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CURRENT FIDUCIARY DUTY ISSUES

GC NETWEAVERS CLE PROGRAM

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Biographical Information

Practice: Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions ("M&A") and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the Model Asset Purchase Agreement with Commentary (2001). He is Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section's Corporation Law Committee; and on behalf of these groups, has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: Fiduciary Duties of Corporate Directors and Officers in Texas, 43 Texas Journal of Business Law 45 (Spring 2009); Responsibilities of Officers and Directors under Texas and Delaware Law, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: Joint Venture Formation, 44 Texas Journal of Business Law 129 (2012); Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code, 42 Texas Journal of Business Law 171 (Spring 2007); Choice of Entity Alternatives, 39 Texas Journal of Business Law 379 (Winter 2004); Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions, 54 SMU Law Review 249 (Winter 2001); M & A: Private Company Acquisitions: A Mock Negotiation, 116 Penn St. L. Rev. 743 (2012); Asset Acquisitions: Assuming and Avoiding Liabilities, 116 Penn St. L. Rev. 913 (2012); Asset Acquisitions: A Colloquy, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: Major Themes of the Sarbanes-Oxley Act, 42 Texas Journal of Business Law 339 (Winter 2008); Communicating with Auditors After the Sarbanes-Oxley Act, 41 Texas Journal of Business Law 131 (Fall 2005); The Sarbanes-Oxley Act and Its Expanding Reach, 40 Texas Journal of Business Law 305 (Winter 2005); Congress Takes Action: The Sarbanes-Oxley Act, XXII Corporate Counsel Review 1 (May 2003); and Legislation: The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Honors: For over ten years, Mr. Egan has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He won the Burton Award for Legal Achievement in 2005, 2006, 2008 and 2009. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal (which profiled him in 2005) and Who's Who Legal. In 2009, his paper entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years.

Publications

- "*How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations,*" University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law, Dallas, February 14, 2014 (hereinafter, my "**Fiduciary Duty Paper**"): http://www.jw.com/publications/article/1945
- "*Choice of Entity Decision Tree,*" TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course, San Antonio, May 23, 2014 (hereinafter, my "**Choice of Entity Paper**"): http://www.jw.com/publications/article/1977
- "*Acquisition Structure Decision Tree,*" TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course, San Antonio, May 23, 2014 (hereinafter, my "**Acquisitions Paper**"): http://www.jw.com/publications/article/1980

Agenda

Overview of Fiduciary Duties

Fiduciary Duty Paper pp 6-55

- Focus on both Texas and Delaware fiduciary duty principles because most of the corporations in Texas are governed under either the Texas Business Organizations Code ("**TBOC**") or the Delaware General Corporation Law ("**DGCL**"). Both TBOC and DGCL provide that business and affairs of a corporation shall be managed by or under the direction of the board of directors ("**Board**"), and both DGCL and TBOC leave fiduciary duty matters to common law, with limited authorization to limit fiduciary duties and director liabilities in specified situations.
- **Neither Texas nor Delaware statutes make any distinction between public or private corporations in measuring the duties and liabilities of directors, nor do the courts.** Most fiduciary duty litigation in Texas is in private company context, but same fiduciary principles are generally applicable to both public and private corporations, although the context will dictate who is likely to complain and what directors can/should do to comply with their fiduciary duties.
- Applicable law—the internal affairs doctrine is followed in both Texas and Delaware, which means that the law of the state of incorporation governs fiduciary duty cases.

Overview of Fiduciary Duties – cont'd.

- Texas fiduciary duty case law is old and sparse but, if old cases still good, shows considerable judicial deference to actions by disinterested directors. In contrast, Delaware has rich tapestry of current case law, but it is "contextual" and often bright lines hard to find.
- Part of difference comes from different court systems for resolving corporate disputes. In Texas corporate disputes are heard in general civil trial courts with juries and appeals to the Texas Courts of Civil Appeals and the Supreme Court. In Delaware fiduciary duty cases are tried in the Delaware Court of Chancery, which is a court of equity and does not have juries, and then appeals directly to the Supreme Court.
- The basic fiduciary duties in Texas and Delaware are care and loyalty (including good faith and candor), but there are differences as to how they are articulated in the two states.

Texas Fiduciary Duties

- Texas has its own body of precedent with respect to director fiduciary duties. In *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707 (5th Cir. 1984), the Fifth Circuit sharply criticized the parties' arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties.
- The Fifth Circuit stated in *Gearhart* that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances. Good faith under *Gearhart* is an element of the duty of loyalty.

Texas Fiduciary Duties – cont'd

- Texas has a strong business judgment rule which was explained in *Gearhart* as follows:
  - "The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.
  - This strong business judgment rule results in plaintiffs seeking to frame their complaints in terms of duty of loyalty violations to which the business judgment rule is inapplicable. The limitation of director liability provisions which many Texas corporations include in their certificates of incorporation under TBOC § 7.001 is not applicable to breaches of the duty of loyalty or actions not in good faith.

Delaware Fiduciary Duties

- Care.
  - ***a. Business Judgment Rule; Informed Action; Gross Negligence*.**
    - The duty of care in Delaware requires a director to perform his duties with such care as an ordinarily prudent man would use in similar circumstances. Subject to numerous limitations, Delaware has a business judgment rule "that a court will not substitute its judgment for that of the Board if the latter's decision can be 'attributed to any rational business purpose'." *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985).
    - The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors have an obligation to inform themselves of all material information reasonably available to them before making a business decision and, having so informed themselves, to act with the requisite care in making such decision. Directors are not required, however, "to read in haec verba every contract or legal document," or to "know all particulars of the legal documents [they] authorize[ ] for execution." *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1078 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).
    - Although a director must act diligently and with the level of due care appropriate to the particular situation, the Delaware courts have held that action (or inaction) will constitute a breach of a director's fiduciary duty of care only if the director's conduct rises to the level of gross negligence. "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason." *McPadden v. Sidhu*, 964 A.2d 1262 (Del. Ch. 2008).

Delaware Fiduciary Duties – cont'd

- Compliance with the duty of care requires active diligence. Accordingly, directors should attend Board meetings regularly; they should take time to review, digest, and evaluate all materials and other information provided to them; they should take reasonable steps to assure that all material information bearing on a decision has been considered by the directors or by those upon whom the directors will rely; they should actively participate in board deliberations, ask appropriate questions, and discuss each proposal's strengths and weaknesses; they should seek out the advice of legal counsel, financial advisors, and other professionals, as needed; they should, where appropriate, reasonably rely upon information, reports, and opinions provided by officers, experts or board committees; and they should take sufficient time (as may be dictated by the circumstances) to reflect on decisions before making them.
- Action by unanimous written consent ordinarily does not provide any opportunity for, or record of, careful Board deliberations. *Official Comm. of Unsecured Creditors of Integrated Health Serv., Inc. v. Elkins*, C.A. No. 20228, 2004 WL 1949290 at *14 (Del. Ch. Aug. 24, 2004) (discussing how Compensation Committee forgiveness of a loan to the CEO by written consent without any evidence of director deliberation or reliance upon a compensation expert raised a Vice Chancellor's "concern as to whether it acted with knowing or deliberate indifference.").

Delaware Fiduciary Duties – cont'd

- ***b. Business Judgment Rule Not Applicable When Board Conflicted.***
  - In *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court held that the business judgment rule was not applicable to the Board's decision to approve a going private stock reclassification proposal in which by amendment to the certificate of incorporation common stock held by smaller stockholders was converted into non-voting preferred stock because the directors were conflicted.
- ***c. Inaction.***
  - A directors' decision may be not to take any action; if that decision is challenged, the focus will be on the process by which the decision not to act was made.
  - Where the failure to oversee or to act is so severe as to evidence a lack of good faith, the failure may be found to be a breach of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

Delaware Fiduciary Duties – cont'd

- ***d. Reliance on Reports and Records.***
  - DGCL § 141(e) provides statutory protection to directors who rely in good faith upon corporate records or reports in connection with their efforts to be fully informed a member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Delaware Fiduciary Duties – cont'd

- ***e. Limitation on Director Liability.***
  - DGCL § 102(b)(7) allows a Delaware corporation to provide in its certificate of incorporation limitations on (or partial elimination of) director liability for monetary damages in relation to the duty of care.
  - The liability of directors may not be so limited or eliminated, in connection with breaches of the duty of loyalty, the failure to act in good faith, intentional misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.
  - TBOC § 7.001 originated from, and is comparable to, DGCL § 174 and likewise does not apply to actions in breach or the duty of loyalty or not in good faith.

Delaware Fiduciary Duties – cont'd

- Loyalty.
  - *a. Conflicts of Interest.*
    - The duty of loyalty mandates "that there shall be no conflict between duty and self-interest." It demands that the best interests of the corporation and its stockholders take precedence over any personal interest or bias of a director that is not shared by stockholders generally.
    - Conflicts of interest do not per se result in a breach of the duty of loyalty – it is the manner in which an interested director handles a conflict and the processes invoked to ensure fairness to the corporation and its stockholders that will determine the propriety of the director's conduct and the validity of the particular transaction. Only <u>material</u> personal interests or influences will imbue a transaction with duty of loyalty implications.
    - The duty of loyalty may be implicated in connection with numerous types of corporate transactions, including, for example, the following: contracts between the corporation and directors or entities in which directors have a material interest; management buyouts; dealings by a parent corporation with a subsidiary; corporate acquisitions and reorganizations in which the interests of a controlling stockholder and the minority stockholders might diverge; usurpations of corporate opportunities; competition by directors or officers with the corporation; use of corporate office, property or information for purposes unrelated to the best interest of the corporation; insider trading; and actions that have the purpose or practical effect of perpetuating directors in office.
    - A director can be found guilty of a breach of duty of loyalty by approving a transaction in which the director did not personally profit, but that benefited the majority stockholder to the detriment of the minority stockholders.

Delaware Fiduciary Duties – cont'd

– ***b. Good Faith.***
  - Good faith is an integral component of the duty of loyalty (not a separate fiduciary duty).
  - Good faith requires that directors act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. While the Court's review requires it to examine the Board's subjective motivation, the Court will utilize objective facts to infer such motivation.
  - The availability of damages as a remedy against directors who are found to have acted in bad faith increases the focus on the duty of good faith. DGCL § 102(b)(7) authorizes corporations to include in their certificates of incorporation a provision eliminating or limiting directors' liability for breaches of the fiduciary duty of care, but DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith or breaches of the duty of loyalty. A finding of a lack of good faith has profound significance for directors not only because they may not be exculpated from liability for such conduct, but also because a prerequisite to eligibility for indemnification under DGCL § 145 is that the directors who were unsuccessful in their litigation nevertheless must demonstrate that they have acted "in good faith and in a manner the person reasonably believed was in or not opposed to the best interests of the corporation."

Delaware Fiduciary Duties – cont’d

– ***c. Confidentiality.***

- A director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.
- This principle is often memorialized in corporate policies. *See Disney v. Walt Disney Co.*, C.A. No. 234-N (Remand Opinion June 20, 2005), discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). See The Walt Disney Company Code of Business Conduct and Ethics for Directors available at http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors.

Misbehaving Directors

Fiduciary Duty Paper pp 28-31

- "Misbehaving Directors" in today's context is focused on directors using confidential corporate information inconsistently with their fiduciary duties. When directors receive information in the course of their service as directors, the information belongs to the corporation and may be used by the directors only for the benefit of the corporation and its shareholders as a whole.
  - Use by a director of confidential corporate information to purchase or sell securities for the personal benefit of the director or related persons, as well as violating the director's fiduciary duty of loyalty, can violate applicable federal and state securities laws as well as the Uniform Trade Secrets Act enacted in Texas effective September 1, 2013, but those violations are not today's focus. Likewise we will not focus on the traditional corporate opportunity issues that arise when a director wants to pursue a business opportunity that rightfully should go to the corporation and the corporation is capable of exploiting it.
  - Rather our discussion will revolve around a situation increasingly common where an activist director joins a Board as a result of winning a proxy contest or threating one. The situation also arises in the context where a private equity or other investor group makes a substantial investment in the company and its representative joins the Board. In each case the director is representing new investors seeking a quicker and more substantial return on their invested capital. That objective is laudable, but when the rest of the Board is not ready to take the actions the director wants—or act as quickly—and the director takes the reins and reaches outside of the Board room and uses confidential information in making his case to third parties, the director may violate the fiduciary duty of loyalty.

Misbehaving Directors – cont'd

- Two situations illustrate this issue. The first is very public and involves J. C. Penney Company, a NYSE listed company, and director William Ackman, who represented on its Board a hedge fund which was its 18% and largest stockholder. The second involves Shocking Technologies, Inc., a closely held private company that was also in financial difficulty, and a director representing two series of preferred stock. These cases also illustrate the tension between the bedrock principle of fiduciary duty law in both Delaware and Texas that directors owe the same fiduciary duties to all stockholders and should not give preference to the interests of the stockholder who the director is representing on the Board.

Shocking Technologies, Inc. v. Michael

- In *Shocking Technologies, Inc. v. Michael*, C.A. No. 7164-VCN (Del. Ch. Oct. 1, 2012), a director ("**Michael**") of a privately held Delaware corporation in dire financial straits, who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information about the company to another preferred shareholder considering an additional investment in the company.
- The Chancery Court found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a "better deal" which would include Board representation for such investor (thereby changing the balance of power on the Board in Michael's favor).
- In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

  The fiduciary duty of loyalty imposes on a director "an affirmative obligation to protect and advance the interests of the corporation" and requires a director "absolutely [to] refrain from any conduct that would harm the corporation". Encompassed within the duty of loyalty is a good faith aspect as well. "To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation. **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The "essence of the duty of loyalty" stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is "adverse to the interests of [his] corporation.**" [Emphasis added]

Shocking Technologies, Inc. v. Michael – cont'd

- Shocking Technologies involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there should be increased Board representation for the preferred stock. Michael argued that the company's governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael's desire to increase his influence and control over the Board at a time when the company faced financial difficulties.
- As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company's only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company's stock. Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation. The Court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding, or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

Shocking Technologies, Inc. v. Michael – cont'd

- In rejecting Michael's argument that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the Board, the Court wrote:

  Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance objectives aligned nicely with his self-interest. When he and his fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking. That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.

  * * *

  Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.

  * * *

  [a] director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, **internal disagreement will not generally allow a dissident to release confidential corporate information**.

Shocking Technologies, Inc. v. Michael – cont'd

- The Court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists, but a director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further the objectives, and may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation.
- The Court in *Shocking Technologies*, however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

  Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty.
- The Court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation.
- The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be.

J.C. Penny Company

- A story on page B-1 of the Wall Street Journal of Monday, August 12, 2013, entitled “Penny Board Assails Director” reports: “J.C.Penny Co.’s Board is weighing whether to take action against William Ackman, a director and the company’s largest stockholder. After the hedge-fund manager publicly released confidential boardroom deliberations in two separate salvos last week……The Board also met late Sunday afternoon by telephone to consider its next steps after Mr. Ackman pressed directors to quickly replace Chief Executive Myron “Mike’ Uhlman … The board didn’t take any immediate action regarding Mr. Ullman.…An unusually public dispute erupted at the top of the company late last week when Mr. Ackman made public a letter calling on the board to move more quickly to replace Mr. Ullman. That opened a rift at the struggling department-store chain that has rattled investors and threatened efforts to stop a deep slide in sales. Mr Ackman’s actions ‘crossed the line’ and made him a ‘rogue’ director, one of the people said—a term that doesn’t have any legal significance but which highlights the level of some directors’ concerns. It is far from clear that Mr. Ackman has violated his duty in any way, however, and his fellow directors appeared to have few options for isolating him.” We will discuss those options later.

J.C. Penny Company – cont’d

- The Wall Street Journal of Tuesday, August 13, 2013, contained a story entitled “Ackman Resigns From J.C. Penny’s Board” that reports: “When activist investor William Ackman dialed into a meeting of J.C. Penney Co.'s board late Sunday afternoon, some of his fellow directors were waiting with a message. The hedge-fund manager, they said, had breached his boardroom duties by disclosing confidential information about the company's CEO search and financial condition, a person familiar with the discussions said. Following that discussion, Mr. Ackman offered to resign, the person said. His resignation, the details of which were hammered out by lawyers in negotiations that stretched into early Tuesday morning, brought an end to an unusually public conflict among directors that had threatened the struggling company's turnaround efforts.”
- Other stories have speculated that Mr. Ackman’s resignation was coerced and that J.C. Penny was considering legal action against Mr. Ackman, but at least one source claims that his resignation was voluntary.
- One can speculate whether lawyers for J.C, Penny or Mr. Ackman considered the teachings of the *Shocking Technologies* case.

Alternatives to Dealing with Misbehaving Directors

- Litigation
  - Litigation against a misbehaving director can be expensive and damaging to the company.
  - *Shocking Technologies* illustrates that duty of loyalty litigation against a misbehaving director, even where the company wins, may not produce the desired outcome.

Alternatives to Dealing with Misbehaving Directors – cont'd

- <u>Executive or Special Committee</u>
  - Many Executive Committees have broad powers to act between Board meetings except in those few fundamental actions that are by the TBOC or the DGCL reserved to the Board such as amending the Bylaws or approving or recommending a merger or charter amendment to the shareholders.

Alternatives to Dealing with Misbehaving Directors – cont'd

- *Kalisman v. Friedman* (C.A. No. 8447-VCL April 17, 2013) teaches that Boards coping with dissident directors can isolate them through a formal committee structure, but cannot isolate them by hiding information and surprising them with detailed corporate restructuring plans presented only hours before a Board meeting at which they would be considered. Jason Kalisman was founding member of private equity fund that was company's largest stockholder and the fund's representative on its Board, and was a member of a Board special committee tasked with evaluating the company's strategic alternatives. After the fund announced that it intended to run a proxy contest for control of the Board at its next annual meeting, the other directors developed a plan to dilute the fund in a recapitalization without involving Kalisman until presenting deal documents a few hours before the Board meeting at which they were to be voted upon.

Alternatives to Dealing with Misbehaving Directors – cont'd

– Kalisman demanded broad access to company information—including attorney-client communications—and skirmishing in the courts ensued. Largely siding with Kalisman, the Court of Chancery held that a director's right to company information is "essentially unfettered in nature," and companies may not pick and choose which directors receive which information. The Court held that Kalisman should be treated as a "joint client" in respect of legal advice rendered to the company, insofar as he—like the other directors—had a responsibility for proper management of the company and was entitled to receive privileged company information. In response to the company's concern that Kalisman would share the materials with the fund, the Court concluded that "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director," noting, however, that the director could be held to account if company information was misused as a result (the company could also in a bylaw or written policy restrict such sharing of information).

Alternatives to Dealing with Misbehaving Directors – cont'd

– While the Court in *Kalisman* recognized broad director information rights, it also expressly observed that a Board can: (i) create a special committee (or a committee can create a subcommittee) that excludes certain directors (so long as this is done on an appropriate record and with the knowledge of the excluded directors, such a committee can retain separate legal counsel and its communications with counsel will, to the extent necessary for the committee's work (such as negotiating a transaction), remain privileged relative to the excluded directors); and (ii) when a defendant corporation can show "sufficient adversity exists between the director and the corporation such that the director could no longer have a reasonable expectation that he was a client of the Board's counsel," the Board or committee may withhold privileged information from the adverse director (the Court found that the requisite adversity did not commence when the dissident announced it would nominate its own slate of directors for a proxy contest, perhaps because the other directors conspired behind his back; the requisite adversity commenced when the Board formed a special committee to deal with a transaction he opposed).

Alternatives to Dealing with Misbehaving Directors – cont'd

- Removal
  - Under both TBOC § 21.409 and DGCL § 141(k), removal of directors, with or without cause, requires a shareholder vote. DGCL § 225(c) allows removal of a director by the Court of Chancery if there has been a prior judgment that the director breached the duty of loyalty.

Alternatives to Dealing with Misbehaving Directors – cont'd

- Not Renominating the Director at the Next Annual Meeting of Shareholders
  - *Sherwood v. Chan Tze Ngon*, 2011 Del. Ch. LEXIS 202 (Dec. 20, 2011), shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives. The *Sherwood* case involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting. The Court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the board to remove him from the Company's slate." The Court commented that it is "important that directors be able to register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion."

Recipients of Confidential Information from Director Can Also Face Legal Action

- In *NACCO Industries, Inc. v. Applica Incorporated*, C.A. No. 2541-VCL (Dec. 22, 2009), NACCO (the acquirer under a merger agreement) brought claims against Applica (the target company) for breach of the merger agreement's "no-shop" and "prompt notice" provisions for assistance it gave to hedge funds managed by Herbert Management Corporation (collectively "**Harbinger**"), which made a topping bid after the merger agreement with NACCO was executed. NACCO also sued Harbinger for common law fraud and tortious interference with contract, alleging that while NACCO and Applica were negotiating a merger agreement.
- Applica insiders provided confidential information to principals at the Harbinger hedge funds, which were then considering their own bid for Applica. During this period, Harbinger amassed a substantial stake in Applica (which ultimately reached 40%), but reported on its Schedule 13D filings that its purchases were for "investment," thereby disclaiming any intent to control the company. After NACCO signed the merger agreement, communications between Harbinger and Applica management about a topping bid continued. Eventually, Harbinger amended its Schedule 13D disclosures and made a topping bid for Applica, which then terminated the NACCO merger agreement. After a bidding contest with NACCO, Harbinger succeeded in acquiring the company.
- The Vice Chancellor also upheld NACCO's common law fraud claims against Harbinger based on the alleged inaccuracy of Harbinger's Schedule 13D disclosures about its plans regarding Applica. The Vice Chancellor dismissed Harbinger's contention that all claims related to Schedule 13D filings belong in federal court, holding instead that a "Delaware entity engaged in fraud"—even if in an SEC filing required by the 1934 Act—"should expect that it can be held to account in the Delaware courts." The Vice Chancellor emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger's statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law.

ATTORNEY-CLIENT PRIVILEGE

Acquisitions Paper pp 275-281

- Work Product Doctrine. The work product doctrine protects documents prepared by an attorney in anticipation of litigation or for trial. The work product doctrine focuses on the adversary system and attorney's freedom in preparing for trial. The threshold determination in a work product case is whether the material sought to be protected was prepared in anticipation of litigation or for trial. Work product protection allows protected material to be obtained by the opposing party only upon a showing of substantial need and undue hardship. This form of protection relates strictly to documents prepared in anticipation of litigation or for trial. Therefore, in absence of any anticipated or pending litigation, documents prepared for the purposes of a specific business transaction are not protected by the work product doctrine.
- Attorney-Client Privilege. The attorney-client privilege protects communications of legal advice between attorneys and clients, including communications between corporate employees and a corporation's attorneys to promote the flow of information between clients and their attorneys. An oft-quoted definition of the attorney-client privilege is found in *U.S. v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358-59 (D. Mass. 1950):
  - "The privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client."

ATTORNEY-CLIENT PRIVILEGE – cont'd

- Although the attorney-client privilege does not require ongoing or threatened litigation, it is more narrow than the work product doctrine because it covers only "communications" between the lawyer and his client for the purposes of legal assistance.
- The core requirement of the attorney-client privilege is that the confidentiality of the privileged information be maintained. Therefore, the privilege is typically waived when the privilege holder discloses the protected information to a third party. A waiver of attorney-client privilege destroys the attorney-client privilege with respect to all future opposing parties and for the entire subject matter of the item disclosed.
- Courts have developed two doctrines of exceptions to the waiver of the privilege through voluntary disclosure: (1) the "joint defendant" rule, which protects from disclosure communications relevant to a matter of common interest between two or more clients of the same lawyer; and (2) the "common interest" doctrine under which privileged information may be disclosed to persons with a common legal interest whether or not they are co-plaintiffs or co-defendants in litigation.

ATTORNEY-CLIENT PRIVILEGE – cont'd

- Waiver in M&A Transactions. The core requirement of the common interest doctrine is the existence of a shared legal interest. Disclosures by a corporation and its counsel to the corporation's investment banking firm during merger discussions have resulted in a waiver of the attorney-client privilege because the common interest rule did not apply.
- Generally, (i) in a statutory merger the surviving corporation can assert the attorney-client privilege, (ii) in a stock-for-stock deal the privilege goes with the corporation, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale some cases hold no privilege passes because the corporate holder of the privilege has not been sold while others hold that a transfer of all of sellers right, title and interest in the assets of a business effectively transfers the right to assert or waive the privilege.

ATTORNEY-CLIENT PRIVILEGE – cont'd

- In *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155, 155 (Del. Ch. 2013), the Delaware Chancery Court held that under DGCL § 259, all privileges—including the attorney-client privilege—pass from the acquired corporation to the surviving corporation in a merger, absent a provision in the merger agreement to the contrary. The case arose when the acquirer sued the seller over a year after consummation of the merger alleging it had been fraudulently induced to enter into the merger and notified the seller that among the computer files it received in the merger were pre-merger communications between the acquired company and its deal counsel. Even though the seller had not taken the steps of protecting the privileged communications by a merger agreement provision or the physical removal of the communications from the computer files received by the buyer, the sellers asserted continuing privileged control of the attorney client communications.
- The opinion by Chancellor Leo Strine (now Chief Justice of the Delaware Supreme Court) literally applied DGCL § 259, which provides that in a merger "all . . . privileges" become the property of the surviving corporation in explaining his holding that the target's attorney-client privilege vested in the surviving corporation in the merger. While holding that "*all* means *all*," the Court emphasized that parties can modify the statutory default rule by including in the merger agreement a provision specifying who retains control over privileges, including privileged communications relating to the negotiation of the merger. *Great Hill* also highlights the need to take practical steps to ensure that the parties' agreements over who maintains control over privilege are given effect, such as by taking steps to remove communications as to which the seller wants to continue to control privilege from the computer systems transferred to the buyer.
- Because the Court decided that the privilege belonged to the surviving corporation, the Court did not decide whether the sellers had waived any privilege by allowing the buyer to have access to the communications. The Court, however, commented that the sellers' "lengthy failure to take any reasonable steps to ensure the [b]uyer did not have access to the allegedly privileged communications" presented a "substantial issue."

ATTORNEY-CLIENT PRIVILEGE – cont'd

- In an asset sale (including a sale of a division) the parties can provide contractually for the buyer to have the benefit of the privilege. As Section 12.6 of ABA Model Asset Purchase Agreement (2001) does by analogy to joint defense and common interest cases:
  - The Disclosing Party is not waiving, and will not be deemed to have waived or diminished, any of its attorney work product protections, attorney client privileges, or similar protections and privileges as a result of disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party, regardless of whether the Disclosing Party has asserted, or is or may be entitled to assert, such privileges and protections. The parties (a) share a common legal and commercial interest in all of the Disclosing Party's Confidential Information that is subject to such privileges and protections, (b) are or may become joint defendants in Proceedings to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, (c) intend that such privileges and protections remain intact should either party become subject to any actual or threatened Proceeding to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, and (d) intend that after the Closing the Receiving Party shall have the right to assert such protections and privileges. No Receiving Party shall admit, claim or contend, in Proceedings involving either party or otherwise, that any Disclosing Party waived any of its attorney work product protections, attorney client privileges, or similar protections and privileges with respect to any information, documents or other material not disclosed to a Receiving Party due to the Disclosing Party disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party.

ATTORNEY-CLIENT PRIVILEGE – cont'd

- Company Email No Expectation of Privacy: *In re Information Management Services, Inc. Derivative Litigation*, C.A. No. 8168-VCL (Del. Ch. Sept. 5, 2013), the Delaware Chancery Court held that communications between executives and their individual counsel made using company email accounts were not privileged because there was no reasonable expectation of privacy. A waiver of attorney-client privilege destroys the attorney-client privilege with respect to all future opposing parties and for the entire subject matter of the item disclosed. *See In re Grand Jury Proceedings*, 78 F.3d 251, 255 (6th Cir. 1996). Result is that some directors set up a private email account for matters relating to companies on whose Boards they serve.

ATTORNEY-CLIENT PRIVILEGE – cont'd

- In-House Counsel Privilege Challenges. Some recent decisions have questioned the availability of the attorney-client privilege except in preparation for litigation or potential litigation. *Compare U.S. ex rel. Barko v. Halliburton Company* (D.C. CA 2014 No. 2005-1276) (District Court rejected the company's claims of attorney-client privilege and work product protection for documents prepared by in-house counsel in connection with its internal investigation; Court determined that because Department of Defense contracting regulations require contractors to have internal control systems, the internal investigation was undertaken pursuant to regulatory law and corporate policy rather than for the sole purpose of obtaining legal advice; the assertion of work product protection was also rejected on the grounds that the internal investigation was conducted in the ordinary course of business irrespective of the prospect of litigation; *see* amicus brief filed by U.S. Chamber of Commerce, available at http://www.acc.com/advocacy/upload/In-re-KBR-031914.pdf), *to Exxon Mobil Corp. v. Clarence Hill, et al* (Fifth Circuit, No. 13-30830, May 6, 2014) (Fifth Circuit held that memorandum prepared by in-house counsel in connection with contract negotiations was privileged).

ATTORNEY-CLIENT PRIVILEGE – cont'd

- The SEC Staff has been skeptical of attorney-client privilege claims in connection with whistle-blower claims. Dodd-Frank §§ 922 and 929A expanded the provisions for whistle-blower protection in SOX § 806 by, *inter alia*, covering private subsidiaries or affiliates of publicly traded companies whose financial information is included in the consolidated financial statements of such companies and covering nationally recognized statistical rating organizations. *See Lawson v. FMR LLC* (U.S. Supreme Court Mar. 4, 2014) (SOX § 806, which bans retaliation against whistleblowers, applies not only to employees of public companies, but also to employees of contractors and subcontractors who carry out work for public companies, significantly expanding the coverage of SOX).

CYBERSECURITY

Fiduciary Duty Paper pp 15-27 and Appendix D

- Tuesday, May 6, 2014. New York Times Business Day, page B1:
  - The chief executive of Target … resigned from the company … signaling the depths of the damage done by last year's extensive breach of customers' information
- From a regulatory perspective, federal and state laws create obligations on how companies must protect data and maintain cybersecurity. Under federal law, certain industries have heightened obligations as a result of laws such as HIPAA and Graham-Leach-Bliley. In addition, the federal securities laws, including the Sarbanes–Oxley Act, require that corporate leadership maintain adequate controls over their systems which could be implicated upon a cybersecurity breach.

CYBERSECURITY – cont'd

- *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996), involved derivative claims that Caremark's Board breached its fiduciary duty to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes was approved. In approving at settlement, the Chancery Court discussed the scope of a Board's duty to supervise or monitor corporate performance and stay informed about the business of the corporation as follows:
  - [I]t would … be a mistake to conclude … that corporate boards may satisfy their obligations to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

  Stated affirmatively, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may … render a director liable."
- "As part of the board's risk oversight function, the board should have an understanding of the cyber risks the company faces in operating its business and should be comfortable that the company has systems in place to identify and manage cyber risks, prevent cyber breaches and respond to cyber incidents when they occur. This should include an understanding of the extent to which a company's insurance may provide protection in the event of a major cyber incident." John F. Olson, Jonathan C. Dickey, Amy L. Goodman and Gilliam McPhee, *Current Issues in Director and Officer Indemnification and Insurance*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jul. 31, 2013, at 8.

RIGHTS PLANS

Fiduciary Duty Paper pp 310-332

- WSJ Thur 5/8/14 pages C1 & C2, *"POISON PILL" Gets a Bit More Toxic*:
  - "Poison pills just got a shot in the arm. Long used by companies to thwart hostile acquirers, these arrangements are finding favor among companies seeking protection from activist investors. Last week, these new types of "pills," as they are known on Wall Street, got the thumbs up from the Delaware courts, a big win for companies lately getting creative in fights against activists. On Friday, Vice Chancellor Donald Parsons of the Delaware Court of Chancery ruled that auction house Sotheby's acted reasonably when it adopted, and later maintained, a poison pill aimed squarely at activist hedge funds circling the company's stock last fall. The plan limited these investors, including Daniel Loeb's Third Point LLC, to under a 10% stake but let passive investors—thought to be friendlier to management—buy twice as much. Mr. Parsons found credible the concerns of Sotheby's board that Mr. Loeb, who was seeking board seats, in the absence of a pill could gain "effective control" over the company without having to pay a premium. Mr. Loeb and Sotheby's announced a settlement Monday. The decision affirms the legality of a new generation of poison pills, which are being adopted more frequently by companies in hedge funds' cross hairs."
- Rights plans are used in privately held companies as well as public companies as accumulations of stock by outsiders "looking to turn a quick buck" can be disruptive to well-developed corporate plans.

RIGHTS PLANS – cont'd

- Delaware cases have suggested that failure to adopt a Rights Plan to empower a Board in dealing with a potential change in control threat may suggest that the Board has not handled the process in accordance with its fiduciary duties.
  - *In re CNX Gas Corp. Shareholders Litigation*, C.A. No. 5377-VCL, 2010 Del. Ch. LEXIS 139, at *1 (Del. Ch. July 5, 2010)
  - *Louisiana Municipal Employees' Retirement System v. Fertitta*, C.A. No. 4339-VCL, 2009 Del. Ch. LEXIS 144, at *2 (Del. Ch. July 28, 2009)

RIGHTS PLANS – cont'd

- The Basic Design. A typical Rights Plan provides for the issuance and distribution to shareholders of rights ("**Rights**") to purchase common stock or preferred stock of the corporation that, when triggered by a non-Board-approved outside acquirer becoming the beneficial owner of more than a specified percentage (typically 10-20%) of the corporation's common stock, would give the holder of each share of common stock (other than those held by the acquirer) the right to purchase additional shares of common stock at a significant discount (typically 50%). The typical Rights Plan reserves to the Board the right to redeem the Rights for a nominal amount at any time before the Rights are triggered, and this power to redeem the Rights gives the Board tremendous power to negotiate with the would be acquirer. The goal of the Rights Plan is to deter acquisitions not approved by the Board by imposing unacceptable levels of dilution on potential acquirers, thus channeling the negotiation of any potential acquisition through the Board. Adoption of the Rights Plan by no means makes the corporation invulnerable to takeover. There is nothing in a Rights Plan to prevent an acquirer from launching an election contest to replace the current Board with new directors who would elect to redeem the Rights Plan, allowing the acquirer to consummate an acquisition without risk of dilution. The adoption of the Rights Plan, however, gives the acquirer a powerful incentive to negotiate with the Board and enhances the Board's ability to pursue value maximizing alternatives rather than succumbing to a hostile takeover bid that may not be in the best interests of the corporation or its shareholders.
- Adoption of the Rights Plan. As a first step, the Board will adopt resolutions approving and adopting the Rights Plan itself. It can be implemented without shareholder action or approval. Much like a stock option or other equity incentive plan, the Rights Plan defines the rights of a class of persons to receive a specified class of securities. Each Right would give its holder the option to purchase one share of the corporation's common stock (or preferred stock convertible into common stock) at a price per share determined by the Board.

RIGHTS PLANS – cont'd

- Authorization of Issuance and Distribution of Rights. Once the Rights Plan has been approved by the Board, the Board must take steps to actually issue and distribute the Rights to the Company's shareholders. This is done by the Board adopting resolutions authorizing the issuance and distribution to shareholders of one Right for every share of common stock issued and outstanding. The Rights would be issued and distributed to all shareholders—even the potential acquirer—but would, again, only be exercisable once triggered, and then only by shareholders other than the acquirer.
- The Triggering Event. The Rights would be designed so as to only be exercisable if "triggered" when a potential acquirer becomes the beneficial owner of a certain threshold percentage of the corporation's stock, and would be exercisable by all shareholders *except* the triggering acquirer. Thus, definition of the triggering event is key, as it determines when and by whom the Rights will be exercisable and, more importantly, exactly who will be deterred from attempting to acquire control of the corporation without Board approval. Under a Rights Plan, the exercisability of the Rights will be triggered as soon as a person, together with its affiliates and associates, becomes an "**Acquiring Person**" by acquiring beneficial ownership (generally a defined term similar to, but more inclusive than, Rules 13d-3 and 13d-5 under the 1934 Act) of a specified percentage of the common stock then outstanding.

RIGHTS PLANS – cont'd

- Flip-In and Flip Over. Once the Rights Plan is triggered, each holder of a Right (other than any Acquiring Person and certain related parties, whose Rights automatically become null and void) will have the right to receive, upon exercise, common stock having a value equal to two times the exercise price of the Right. This is known as the "**flip-in event**." The Rights typically may not be exercised for a ten-day period following a flip-in event, during which the Company still has the ability to cause the Rights to be redeemed.
- Additionally, if at any time following the date on which a person becomes an Acquiring Person:
  - 1. The corporation is acquired in a merger or other business combination transaction in which the corporation is not the surviving corporation;
  - 2. The corporation is acquired in a merger or other business combination transaction in which it is the surviving entity and all or part of its common stock is converted into securities of another entity, cash or other property; or
  - 3. 50% or more of the corporation's assets, cash flow or earning power is sold or transferred,
- then each holder of a Right will have the right to receive, upon exercise, common stock of the acquiring company having a value equal to two times the exercise price of the Right. This is known as a "**flip-over**" event.

RIGHTS PLANS – cont'd

- Exchange. Additionally, at any time after the Rights are triggered, Rights Plans often provide that the Board may exchange the Rights (other than Rights owned by the Acquiring Person, which will have become void), in whole or in part, at an exchange ratio of one share of common stock or an equivalent security, per Right (subject to adjustment). The exchange alternative results in less dilution than a traditional flip-in, but is a simple mechanism that can be implemented by the Board alone more quickly than a flip-in if the corporation has sufficient authorized but unissued shares. To satisfy Rights Plan requirements that the exchange shares not be issued to the Acquiring Person or its Affiliates, a trust can be formed to hold the exchange shares until ownership issues can be resolved.
- Redemption. Most Rights Plans provide that the corporation may redeem Rights in whole, but not in part, at a price of $0.01 per Right at any time prior to their being triggered. Immediately upon the action of the Board authorizing the redemption, the Rights will terminate and the only right of the holders of Rights will be to receive the redemption price.

RIGHTS PLANS – cont'd

- Delaware Rights Plan Fiduciary Duty Precedent. It is a settled principle of Delaware law that a Rights Plan, if drafted correctly, is valid as a matter of Delaware law.
- Because the adoption of a Rights Plan is likely to deter certain acquisitions, and can have the effect of entrenching directors and management, such plans are often subject to judicial scrutiny. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985), which is still applied in evaluating shareholder Rights Plans, the Delaware Supreme Court held that when directors authorize takeover defensive measures, there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."As a result, the *Unocal* standard requires directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation) and (ii) the responsive action taken was "reasonable in relation to the threat posed" (established by showing that the response to the threat was not "coercive" or "preclusive" and then by demonstrating that the response was within a "range of reasonable responses" to the threat perceived).

RIGHTS PLANS – cont'd

- Typically, establishing that a Rights Plan is valid at the time of its adoption is no longer a major hurdle. A Board may even have an affirmative duty to adopt a Rights Plan where failure to do so would subject the corporation to an unfair transaction. *See Louisiana Municipal Employees' Retirement System v. Fertitta*, C.A. No. 4339-VCL, 2009 Del. Ch. LEXIS 144, at *30 n.34 (Del. Ch. July 28, 2009) (holding that a "board's failure to employ a [rights plan], together with other suspect conduct, supports a reasonable inference at the motion to dismiss stage that the board breached its duty of loyalty in permitting the creeping takeover.").
- The litigation concerning Rights Plans now focuses on whether or not a Board should be required to redeem the Rights in response to a particular bid. In this respect, Courts applying Delaware law have upheld, or refused to enjoin, determinations by Boards not to redeem Rights in response to two-tier offers or inadequate 100% cash offers as well as to protect an auction or permit a target to explore alternatives. On the other hand, some decisions have held that the Rights may not interfere with shareholder choice at the conclusion of an auction or at the "end stage" of a target's attempt to develop alternatives. The key is for the Board to be informed and acting to maximize stockholder value rather than entrenchment.

RIGHTS PLANS – cont'd

- <u>Texas Fiduciary Rights Plan Duty Precedent.</u> In *Gearhart Industries v. Smith International*, 741 F.2d 707, 710 (5th Cir. 1984), the Fifth Circuit, applying Texas law, upheld the issuance of the equivalent of a poison pill (subordinated debentures and warrants to purchase Gearhart common stock with so-called "springing" features, which would reduce the exercise price of the warrants by approximately 25% upon the occurrence of certain events, including certain attempts to effect a change in control).
- Later in *A. Copeland Enterprises, Inc. v. Guste*, 706 F. Supp. 1283, 1285 (W.D. Tex. 1989), a federal District Court for the Western District of Texas upheld the Board's adoption of a Rights Plan in response to a hostile tender offer.

RIGHTS PLANS – cont'd

- Redemption of the Rights Plan. Today, litigation concerning Rights Plans generally focuses on whether or not a Board should be required to *redeem* the Rights Plan in response to a particular bid. In *Copeland*, for example, the Court suggested that it would enjoin the use of the Church's Rights Plan were it not removed at the close of an auction to facilitate a sale of the corporation to the highest bidder. Courts applying Delaware law have upheld, or refused to enjoin, determinations by Boards not to redeem Rights in response to two-tier offers or inadequate 100% cash offers as well as to protect an auction or permit a target to explore alternatives. On the other hand, some decisions have held that Rights Plans may not interfere with shareholder choice at the conclusion of an auction or at the "end stage" of a target's attempt to develop alternatives.
- An informed and independent Board's decision not to redeem Rights to allow an all-cash, fully financed tender offer to go forward where the Board has concluded that the offer price is inadequate was upheld in *Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011), although Chancellor Chandler commented a board cannot "*just* say no" to a tender offer. It must first pass through two prongs of exacting judicial scrutiny by a judge who will evaluate the actions taken by, and the motives of, the board; only the board is found to be acting in good faith, after reasonable investigation and reliance on the advice of outside advisors, convinces the Court that a hostile tender offer poses a legitimate threat to the corporate enterprise, may address that perceived threat by blocking the tender offer and forcing the bidder to elect a board majority that supports its bid.

RIGHTS PLANS – cont'd

- In *Third Point LLC v. Ruprecht, et al.*, C.A. No. 9469-VCP (Del. Ch. May 2, 2014), the Delaware Chancery Court rejected preliminary injunction relief against Sotheby's annual meeting in denying a plaintiff's claim that the Board had violated its fiduciary duties by (1) adopting a stockholder rights plan with a two-tiered trigger, capping stockholders who file Schedule 13Ds at 10% of the outstanding stock, but permitting passive investors who file Schedule 13Gs to acquire up to 20% of the outstanding stock; and (2) refusing to grant Third Point, the company's largest stockholder, a waiver enabling it to acquire up to 20% of the outstanding stock. Applying the *Unocal* standard, the Court held that the majority-independent Board had shown that it acted reasonably in identifying a legally cognizable threat—that Third Point, alone or with others, might acquire a controlling interest in the company without paying Sotheby's other stockholders a premium—and that its response to the threat was reasonable. The Court also upheld the Board's refusal of Third Point's request for a waiver as the Board made a sufficient showing as to the threat that Third Point might be able to exercise "negative control" if permitted to accumulate up to 20% of the outstanding stock.

Change in Control Provisions in Loan Documents

- Lenders are frequently concerned about the effect of a change in control of a company on the company's ability to pay its debts. As a result it is common for loan agreements, debt indentures and similar documents to contain provisions to the effect that a change in control of the company gives the lender a right to accelerate the maturity of the debt. Because they can make it more difficult and expensive for a third party to take over the company and hence may tend to protect positions of incumbent management, they can be subject to judicial scrutiny comparable to a rights Plan. *See San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, 938 A.2d 304, 306 (Del. Ch. 2009) (Delaware Chancery Court held that the continuing directors provision in Amylin's bond indenture did not prohibit incumbent directors from "approving" persons nominated by stockholders even as the incumbent Board publicly opposed those nominees in a proxy contest and that the Amylin Board complied with its duty of care in approving the Indenture, but cautioned counsel to be mindful of the Board's duties to protect stockholders in considering change in control provisions in loan documents; the plaintiff's attorneys were awarded fees and expenses of $2.9 million for their role in disabling the "continuing director" provisions in the indenture that allegedly hindered shareholder voting for directors); *Kallick v. SandRidge Energy, Inc.*, C.A. No. 8182-CS, 2013 WL 868942 (Del. Ch. Mar. 8, 2013) (Court enjoined the Board of a borrower from soliciting consent revocations in connection with a proxy contest launched by a stockholder to install its own directors on the borrower's Board, until the borrower's incumbent Board approved the proposed directors in order not to trigger a change of control provision in the borrower's credit agreement).

Texas Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2013	
Domestic For-Profit Corporation	22,563
Domestic Limited Liability Company	110,879
Domestic Limited Partnership	5,650
Domestic Nonprofit	10,211
Domestic Professional Corporation	846
Domestic Professional Association	833

Texas Secretary of State – Statistical Information

MASTER FILE STATISTICS FOR December 31, 2013	
Entity Type	Active Entities
Domestic For-Profit Corporation	372,187
Domestic Limited Liability Company	583,482
Domestic Limited Partnership	132,082
Domestic Nonprofit	124,796
Domestic Professional Corporation	17,754
Domestic Professional Association	19,121

Limited Liability Companies

Adjustment/Elimination of Default Fiduciary Duties in LLC Context: Texas Law

- Texas law does not address specifically whether Manager or Member fiduciary or other duties exist or attempt to define them, but implicitly recognizes that these duties may exist in statutory provisions which permit them to be expanded or restricted, and liabilities for the breach thereof to be limited or eliminated, in the Company Agreement.
- TBOC § 101.401 provides that a Company Agreement may expand or reduce (but not eliminate) fiduciary duties as follows:
  – The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.
- The TBOC now allows the elimination of liabilities – to a specified and limited extent – but does not allow the elimination of fiduciary duties, although fiduciary duties may be expanded or reduced in a company agreement. Thus, in theory, equitable remedies may exist to address acts for which any monetary liability has been eliminated by a company agreement.

Adjustment/Elimination of Default Fiduciary Duties in LLC Context: Texas Law (cont'd)

- TBOC § 7.001, as amended in the 2013 Legislative Session by S.B. 847 § 2, does allow for the limitation or elimination of liabilities for breach of fiduciary duties as follows:

Sec. 7.001. LIMITATION OF LIABILITY OF GOVERNING PERSON.

(a) Subsections (b) and (c) apply to:
 (1) a domestic entity other than a partnership or limited liability company;
 (2) another organization incorporated or organized under another law of this state; and
 (3) to the extent permitted by federal law, a federally chartered bank, savings and loan association, or credit union.

(b) The certificate of formation or similar instrument of an organization to which this section applies may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.

(c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:
 (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
 (2) an act or omission not in good faith that:
  (A) constitutes a breach of duty of the person to the organization; or
  (B) involves intentional misconduct or a knowing violation of law;
 (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or
 (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.

(d) The liability of a governing person may be limited or eliminated:
 (1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;

 (2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and

 (3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401.

Adjustment/Elimination of Default Fiduciary Duties in LLC Context: Delaware

- In *Auriga Capital Corp. v. Gatz Props, LLC*, 40 A.3d 839 (Del. Ch. 2012) (Strine, C.), *aff'd*, 59 A.3d. 1206 (Del. 2012), the Court held that an LLC's managing member owed, and breached, fiduciary duties of care and loyalty in connection with the sale of the company at an "auction" structured and won by the managing member.
  - LLC Agreement provided: "Neither the Manager nor any other Member shall be entitled to cause the company to enter . . . into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties" without approval of a majority of the non-affiliated members. *Gatz*, 40 A.3d at 857.
  - Court of Chancery held that the LLC agreement at issue contractually incorporated a core element of the common law fiduciary duty of loyalty and required entire fairness review.
  - Court of Chancery *in dicta* mused that default fiduciary duties exist in the LLC context, but that they can be supplanted or modified by clear contractual provisions.
  - Delaware Supreme Court affirmed the holding on contractual grounds, and noted that the Court of Chancery's "statutory pronouncements must be regarded as dictum without any precedential value." *Gatz*, 59 A.3d. at 1218.

Adjustment/Elimination of Default Fiduciary Duties in LLC Context: Delaware – *Auriga* post-script

- *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012) (Laster, V.C.) (finding that a manager owes default fiduciary duties to an LLC and its members).
  - Section 18-1101(c) of the LLC Act, which permits the expansion, restriction or elimination of fiduciary duties by provisions in an LLC agreement, implies that default fiduciary duties exist.
  - "As the Delaware Supreme Court recognized in *Gatz*, the long line of Chancery precedents holding that default fiduciary duties apply to the managers of an LLC are not binding on the Supreme Court, but are appropriately viewed as *stare decisis* by this Court." *Id.* at 660.
  - The *Auriga* Chancery Court's "explanation of the rationale for imposing default fiduciary duties remains persuasive, at least to me." *Id.* at 660-61.

Adjustment/Elimination of Default Fiduciary Duties in LLC Context: Delaware – *Auriga* post-script

- Effective August 1, 2013, the Delaware Limited Liability Company Act was amended to provide that "the rules of law and equity relating to fiduciary duties" apply "in any case not provided for in this chapter." 6 *Del. C.* § 18-1104

- The Synopsis accompanying the amendment states that the amendment "confirms that in some circumstances" default fiduciary duties exist, but does not change the rule that fiduciary duties "may be expanded, restricted or eliminated by the limited liability company agreement."

  – *6 Del. C.* § 18-1101(c) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.")

- Note: The covenant of good faith and fair dealing cannot be eliminated.

Limited Partnerships

Adjustment/Elimination of Default Fiduciary Duties in Limited Partnership Context: Texas

- Case law in Texas has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases. Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners. Those in control of the general partner have been held to the same high standards.
- Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides otherwise, a general partner in a limited partnership has the duties of care and loyalty set forth in TBOC section 152.204, which basically codify those duties without giving them the “fiduciary” appellation.
- Under the TBOC, *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.

Adjustment/Elimination of Default Fiduciary Duties in Limited Partnership Context: Texas (cont'd)

- The TBOC states in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership "has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners."

- This language indicates that the partnership agreement may modify the internal liabilities of a general partner. Although there are questions whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation, in *Strebel v. Wimberly II*, 311 S.W.3d 267 (Tex. App. 2012), *reh'g overruled* (May 1, 2012), the Court denied a limited partner's claims for general partner breach of fiduciary duty on the basis of a limited partnership agreement provision that "the General Partner shall have no duties (including fiduciary duties) except as expressly set forth in this Agreement."

- In the 2013 Legislative Session, TBOC § 7.001(d)(2) was amended to provide that the liability of a general partner may be limited or eliminated "in a limited partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply [a for-profit corporation] and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152."

Adjustment/Elimination of Default Fiduciary Duties in Limited Partnership Context: Delaware

- Delaware expressly allows the limitation or elimination of partner fiduciary duties in the limited partnership agreement, but does not allow the elimination of the contractual covenant of good faith and fair dealing which Delaware recognizes in all partnership agreements.

- Limitations on fiduciary duty in a limited partnership agreement will be respected by Delaware courts when they are expressly set forth in the four corners of the limited partnership agreement.

- Types of limiting provisions:
  - Eliminating default fiduciary duties; requirement only to act in good faith (subjective/objective)
  - Indemnification mandated/no liability if act in good faith (subjective/objective)
  - Reliance on experts/conclusive presumption of good faith
  - “Special Approval” by conflicts committee/conclusive presumption of good faith

Duties in the Limited Partnership Context: Recent Delaware Cases

- Five Delaware Supreme Court decisions issued between May 20, 2013 and August 26, 2013 involving transactions by a limited partnership with a related party address the effectiveness of contractual provisions in a limited partnership agreement that modify or eliminate default fiduciary duties and substitute therefor contractual "safe harbors" to cleanse conflicted transactions.
- *Norton v. K-Sea Transp. Partners L.P.*, 67 A.3d 354 (Del. May 28, 2013) (examining the role of a provision providing for a conclusive presumption of good faith)
- *Brinckerhoff v. Enbridge Energy Co.*, 67 A.3d 369 (Del. May 28, 2013) (interpreting an undefined express duty of good faith)
- *Gerber v. Enterprise Prods. Holdings, LLC*, 67 A.3d 400 (Del. June 10, 2013) (examining the role of the implied covenant of good faith and fair dealing)
- *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. July 22, 2013) (discussing the pleading standard for a claim for breach of an express duty of subjective good faith and the relevance of objective reasonableness)
- *DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chicago*, No. 547, 2012, 2013 WL 4517001 (Del. August 26, 2013) (removal of a general partner met the contractual subjective good faith standard in the partnership agreement because the action was not "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith")

Norton v. K-Sea Transportation Partners L.P. – Background

- Plaintiff argued that general partner was overpaid for its incentive distribution rights in connection with a third party's acquisition of the partnership.
- Plaintiff alleged breach of common law fiduciary duties and contractual duties.
- The general partner argued that conflicts committee obtained an appropriate fairness opinion in connection with the transaction, which it argued provided the general partner with a "conclusive presumption" of good faith under the terms of the limited partnership agreement.
- The Court of Chancery dismissed the complaint and the plaintiffs appealed.
  - *The plaintiffs did not appeal the Court of Chancery's dismissal of the claim for breach of the implied covenant of good faith and fair dealing.*

Norton v. K-Sea Transportation Partners L.P. – Key Contractual Provisions

- Limited partnership agreement created contractual procedures for mergers and provided that general partner could consent to a merger "in the exercise of its discretion."
  - Agreement also eliminated common law duties applicable to a decision to consent to the merger and imposed a contractual duty of good faith: "Any standard of care and duty imposed by this Agreement or under . . . any applicable law, rule or regulation shall be modified, waived or limited . . . as required to permit the General Partner to act under this Agreement and to make any decision pursuant to the authority prescribed in this Agreement, so long as such action is reasonably believed by the General Partner to be in, or not inconsistent with, the best interests of the Partnership." *Norton*, 67 A.3d at 361.
  - Agreement provided that the general partner's actions were entitled to a conclusive presumption of good faith if taken in reliance upon the opinion of an advisor on a matter it reasonably believed to be within the advisor's "expert competence."

Norton v. K-Sea Transportation Partners L.P. – Good Faith was Conclusively Presumed

- Although the Court found the facts alleged, standing alone, sufficient to state a claim that the general partner did not act in good faith, application of the conclusive presumption provision in the limited partnership agreement precluded any such claim.
- The conflicts committee obtained an opinion from a financial advisor that the consideration paid to the unaffiliated common unitholders was financially fair. There was no allegation that the financial advisor lacked the requisite expertise to render the opinion and the only reasonable inference was that the general partner relied on the fairness opinion. Accordingly, the conclusive presumption applied and satisfied the general partner's contractual duty to exercise its discretion in "good faith."
- *The Court acknowledged the conclusive presumption provision "dramatically" restricted a unitholder's ability to challenge a conflicted transaction, but emphasized that neither party raised any issue regarding the Vice Chancellor's discussion of the implied covenant of good faith and fair dealing.*
- Plaintiff "willingly invested in a limited partnership that provided fewer protections to limited partners than those provided under corporate fiduciary duty principles. He is bound by his investment decision." *Id.* at 368.

Brinckerhoff v. Enbridge Energy Company, Inc. – Background/Key Contractual Provisions

- Derivative and class action complaint brought on behalf of the unitholders of limited partnership that challenged a joint venture between the limited partnership and the parent of the general partner of the limited partnership.
- The general partner's board of directors formed a special committee to determine whether the joint venture was fair and reasonable to the limited partnership, but was not instructed to consider alternatives. The special committee hired legal and financial advisors and recommended that the limited partnership proceed with the joint venture.
- The plaintiff alleged breach of express and implied contractual duties under the limited partnership agreement.
- The limited partnership agreement provided for indemnification against liability for money damages "for losses sustained or liability incurred as a result of any act or omission if such [i]ndemnitee acted in good faith."
  - Although the limited partnership agreement also included a provision providing a conclusive presumption of good faith if the general partner relied on an advisor's opinion, the Court declined to consider that provision in its ruling as the Court of Chancery did not rest its decision solely on that provision and had separately held that the complaint failed to allege facts that the general partner acted in bad faith.

Brinckerhoff v. Enbridge Energy Company, Inc. – Defining Contractual Good Faith

- Due to the exculpation provision, the plaintiff had to adequately plead that the defendants acted in bad faith in connection with the joint venture agreement.
- To state such a claim, the Court employed a common law definition of the business judgment rule to define the good faith requirement, stating the plaintiff would have to allege that the decision to enter into the agreement was "***so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith***." *Brinckerhoff*, 67 A.3d at 373 (internal quotation marks omitted).
  - The Court also applied the same definition of good faith in construing an express contractual standard in *DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund of Chicago*, No. 547, 2012, 2013 WL 4517001 (Del. 2013)
- The Court ruled that the allegations in the complaint, including that the committee never engaged in hard bargaining or marketed the transaction to third parties, failed to satisfy this high standard.
- *The Court rejected the implied covenant claim on the basis that the plaintiff failed to challenge the Court of Chancery's dismissal of that claim.*

Gerber v. Enterprise Products Holdings, LLC – Background

- The plaintiff brought a class action complaint challenging, in essence, the purchase and sale of the general partner of one of the limited partnerships in the Enterprise entity family and the merger of that limited partnership. Enterprise GP Holdings, L.P. ("EPE") had purchased Texas Eastern Products Pipeline Company, LLC ("TEPPCO GP") for $1.1 billion in 2007 from an affiliate and then sold it in 2009 to another affiliate for $100 million. Plaintiff had previously brought a lawsuit challenging the 2007 purchase and had threatened to sue on the 2009 sale.
- In 2010, EPE was bought by Enterprise Products Partners, L.P. ("EPD"). The proxy statement disclosed that elimination of derivative claims against EPE was a purpose of the transaction, but the fairness opinion relied upon by the conflicts committee did not separately value the derivative claims being eliminated or the value of the limited partnership interests of the minority holders. The plaintiff filed a complaint claiming the conflicts committee did not appropriately value the 2009 and 2007 claims in approving that merger, and combined that claim with a claim directly challenging the 2009 sale. The complaint pled claims for breach of express and implied contractual duties.

Gerber v. Enterprise Products Holdings, LLC – Key Contractual Provisions

- The Enterprise limited partnership agreement replaced common law fiduciary duties with a contractual duty of subjective good faith:
  - required the general partner or any of its "Affiliates" to act in "good faith"; and
  - defined "good faith" as a "belie[f] that the determination or other action is in the best interests of the Partnership." *Gerber*, 67 A.3d at 410.
- The Enterprise limited partnership agreement also created two layers of safe harbors:
  - created four safe harbors, including Special Approval by a conflicts committee, with respect to conflict of interest transactions that insulated the general partner and its "Affiliates" from a claim they breached "any duty stated or implied by law or equity"; and
  - created a conclusive presumption of good faith for actions taken in reliance upon the opinion of an advisor on a matter it reasonably believed to be within the advisor's expert competence.
- The Court of Chancery dismissed the complaint ruling that Special Approval precluded an express claim and the conclusive presumption applied to preclude a claim based on the implied covenant.

Gerber v. Enterprise Products Holdings, LLC – Role of the Implied Covenant

- While the Supreme Court agreed that there was no breach of the express good faith standard, the Supreme Court rejected the Court of Chancery's ruling that the "conclusive presumption" provision precluded a claim based on the implied covenant of good faith and fair dealing, which cannot be eliminated by contract. 6 *Del. C.* § 17-1101(d).
- The Court held that the temporal focus for an implied covenant claim requires a court to determine "whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter." *Id.* at 418. In the context of a discretionary right, the implied covenant requires a party to exercise its discretion reasonably, meaning that the action cannot be arbitrary or unreasonable.
- The Court ruled that the plaintiff sufficiently alleged that the financial advisor's opinions were flawed. The opinions should have valued the derivative claims and addressed the fairness of the transaction to the minority limited partners instead of to partners as a whole.
- The Special Approval process was held flawed because of the reliance on the flawed financial advisor's opinion. As such, the plaintiff could proceed with his implied covenant claim.

Allen v. Encore Energy Partners, L.P. – Background

- Class action brought on behalf of the former unitholders of Encore Energy Partners, L.P. ("Encore") that challenged the use of a "Special Approval" process that was employed by the general partner to approve a conflict transaction pursuant to which Vanguard Natural Resources, LLC ("Vanguard"), holder of 46% of Encore's units, acquired all of the outstanding common units of Encore in a unit-for-unit exchange (the "Merger").
- The plaintiff argued that the general partner of Encore, its board of directors, and Vanguard breached their contractual duties by proposing, approving and consummating the Merger. The defendants moved to dismiss all of the claims in the complaint and the Court of Chancery granted the motion in its entirety. The plaintiff appealed.
  - *The plaintiff did not appeal the Court of Chancery's dismissal of his claim for breach of the implied covenant of good faith and fair dealing.*

Allen v. Encore Energy Partners, L.P. – Key Contractual Provisions

- The Encore limited partnership agreement replaced common law fiduciary duties with an express duty of subjective good faith.
  - The subjective good faith standard set forth in the limited partnership agreement required that when the general partner took an action, such as approving the Merger, it was required to take such action in "good faith," defined as a "belie[f] that the determination or other action is in the best interests of the Partnership."
- The Encore limited partnership agreement also established a "Special Approval" safe harbor *expressly* constrained by the contractual duty of subjective good faith.
  - The Encore LPA defined "Special Approval" as "approval by a majority of the members of the Conflicts Committee acting in good faith." The Court ruled that the definition of "good faith" above also applied in this context.
- The Encore limited partnership agreement further provided a rebuttable presumption that the conflicts committee satisfied the contractual duty of good faith when they approved the Merger by Special Approval.

Allen v. Encore Energy Partners, L.P. – Pleading a Breach of the Contractual Duty

- The Court identified two distinct ways to state a claim for breach of the express subjective good faith standard in the Encore limited partnership agreement.

- Alleging facts that enable a court to reasonably infer that the conflicts committee:

  - (1) “[B]elieved it was acting against Encore’s best interests when approving the Merger”; or

  - (2) “[C]onsciously disregarded its duty to form a subjective belief that the Merger was in Encore’s best interests.” *Allen*, 72 A.3d at 106.

Allen v. Encore Energy Partners, L.P. – Pleading State of Mind/Objective Reasonableness

- Objective reasonableness is relevant in determining whether a complaint states a claim for breach of a subjective good faith standard.
  - "Some actions may objectively be so egregiously unreasonable, however, that they 'seem[] essentially inexplicable on any ground other than subjective bad faith.' It may also be reasonable to infer subjective bad faith in less egregious transactions when a plaintiff alleges objective facts indicating that a transaction was not in the best interests of the partnership and that the directors knew of those facts." *Id.* at 107.
- The Court, however, cautioned that "the subjective good faith standard remains distinct from an objective, 'reasonable person' standard."
  - "[T]he ultimate inquiry must focus on the subjective belief of the specific directors accused of wrongful conduct. The directors' personal knowledge and experience will be relevant to a subjective good faith determination, which must focus on measuring the directors' approval of a transaction against their knowledge of the facts and circumstances surrounding the transaction. Trial judges should avoid replacing the actual directors with hypothetical reasonable people when making the inquiry." *Id.*

Limited Partnership Summary

- Drafters of limited partnership agreements can include a provision creating a conclusive presumption of good faith that can ratify an express contractual duty. Such a provision, however, cannot be used to eliminate the implied covenant of good faith and fair dealing.

- Although the implied covenant will generally be used to fill contractual gaps, drafters should be particularly aware of the role of the implied covenant in constraining discretionary rights under a limited partnership agreement. Transactional advisors should anticipate that the use of discretionary contractual safe harbors to effectuate transactions will likely be subject to judicial review under the implied covenant to determine if the approval constituted arbitrary or unreasonable conduct (based on a retrospective focus).

January 16, 2014

AN INTRODUCTION TO THE TEXAS BUSINESS LAW FOUNDATION (2014)

The Texas Business Law Foundation is a non-profit corporation organized in 1988 and supported by businesses, law firms, professors of business law and individuals throughout Texas. The Foundation's objective is to promote a favorable business climate in Texas through the maintenance of a modern system of business laws. To achieve this goal, the Foundation sponsors Texas legislation that advances the law and solves problems, monitors state legislative and administrative proposals of interest to Foundation members, endorses or opposes those proposals and serves as a source of advice and consultation to the legislative, judicial and executive branches of Texas government.

Whether sponsoring a uniform state business statute or a modernization of usury and organizational laws, the Foundation can be relied on to provide a package of progressive and sound business law legislation at each biennial session of the Texas Legislature. The Foundation has also been vigilant in monitoring bills that are adverse to the interests of business in Texas and in mobilizing opposition where appropriate. Among the proposed laws successfully opposed by the Foundation were those that would regulate the compensation of management, impose at a state level regulations similar to but beyond those in the Sarbanes-Oxley Act of 2002, and void certain indemnification arrangements. Your contribution to the Foundation assures your firm or company a voice in the future direction of Texas business law and the chance to participate in promoting an environment that is advantageous to your company or clients.

In supporting or opposing legislation, the Foundation has both acted as the primary advocate or opponent and partnered with or provided support to other like-minded organizations in its effort to achieve the desired outcome. The Foundation avoids active sponsorship of legislation that is not viewed favorably by its members or that is more high profile and controversial (for example, tort reform). In addition to its legislative efforts, the Foundation has drafted and filed amicus briefs and position papers with the courts and regulatory bodies in support of or opposition to litigation, regulation or legislation.

The directors of the Foundation are lawyers in private practice, general counsels of major corporations, and distinguished professors of law and corporate executives who concentrate on governmental relations and public affairs. The current officers of the Foundation and their affiliations are as follows:

Chairman: Byron F. Egan, Jackson Walker L.L.P., Dallas
Vice Chairman: Scott G. Night, Haynes and Boone, LLP, Dallas
Secretary-Treasurer: Michael L. Laussade, Jackson Walker L.L.P., Dallas

The Foundation's Sustaining and Contributing Members include:

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For further information regarding the purposes, history and successes of the Foundation, *see Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, "The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*," 41 Texas Journal of Business Law 41 (Spring 2005), available at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1239.

For more information on how to join the Foundation and to assist in its efforts, please contact:

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LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION
83RD TEXAS LEGISLATURE (2013)

The Texas Business Law Foundation sponsored and shepherded the following bills through the 83rd Texas Legislature, which commenced January 11, 2013 and adjourned on May 27, 2013, from their introduction through their passage:

1. Updating Corporate Statutes. S.B. 847 by Sen. John J. Carona amended the Texas Business Organizations Code ("*TBOC*") to update its provisions relating to corporations, partnerships and LLCs, including (i) simplification of the required contents for amended and restated certificates of formation, (ii) requiring limited partnerships to give winding up notices to potential claimants much like corporations are currently required to do, (iii) clarifying that the governing documents of partnerships and LLCs may eliminate monetary liability of their governing persons to the same extent that a corporate certificate of formation can do so for directors and to the further extent permitted by the specific partnership and LLC provisions of the TBOC, (iv) clarification that partnership agreements and LLC company agreements may provide rights to persons who are not parties thereto (e.g., officers, managers or creditors), and (v) clarification of the powers of an LLC series and that a series is not a separate entity. S.B. 847 also amended Section 24.003 of the Texas Business and Commerce Code ("*TB&CC*") to eliminate a subsection that provided that a general partner's nonpartnership assets are considered in determining the solvency of the partnership for fraudulent transfer purposes. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB847.

2. Social Purposes in For-Profit Corporations. S.B. 849 by Sen. John J. Carona amended the TBOC to allow for-profit corporations to include "social purposes" in their certificates of formation and to specify that their governing persons are entitled to consider those social purposes in making decisions on behalf of the corporations. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB849.

3. Finance Code. H.B. 1979 by Rep. Mike Villarreal amended Section 306.003 of the Finance Code to allow parties to commercial loans to agree that (i) interest is to be computed on the basis of actual days over a year of 360 days or twelve 30-day months and (ii) accrued interest may be paid on a periodic basis (not more often than monthly) by adding it to the principal balance of the loan. H.B. 1979 also confirmed that the provisions in Chapter 306 are meant to be safe harbors and do not create a negative implication for other transactions. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=HB1979.

4. Amendments to Section 4A.108, Texas Business & Commerce Code. S.B. 230 by Sen. John J. Carona amended TB&CC Section 4A.108 so that international consumer wire transfers will remain covered by TB&CC Section 4A.108. The amendment was necessitated by an amendment to the federal Electronic Funds Transfer Act effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act that would have removed the statutory framework for such transfers. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB230.

5. Amendments to Section 9.516(b), Texas Business & Commerce Code. SB 474 by_Sen. John J. Carona amended TB&CC Section 9.516(b) to eliminate organization information from

financing statements that is not otherwise required by the TB&CC. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB474.

6. Uniform Trade Secrets Act. SB 953 by Sen. John J. Carona enacted the Uniform Trade Secrets Act ("*UTSA*") to generally modernize existing Texas common law relating to misappropriation of trade secrets, but made the following changes from the UTSA: (i) does not require that information have been in "continuous use", resulting in a broader class of trade secrets, (ii) provides that injunctive relief is a proper remedy, (iii) provides that attorneys' fees are available to a plaintiff where misappropriation was willful and malicious, and are available to a defendant where a claim of misappropriation was made in bad faith, and (iv) provides that damages for misappropriation can include both actual loss and unjust enrichment, or alternatively imposition of a reasonable royalty, plus exemplary damages not exceeding twice any damage award. The UTSA has been adopted in 46 other states. Available at http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=83R&Bill=SB953.

We also contributed to changes in the course or content of, or the demise of, several bills that were introduced by others in the Regular Session and affected statutes that have traditionally been of interest to the Foundation, including:

(i) Assumed Name Filings. Chapter 71 of the TB&CC requires a filing entity to file an assumed name certificate if it conducts business in Texas in a name other than the one in its certificate of formation on file with the Secretary of State and include certain information. S.B 699 by Sen. John J. Carona at the request of the Secretary of State amended TB&CC Section 71.102 to eliminate the requirement that an assumed name certificate include the entity's registered office (as it is already in another filing with the Secretary of State) and simplified the information required in connection with a principal office. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB699.

(ii) Series LLC Name Filing. H.B. 1624 by Rep. Philip Cortez was initially proposed as an amendment to TBOC Section 101.601 adding a requirement that an LLC establishing a series shall name the series with a name that contained the name of the LLC followed by the word "series" and a unique identifying number. The bill was reworked into a simple amendment to the TB&CC Section 71.002(2) to require an assumed name filing for an LLC series established by its company agreement. H.B. 1624 as passed did not contain any requirements as to the naming of any series. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1624.

(iii) Powers of Attorney. H.B. 2918 by Rep. Senfronia Thompson, as passed and effective January 1, 2014, changed the current statutory durable power of attorney form in Estates Codes Section 752.051 from an "opt-out" form to an "opt-in" form (i.e. from a form in which powers are granted unless expressly excluded to one in which powers are not granted unless affirmatively so provided) and added wording regarding the fiduciary duties and other legal responsibilities of an agent appointed pursuant to a statutory durable power of attorney. Foundation representatives monitored the bill so that it did not end up containing provisions that would have applied to powers of attorney in entity organization and governance documents, financing documents and other commercial documents. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB2918.

(iv) Banks. S.B. 804 by Sen. John J. Carona revised provisions in certain laws governing certain banks and trust companies in Texas to conform to changes in terminology made by the TBOC. This legislation was prepared by the Department of Banking and primarily substitutes the term "certificate of formation" for the term "articles of association." Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=SB804.

(v) Bank Regulation. H.B. 1664 by Rep. Mike Villarreal amended provisions of the Finance Code relating to the subpoena and other regulatory powers of state bank and trust company regulators, the opening of state bank deposit or loan production offices, limitations on the providing by a state bank or trust company of confidential information to its advisory directors, meetings of the board of directors of a state bank, holding real estate and mineral royalty interests, and other matters relating to the regulation of state banks, trust companies and bank holding companies. Available at http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=83R&Bill=HB1664.

LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION 82ND TEXAS LEGISLATURE (2011)

The Texas Business Law Foundation sponsored and shepherded the following bills through the 82nd Texas Legislature, which convened on January 11, 2011 and adjourned on May 30, 2011, from their introduction through their passage:

1. LLC Veil Piercing Limits. Senate Bill 323 amended the Texas Business Organizations Code ("TBOC") to provide that the TBOC provisions limiting the liability of shareholders of Texas corporations apply equally to managers and members of Texas limited liability companies ("LLCs") if or to the extent LLC veil piercing becomes recognized in Texas. SB 323 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB521.

2. Derivative Plaintiff Qualification. Senate Bill 1568 deleted a TBOC provision that was ambiguous and inconsistent with other TBOC provisions and court holdings relating to standing to bring a derivative action on behalf of a corporation after a merger. Now it is clear that a derivative plaintiff must own stock at the time of the act complained of and continuously to the completion of the lawsuit. SB 1568 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568.

3. Business Entity Statute Updating. Senate Bill 748 is a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC that addresses issues that have arisen in recent experience under the TBOC and makes the statute more user friendly for Texas entities. SB 748 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748.

4. More Flexibility to Choose Law Applicable to Large Transactions. House Bill 2991 amended chapter 271 of the Texas Business and Commerce Code to add additional flexibility in choosing the law of a particular jurisdiction to govern large business transactions. HB 2991 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB2991.

5. Secured Transactions. Senate Bill 782 amended Texas Business and Commerce Code Chapter 9 to adopt changes approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states. The majority of the changes are for enhanced clarity or to reflect advances in technology or changes in business practice. SB 782 is available at: http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782.

In 2011 the Foundation also successfully opposed proposed legislation that, if enacted, would have been generally unfavorable to the conduct of business. Among the bills the Foundation opposed in 2011 that did not pass were bills restricting the choice of foreign law and adding requirements for powers of attorney that could affect commercial transactions.

OTHER LEGISLATION SPONSORED BY TEXAS BUSINESS LAW FOUNDATION

During its history, the Texas Business Law Foundation has been extremely successful in obtaining the passage of its legislative program by the Texas Legislature. Most of the laws that the Foundation has sponsored and passed are listed below:

Amendments to Texas Business Corporation Act in 1985, 1989, 1991, 1993, 1995, 1997, 2003 and 2005

Revised Limited Partnership Act of Texas in 1991, and amendments in 1993, 1995, 1997, 2003 and 2005

Revised Partnership Act of Texas, and amendments in 2003 and 2005

Limited Liability Partnership Amendments to Uniform Partnership Act and to Revised Partnership Act of Texas

Limited Liability Company Act of Texas in 1991, amendments in 1993, 1995, 1997, 2003, 2005, and 2007

Business and Commerce Code Amendments (i.e., Revised UCC Articles 1, 2A, 3, 4, 4A, 5, 6, 7, 8 and 9) in 1991, 1995, 1997, 1999, 2003 and 2005, technical amendments to UCC Article 9 in 2001, 2003, and 2007, and amendments to UCC Articles 3 and 4 in 2005

Uniform Unincorporated Non-Profit Association Act in 1995

Amendments to Non-Profit Corporation Act in 1993 and 1995

Texas Environmental and Safety and Health Audit Privilege Act in 1995

Amendments to Real Estate Investment Trust Act in 1995 and 1997

Contractual Choice of Law in 1993

Covenants Not to Compete Amendments in 1989, 1991 and 1993

Professional Service Negligence Bill in 1995

Usury Reform Amendments in 1993, 1997, 1999 and 2005

Contractual Choice of Venue Bill in 1999
Euro Conversion Bill in 1999

Uniform Electronic Transactions Act in 2001

Texas Business Organizations Code in 2003, and amendments thereto in 2005, 2007 and 2009.

Anti-Botnet Bill in 2009

Amendments to Certificate of Title Statutes in 2009

In addition, the Foundation has in each legislative session monitored and either endorsed or opposed any number of other bills, all from the standpoint of their benefit to the conduct of business in the State of Texas. The Foundation's efforts have also resulted in the modification of legislation to reduce its negative effect on business.

TEXAS BUSINESS LAW FOUNDATION
Sustaining Membership Form

The Texas Business Law Foundation is a non-profit organization dedicated to the improvement and implementation of laws favorable to organizations doing business in the State of Texas. The Foundation's activities include the drafting and support of pro-business legislation, the filing of amicus briefs and position papers with the courts and regulatory bodies on significant issues affecting Texas businesses and other activities associated with the enactment of pro-business legislation and regulations.

Membership dues are used to further the mission of the Foundation and are used primarily to pay lobbying expenses. Dues and other contributions to the Foundation are not deductible as charitable contributions for federal income tax purposes. In addition, the Foundation estimates that approximately 100 percent of the dues collected by the Foundation will be allocable to the Foundation's activities with respect to "influencing legislation," as the term is defined in section 162(e) of the Internal Revenue Code, and thus will not be deductible as a trade or business expense under section 162(a) of the Internal Revenue Code. No funds are used for political contributions.

Membership may be either on an individual basis or through an organization. Dues are payable annually at $2,500 a year for sustaining members and cover the fiscal year period from September 1 to August 31. We also have participating organizational memberships for small law firms and small businesses (called Contributing Memberships).

Sustaining members will receive regular updates on the Foundation's legislative, judicial and other efforts and will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to The Texas Business Law Foundation at the address provided below:

Membership:	Sustaining Membership	$2,500
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

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Membership may be either on an individual basis or through an organization. Dues are payable annually and cover the fiscal year period from September 1 to August 31. Individual memberships are $100 per year (called "Fellows") and organizational memberships are $2,500 per year (called "Sustaining Memberships"). We also have participating organizational memberships for small law firms and small businesses (called "Contributing Memberships") for $1,000 per year.

All members will receive regular updates on the Foundation's legislative, judicial and other efforts. Sustaining members will also be entitled to the appointment of a director to the Board of Directors of the Foundation.

Please complete the following and return this form and your check payable to Texas Business Law Foundation at the address provided below:

Membership:	[_____] Sustaining Membership	$2,500
	[_____] Contributing Membership	$1,000
	[_____] Fellow Membership	$ 100
Name/Organization:		
Organizational Contact:		
Address:		
Telephone Number:		
Fax Number:		
Email Address:		

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