead to exposure if not implemented carefully include closing facilities, laying off employees, managing cash flow by withholding payments for earned wages, accessing cash accounts (even temporarily) that are established under law solely for the benefit of employees, or by failing to pay payroll taxes.

Exposure of directors under Federal and state labor and employment laws results from the more fluid and less formal nature of these laws in imposing derivative liability. In the corporate context there are formal doctrines such as “piercing the corporate veil” or establishing “alter ego” status, which in turn require significant showings of both domination of operations and fraud—showings that are often difficult to establish as a predicate for derivative liability. In the area of employment and labor law, however, as a matter of public policy the doctrines are more protective of employees, unions and others affected by adverse action.

Under certain Federal and state statutes, the definition of “employer” may apply not only to the entity as employer, but also to individual officers or directors who effectively exercise actual and direct control over the employment relationship. Under these laws, directors can be exposed to personal liability including claims for unpaid wages and benefits. In addition, under certain state and local discrimination laws, directors who are involved in personnel decisions can be exposed to individual liability for claims of

discriminatory treatment (e.g., termination, failure to promote) or even unlawful sexual harassment. That is not to say that director status automatically exposes directors to such risks, but the possibility exists that a director’s involvement in the personnel decisions of a portfolio company could rise to a level where personal liability could result.

The broader reach and protective nature of the labor laws create exposure not only for directors, but in certain circumstances, for the venture capital and private equity firms such directors represent. Upstream liability for an investment firm or management company can occur through the application of joint employer or common ownership tests. These tests in turn are based on facts and circumstances that rest on common stock ownership, common directors, de facto exercise of control, dependency of operations and common personnel policies—all of which may be relied upon to impose “upstream” liability on a venture capital or private equity firm whose directors are too involved in the labor or employment decisions of its portfolio companies that are attacked as unlawful. Real life examples of this upstream liability can occur in the context of mass layoffs or plant closures, under the Federal and state WARN laws, under the Federal unfair labor practices laws, and even for violations of Federal and state family leave laws. Furthermore, certain states such as New York impose an absolute liability on the top shareholders of a privately held corporation for the payment of earned but unpaid wages and benefits.

Perhaps most important, Federal pension and retirement laws (ERISA and Department of Labor regulations) strictly regulate the treatment of employee welfare and retirement funds (e.g., health care premiums or 401(k) contributions to be paid out of wages), just as Federal tax law strictly regulates the payment of payroll taxes. In distress situations, employers who try to manage their working capital needs by using the “float” from these types of “protected” assets may be exposing their officers and directors to civil and even criminal liability. The issues in these cases are technical and often involve determinations as to whether the directors were “fiduciaries” under ERISA and had significant involvement in the financial affairs of the



corporation, but the possibility of liability exists and should be treated seriously.

### **Precautionary Steps.**

In the area of labor and employment, directors have to walk a fine line between (i) overseeing their investments and setting appropriate guidelines for management to implement, and (ii) becoming so involved in managing the entity that individual liability issues could arise. Given the mosaic of exposure under labor and employment laws, as a matter of due diligence and best practices, directors should consider the following precautionary steps:

**Comply with Federal Payroll Tax and ERISA Requirements.** Confirm that the corporation is in full compliance with Federal payroll tax and ERISA obligations. This involves assurances from the corporation's outside auditors as well as certification and confirmation from the chief financial officer.

**Do Not Micro-Manage Employment Issues.** Make employment and workforce decisions the responsibility of management and do not "micro-manage" personnel or employment decisions at the board level. Excessive entanglement by directors in personnel decisions can lead to liability not only for the directors, but possibly for the investment firm they represent.

**Conduct an Audit to Assess Accrued Benefits Liability.** Improperly structured benefit plans and accrual policies can result in unrecorded liabilities that increase the costs of dissolution, and in certain circumstances, could result in personal exposure to directors for unpaid liabilities. Qualified labor counsel and the corporation's accountant should review benefit plans and policies to verify the accruals and assess whether exposure exists.

**Ensure Adequate Funds Exist to Pay Wages.** Ensure that the corporation has in place proper procedures and resources to pay earned wages and benefits when due. Do not under any circumstances require employees to continue working past the point where the corporation lacks sufficient funds to pay employee wages.

**Review Insurance Policies.** Confirm whether the corporation has adequate insurance in place to protect directors from exposure to employment related claims and adequate indemnification and advancement provisions in the corporation's charter. Directors representing venture or private equity funds should also confirm whether their own fund's insurance policies provide adequate coverage for claims by employees of their portfolio companies.

### **Conclusion.**

These are uncertain times in which a company's fortunes can deteriorate rapidly. The prospect of insolvency can dramatically escalate director risk. Notwithstanding the state of the economy, good governance and best practices should always reduce board risk. Even in the most uncertain times, directors who act thoughtfully and responsibly will have the protections of the business judgment rule and can avoid other landmines that create personal exposure. The suggestions in this article for directors of a troubled corporation are certainly not an exhaustive list, but if followed, offer an effective head start in effectively managing board risk. ☺

<sup>1</sup> Unless otherwise noted, this article discusses only the law in Delaware. Although there are differences, the general responsibilities of a director of a corporation formed in another jurisdiction will likely be very similar to Delaware because of the national influence of Delaware corporate law. In addition, although the article address duties and obligations of directors, individuals serving as "managers" or "managing members" of limited liability companies can use this article as a starting point and general guide, subject to any exculpatory provisions in their operating agreements that might limit their liability to members of the entity.

<sup>2</sup> *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989).

<sup>3</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.15 (2009).

<sup>4</sup> See, e.g., *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.15 (2009).

<sup>5</sup> *Ritter*, 911 A.2d at 369-370; see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.17 (2009).

<sup>6</sup> *Andarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.16 (2009).

<sup>7</sup> *Lewis*, 473 A.2d at 812; see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.19[A] (2009).

<sup>8</sup> *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.19[A] (2009).

<sup>9</sup> Courts will generally not disturb a board decision meeting the elements of the business judgment rule if it can be attributed to any rational business purpose. See *In re infoUSA, Inc. Shareholders Litigation*, Consol. C.A. No. 1956-CC (Del. Ch. Aug. 13, 2007), slip op. at 71; *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995); see also Balotti, *Delaware Law of Corporations & Business*

Organizations, § 4.19[A] (2009).

- 10 *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) ("As a procedural guide the business judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff."); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.19[A] (2009).
- 11 The burden of proving entire fairness is a heavy burden. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del.), modified, 636 A.2d 956 (Del. 1994); *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52 (Del. 2006); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.19[B][1] (2009).
- 12 *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.19[B][1] (2009).
- 13 *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004).
- 14 See, e.g., *Prod. Res. Group, L.L.C.*, 863 A.2d at 787; *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007).
- 15 *Id.*
- 16 See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communs. Corp.*, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).
- 17 *Gheewalla*, 930 A.2d at 94.
- 18 *Id.* at 101.
- 19 *Id.* at 103.
- 20 See, e.g., *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tenenbaum Capital Ptnrs, LLC (In re Radnor Holdings Corp.)*, 353 B.R. 820, 842-843 (Bankr. D. Del. 2006); *Prod. Res. Group, L.L.C.*, 863 A.2d at 793 ("Although Section 102(b)(7) itself does not mention creditors specifically, its plain terms apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors.").
- 21 Sara E. Apel, *In Too Deep: Why The Federal Courts Should Not Recognize Deepening Insolvency as a Cause of Action*, 24 Emory Bankr. Dev. J. 85 (2008); Paul Rubin, *New Liability Under "Deepening Insolvency": The Search for Deep Pockets*, Am. Bankr. Inst. J., Apr. 2004 at 50 (citing a widely cited definition from *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001) ("an injury to the [debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life")).
- 22 Apel, *supra* note 21, at 85-86.
- 23 Mary E. Borja, *Zone of Insolvency and Deepening Insolvency: Where Are We Today?*, 2008 ABA Section of Litigation Committee on Corporate Counsel CLE Seminar, Feb. 14-17, 2008, at 3.
- 24 Apel, *supra* note 21, at 86.
- 25 Borja, *supra* note 23, at 5.
- 26 *Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd sub nom. Trenwick America Litigation Trust v. Billet*, No. 495 2007 WL 2317768 (Del. Aug. 14, 2007).
- 27 Notwithstanding their willingness to still entertain the theory as a measure of damages, such courts have required a heavy burden for plaintiffs to prove deepening insolvency. See Borja, *supra* note 23, at 7.
- 28 *Id.* at 2; see, e.g., *Booth Oil Site Admin. Group v. Safety-Kleen Corp.*, No. 98-CV-696(A), 2007 WL 2892621, at 38 (W.D.N.Y. Sept. 27, 2007) (under New York law, recognizing fiduciary duties by directors to creditors where the corporation enters into the zone of insolvency). Notwithstanding the foregoing, in California, Massachusetts and Texas, i.e., states with a high concentration of venture and private equity investment activity, the trend appears consistent with Delaware; see, e.g., *Pittelman v. Pearce*, 6 Cal. App. 4th 1436, 1443-1446 (Cal. App. 2d Dist. 1992) (holding that no duty owed to holders of corporate bonds whose credit rating and market value fell after a highly leveraged buyout); *In re Mi-Lor Corp. v. Gottsegen*, 2002 WL 31618548, at \*2 (D. Mass. Nov. 20, 2002) (holding that directors normally do not owe creditors duties that go beyond contractual terms of creditor agreements (citing Delaware cases); stating, in dicta, that "duties shift to creditors" when corporation becomes insolvent); *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006) (holding that Texas law does not impose fiduciary duties in favor of creditors on the directors of an insolvent, but still operating, corporation); but see, *Vartec Telecom, Inc. v. Fail*, Bankr. No. 04-81694-HDH-7, Adv. No. 0603506, 2007 WL 2872283, at 2-3 (Bankr. N.D. Tex. Sept. 24, 2007) (finding under Texas and Delaware law that a fiduciary duty is owed to creditors when a company is in the vicinity or zone of insolvency).
- 29 *Nelson v. Emerson*, 2008 Del. Ch. LEXIS 56, 4-5 (Del. Ch. May 6, 2008).
- 30 *Trenwick*, 906 A.2d at 205.
- 31 The necessary elements of Section 141(e) are: (i) reliance is in good faith, (ii) the director has a reasonable belief in the competence of the expert or person presenting the report, and (iii) reasonable care is made in the selection of such person. 8 Del. Code § 141(e).
- 32 This is a significant point given the recent tendency of Delaware courts to find ways to review director conduct that they find questionable, even if it means limiting the application of corporate doctrines or laws that in other circumstances have protected a board from such a review. See, e.g., *Ryan v. Lyondell Chem. Co.*, 2008 Del. Ch. LEXIS 105 (Del. Ch. July 29, 2008) (holding that target company's directors were not entitled to exculpation, on summary judgment, under the company's § 102(b)(7) charter provision where the alleged fiduciary breach involved the board's failure to engage in an active sale process); *Bridgeport Holdings Inc. Liquidating Trust v. Boyer*, 388 BR 548, 564 (Bankr. D. Del. 2008) (holding that a claim for breach of loyalty may be premised upon the failure of a fiduciary to act in good faith).
- 33 8 Del. C. § 102(b)(7).
- 34 *Id.*; see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.13[B] (2009).
- 35 A further limitation on the scope of Section 102(b)(7) is that it will not limit or eliminate the liability of a director for any act or omission occurring before the time the provision becomes effective in the corporation's charter. *Id.*
- 36 See, e.g., *Schoon v. Troy Corp.*, 948 A.2d 1157, 1166 (Del. Ch. 2008) (denying advancement of defense expenses to former directors due to bylaw changes).
- 37 In the Alantec litigation, the plaintiffs alleged that the directors violated their fiduciary duties in connection with a highly dilutive financing. In 1991, anticipating the need to effect a dilutive financing that would require founder approval, the board granted significant options to certain executives and employees for the alleged purpose of diluting the ability of the founders with control of a majority of the common stock to block the transaction. Following such grant, the grantees exercised their options and voted along with the investors to approve a highly dilutive preferred stock financing that diluted the founders' stake in the company from approximately 8 percent to significantly less than one percent. The inside investors were the primary participants in the financing. In 1996, Alantec received an offer to acquire the company for approximately \$770 million. The founders' stake was only worth \$600,000 but would have been worth over \$40 million but for the dilutive financing. In 1996, the founders of Alantec Corporation filed litigation against the directors of the corporation who were also representatives of their respective venture capital firms. The plaintiffs alleged, among other things, inadequate disclosure to the board and conflicts of interest. The investor directors agreed to settle the case prior to trial for \$15 million.
- 38 8 Del. C. § 144(a); see also Balotti, *Delaware Law of Corporations & Business Organizations*, § 4.16[A] (2009).
- 39 See, e.g., *In re Wheelabrator Techs., Inc. Shareholders Litigation*, 663 A.2d 1194, 1205 n.8 (Del. Ch. 1995).



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