# Lessons for Co-Founders Excluded from Business Venture

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## Delaware Law Update

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*Delaware Court of Chancery addresses breach of fiduciary duty claims when co-founders pursue business venture with another party*

The Delaware Court of Chancery, in *McKenna v. Singer*, C.A. No. 11371-VCMR (Del. Ch. July 31, 2017), held that co-founders who ultimately decided to pursue an opportunity with a third-party investor did not breach any fiduciary duties to the other co-founders.

The story begins when two of the four co-founders (known here as the McKennas) approached the other two co-founders (the Singers) about partnering with each other to finance the work and equipment required to convert the energy source for buildings from heating oil to natural gas. The Singers owned and operated an energy distribution business. The McKennas, on the other hand, claimed to have financing experience.

The Singers and the McKennas formed two Delaware limited liability companies (REF and Green Energy Companies) and attempted to raise capital. However, no one was willing to invest on their proposed terms. An investment opportunity arose when Westport Capital Partners proposed alternative terms for an investment in the business idea. Under the Westport terms, the Singers would contribute their business (which they owned without the McKennas) to a new entity, and Westport would contribute cash. The McKennas would run the financing portion of the business, under Westport's direction, as employees. After extended negotiations, the Singers and Westport entered into a deal primarily on Westport's proposed terms. However, they could not come to an agreement with the McKennas. As such, the McKennas were left out of the deal.

The McKennas filed a complaint alleging, among other things, claims for breach of fiduciary duty against the Singers, Westport and the entity formed for the purpose of the Singer-Westport deal.

In response, the defendants asserted that the McKennas came to the Court of Chancery with unclean hands. Specifically, the defendants asserted that the McKennas made a series of misrepresentations to the Singers in their initial discussions to form the very business they now invoked as the basis for their claims. Prior to the formation of REF and Green Energy Companies, the McKennas led the Singers to believe that one of the McKennas had financed the installation of costly geothermal energy systems and had been involved with securitization of loans. The McKennas also represented to the Singers that one of the McKennas had extensive financial experience, a point which was important to the Singers because they were not familiar with finance or underwriting loans. However, as the court determined, those claims by the McKennas were false.

The Court of Chancery is a court of equity, and "[t]he maxim of equity that '[he] who comes into equity must do so with clean hands' . . . is well embedded in American jurisprudence." As the court stated, the McKennas are not entitled to equitable relief when their "own acts offend the very sense of equity to which [they] appeal[]." As the court stated in *Skoglund v. Ormand Industries, Inc.*, "the purpose of the clean hands maxim is to protect the public and the court against misuse by one who, because of his conduct, has forfeited his right to have the court consider his claims, regardless of their merit."

In concluding that the McKennas had unclean hands, the court stated that the McKennas' misrepresentations had an "immediate and necessary" relationship to the formation of the Delaware LLCs, and that the McKennas cannot now seek to enforce the fiduciary duties that attached in part because of their misrepresentations.

As the court indicated, even without the doctrine of unclean hands, the McKennas failed to prove the breach of fiduciary duty claims. A claim for breach of fiduciary duty requires proof of two elements: (1) that a fiduciary duty existed, and (2) that the defendant breached that duty. The court, in explaining that a fiduciary duty existed between the co-founders, stated that "managers of Delaware limited liability companies owe the same fiduciary duties as directors of Delaware corporations when the limited liability company agreement does not opt out of fiduciary duties." In this case, there were no allegations that fiduciary duties were restricted or eliminated. As such, the managers of REF and Green Energy Companies owed fiduciary duties of care and loyalty.

However, the court ultimately found that the defendants did not breach their fiduciary duties. In this case, the McKennas argued that the Singers breached their duty of loyalty by misappropriating the opportunity for REF and Green Energy Companies to obtain the Westport investment. In analyzing the McKennas' claim, the court referred to an often-cited Delaware Supreme Court decision, *Guth v. Loft, Inc.*, which explains that when a director pursues a corporate opportunity for himself or herself, the director violates the duty of loyalty. Another Delaware Supreme Court case, *Broz v. Cellular Information Systems, Inc.*, explained the corporate opportunity doctrine as follows:

**[A] corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.**

The *Broz* factors generally are applied where a director and a corporation compete in buying an asset. However, the Delaware Supreme Court, in *Thorpe by Castleman v. CERBCO, Inc.*, applied this doctrine in the context of competition between a corporation and its controlling stockholder in selling stock to a potential buyer. The Supreme Court explained that "[i]n order for the [controlling stockholder] and [the corporation] to compete against one another, their stock must have been rough substitutes in the eyes of [the potential buyer]." As stated by the Supreme Court, transactions which are not "economically rational alternatives" need not be considered by a court when evaluating a corporate opportunity scenario.

As in *Thorpe*, the Singers' business (in which the McKennas owned no interest) and the joint venture formed by the Singers and the McKennas were competing for Westport's investment of capital. However, unlike in *Thorpe*, Westport made clear from the outset of its evaluation that the investment structures the McKennas proposed were not "economically rational alternatives" for Westport. Thus, the court held that the McKennas' argument that the Singers misappropriated a corporate opportunity for REF and Green Energy Companies failed to prove a breach of the Singers' fiduciary duties.

The plaintiffs also argued that the Singers breached their fiduciary duties to the McKennas through secret dealing with Westport. The Court of Chancery explained that because Green Energy Companies had no interest in or expectancy of the Westport investment, and because the McKennas were aware of that fact, the Singers had no obligation to tell the McKennas when and how they planned to close the deal with Westport.This opinion is noteworthy because it explains the fiduciary duty standards for co-founders and the importance of not misrepresenting each party's experiences or credentials. It is important to remember that a co-founder's actions prior to the formation of a business venture may impact the rights he or she may have if he or she wishes to seek equitable intervention by the Delaware courts.