DIRECTOR FIDUCIARY DUTIES UNDER DELAWARE AND TEXAS LAW

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TABLE OF CONTENTS

Page

I. Introduction. 1
II. Corporate Fiduciary Duties Generally. 2
A. General Principles. 2
B. Applicable Law. 4
C. Fiduciary Duties in Texas Cases. 7
1. Loyalty. 7
a. Good Faith. 7
b. Self-Dealing Transactions. 8
c. Oversight. 8
2. Care. 8
a. Business Judgment Rule; Gross Negligence 8
b. Reliance on Reports. 10
c. Charter Limitations on Director Liability. 10
3. Other (obedience) 10
D. Fiduciary Duties in Delaware Cases. 11
1. Loyalty. 11
a. Conflicts of Interest 11
b. Good Faith. 12
c. Oversight/Caremark. 14
d. Candor. 21
2. Care. 23
a. Business Judgment Rule; Informed Action; Gross Negligence. 23
b. Business Judgment Rule Not Applicable When Board Conflicted. 24
c. Inaction. 26
d. Reliance on Reports and Records. 26
e. Limitation on Director Liability 26
E. Fiduciary Duties of Officers. 27
F. Derivative Actions. 28
G. Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties. 33
1. Overview. 33
2. Shareholder Causes of Action. 34
3. Director Independence. 35
a. Power to Independent Directors 35
b. Audit Committee Member Independence. 40
c. Nominating Committee Member Independence. 43
d. Compensation Committee Member Independence. 44
e. State Law. 45
4. Compensation. 50
a. Prohibition on Loans to Directors or Officers. 50
b. Stock Exchange Requirements. 52
c. Fiduciary Duties. 52
5. Related Party Transactions. 52

5420669v.1

a. Stock Exchanges. 52
b. Interested Director Transactions —TBOC § 21.418; TBCA Art. 2.35-1; and DGCL § 144. 53
H. Contractual Limitation of Corporate Fiduciary Duties. 54
1. Limitation of Director Liability. 55
2. Renunciation of Corporate Opportunities. 57
3. Interested Director Transactions. 57
III. Shifting Duties When Company on Penumbra of Insolvency. 59
A. Insolvency Can Change Relationships 59
B. When is a Corporation Insolvent or in the Vicinity of Insolvency? 61
C. Director Liabilities to Creditors. 63
D. Business Judgment Rule/DGCL § 102(b)(7) During Insolvency. 65
E. Deepening Insolvency. 68
F. Conflicts of Interest. 72
G. Fraudulent Transfers. 72
IV. Executive Compensation Process. 72
A. Fiduciary Duties. 72
B. Specific Cases. 73
1. Walt Disney. 73
a. Facts. 74
b. May 28, 2003 Chancery Court Opinion. 74
c. September 10, 2004 Chancery Court Opinion (Ovitz' Fiduciary Duties Regarding His Employment Agreement). 74
d. August 9, 2005 Chancery Court Post Trial Opinion. 75
e. June 8, 2006 Supreme Court Opinion. 77
2. Integrated Health. 81
3. Sample v. Morgan. 84
4. Ryan v. Gifford. 87
5. In re Tyson Foods, Inc. Consolidated Shareholder Litigation. 90
6. Desimone v. Barrows 95
7. Teachers' Retirement System of Louisiana v. Aidinoff 97
8. Valeant Pharmaceuticals v. Jerney 97
C. Non-Profit Corporations. 100
V. Standards of Review in M&A Transactions. 102
A. Texas Standard of Review. 102
B. Delaware Standard of Review. 104
1. Business Judgment Rule. 104
2. Enhanced Scrutiny. 105
a. Defensive Measures. 106
b. Sale of Control. 106
3. Entire Fairness. 108
C. Action Without Bright Lines. 109
VI. M&A Transaction Process. 109
A. Statutory Framework: Board and Shareholder Action. 109
B. Management's Immediate Response. 110
C. The Board's Consideration. 111

5420669v.1

1. Matters Considered. 111
2. Being Adequately Informed. 112
a. Investment Banking Advice. 112
b. Value of Independent Directors, Special Committees. 114
c. Significant Recent Process Cases. 121
D. Value of Thorough Deliberation. 138
E. The Decision to Remain Independent. 139
1. Judicial Respect for Independence 140
2. Defensive Measures. 142
F. The Pursuit of a Sale. 143
1. Value to Stockholders. 143
2. Ascertaining Value 144
3. Process Changes 149
4. Disparate Treatment of Stockholders 155
5. Protecting the Merger. 158
a. No-Shops 159
b. Lock-ups 161
c. Break-Up Fees. 162
6. Specific Cases Where No-Shops, Lock-ups, and Break-Up Fees Have Been Invalidated. 163
7. Specific Cases Where No-Shops, Lock-ups and Break-Up Fees Have Been Upheld. 164
8. Post Signing Market Check/"Go-Shop". 167
G. Dealing with a Competing Acquiror. 168
1. Fiduciary Outs. 169
a. Omnicare, Inc. v. NCS Healthcare, Inc. 169
b. Orman v. Cullman. 173
c. Optima International of Miami, Inc. v. WCI Steel, Inc. 174
d. Energy Partners, Ltd. v. Stone Energy Corp. 176
e. Johnson & Johnson v. Guidant Corp. 177
2. Level Playing Field. 178
3. Match Rights. 179
4. Best Value. 180
H. Postponement of Stockholder Meeting to Vote on Merger. 181
VII. Responses to Hostile Takeover Attempts. 182
A. Certain Defenses. 182
B. Rights Plans. 182
C. Business Combination Statutes. 185
1. DGCL § 203. 185
2. Texas Business Combination Statutes. 186
VIII. Going Private Transactions 187
A. In re Pure Resources Shareholders Litigation 187
B. In re Emerging Communications, Inc. Shareholders Litigation 191
C. In re PNB Holding Co. Shareholders Litigation 192
D. In re SS&C Technologies, Inc. Shareholder Litigation 194
E. In re Netsmart Technologies 196

F. In re Topps Company Shareholders Litigation 204
G. In re Lear Corporation Shareholder Litigation 209
IX. M&A During the Credit Crunch 214
A. General. 214
B. Pre-Crunch Sensitivity to Target Financial Stress. 215
C. Bear Stearns. 215
D. Merrill Lynch. 221
E. Wachovia. 222
F. Observations from Merrill Lynch, Bear Stearns and Wachovia. 227
X. Other Director Considerations. 228
A. Enforceability of Contracts Violative of Fiduciary Duties 228
B. Director Consideration of Long-Term Interests. 229
C. Liability for Unlawful Distributions. 230
D. Reliance on Reports and Opinions. 231
E. Inspection of Records. 231
F. Bylaws. 231
G. Right to Resign. 234
XI. Asset Transactions. 235
A. Shareholder Approval. 235
1. DGCL. 236
2. Texas Corporate Statutes. 238
3. Model Business Corporation Act. 239
B. De Facto Merger. 239
XII. Dissent and Appraisal Rights. 240
A. Delaware Law. 241
1. When DGCL Appraisal Rights Are Triggered. 241
2. Who Is Entitled to DGCL Appraisal Rights. 243
3. Procedural Aspects of DGCL Appraisal. 243
4. Valuation under DGCL. 245
B. Texas Corporate Statutes. 245
1. When Texas Statutory Appraisal Rights Are Triggered. 245
2. Who Is Entitled to Texas Statutory Appraisal Rights. 246
3. Procedural Aspects of Texas Statutory Appraisal. 247
4. Valuation under Texas Corporate Statutes. 249
C. Model Business Corporation Act. 249
XIII. Alternative Entity Fiduciary Duties. 250
A. General Partnership 250
B. Limited Partnership 252
C. Limited Liability Company 258
XIV. Conclusion. 263

Appendix A – Summary of the Sarbanes-Oxley Act of 2002

Appendix B – Options Backdating Issues

Appendix C – Summary of SEC Executive Compensation Disclosure Rules

TABLE OF CASES

A. Copeland Enterprises, Inc. v. Guste, 706 F. Supp. 1283 (W.D. Tex. 1989) 5, 8, 102, 103, 183, 184
In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. 2003) 15, 16
Ace Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999) 159, 160, 168, 169, 174, 228
Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al., 2002 Del. Ch. LEXIS 11 .... 63, 65, 66
In re Appraisal of Shell Oil Co., C.A. No. 8080 (Del. Ch. Oct. 30, 1992) 245
In re Aquila, Inc., 805 A.2d 184 (Del. Ch. 2002) 189
Arnold v. Society for Savings Bancorp, Inc., 650 A.2d 1270 (Del. 1994) 4, 107
Aronson v. Lewis, 473 A.2d 805 (Del. 1984) 29, 47, 49, 104, 108, 117
Askanase v. Fatjo, No. H-91-3140, 1993 WL. 208440 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997) 60, 61, 65
Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989) 109, 112, 127, 144, 145, 178, 179, 180, 219
Beam v. Martha Stewart, 845 A.2d 1040 (Del. 2004) 49
In re Bear Stearns Litigation, ____ N.Y.S.2d ____, 2008 WL 5220514, 2008 N.Y. Slip Op. 28500 (N.Y.Sup., Dec 04, 2008) (NO. 600780/08) 215, 227
Beaumont v. American Can Co., Index No. 28742/87 (N.Y. Sup. Ct. May 8, 1991) 156
Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp., 822 A.2d 396 (Del. 2003) 6
Benchmark Capital Partners IV, L.P. v. Vague, 2002 Del. Ch. LEXIS 90 (Del. Ch. July 15, 2002), *aff'd sub nom. Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, 822 A.2d 396 (Del. 2003) 6
In re Bennett, 989 F.2d 779 (5th Cir. 1993) 252
Benson v. Braun, 155 N.Y.S.2d 622 235
Berg v. Ellison, CA No. 2949-VCS (Del. Ch. June 12, 2007) 167, 179
Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners, 2001 WL 1641239 (Del. Ch. Dec. 4, 2001) 254
Biondi v. Scrushy, C.A. No. 19896, 2003 Del. Ch. LEXIS 7 (Del. Ch. Jan. 16, 2003) 48
Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) 13, 181, 219
BNS Inc. v. Koppers Co., 683 F. Supp. 458 (D. Del. 1988) 183
Boyer v. Wilmington Materials, Inc., 1997 Del. Ch. LEXIS 97 (Del. Ch. June 27, 1997) 115
Brandin v. Deason, 2123-VCL (Del. Ch. July 20, 2007) 88
Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997) 104, 162
Brazosport Bank of Tex. v. Oak Park Townhouses, 837 S.W.2d 652 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993) 252, 253
Brehm v. Eisner, 746 A.2d 244 (Del. 2000) 49, 114, 231
Burk Royalty Co. v. Walls, 616 S.W.2d 911 (Tex. 1981) 10
Burks v. Lasker, 441 U.S. 471 (1979) 3
CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008) 3, 232
In re Caremark International, Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996) 14, 15, 16, 17, 18, 19, 20, 21, 47, 107, 213, 214

Cargill, Inc. v. JWH Special Circumstance LLC, CA No. 3234-VCP (Del. Ch. Nov. 7, 2008). 254
Cargo Partner AG v. Albatrans Inc., 352 F.3d 41 (2d Cir. 2003) 239
Carl M. Loeb, Rhoades & Co. v. Hilton Hotels Corp., 222 A.2d 789, 793 (Del. 1966) 243
Carmody v. Toll Brothers, Inc., 723 A.2d 1180 (Del. Ch. 1998) 184
Carrieri v. Jobs.com, 393 F.3d 508 (5th Cir. 2004) 60
Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254 (D. Kan. 2000) 263
Cates v. Sparkman, 11 S.W. 846 (1889) 9
Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) 11, 12, 23, 107, 111, 113, 114, 139, 143, 144
Chaffin v. GNI Group, Inc., C.A. No. 16211, 1999 Del. Ch. LEXIS 182 (Del. Ch. Sept. 3, 1999) 49
In re CheckFree Corp., C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) 22, 31, 199
Cirrus Holding v. Cirrus Ind., 794 A.2d 1191 (Del Ch. 2001) 160, 143
Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990) 115, 118
Citron v. Fairchild Camera & Instr. Corp., 569 A.2d 53 (Del. 1989) 49, 110, 111, 112, 113, 180
In re CITX Corp. Inc., 448 F.3d 672 (3d Cir. 2006) 66
Clements v. Rogers, 790 A.2d 1222 (Del. Ch. 2001) 118, 120
C.M. Asfahl Agency v. Tensor, Inc., 135 S.W.3d 768 (Tex.App.─Houston [1st Dist.] 2004) 240
In re CNET Networks Inc. Derivative Litigation, No. C-06-3817 WHA, 2007 WL 1089690 (N.D. Cal. Apr. 11, 2007) 96, 97
Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949) 3
Connolly v. Gasmire, 257 S.W.3d 831, 851 (Tex.App.—Dallas 2008) 15. 31
Continuing Creditors' Committee of Star Telecommunications Inc. v. Edgecomb, 385 F.Supp.2d 449 (D. Del. 2004) 68
Cooper v. Pabst Brewing Co., C.A. No. 7244 (Del. Ch. June 8, 1993) 245
Cotton v. Weatherford Bancshares, Inc., 187 S.W.3d 687 (Tex. App.—Fort Worth 2006) 27
Conrad v. Blank, C.A. No. 2611-VCL (Del. Ch. September 7, 2007) 87
Conrad v. Judson, 465 S.W.2d 819 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.) 252
Conway v. Bonner, 100 F.2d 786 (5th Cir. 1939) 60
County of York Employees Retirement Plan v. Merrill Lynch & Co., Inc., 2008 WL 4824053 (Del.Ch., Oct 28, 2008) (NO. CIV.A. 4066-VCN) 215, 221, 227
Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., C.A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. 1991) 61, 63
Crenshaw v. Swenson, 611 S.W.2d 886 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) 252, 253
Crescent/Mach I Partners, L.P. v. Twiner, 846 A.2d 963 (Del. Ch. 2000) 12
CRTF Corp. v. Federated Department Stores, Inc., 683 F. Supp. 422 (S.D.N.Y. 1988) 183
Daniel v. Falcon Interest Realty Corp., 190 S.W.3d 177 (Tex. App.—Houston [1st Dist.] 2005, no pet. hist) 255
Decker v. Mitchell (In re JTS Corp), 305 B.R. 529 (Bankr. N.D. Cal. 2003) 61
In re Dehon, Inc., 334 B.R. 55 (Bank. D. Mass. 2005) 66

Delta Holdings, Inc. v. National Distillers & Chemical Corp., 945 F.2d 1226 (2d Cir. 1991) 71
DePinto v. Landoe, 411 F.2d 297 (9th Cir. 1969) 235
Desert Partners, L.P. v. USG Corp., 686 F. Supp. 1289 (N.D. Ill. 1988) 111, 141, 142, 183
Desimone v. Barrows, C.A. No. 2210-VCS (Del. Ch. June 7, 2007) 95
In re Digex, Inc. Shareholders Litigation, 789 A.2d 1176 (Del. Ch. 2000) 115, 118, 119, 186
District 65 UAW v. Harper & Roe Publishers, 576 F. Supp. 1468 (S.D.N.Y 1983) 235
Dragt v. Dragt/DeTray, LLC, 161 P.3d 473 (Wash. App. 2007) 262
Edgar v. MITE Corp., 457 U.S. 624 (1982) 4, 5
Ehrenhaus v. Baker, 2008 WL 5124899, 2008 NCBC 20 (N.C.Super., Dec 05, 2008) (NO. CIV.A. 08 CVS 22632) 215, 222
Elliott Associates v. Avatex Corp., 715 A.2d 843 (Del. 1998) 6
Elloway v. Pate, 238 S.W.3d 882 (Tex.App.—Houston [14th Dist.] 2007) 32, 95, 143
Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2000) 56
In re Emerging Communications, Inc. Shareholders Litigation, C.A. No.16415, 2004 WL 1305745 (Del. Ch. May 3, 2004) 191
Emerson Radio Corp. v. International Jensen Inc., 1996 WL. 483086 (Del. Ch. 1996) 156, 168
Energy Partners, LTD. v. Stone Energy Corp., C.A. Nos. 2374-N, 2402-N, 2006 Del. Ch. LEXIS 182 (Del. Ch. Oct. 11, 2006) 176
In re Enivid, Inc., 345 B.R. 426 (Bankr. D. Mass. 2006) 66
Equitec-Cole Roesler v. McClanahan, 251 F. Supp. 2d 1347, 1350 (S.D. Tex. 2003) 32
Equity-Linked Investors LP v. Adams, 705 A.2d 1040 (Del. Ch. 1997) 61, 63
Esopus Creek Value LP v. Hauf, No. 2487-N (Del. Ch. Nov. 29, 2006) 237
In re Exide v. Credit Suisse First Boston, 299 B.R. 732 (Bankr. D. Del. 2003) 68
Express Scripts, Inc. v. Crawford, Civil Action No. 2663-N (Del. Ch. February 13, 2007) 28
Express Scripts, Inc. v. Crawford, 2007 WL 707550 (Del. Ch. Feb. 23, 2007) 113, 242
In Re: F5 Networks Derivative Litigation, 2007 U.S.Dist. LEXIS 56390 (W.D. Wash., Aug. 1, 2007) 96
Fagan v. La Gloria Oil & Gas Co., 494 S.W.2d 624 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ) 59, 60
Faour v. Faour, 789 S.W.2d 620 (Tex. App.—Texarkana 1990, writ denied) 24
Farnsworth v. Massey, 365 S.W.2d 1 (Tex. 1963) 247
FDIC v. Benson, 867 F. Supp. 512 (S.D. Tex. 1994) 9
FDIC v. Brown, 812 F. Supp. 722 (S.D. Tex. 1992) 9
FDIC v. Harrington, 844 F. Supp. 300 (N.D. Tex. 1994) 7, 8, 9
FDIC v. Schreiner, 892 F. Supp. 869 (W.D. Tex. 1995) 9
FDIC v. Wheat, 970 F.2d 124 (5th Cir. 1992) 235
Fed. United Corp. v. Havender, 11 A.2d 331, 342 (Del. 1940) 241
Ferguson v. Williams, 670 S.W.2d 327 (Tex. App.—Austin 1984, writ ref'd n.r.e.) 253
Field v. Allyn, 457 A.2d 1089 (Del. Ch.), *aff'd* 467 A.2d 1274 (Del. 1983) 233
In re First Boston, Inc. Shareholders Litigation, 1990 Del. Ch. LEXIS 74, Fed. Sec. L. Rep. (CCH) 95322 (Del. Ch. June 7, 1990) 119
First Marblehead Corp. v. House, 473 F.3d 1, 6 (1st Cir. 2006) 82
First Union Corp. v. SunTrust Banks, Inc., 2001 NCBC 9A ¶ 32 (N.C. Super. Ct. Aug. 10, 2001) 224, 226
Fisk Ventures, LLC v. Segal, 2008 WL 1961156 (Del. Ch. 2008) 260

Fitzgerald v. Cantor, No. CIV.A.16297-NC, 1999 WL 182573 (Del. Ch. Mar. 25, 1999) 263
Flanary v. Mills, 150 S.W.3d 785 (Tex. App. - Austin 2004)..7
Fleet Nat. Bank v. Boyle, 2005 WL 2455673 (E.D. Pa. 2005) 65
Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976)...53, 54, 57, 58
Floyd v. Hefner, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006)..............................3, 9, 60, 61, 65
In re FLS Holdings, Inc. S'holders Litigation, 1993 WL 104562 (Del. Ch. Apr. 21, 1993) 121
Fogel v. U.S. Energy Systems Inc., No. 3271-CC (Del. Ch. Dec. 13, 2007) 3
In re Fort Howard Corp. Shareholders Litig., 1988 WL 83147 (Del. Ch. 1988) 116, 117, 118, 144, 166
Frantz Manufacturing Co. et al. v. EAC Industries, 501 A.2d 401 (Del. 1985)..........................234
Friese v. Superior Court of San Diego County, 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005) 6
Gantler v. Stephens, ___ A.2d ___, 2009 WL 188828 (Del. 2009).........22, 24, 25, 27, 53, 57, 106
Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), *cert denied*, 401 U.S. 974 (1971).........89
Gearhart Industries, Inc. v. Smith International, Inc., 741 F.2d 707 (5th Cir. 1984) 3, 4, 5, 7, 8, 9, 10, 33, 45, 60, 102, 103, 104, 183
In re General Homes Corp., 199 B.R. 148 (S.D. Tex. 1996) 60
Gerdes v. Reynolds, 28 N.Y.S.2d 622 (N.Y. S.Ct. 1941) 235
Gesoff v. IIC Indus. Inc., C.A. Nos. 19473, 19600 (Del. Ch. May 18, 2006).............................123
Geyer v. Ingersoll Pub. Co., 621 A.2d 784 (Del.Ch. 1992) 60, 61, 62, 68
Gimbel v. The Signal Companies, Inc., 316 A.2d 599 (Del. Ch. 1974).....................................236
Globis Partners, L.P. v. Plumtree Software, Inc., C.A. No.1577-VCP (Del. Ch. Nov. 30, 2007)..106, 199
Golden Cycle, LLC v. Allan, 1998 WL 892631 (Del. Ch. December 10, 1998) 111
Goodwin v. Live Entertainment, Inc., 1999 WL 64265 (Del. Ch. 1999).......48, 112, 162, 164, 180
Grand Metropolitan Public, Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988) 183
In re Greater Southeast Community Hospital Corp., 333 B.R. 506 (Bankr. Dist. Colo. 2005) 68
Greater Southwest Community Hospital Corp. I v. Tuft, 353 B.R. 324 (Bank. D. Dist. Col. 2006) 65
Grider v. Boston Co., Inc., 773 S.W.2d 338 (Tex. App.—Dallas 1989, writ denied)................258
Grimes v. Donald, 673 A.2d 1207 (Del. 1996)...117
Grobow v. Perot, 539 A.2d 180 (Del. 1988) 117
Growe v. Bedard, 2004 WL 2677216 (D. Me. 2004) 65
Guth v. Loft, 5 A.2d 503 (Del. 1939) 11, 12
Harbor Finance Partners v. Huizenga, 751 A.2d 879 (Del. Ch. 1999) 49
Hariton v. Arco Elecs., Inc., 182 A.2d 22, 25 (Del. Ch. 1962)..241
Healthco International, Inc. v. Hicks, Muse & Co. (In re Healthco Intern. Inc.), 195 B.R. 971 (Bank. D. Mass. 1966) 66
In re Hechinger Inv. Co. of Del., 327 B.R. 537 (D. Del. 2005)..65
Heineman v. Datapoint Corp., 611 A.2d 950 (Del. 1992)..49
Hixson v. Pride of Texas Distributing Co., 683 S.W.2d 173 (Tex.App.-Fort Worth 1985, no writ)..60
Hochberg v. Schick Investment Company, 469 S.W.2d 474, 476 (Civ. App.—Fort Worth 1971, no writ)..247
Hollaway v. Skinner, 898 S.W.2d 793 (Tex. 1995) 28

Hollinger Inc. v. Hollinger International, Inc., 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004) 236, 237, 243
Hollis v. Hill, 232 F.3d 460 (5th Cir. 2000)....5
In re Holly Farms Corp. Shareholders Litigation, 564 A.2d 342 (Del. Ch. 1988) 164, 183
Huffington v. Upchurch, 532 S.W.2d 576 (Tex. 1976)....252, 253
Hughes v. St. David's Support Corp., 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied)....252, 253
Indiana Electrical Workers Pension Fund v. Millard, S.D.N.Y., No. 07 Civ. 172 (JGK), 7/24/07) 97
In Re: INFOUSA, Inc. Shareholders Litigation, CA No. 1956-CC (Del. Ch. August 20, 2007) 21, 47, 49, 195
International Bankers Life Insurance Co. v. Holloway, 368 S.W.2d 567 (Tex. 1967) 7
International Telecharge, Inc. v. Bomarko, Inc., 766 A.2d 437 (Del. 2000) 118
Invacare Corporation v. Healthdyne Technologies, Inc., 968 F. Supp. 1578 (N.D. Ga. 1997) 184
In re IT Group Inc., 2005 WL 3050611 (D. Del. 2005) 66
Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987)....142
In re IXC Commc'ns, Inc. S'holders Litig., C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999) 112, 159, 174, 224
Jackson v. Turnbull, C.A. No. 13042 (Del. Ch. Feb. 8, 1994) , *aff'd*, 653 A.2d 306 (Del. Dec. 7, 1994)....156, 244
James River-Pennington, Inc. v. CRSS Capital, Inc., 1995 WL 106554 (Del. Ch. Mar. 6, 1995) 254
Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584 (Del. Ch. 1986) 115, 156
Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193, 199–200 (Tex. 2002) 251
Johnson v. J. Hiram Moore, Ltd., 763 S.W.2d 496 (Tex. App.—Austin 1988, writ denied)....253
Johnson v. Peckham, 120 S.W.2d 786 (Tex. 1938)....252
Johnson & Johnson v. Guidant Corp., 06 Civ. 7685 (S.D.N.Y. Aug. 29, 2007) 178
Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 156 A. 350 (Del. Ch. 193l) 28
Julian v. Eastern States Construction Service, Inc., C.A. No. 1892-VCP, 2008 WL 2673300 (Del. Ch. July 8, 2008)....98, 99
Kahn v. Dairy Mart Convenience Stores, Inc., 1996 Del. Ch. LEXIS 38 (Del. Ch. March 29, 1996) 115, 117, 120
Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110 (Del. 1994) 65, 72, 109, 115, 117, 119, 120, 188, 189, 192, 193, 194
Kahn v. Lynch Communications Systems, Inc., 669 A.2d 79 (Del. 1995) 119
Kahn v. MSB Bancorp, Inc., 1998 WL 409355 (Del. Ch. 1998), *aff'd* 734 A.2d 158 (Del. 1999) 114, 139, 142
Kahn v. Roberts, 679 A.2d 460 (Del. 1996) 115
Kahn v. Sullivan, 594 A.2d 48 (Del. 1991)....115, 118
Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997)....49, 114, 117, 120
Katell v. Morgan Stanley Group, Inc., 1995 Del. Ch. LEXIS 76, Fed. Sec. L. Rep. (CCH) 98861 (Del. Ch. June 15, 1995) 116

5427504v.1

In re KDI Corp. Shareholders Litigation, 1990 Del. Ch. LEXIS 201, Fed. Sec. L. Rep. (CCH) 95727 (Del. Ch. Dec. 13, 1990) 118
KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc., Civ. A. No. 12683, 1993 WL 285900 (Del. Ch. July 27, 1993) (unpublished mem. op.)....................254
In re Kids Creek Partners, L.P., 212 B.R. 898 (Bankr. N.D. Ill. 1997) 254
Knapp v. North American Rockwell Corp., 506 F.2d 361 (3rd Cir. 1974), *cert. den.* 421 U.S. 965 (1975)....................239
Kohls v. Duthie, 765 A.2d 1274 (Del. Ch. 2000)....................115, 116, 118
Krim v. ProNet, Inc., 744 A.2d 523 (Del. 1999)....................143
Kunz v. Huddleston, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). 252
Landon v. S & H Marketing Group, Inc., 82 S.W.3d 666 (Tex. App.—Eastland 2002)...........7, 8, 54, 58
In re Lear Corporation Shareholder Litigation, 2007 WL 173258 (Del. Ch. June 15, 2007) 168, 209, 211
In re Lear Corporation Shareholder Litigation, Cons. C.A. No. 2728-VCS, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008) 211, 212, 214
Leonard Loventhal Account v. Hilton Hotels Corp., C.A. No. 17803, 2000 WL. 1528909 (Del. Ch. Oct. 10, 2000)....................182
Levco Alternative Fund Ltd. v. Reader's Digest Association, Inc., 803 A.2d 428 (Del. Aug. 13, 2002) 121, 122
Lewis v. Anderson, 477 A.2d 1040, 1047–49 (Del. 1984)....................32
Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985) 49
Lifshutz v. Lifshutz, 199 S.W.3d 9 (Tex. App.-San Antonio 2006) 27
In re Linear Technology Corp. Derivative Litigation, 2006 WL 3533024 (N.D.Cal. Dec. 7, 2006) 96
In re LNR Property Corp. Shareholder Litigation (Del. Ch., Con. C.A. No. 674-N, November 4, 2005) 121
London v. Tyrrell, CA 3321-CC (Del. Ch. June 24, 2008)....................30
In re Loral Space and Communications Inc. Consolidated Litigation, C.A. No. 2808-VCS, 2008 WL 4293781 (Del. Ch. September 19, 2008)....................133, 215
Louisiana Municipal Police Employees' Retirement Sys. v. Crawford, Civil Action No. 2635-N (Del. Ch. February 13, 2007)....................31
Louisiana Municipal Police Employees' Retirement System v. Crawford, 2007 WL 582510 (Del. Ch. Feb. 23, 2007) 113, 242
In re Lukens Inc. Shareholders Litig., 757 A.2d at 738....................180
MAI Basic Four, Inc. v. Prime Computer, Inc., [1988-89 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988) 183
Malone v. Brincat, 722 A.2d 5 (Del 1998) 4, 59
Marron v. Ream, Civil Action No. H-06-1394, 2006 U.S. Dist. LEXIS 72831 (S.D. Tex. May 8, 2006)....................32, 33
Massey v. Farnsworth, 353 S.W.2d 262, 267-268 (Civ. App.—Houston 1961), *rev'd on other grounds*, 365 S.W.2d 1 (Tex. 1963) 246
Matador Capital Management Corp. v. BRC Holdings, Inc., 729 A.2d 280 (Del. Ch. 1998) 110, 143, 159, 162, 165, 181
Matulich v. Aegis Communications Group, Inc., 942 A.2d 596 (Del. 2008) 5

5427504v.1

In re MAXXAM, Inc./Federated Development Shareholders Litigation, 659 A.2d 760 (Del. Ch. 1995) 49, 117
In re MAXXAM, Inc./Federated Development Shareholders Litigation, 1997 Del. Ch. LEXIS 51 (Del. Ch. Apr. 4, 1997) 115, 117
McCollum v. Dollar, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved) 7, 8, 9
McConnell v. Hunt Sports Enterprises, 725 N.E.2d 1193 (Ohio App. 1999) 262
McDermott, Inc. v. Lewis, 531 A.2d 206 (Del. 1987) 4
McLendon v. McLendon, 862 S.W.2d 662 (Tex. App.—Dallas 1993, writ denied) 252
McMillan v. Intercargo Corp., 768 A.2d 492 (Del. Ch. 2000) 143, 219
McPadden v. Sidhu, C.A. No. 3310-CC, 2008 WL 4017052 (Del. Ch. August 29, 2008) 24, 137, 138
Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928) 251
Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994) 161
Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786 (Del. Ch. 2007) 181, 219
M.G. Bancorporation Inc. v. LeBeau, 737 A.2d 513, 526 (Del. 1999) 245
Michelson v. Duncan, 407 A.2d 211 (Del. 1979) 53, 57
Milam v. Cooper Co., 258 S.W.2d 953 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.) 8
Miller v. American Real Estate Partners, L.P., No. CIV.A.16788, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.) 256
Miller v. McCown De Leeuw & Co. (In re Brown Schools), 2008 Bankr. LEXIS 1226, at *19-23 (Bankr. D. Del. Apr. 24, 2008) 71
Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988) 108, 112, 113, 114, 116, 118, 120, 140, 144, 162, 163, 169, 179
Mills Acquisition Co. v. Macmillan, Inc., 1988 WL 108332 [1988-89 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), rev'd on other grounds, 559 A.2d 1261 (Del. 1989) 183
Missouri Pacific Railway v. Shuford, 72 Tex. 165, 10 S.W. 408 (1888) 10
Mizel v. Connelly, C.A. No. 16638, 1999 Del. Ch. LEXIS 157 (Del. Ch. July 22, 1999) 49
In re MONY Group Inc. Shareholder Litigation, 852 A.2d 9 (Del. Ch. 2004) 4, 145, 149
In re MONY Group Inc. Shareholders Litigation, 853 A.2d 661 (Del. Ch. 2004) 149
Moore Business Forms, Inc. v. Cordant Holdings Corp., 1996 Del. Ch. LEXIS 56 (Del. Ch. June 4, 1996) 116
Moore Corp. Ltd. v. Wallace Computer Services, Inc., 907 F. Supp. 1545 (D. Del. 1995) 138, 140, 142, 183
Moran v. Household International, Inc., 490 A.2d 1059 (Del. Ch.), aff'd, 500 A.2d 1346 (Del. 1985) 23
Moran v. Household International, Inc., 500 A.2d 1346 ....139, 142, 182
In re Netsmart Technologies, 924 A.2d 171 (Del. Ch. 2007) 168, 196, 199, 202, 211
Newcastle Partners, L.P. v. Vesta Insurance Group, Inc., 887 A.2d 975 (Del. Ch. 2005), aff'd 906 A.2d 807 (Del. 2005) 237
North American Catholic Educational Programming Foundation Inc. v. Gheewalla, 930 A.2d 92, 2007 WL 1453705 (Del. 2007) 59, 61, 63, 65
Odyssey Partners v. Fleming Companies, 735 A.2d 386 (Del. Ch. 1999) 47, 62
Official Committee of Bond Holders of Metricom, Inc. v. Derrickson, 2004 WL 2151336 (N.D. Cal. 2004) 65

Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004) 24, 81, 83
Official Committee of Unsecured Creditors v. R.F. Lafferty Co., Inc., 267 F.3d 340 (3d Cir. 2001) 68
Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006) 71, 72
Oliver v. Boston University, C.A. No. 16570 (Del. Ch. Apr. 14, 2006) 124
Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003)..........................169, 170, 171, 172, 173, 174, 175, 215, 227
Onti, Inc. v. Integra Bank, 751 A.2d 904, 907 (Del. Ch. 1999)..245
Optima International of Miami, Inc. v. WCI Steel, Inc., C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT)...174, 215
In Re Oracle Corp. Derivative Litigation, 824 A.2d 917, 2003 WL. 21396449 (Del. Ch. 2003) 29, 47, 49
Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002)..48
Orman v. Cullman (General Cigar), C.A. No. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004)...173, 174
Pace v. Jordan, 999 S.W.2d 615, 622 (Tex. App. – Houston [1st Dist.] 1999, pet. denied).........29
Palmer v. Fuqua, 641 F.2d 1146 (5th Cir. 1981) 252
Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994)...........105, 107, 108, 111, 114, 140, 143, 144, 147, 151, 153, 159, 160, 162, 163, 169, 171, 179, 219, 228
Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) 108, 114, 139, 140, 142, 144
Paramount Communications Inc. v. Time Inc., 1988 WL 79880 (Del. Ch. 1988) [1989 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1988), *aff'd*, 571 A.2d 1140 (Del. 1989) 183
Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211 (Del. Ch. 2001), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 123 S. Ct. 2076 (2003) 47
Parkview Gen. Hosp. v. Waco Constr., Inc., 531 S.W.2d 224, 228 (Civ. App.—Corpus Christi 1975, no writ)..248
Parnes v. Bally Entm't Corp., 722 A.2d 1243 (Del. 1999)..32
Pate v. Elloway, No. 01-03-00187-CV, 2003 WL 22682422 (Tex.App.—Houston [1st Dist.] Nov. 13, 2003, pet. denied)...32
In re Pennaco Energy, Inc. Shareholders Litigation, 787 A.2d 691 (Del. Ch. 2001) 162, 219
People ex rel Spitzer v. Grasso, 2007 NY Slip Op 03990 (Supreme Court, Appellate Division, May 8, 2007) 101, 102
Pepper v. Litton, 308 U.S. 295 (1939)..103
Pereira v. Cogan, 294 B.R. 449 (SDNY 2003), *reversed on other grounds and remanded*, *Pereira v. Farace*, 413 F.3d 330 (2nd Cir. 2005) 27, 66, 67
Pereira v. Farace, 413 F.3d 330 (2nd Cir. 2005) 24, 60
In re Performance Nutrition, Inc., 237 B.R. 93 (Bankr. N.D. Tex. 1999) 60
Phelps Dodge Corp. v. Cypress Amax Minerals Co., 1999 WL 1054255 (Del. Ch. 1999)........154, 159, 160, 168

5427504v.1

Philadelphia Electric Co. v. Hercules, Inc., 762 F.2d 303 (3rd Cir. 1985) 239
Plas-Tex v. Jones, 2000 WL. 632677 (Tex. App.-Austin 2002; not published in S.W.3d) 60
In re Ply Gem Industrial, Inc. S'holders Litigation, C.A. No. 15779-NC, 2001 Del. Ch. LEXIS 84 (Del. Ch. 2001) 48
In re PNB Holding Co. Shareholders Litigation, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) 192, 193
Pogostin v. Rice, 480 A.2d 619 (Del. 1984) 116, 140
Potter v. Hughes, 546 F.3d 1051, 1056 (9th Cir. 2008) 32
Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).......... 63, 65, 68
In re Pure Resources Shareholders Litigation, 808 A.2d 421 (Del. Ch. 2002).................. 187, 199
Quark Inc. v. Harley, 1998 U.S. App. LEXIS 3864 (10th Cir. March 4, 1998).......................... 235
Quickturn Design System, Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998) 105, 142, 175, 184
Raab v. Villager Indus., Inc., 355 A.2d 888, 894 (Del. 1976), *cert. denied sub nom. Mitchell v. Villager Indus., Inc.*, 429 U.S. 853 (1976)... 244
Rabkin v. Olin Corp., 1990 Del. Ch. LEXIS 50, Fed. Sec. L. Rep. (CCH) 95255 (Del. Ch. Apr. 17, 1990), *reprinted in* 16 Del. J. Corp. L. 851 (1991), *aff'd*, 586 A.2d 1202 (Del. 1990) 119
Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) 117
Rand, 1994 WL 89006 .... 162, 165
Raynor v. LTV Aerospace Corp., 317 A.2d 43, 46 (Del. Ch. 1974) 245
In re Reading Co., 711 F.2d 509 (3d Cir. 1983) 156
In re Resorts International Shareholders Litigation, 570 A.2d 259 (Del. 1990) 115, 120
Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985)........... 106, 125, 127, 128, 129, 130, 131, 132, 133, 134, 136, 138, 139, 141, 142, 143, 144, 145, 147, 148, 150, 151, 153, 154, 160, 161, 162, 163, 166, 168, 172, 173, 179, 199, 200, 204, 205, 208, 209, 210, 211, 214, 219, 220
RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship, HPA, Inc., No. 16873, 1999 WL 550350 (Del. Ch. July 16, 1999) (unpublished mem. op.)... 254
Roberts v. General Instrument Corp., 1990 WL 118356 (Del. Ch. 1990) 158, 162, 166
Romero v. US Unwired, Inc., No. 04-2312, 2006 WL 2366342 (E.D. La. Aug. 11, 2006) 33
Roselink Investors, L.L.C. v. Shenkman, 386 F.Supp.2d 209 (S.D.N.Y. 2004)............................ 65
Roth v. Mims, 298 B.R. 272 (N.D. Texas 2003) 66
RSL Communications PLC ex rel. Jervis v. Bildirici, 2006 WL 2689869 (S.D.N.Y. 2006) 65
RTC v. Acton, 844 F. Supp., 307 (N.D. Tex. 1994) 9
RTC v. Miramon, 22 F.3d 1357 (5th Cir. 1994) 9
RTC v. Norris, 830 F. Supp. 351 (S.D. Tex. 1993)... 9, 10
Rudisill v. Arnold White & Durkee, P.C., 148 S.W.3d 556 (Tex. App. 2004) 238
Ryan v. Gifford, 918 A.2d 341 (Del. Ch. Feb. 6, 2007)................................. 30, 87, 88, 90, 95, 96
Ryan v. Gifford, 2007 WL 4259557 (Del. Ch. Dec. 3, 2007) 89
Ryan v. Lyondell Chemical Company, C.A. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008) ("*Lyondell I*") and on denial of certification of interlocutory appeal 2008 WL 4174038 (Del. Ch. August 29, 2008) ("*Lyondell II*").................... 125, 127, 129, 131, 132, 133, 214, 227
Saito v. McCall, C.A. No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec 20, 2004) 16
Sample v. Morgan, 914 A.2d 647 (Del. Ch. Jan. 23, 2007)... 84

5427504v.1

Sample v. Morgan, 2007 WL 4207790 (Del. Ch. Nov. 27, 2007) 86
Schacht v. Brown, 711 F.2d 1343 (7th Cir 1983) 68
Schilling v. Belcher, 582 F.2d 995 (5th Cir. 1978) 33
Schrage v. Bridgeport Oil Co., Inc., 71 A.2d 882 (Del. Ch. 1950) 156
In re Scott Acq. Corp., 344 B.R. 283 (Bankr. D. Del.) 68
Seagraves v. Urstady Property Co., 1996 Del. Ch. LEXIS 36 (Del. Ch. Apr. 1, 1996) 115
Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc., No. 8853, 1987 WL 12500 (Del. Ch. June 19, 1987) 89
Selfe v. Joseph, 501 A.2d 409, 411 (Del. 1985) 245
Sheppard v. A.C.&S Co., Inc., 484 A.2d 521 (Del. Super. 1984) 240
In re Siliconix, 2001 WL 716787 (Del. Ch. June 21, 2001) 189
Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) 23, 104
Smith v. Bolin, 271 S.W.2d 93 (Tex. 1954) 253
Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) 23, 24, 105, 111, 112, 114, 125, 139, 140, 145, 169, 212
SmithKline Beecham Corp. v. Rohm and Haas Corp., 89 F.3d 154 (3rd Cir. 1996) 239
Solar Cells, Inc. v. True N. Partners, LLC, No. CIV.A.19477, 2002 WL 749163 (Del. Ch. Apr. 25, 2002) 261
Solash v. Telex Corp., 1988 WL 3587 (Del. Ch. Jan. 19, 1988) 11
Solomon v. Pathe Communications Corp, 672 A.2d 35 (Del. 1996) 188, 189
Spiegal v. Buntrock, 571 A.2d 767 (Del. 1990) 116
In re SS&C Technologies, Inc. Shareholder Litigation, 911 A.2d 816 (Del. Ch. 2006) 116, 194
Stanziale v. Pepper Hamilton, LLP, (In re Student Finance Corp.), 355 B.R. 539 (D. Del. 2005) 68
State v. Nevitt, 595 S.W.2d 140 (Tex.App.-Dallas 1980, writ ref'd n.r.e.) 60
Steel Partners II, L.P. v. Point Blank Solutions, Inc., 2008 WL 3522431 (Aug. 12, 2008) 237
Stephenson v. Commonwealth & S. Corp., 156 A.215, 216 (Del. Ch. 1931), *aff'd on other grounds*, 168 A. 211 (Del. 1933) 243
Stone v. Ritter, 911 A.2d 362, 2006 WL 3169168 (Del. 2006) 4, 12, 13, 14, 18, 19, 26, 213
Story v. Kennecott Copper Corporation, 394 N.Y.S. 2d 353, Sup. Ct. (1977) 235
Strassburger v. Earley, 752 A.2d 557 (Del. Ch. 2000) 12, 117, 118, 120
Sullivan Money Management, Inc. v. FLS Holdings, Inc., Del. Ch., C.A. No. 12731 (Nov. 20, 1992), *aff'd*, 628 A.2d 84 (Del. 1993) 5
Suntech Processing Sys., L.L.C. v. Sun Communications, Inc., No. 05-99-00213-CV, 2000 WL 1780236 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication) 259
Swinger v. U.S., 652 F. Supp. 464 (1987) 65
T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536 (Del. Ch. 2000) 115
T.A. Pelsue Co. v. Grand Enterprises Inc., 782 F. Supp. 1476 (D. Colo. 1991) 235
In re Talley Indus., Inc. Shareholders Litigation, 1998 WL. 191939 (Del. Ch. 1998) 112
Teachers' Retirement System of Louisiana v. Aidinoff, 900 A.2d 654 (Del. Ch. 2006) 97
In re Tele-Communications, Inc. Shareholders Litig., C.A. No. 16470-CC (Del. Ch. Dec. 21, 2005, revised January 10, 2006) 121
In re Telesport Inc., 22 B.R. 527 (Bankr. E.D. Ark. 1982) 234
In re The Limited, Inc. S'holders Litigation, 2002 Del. Ch. LEXIS 28, 2002 WL 537692 (Del. Ch. Mar. 27, 2002) 49

Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996) 236
Tooley v. Donaldson, Lufkin & Jenrette, 845 A.2d 1031 (Del. 2004)....................32
In re Topps Company Shareholder Litigation, C.A. No. 2998-VCS (Del. Ch. June 19, 2007) 168, 180, 204
In re Toys "R" Us, Inc. Shareholder Litigation, 877 A.2d 975 (Del. Ch. 2005) 149, 219
In re Trans World Airlines, Inc. Shareholders Litig., 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988) reprinted in 14 Del. J. Corp. L. 870 (1989) 120
Trenwick America Litigation Trust v. Ernst & Young LLP, et al., 906 A.2d 168 (Del. Ch. 2006) 68, 70, 71, 72
TW Services v. SWT Acquisition Corp., C.A. No. 10427, 1989 Del. Ch. LEXIS 19 (Mar. 2, 1989) 183
In re Tyson Foods, Inc. Consolidated Shareholder Litigation, 919 A.2d 563, 2007 WL 416132 (Del.Ch. Feb. 6, 2007) 29, 90, 95, 96
In re Tyson Foods, Inc. Consolidated Shareholder Litigation, C.A. No. 1106-CC (Del.Ch. August 15, 2007) 95
In re United Finance Corporation, 104 F.2d 593 (7th Cir. 1939)....................63
Unitrin, Inc. v. America General Corp., 651 A.2d 1361 (Del. 1995)....................106, 111, 114, 140, 142, 219
Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) 23, 104, 106, 111, 114, 140, 142, 151, 157, 163, 170, 172, 179, 181, 214, 218
In re USACafes, L.P. Litig., 600 A.2d 43 (Del. Ch. 1991) 254, 263
Valeant Pharmaceuticals International v. Jerney, 2007 WL 704935 (Del. Ch. March 1, 2007) 97, 98, 100
VantagePoint Venture Partners v. Examen, Inc., 871 A.2d 1108 (Del. 2005)....................5
In Re: Vartec Telecom, Inc., Case No. 04-81694-HDH-7 2007 WL 2872283 (U.S. Bkr. Ct. N.D. Tex. September 24, 2007) 60
In re Verestar, Inc., 343 B.R. 444 (Bankr. S.D.N.Y. 2006) 68
In re Villa West Assocs., 146 F.3d 798 (10th Cir. 1998) 254
In re Vitalink Communications Corp. Shareholders Litigation, 1991 WL 238816 (Del. Ch. 1991)....................112, 145, 166
Wal-Mart Stores, Inc. v. Coughlin, 255 S.W.3d 424 (April 12, 2007)....................73
In re Walt Disney Co. Derivative Litigation, 731 A.2d 342 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) 49
In re The Walt Disney Co. Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003)....................67, 81, 82, 83
In re The Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005)....................73, 75
In re The Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006)....................12, 13, 18, 19, 27, 73, 74, 77, 129, 213
Warner Communications Inc. v. Chris-Craft Indus., Inc., 583 A.2d 962 (Del. Ch. 1989)....................5, 6
Watchmark Corp. v. Argo Global Capital, LLC, et al, C.A. 711-N (Del. Ch. November 4, 2004) 6
Watson v. Limited Partners of WCKT, Ltd., 570 S.W.2d 179 (Tex. Civ. App.—Austin 1978, writ ref'd n.r.e.)....................252
Wayne County Employees' Retirement System v. Corti, et al., 954 A.2d 319 (Del.Ch., July 1, 2008)....................215
Weaver v. Kellog, 216 B.R. 563 (S.D. Tex. 1997)....................65
Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) 71, 99, 108, 112, 113, 119

Weinstein Enterprises, Inc. v. Orloff, 870 A.2d 499 (Del. 2005) 237
In re Western National Corp. Shareholders Litigation, 2000 WL 710192 (Del. Ch. May 22, 2000) 115
Williams v. Geier, 671 A.2d 1368 (Del. 1996) 104
Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex. 1990)..29
Xerox Corp. v. Genmoora Corp., 888 F.2d 345 (5th Cir.1989)..235
Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) 27
Zauber v. Murray Sav. Ass'n, 591 S.W.2d 932, 937-938 (Tex. Civ. App. 1979) 33
Zirn v. VLI Corp., 621 A.2d 773 (Del. 1993) 27, 56
In re Zoran Corporation Derivative Litigation, 2007 WL 1650948 (N.D. Cal. June 5, 2007) 96, 97

DIRECTOR FIDUCIARY DUTIES UNDER DELAWARE AND TEXAS LAW

By

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I. Introduction.

The conduct of corporate directors and officers in Texas is subject to particular scrutiny in the context of executive compensation and other affiliated party transactions, business combinations (whether friendly or hostile) when the corporation is charged with illegal conduct, and when the corporation is insolvent or in the zone of insolvency. The high profile stories of how much corporations are paying their chief executive officer ("*CEO*") and other executives, corporate scandals, bankruptcies and related developments have further focused attention on how directors and officers discharge their duties, and have caused much reexamination of how corporations are governed and how they relate to their shareholders.

The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners. These troubled times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including their duties of care, loyalty and oversight. Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions ("*M&A*") to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is on the penumbra of insolvency, the beneficiaries of those duties may begin to expand to include the creditors.

Congressional focus on how corporations should be governed following corporate debacles earlier in this decade led to the Sarbanes-Oxley Act of 2002 ("*SOX*"),[1] which President

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1 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in several sections of 15 U.S.C.A.) ("*SOX*"); *see* Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=505; Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); Byron F. Egan, *Communications with Accountants After the Sarbanes-Oxley Act (including Attorney Letters to Auditors re Loss Contingencies, Attorney Duties under SOX §§ 303 and 307, Options Backdating)* (Oct. 24, 2006), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=624; and Byron F. Egan, *Responsibilities of Attorneys and Other M&A Professionals After the Sarbanes-Oxley Act* (November 7, 2008), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1035.

Bush signed on July 30, 2002. SOX was intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.[2]

While SOX and related changes to SEC rules and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law.[3] Our focus will be in the context of companies organized under the Delaware General Corporation Law (as amended to date, the "*DGCL*") and the applicable Texas statutes.

Prior to January 1, 2006, Texas business corporations were organized under, and many are still governed by, the Texas Business Corporation Act, as amended (the "*TBCA*"),[4] which was supplemented by the Texas Miscellaneous Corporation Laws Act (the "*TMCLA*").[5] However, corporations formed after January 1, 2006 are organized under and governed by the Texas Business Organization Code ("*TBOC*").[6] For entities formed before that date, only the ones voluntarily opting into the TBOC will be governed by the TBOC until January 1, 2010, at which time all Texas corporations will be governed by the TBOC. However, because until 2010 some Texas for-profit corporations will be governed by the TBCA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term "*Texas Corporate Statutes*" is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.[7]

II. Corporate Fiduciary Duties Generally.

A. General Principles.

The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago. The current

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2 The SOX is generally applicable to all companies required to file reports, or that have a registration statement on file, with the Securities and Exchange Commission (*"SEC"*) regardless of size (*"public companies"*). Although the SOX does have some specific provisions, and generally establishes some important public policy changes, it is implemented in large part through rules adopted by the SEC. See Summary of the Sarbanes-Oxley Act of 2002 attached as **Appendix A**. Among other things, the SOX amends the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*).

3 See William B. Chandler III and Leo E. Strine Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* (February 26, 2002), which can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367720; *cf.* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007); Leo E. Strine, Jr., *Toward A True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARVARD L. REV. 1759 (2006).

4 TEX. BUS. CORP. ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2007).

5 TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2007).

6 The TBOC provides that the TBOC provisions applicable to corporations (TBOC Titles 1 and 2) may be officially and collectively known as *"Texas Corporation Law"* (TBOC § 1.008(b)). *See* Byron F. Egan, *Choice of Entity Decision Tree* (May 18, 2007), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=796.

7 The term *"charter"* is used herein interchangeably with (i) *"certificate of incorporation"* for Delaware corporations, (ii) *"certificate of formation"* for corporations governed by the TBOC and (iii) *"certificate of incorporation"* for corporations organized under the TBCA, in each case as the document to be filed with the applicable Secretary of State to form a corporation.

concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.[8]

Both the Texas Corporate Statutes and the DGCL provide that the business and affairs of a corporation are to be managed under the direction of its board of directors ("*Board*").[9] While the Texas Corporate Statutes and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the notice and voting procedures for meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions.[10] In Texas, the

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8 The "fiduciary duties of corporate officers and directors ... are creatures of state common law[.]" *Gearhart Industries, Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (citing *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549 (1949)); *see also Burks v. Lasker*, 441 U.S. 471, 477 (1979). Federal courts generally apply applicable state common law in fiduciary duty cases. *Floyd v. Hefner*, C.A. No. H-03-5693 (S.D. Tex. Sept. 29, 2006).

9 TBOC § 21.401; TBCA art. 2.31; and DEL. CODE ANN. tit. 8, § 141(a) (title 8 of the Delaware Code Annotated to be hereinafter referred to as the *"DGCL"*); *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (Board authority to manage the corporation under DGCL § 141(a) may not be infringed by a bylaw adopted by the stockholders under DGCL § 109 in a manner that restricts the power of directors to exercise their fiduciary duties); *see infra* notes 712-716 and related text.

10 Although the DGCL "does not prescribe in detail formal requirements for board meetings, the meetings do have to take place [and] the mere fact that directors are gathered together does not a meeting make"; where there is no formal call to the meeting and no vote taken, directors caucusing on their own and informally deciding among themselves how they would proceed is like simply polling board members and "does not constitute a valid meeting or effective corporate action." *Fogel v. U.S. Energy Systems Inc.*, No. 3271-CC (Del. Ch. Dec. 13, 2007).

The *Fogel* case arose in the context of a confrontation between three independent directors and the Board chairman they sought to terminate (there were no other directors). The opinion by Chancellor William B. Chandler III recounted that U.S. Energy "was in precarious financial condition" when Fogel was hired in 2005 to become CEO and a director (ultimately, becoming Board chairman as well). Fogel's initial tenure with the company was successful, but trouble soon followed.

Upon learning of the entity's financial woes, the Board decided at a June 14, 2006 meeting to hire a financial adviser or restructuring official. The Board resolved to meet again on June 29 to interview potential candidates, but prior to that meeting, the three independent directors communicated with one another about Fogel's performance, ultimately deciding that he would have to be terminated.

On the morning of June 29, they met in the law offices of their outside counsel and decided to fire Fogel. The three directors then confronted Fogel in the Boardroom where the meeting was to take place, advised that they had lost faith in him, and stated that they wanted him to resign as chairman and CEO. Fogel challenged the directors' ability to fire him and ultimately refused to resign, whereupon an independent director informed him that he was terminated.

Thereafter, on July 1, Fogel e-mailed the company's general counsel and the board calling for a special shareholder meeting for the purpose of voting on the removal of the other directors and electing their replacements. Later that day, during a scheduled Board meeting, the Board formally passed a resolution terminating Fogel and thereafter ignored Fogel's call for a special meeting. Litigation ensued.

The issue in the case was whether Fogel was still CEO and Board chairman at the time he called for a special meeting of shareholders. If the independent directors' June 29 decision to fire Fogel constituted formal Board action, Fogel was terminated before July 1 and lacked authority to call for a special meeting of shareholders. If not, Fogel remained Board chairman and CEO until the July 1 formal resolution, which passed after Fogel called for the special meeting of shareholders.

The Court noted that under DGCL § 141 termination of the chairman and CEO required Board "action, and the board can only take action by means of a vote at a properly constituted meeting. * * * Although the [DGCL] does not prescribe in detail formal requirements for board meetings, the meetings do have to take place." In this case, the Chancellor concluded that the June 29 confrontation between Fogel and the independent directors did not constitute a meeting. The mere fact that directors were gathered and caucusing did not constitute a meeting as there was no formal call to the meeting and there was no vote whatsoever.

"Simply 'polling board members does not constitute a valid meeting or effective corporation action,'" the Chancellor instructed. In any event, the Court added, if the meeting did occur, it would be void because the independent directors—who kept secret their plan to fire Fogel—obtained Fogel's attendance by deception. Although Fogel lacked fiduciary duty of a director has been characterized as including duties of loyalty (including good faith), care and obedience.[11] In Delaware, the fiduciary duties include those of loyalty (including good faith) and care.[12] Importantly, the duties of due care, good faith and loyalty give rise to a fourth important precept of fiduciary obligation under Delaware law – namely, the so-called "duty of disclosure," which requires the directors disclose full and accurate information when communicating with stockholders.[13] The term "duty of disclosure," however, is somewhat of a misnomer because no separate duty of disclosure actually exists. Rather, as indicated, the fiduciary obligations of directors in the disclosure context involve a contextually-specific application of the duties of care and loyalty.[14]

B. Applicable Law.

"The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs,"[15] and "under the commerce clause a state 'has no interest in regulating the internal affairs of foreign corporations.'"[16] "Internal corporate affairs" are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders," and are to be distinguished from matters which are not unique to corporations:

> It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the

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the votes needed to protect his employment, the Chancellor reasoned that had he known of the defendants' plans beforehand, "he could have exercised his right under the bylaws to call for a special meeting before the board met. The deception renders the meeting and any action taken there void." Accordingly, Fogel was still authorized on July 1 to call for a special shareholder meeting, and corporation and its Board were ordered to hold such a meeting.

The Chancellor disagreed with the independent directors' argument that even if the June 29 meeting and termination were deficient, "any problems were cured" when the Board ratified its June 29 actions during the July 1 meeting, holding: "When a corporate action is void, it is invalid *ab initio* and cannot be ratified later." The Chancellor said the action taken at the July 1 meeting may have resulted in Fogel's termination, but the termination was effective only as of that vote. By that time, however, Fogel already had issued his call for a special shareholders' meeting.

Nonetheless, the Court concluded that the independent directors ignoring Fogel's call for a special meeting was not to thwart a shareholder vote, but because they "believed in good faith" that Fogel had been terminated and thus "lacked the authority to call for such a meeting." Accordingly, the Chancellor held that the three independent directors did not breach their fiduciary obligations of loyalty.

11 *Gearhart Industries, Inc. v. Smith Intern., Inc.*, 741 F.2d at 719.

12 While good faith "may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty," the Delaware Supreme Court recently clarified the relationship of "good faith" to the duties of care and loyalty, noting that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith." *Stone v. Ritter,* 911 A.2d 362, 2006 WL 3169168 (Del. 2006). *See infra* notes 54-81, 255-286 and related text.

13 "Once [directors] traveled down the road of partial disclosure … an obligation to provide the stockholders with an accurate, full, and fair characterization" attaches. *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1280 (Del. 1994); *see also In re MONY Group S'holder Litig.*, 852 A.2d 9, 24-25 (Del. Ch. 2004) ("[O]nce [directors] take it upon themselves to disclose information, that information must not be misleading.").

14 *Malone v. Brincat*, 722 A.2d 5, 10 (Del 1998) ("[W]hen directors communicate with stockholders, they must recognize their duty of loyalty to do so with honesty and fairness"); *see infra* notes 267-278 and related text.

15 *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

16 *McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987); Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33 (Fall 2006).

> corporate entity. Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real property. Choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction. The internal affairs doctrine has no applicability in these situations.[17]

The internal affairs doctrine in Texas mandates that courts apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.[18] Delaware also subscribes to the internal affairs doctrine.[19]

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17 *Id.* at 215 (citing *Edgar*, 457 U.S. at 645).

18 TBOC §§ 1.101-1.105; TBCA art. 8.02; TMCLA art. 1302-1.03; *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000); *Gearhart*, 741 F.2d at 719; *A. Copeland Enterprises, Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989).

19 *See VantagePoint Venture Partners v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005), in which the Delaware Supreme Court considered whether a class of preferred stock would be entitled to vote as a separate class on the approval of a merger agreement and ruled that Delaware law, rather than California law, governed and did not require the approval of the holders of the preferred stock voting separately as a class for approval of the merger. In reaching that conclusion, the Court held that the DGCL exclusively governs the internal corporate affairs of a Delaware corporation and that Section 2115 of the California Corporations Code, which requires a corporation with significant California contacts (sometimes referred to as a "quasi-California corporation") to comply with certain provisions of the California Corporations Code even if the corporation is incorporated in another state, such as Delaware, is unconstitutional and, as a result of Delaware rather than California law governing, the approval of the merger did not require the approval of the holders of the preferred stock voting separately as a class.

Section 2115 of the California Corporations Code provides that, irrespective of the state of incorporation, the articles of incorporation of a foreign corporation are deemed amended to conform to California law if (i) more than 50% of its business (as defined) was derived from California during its last fiscal year and (ii) more than 50% of its outstanding voting securities are held by persons with California addresses. Section 1201 of the California Corporations Code requires that the principal terms of a merger be approved by the outstanding shares of each class.

Under Examen's certificate of incorporation and Delaware law, a proposed merger of Examen with an unrelated corporation required only the affirmative vote of the holders of a majority of the outstanding shares of common stock and preferred stock, voting together as a single class. The holders of Examen's preferred stock did not have enough votes to block the merger if their shares were voted as a single class with the common stock. Thus they sued in Delaware to block the merger based on the class vote requirements of the California statute.

Under Delaware law, however, holders of preferred stock are not entitled to vote as a class on a merger, even though the merger effects an amendment to the certificate of incorporation that would have to be approved by a class vote if the amendment were effected directly by an amendment to the certificate of incorporation, unless the certificate of incorporation expressly requires a class vote to approve a merger. DGCL § 242(b)(2) provides generally with respect to amendments to certificates of incorporation that the "holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would . . . alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely." In *Warner Communications Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962 (Del. Ch. 1989), the provision of the Warner certificate of incorporation at issue required a two-thirds class vote of the preferred stock to amend, alter or repeal any provision of the certificate of incorporation if such action adversely affected the preferences, rights, powers or privileges of the preferred stock. Warner merged with a Time subsidiary and was the surviving corporation. In the merger, the Warner preferred stock was converted into Time preferred stock and the Warner certificate of incorporation was amended to delete the terms of the preferred stock. The Chancery Court rejected the argument that holders of the preferred stock were entitled to a class vote on the merger, reasoning that any adverse effect on the preferred stock was caused not by an amendment of the terms of the stock, but solely by the conversion of the stock into a new security in the merger pursuant to DGCL § 251. The Chancery Court also reasoned that the language of the class vote provision at issue was similar to DGCL § 242 and did not expressly apply to mergers. *See Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*, Del. Ch., C.A. No. 12731 (Nov. 20, 1992), *aff'd*, 628 A.2d 84 (Del. 1993) (where the certificate of incorporation required a class vote of the preferred stockholders for the corporation to "change, by amendment to the Certificate of incorporation . . . or otherwise," the terms and provisions of the preferred stock, the Court held that "or otherwise" cannot be interpreted to mean merger in the context of a reverse triangular merger in which the preferred stock was converted into cash but the corporation survived); *see also Matulich v. Aegis Communications Group, Inc.*, 942 A.2d 596 (Del. 2008) (where certificate of designation of preferred stock provided

The Delaware Code subjects directors of Delaware corporations to personal jurisdiction in the Delaware Court of Chancery over claims for violation of a duty in their capacity as directors of a Delaware corporation.[20] Texas does not have a comparable statute.

that holders of the preferred stock had no voting rights but had the right of approval and consent prior to any merger, the holders of the preferred stock did not have any statutory right to vote on a merger, but had only a distinguishable contractual right to approve of and consent to mergers; thus since plaintiff's preferred stock was not entitled to vote on the merger, the holder of over 90% of the stock entitled to vote on the merger could approve a short form merger under DGCL § 253 and does not have to establish the entire fairness of the merger). In contrast, in *Elliott Assocs. v. Avatex Corp.*, 715 A.2d 843 (Del. 1998), the certificate of incorporation provision expressly gave preferred stockholders a class vote on the "amendment, alteration or repeal, whether by merger, consolidation or otherwise" of provisions of the certificate of incorporation so as to adversely affect the rights of the preferred stock, and preferred stock was converted into common stock of the surviving corporation of a merger. The Court in *Elliott*, for purposes of its opinion, assumed that the preferred stock was adversely affected, distinguished *Warner* because the charter contained the "whether by merger, consolidation or otherwise" language, and held that the preferred stock had a right to a class vote on the merger because the adverse effect was caused by the repeal of the charter and the stock conversion. The Court in *Elliott* commented that the "path for future drafters to follow in articulating class vote provisions is clear": "When a certificate (like the Warner certificate or the Series A provisions here) grants only the right to vote on an amendment, alteration or repeal, the preferred have no class vote in a merger. When a certificate (like the First Series Preferred certificate here) adds the terms 'whether by merger, consolidation or otherwise' and a merger results in an amendment, alteration or repeal that causes an adverse effect on the preferred, there would be a class vote." *Id.* at 855. *See Benchmark Capital Partners IV, L.P. v. Vague*, 2002 Del. Ch. LEXIS 90, at *25 (Del. Ch. July 15, 2002) ("[A court's function in ascertaining the rights of preferred stockholders] is essentially one of contract interpretation."), *aff'd sub nom. Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, 822 A.2d 396 (Del. 2003); and *Watchmark Corp. v. Argo Global Capital, LLC, et al*, C.A. 711-N (Del. Ch. November 4, 2004). ("Duties owed to preferred stockholders are 'primarily . . . contractual in nature,' involving the 'rights and obligations created contractually by the certificate of designation.' If fiduciary duties are owed to preferred stockholders, it is only in limited circumstances. Whether a given claim asserted by preferred stockholders is governed by contractual or fiduciary duty principles, then, depends on whether the dispute arises from rights and obligations created by contract or from 'a right or obligation that is not by virtue of a preference but is shared equally with the common.'")

Under Texas law and unless the charter otherwise provides, approval of a merger or other fundamental business transaction requires the affirmative vote of the holders of two-thirds of (i) all of the corporation's outstanding shares entitled to vote voting as a single class and (ii) each class entitled to vote as a class or series thereon. TBOC § 21.457; TBCA art. 5.03.F. Separate voting by a class or series of shares of a corporation is required by TBOC § 21.458 and TBCA art. 5.03.E for approval of a plan of merger only if (a) the charter so provides or (b) the plan of merger contains a provision that if contained in an amendment to the charter would require approval by that class or series under TBOC § 21.364 or TBCA art. 4.03, which generally require class voting on amendments to the charter which change the designations, preferences, limitations or relative rights or a class or series or otherwise affect the class or series in specified respects. Unless a corporation's charter provides otherwise, the foregoing Texas merger approval requirements (but not the charter amendment requirements) are subject to exceptions for (a) mergers in which the corporation will be the sole survivor and the ownership and voting rights of the shareholders are not substantially impaired (TBOC § 21.459(a); TBCA art. 5.03.G), (b) mergers affected to create a holding company (TBOC §§ 10.005, 21.459(b); TBCA art. 5.03.H – 5.03.K), and (c) short form mergers (TBOC §§ 10.006, 21.459(b); TBCA art. 5.16.A – 5.16.F).

The California courts, however, tend to uphold California statutes against internal affairs doctrine challenges. *See Friese v. Superior Court of San Diego County*, 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005), in which a California court allowed insider trading claims to be brought against a director of a California based Delaware corporation and wrote "while we agree that the duties officers and directors owe a corporation are in the first instance defined by the law of the state of incorporation, such duties are not the subject of California's corporate securities laws in general or [Corporate Securities Law] section 25502.5 in particular…. Because a substantial portion of California's marketplace includes transactions involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions."

20 10 *Del. C.* § 3114(a) provides (emphasis added):

> Every nonresident of this State who after September 1, 1977, accepts election or appointment as a director, trustee or member of the governing body of a corporation organized under the laws of this State or who after June 30, 1978, serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the

C. Fiduciary Duties in Texas Cases.

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.[21] Good faith under *Gearhart* is an element of the duty of loyalty. *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas, although there are subsequent cases that amplify *Gearhart* as they apply it in the context of lawsuits by the Federal Deposit Insurance Corporation ("*FDIC*") and the Resolution Trust Company ("*RTC*") arising out of failed financial institutions.[22] Many Texas fiduciary duty cases arise in the context of closely held corporations.[23]

1. Loyalty.

a. Good Faith.

The duty of loyalty in Texas is a duty that dictates that the director act in good faith and not allow his personal interest to prevail over that of the corporation.[24] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[25] Whether there exists a personal interest by the director will be a question of fact.[26]

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registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such director, trustee or member is a necessary or proper party, or in any action or proceeding against such director, trustee or member *for violation of a duty in such capacity*, whether or not the person continues to serve as such director, trustee or member at the time suit is commenced. Such acceptance or service as such director, trustee or member shall be a signification of the consent of such director, trustee or member that any process when so served shall be of the same legal force and validity as if served upon such director, trustee or member within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable.

21 *Gearhart*, 741 F.2d at 719-721; *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved); *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002), which quoted and repeated the summary of Texas fiduciary duty principles from *Gearhart*.

22 *See, e.g.*, *FDIC v. Harrington*, 844 F. Supp. 300 (N.D. Tex. 1994).

23 *See Flanary v. Mills*, 150 S.W.3d 785 (Tex. App. – Austin 2004) (uncle and nephew incorporated 50%/50% owned roofing business, but never issued stock certificates or had board or shareholder meetings; uncle used corporation's banking account as his own, told nephew business doing poorly and sent check to nephew for $7,500 as his share of proceeds of business for four years; court held uncle liable for breach of fiduciary duties that we would label loyalty and candor.)

24 *Gearhart*, 741 F.2d at 719.

25 *International Bankers Life Insurance Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1967), in which the court indicated that good faith conduct requires a showing that the directors had "an intent to confer a benefit to the corporation."

26 *Id.* at 578.

b. Self-Dealing Transactions.

In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.[27] The court in *Gearhart* summarized Texas law with respect to the question of whether a director is "interested" in the context of self-dealing transactions:

> A director is considered "interested" if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . .; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated . . .; or (4) transacts business in his director's capacity with a family member.[28]

The Texas Corporate Statutes permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.[29]

c. Oversight.

In Texas an absence of good faith may also be found in situations where there is a severe failure of director oversight. In *FDIC v. Harrington*,[30] a federal district court applying Texas law held that there is an absence of good faith when a board "abdicates [its] responsibilities and fails to exercise any judgment."

2. *Care.*

a. Business Judgment Rule; Gross Negligence.

The duty of care in Texas requires the director to handle his duties with such care as an ordinarily prudent man would use under similar circumstances. In performing this obligation, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests.[31]

In general, the duty of care will be satisfied if the director's actions comport with the standard of the business judgment rule. The Fifth Circuit stated in *Gearhart* that, in spite of the requirement that a corporate director handle his duties with such care as an ordinarily prudent man would use under similar circumstances, Texas courts will not impose liability upon a

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27 *A. Copeland Enterprises*, 706 F. Supp. at 1291; *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App. — Waco 1953, writ ref'd n.r.e.); *see* Kendrick, *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

28 *Gearhart*, 741 F.2d at 719-20 (citations omitted); *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002), which cited and repeated the "independence" test articulated in *Gearhart*. *See also infra* notes 171-177 and related text.

29 TBCA art. 2.02(20), TBOC § 2.101(21); *see infra* note 184 and related text.

30 844 F. Supp. 300 (N.D. Tex. 1994).

31 *Gearhart*, 741 F.2d at 719; *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud. In a footnote in the *Gearhart* decision, the Fifth Circuit stated:

> 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.[32]

In applying the business judgment rule in Texas, the courts in *Gearhart* and other recent cases have quoted from the early Texas decision of *Cates v. Sparkman*,[33] as setting the standard for judicial intervention in cases involving duty of care issues:

> [I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.[34]

In *Gearhart* the Court commented that "[e]ven though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar, supra*, Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud."[35]

Neither *Gearhart* nor the earlier Texas cases on which it relied referenced "gross negligence" as a standard for director liability. If read literally, the business judgment rule articulated in the case would protect even grossly negligent conduct. Federal district court decisions in FDIC and RTC initiated cases, however, have declined to interpret Texas law this broadly and have held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment."[36] These decisions "appear to be the product of the special treatment banks may receive under Texas law" and may not be followed to hold directors "liable for gross negligence under Texas law as it exists now" in other businesses.[37]

Gross negligence in Texas is defined as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the

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32 *Gearhart*, 741 F.2d at 723 n.9.

33 11 S.W. 846 (1889).

34 *Id.* at 849.

35 *Gearhart*, 741 F.2d at 721.

36 *FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *see also FDIC v. Schreiner*, 892 F.Supp. 869 (W.D. Tex. 1995); *FDIC v. Benson*, 867 F. Supp. 512 (S.D. Tex. 1994); *RTC v. Acton*, 844 F. Supp, 307, 314 (N.D. Tex. 1994); *RTC v. Norris*, 830 F. Supp. 351, 357-58 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992); *cf. RTC v. Miramon*, 22 F.3d 1357 (5th Cir. 1994) (followed *Harrington* analysis of Section 1821(K) of the Financial Institutions Reform, Recovery and Enforcement Act (*"FIRREA"*) which held that federal common law of director liability did not survive FIRREA and applied Texas' gross negligence standard for financial institution director liability cases under FIRREA).

37 *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006).

right or welfare of the person or persons to be affected by it."[38] In *Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[39]

The business judgment rule in Texas does not necessarily protect a director with respect to transactions in which he is "interested." It simply means that the action will have to be challenged on duty of loyalty rather than duty of care grounds.[40]

b. **Reliance on Reports.**

Directors may "in good faith and with ordinary care, rely on information, opinions, reports or statements, including financial statements and other financial data," prepared by officers or employees of the corporation, counsel, accountants, investment bankers or "other persons as to matters the director reasonably believes are within the person's professional or expert competence."[41]

c. **Charter Limitations on Director Liability.**

The Texas Corporate Statutes allow a Texas corporation to provide in its certificate of formation limitations on (or partial limitation of) director liability for monetary damages in relation to the duty of care.[42] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, acts not in good faith, intentional misconduct or knowing violations of law, obtaining improper benefits or acts for which liability is expressly provided by statute.[43]

3. Other (obedience).

The duty of obedience in Texas requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the powers of the corporation as defined by its articles of incorporation and Texas law.[44] An *ultra vires* act may be voidable under Texas law, but the director will not be held personally liable for such act unless the act is in violation of a specific statute or against public policy.

The RTC's complaint in *RTC v. Norris*[45] asserted that the directors of a failed financial institution breached their fiduciary duty of obedience by failing to cause the institution to adequately respond to regulatory warnings: "The defendants committed *ultra vires* acts by ignoring warnings from [regulators], by failing to put into place proper review and lending

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38 *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981) (citing *Missouri Pacific Ry. v. Shuford*, 72 Tex. 165, 10 S.W. 408, 411 (1888)).

39 844 F. Supp. at 306 n.7.

40 *Gearhart*, 741 F.2d at 723 n.9.

41 TBCA art. 2.41.D; TBOC § 3.102.

42 TMCLA art. 1302-7.06; TBOC § 7.001; *see infra* note 183 and related text.

43 *Id.*

44 *Gearhart*, 741 F.2d at 719.

45 830 F. Supp. 351 (S.D. Tex. 1993).

procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth's Bylaws."[46] In rejecting this RTC argument, the court wrote:

> The RTC does not cite, and the court has not found, any case in which a disinterested director has been found liable under Texas law for alleged *ultra vires* acts of employees, absent pleadings and proof that the director knew of or took part in the act, even where the act is illegal.
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> . . . .
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> Under the business judgment rule, Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act . . . .[47]

D. Fiduciary Duties in Delaware Cases.

1. Loyalty.

a. Conflicts of Interest.

In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."[48] 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.[49] The Delaware Court of Chancery has summarized the duty of loyalty as follows:

> Without intending to necessarily cover every case, it is possible to say broadly that the duty of loyalty is transgressed when a corporate fiduciary, whether director, officer or controlling shareholder, uses his or her corporate office or, in the case of a controlling shareholder, control over corporate machinery, to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a substantial economic interest, directly or indirectly) and that transaction is not substantively fair to the corporation. That is, breach of loyalty cases inevitably involve conflicting economic or other interests, even if only in the somewhat diluted form present in every 'entrenchment' case.[50]

Importantly, conflicts of interest do not per se result in a breach of the duty of loyalty. Rather, it is the manner in which an interested director handles a conflict and the processes invoked to insure fairness to the corporation and its stockholders that will determine the

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46 *Norris*, 830 F. Supp. at 355.

47 *Id.*

48 *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

49 *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993) (*"Technicolor I"*). *See infra* notes 171-177 and related text.

50 *Solash v. Telex Corp.,* 1988 WL 3587 at *7 (Del. Ch. Jan. 19, 1988). Some of the procedural safeguards typically invoked to assure fairness in transactions involving Board conflicts of interest are discussed in more detail below, in connection with the entire fairness standard of review.

propriety of the director's conduct and the validity of the particular transaction. Moreover, the Delaware courts have emphasized that only material 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. In Delaware, 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 did approve a transaction that benefited the majority stockholder to the detriment of the minority stockholders.[51]

Federal laws can subject corporate directors and officers to additional exposure in conflict of interest situations.[52] Directors and officers have been convicted for "honest services fraud" under 18 USC § 1346 (2008) for entering into contracts on behalf of their employer with entities in which they held an interest without advising their employer of the interest.[53]

b. Good Faith.

Good faith is far from a new concept in Delaware fiduciary duty law. Good faith long was viewed by the Delaware courts (and still is viewed by many commentators) as an integral component of the duties of care and loyalty. Indeed, in one of the early, landmark decisions analyzing the contours of the duty of loyalty, the Delaware Supreme Court observed that "no hard and fast rule can be formatted" for determining whether a director has acted in "good faith."[54] While that observation remains true today, the case law and applicable commentary provide useful guidance regarding some of the touchstone principles underlying the duty of good faith.[55]

The duty of good faith was recognized as a distinct directorial duty in *Cede & Co. v. Technicolor, Inc.*[56] The duty of good faith requires that directors act honestly, in the best interest

51 *Crescent/Mach I Partners, L.P. v. Twiner*, 846 A.2d 963 n.50 (Del. Ch. 2000); *Strassburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000).

52 Regarding the effect of SOX on state law fiduciary duties, *see infra* notes 126-177 and related text.

53 18 USC § 1346 (2008) defines "scheme or artifice to defraud" under the U.S. mail and wire fraud statutes to include "a scheme or artifice to deprive another of the intangible right to receive honest services." *See* Frank C. Razzano and Kristin H. Jones, *Prosecution of Private Corporate Conduct – The Uncertainty Surrounding Honest Services Fraud*, 18 BUS. L. TODAY 37 (Jan.–Feb. 2009).

54 *See Guth*, 5 A.2d at 510.

55 *See Stone v. Ritter*, 911 A.2d 362, 2006 WL 3169168 (Del. 2006); *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); John F. Grossbauer and Nancy N. Waterman, *The (No Longer) Overlooked Duty of Good Faith Under Delaware Law*, VIII "Deal Points" No. 2 of 6 (The Newsletter of the ABA Business Law Section Committee on Negotiated Acquisitions, No. 2, Summer 2003).

56 634 A.2d 345, 361 (Del. 1993) (*Technicolor I*).

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. Like a duty of care analysis, such review likely will focus on the process by which the Board reached the decision under review. Consistent with earlier articulations of the level of conduct necessary to infer bad faith (or irrationality), more recent case law suggests that only fairly egregious conduct (such as a knowing and deliberate indifference to a potential risk of harm to the corporation) will rise to the level of "bad faith."[57]

The impetus for an increased focus on the duty of good faith is the availability of damages as a remedy against directors who are found to have acted in bad 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. However, 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.[58] 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 of the DGCL 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."[59] Accordingly, a director who has breached the duty of good faith not only is exposed to personal liability, but also may not be able to seek indemnification from the corporation for any judgment obtained against her or for expenses incurred (unsuccessfully) litigating the issue of liability.[60] Thus, in cases involving decisions made by directors who are disinterested and independent with respect to a transaction (and, therefore, the duty of loyalty is not implicated), the duty of good faith still provides an avenue for asserting claims of personal liability against the directors. Moreover, these claims, if successful, create barriers to indemnification of amounts paid by directors in judgment or settlement.[61]

In *Stone v. Ritter*,[62] the Delaware Supreme Court held that "good faith" is not a separate fiduciary duty like the duties of care and loyalty, but rather is embedded in the duty of loyalty:

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57 *In re the Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. 2006).

58 Specifically, DGCL § 102(b)(7) authorizes the inclusion in a certificate of incorporation of:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability or a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title [dealing with the unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit . . . .

59 DGCL §§ 145(a)-(b).

60 In contrast, it is at least theoretically possible that a director who has been found to have breached his or her duty of loyalty could be found to have acted in good faith and, therefore, be eligible for indemnification of expenses (and, in non-derivative cases, amounts paid in judgment or settlement) by the corporation. *See Blasius Industries, Inc. v. Atlas Corp.,* 564 A.2d 651 (Del. Ch. 1988) (directors found to have acted in good faith but nevertheless breached their duty of loyalty).

61 The availability of directors and officers liability insurance also may be brought into question by a finding of bad faith. Policies often contain exclusions that could be cited by carriers as a basis for denying coverage.

62 911 A.2d 362, 2006 WL 3169168 (Del. 2006).

> [F]ailure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest.

c. Oversight/Caremark.

Directors also may be found to have violated the duty of loyalty when they fail to act in the face of a known duty to act – i.e., they act in bad faith.[63] In an important Delaware Chancery Court decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,[64] the settlement of a derivative action that involved 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 so doing, the 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.[65]

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."[66] While *Caremark* recognizes a cause of action for uninformed inaction, the holding is subject to the following:

<u>First</u>, the Court held that "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability."[67] It is thus not at all clear that a plaintiff could recover based on a single example of director inaction, or even a series of examples relating to a single subject.

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63 In *Stone v. Ritter,* 911 A.2d 362, 2006 WL 3169168 (Del. 2006), the Delaware Supreme Court held that "the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty."

64 698 A.2d 959 (Del. Ch. 1996); *see* Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and The Standard of Liability Post-Enron*, 6 WYOMING L.REV. 482 (2006).

65 698 A.2d at 970.

66 *Id.*

67 *Id.* at 971.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"[68] which indicates that the presence of an existing information and reporting system will do much to cut off any derivative claim, because the adequacy of the system itself will be protected.

Third, *Caremark* considered it obvious that "no rationally designed information system . . . will remove the possibility" that losses could occur.[69] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[70] This holding indicates that a loss to the corporation is not itself evidence of an inadequate information and reporting system. Instead, the court will focus on the adequacy of the system overall and whether a causal link exists.[71]

The *Caremark* issue of a board's systematic failure to exercise oversight was revisited by the Seventh Circuit applying Illinois law in *In re Abbott Laboratories Derivative Shareholders Litigation*.[72] *Abbott* involved a shareholders derivative suit against the health care corporation's directors, alleging breach of fiduciary duty and asserting that the directors were liable under state law for harms resulting from a consent decree between the corporation and the Food and Drug Administration ("*FDA*"). The consent decree had followed a six-year period during which the FDA had given numerous notices to the corporation of violations of FDA manufacturing regulations and imposed a $100 million fine, which resulted in a $168 million charge to earnings. In reversing a district court dismissal of plaintiff's complaint for failure to adequately plead that demand upon the board of directors would be futile, the Seventh Circuit held that the complaints raised reasonable doubt as to whether the directors' actions were the product of a valid exercise of business judgment, thus excusing demand, and were sufficient to overcome the directors' exemption from liability contained in the certificate of incorporation, at least for purposes of defeating the plaintiffs' motion to dismiss.[73] In so holding, the Seventh Circuit noted that the complaint pled that the directors knew or should have known of the FDA noncompliance problems and demonstrated bad faith by ignoring them for six years and not disclosing them in the company's SEC periodic reports during this period. The Court relied upon Delaware case law and wrote:

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68 *Id.* at 970.

69 *Id.*

70 *Id.* at 970 n.27.

71 *See generally* Eisenberg, *Corporate Governance The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); Pitt, et al., *Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct*, 1005 PLI/CORP. 301, 304 (1997); Gruner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond*, 995 PLI/CORP. 57, 64-70 (1997); Funk, *Recent Developments in Delaware Corporate Law*: *In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311 (1997).

72 325 F.3d 795 (7th Cir. 2003). The *Abbott* court distinguished *Caremark* on the grounds that in the latter, there was no evidence indicating that the directors "conscientiously permitted a known violation of law by the corporation to occur," unlike evidence to the contrary in *Abbott*. *Id.* at 806 (quoting *Caremark*, 698 A.2d at 972). However, the *Abbott* court nonetheless relied on *Caremark* language regarding the connection between a board's systemic failure of oversight and a lack of good faith. *Abbott*, 325 F.3d at 808-09.

73 In *Connolly v. Gasmire*, 257 S.W.3d 831, 851 (Tex.App.—Dallas 2008), a Texas court in a derivative action involving a Delaware corporation declined to follow *Abbott* as the Court found no Delaware case in which *Abbott* had been followed.

> [T]he facts support a reasonable assumption that there was a 'sustained and systematic failure of the board to exercise oversight,' in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith. We find that . . . the directors' decision to not act was not made in good faith and was contrary to the best interests of the company.[74]

The Seventh Circuit further held that the provision in the corporation's articles of incorporation limiting director liability[75] would not be sufficient to sustain a motion to dismiss. It stated that in a case such as this "[w]here the complaint sufficiently alleges a breach of fiduciary duties based on a failure of the directors to act in good faith, bad faith actions present a question of fact that cannot be determined at the pleading stage."[76] The court intimated that had the case involved a simple allegation of breach of the duty of care and not bad faith, the liability limitation clause might have led to a different result.[77]

In *Saito v. McCall*,[78] a derivative suit was brought in the Delaware Chancery Court to recover damages from the directors, senior officers, merger advisors and outside accountants of each of HBO & Company ("*HBOC*") (a healthcare software provider), McKesson Corporation ("*McKesson*") (a healthcare supply management company) and McKesson HBOC, Inc., the surviving corporation (the "*HBOC/McKesson Survivor*") in the 1999 merger of HBOC and McKesson, alleging that: (1) HBOC's directors and officers presided over a fraudulent accounting scheme; (2) McKesson's officers, directors and advisors uncovered HBOC's accounting improprieties during their due diligence, but nonetheless proceeded with the proposed merger; and (3) the Company's board did not act quickly enough to rectify the accounting fraud following the merger. The Chancery Court dismissed most of the claims on procedural grounds, with the notable exception of the claim against the Company's directors alleging *Caremark* violations.

In 1998, HBOC's audit committee met with HBOC's outside auditor to discuss HBOC's 1997 audit and was informed that the 1997 audit was "high risk" and explained its concerns. Although a subsequent SEC investigation established that HBOC was misapplying the generally accepted accounting principles for financial reporting in the U.S. ("*GAAP*"), the auditors did not inform the audit committee of this fact, and reported that there were no significant problems or exceptions and that the auditors enjoyed the full cooperation of HBOC management.

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74 *Abbott*, 325 F.3d at 809.

75 Abbott's certificate of incorporation included the following provision limiting director liability:

> A director of the corporation shall not be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) under Section 8.65 of the Illinois Business Corporation Act, or (iv) for any transaction from which the director derived an improper personal benefit . . . .

Id. at 810.

76 *Id.* at 811.

77 *See id.* at 810.

78 C.A. No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec 20, 2004).

During the summer of 1998, HBOC held discussions with McKesson regarding a potential merger. McKesson engaged independent accountants and investment bankers to assist it in evaluating the proposed merger. In a meeting with these advisors, McKesson's board of directors discussed the proposed merger and the due diligence issues that had surfaced, and first learned of HBOC's questionable accounting practices, although there was no indication that the McKesson board actually knew of any of HBOC's material accounting violations.

In October 1998, after a brief suspension of merger negotiations, the parties resumed discussions and agreed upon a modified deal structure, but they did not resolve the issues related to HBOC's accounting practices. On October 16, 1998, with awareness of some of HBOC's accounting irregularities, McKesson's board approved the merger and agreed to acquire HBOC for $14 billion in McKesson stock. Following the effective time of the merger, the HBOC/McKesson Survivor's audit committee met with its advisors to discuss the transaction and certain accounting adjustments to HBOC's financial statements, which the audit committee knew were insufficient to remedy the accounting improprieties that its auditors had previously identified. The HBOC/McKesson Survivor took some remedial action in April 1999, when it announced that it would restate its prior earnings downward and, a few months later, terminated the senior management responsible for the accounting improprieties.

Thereafter, the plaintiffs brought a duty of oversight claim against the directors of the HBOC/McKesson Survivor alleging, *inter alia*, that the Company directors had failed to (1) correct HBOC's false financial statements, (2) monitor the accounting practices of the Company, (3) implement sufficient internal controls to guard against wrongful accounting practices that were uncovered following the merger, and (4) disclose HBOC's false financial statements. The Court noted that under *Caremark* "a derivative plaintiff must allege facts constituting 'a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information reporting system exists.'" To survive a motion to dismiss, the plaintiff was required to show that the HBOC/McKesson Survivor board should have known that the alleged accounting problems had occurred or were occurring and made no good faith effort to rectify the accounting improprieties. Noting that the plaintiff was entitled to the benefit of all reasonable inferences drawn from the applicable facts, the Court found that the plaintiffs had alleged sufficient facts to infer that the boards of each of McKesson and HBOC – members of which comprised the board of the HBOC/McKesson Survivor – knew, or should have known, of HBOC's accounting irregularities, noting that (i) HBOC's audit committee became aware of the accounting problems when it learned that its 1997 audit was "high risk" and that the McKesson board learned of some of the problems during the July 1998 board meeting at which due diligence issues were discussed, and (ii) the HBOC/McKesson Survivor's audit committee had considered, but failed to act swiftly upon, HBOC's accounting problems. On these facts, the Court concluded that the Company board knew or should have known that HBOC's accounting practices were unlawful and that, despite this knowledge, failed to take any remedial action for several months. While noting that facts later adduced could prove that the Company directors did not violate their duties under *Caremark*, the Court allowed the plaintiffs' claim to survive a motion to dismiss.[79]

[79] The HBOC/McKesson Survivor's certificate of incorporation included an exculpatory provision adopted pursuant to DGCL § 102(b)(7). The parties did not raise, and the Court did not address, the impact of that provision.

In *Stone v. Ritter*[80] the Delaware Supreme Court affirmed *Caremark* as the standard for assessing director oversight responsibility. *Stone v. Ritter* was a "classic *Caremark* claim" arising out of a bank paying $50 million in fines and penalties to resolve government and regulatory investigations pertaining principally to the failure of bank employees to file Suspicious Activity Reports ("*SARs*") as required by the Bank Secrecy Act ("*BSA*") and various anti money laundering regulations. The Chancery Court dismissed the plaintiffs' derivative complaint which alleged that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention." In affirming the Chancery Court, the Supreme Court commented, "[i]n this appeal, the plaintiffs acknowledge that the directors neither 'knew [n]or should have known that violations of law were occurring,' i.e., that there were no 'red flags' before the directors" and held "[c]onsistent with our opinion in *In re Walt Disney Co. Deriv Litig*,[81] … that *Caremark* articulates the necessary conditions for assessing director oversight liability and … that the *Caremark* standard was properly applied to evaluate the derivative complaint in this case."

The Supreme Court explained the doctrinal basis for its holding as follows and, in so doing, held that "good faith" is not a separate fiduciary duty:

> As evidenced by the language quoted above, the *Caremark* standard for so-called "oversight" liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent *Disney* decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). In *Disney*, we identified the following examples of conduct that would establish a failure to act in good faith:
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> > A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.
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> The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* court held was a "necessary condition" for director oversight liability, i.e., "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists...." Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition. Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case

80 911 A.2d 362; 2006 WL 3169168 (Del. 2006).

81 906 A.2d 27 (Del. 2006).

> where failure to exercise oversight was the basis or theory of the plaintiffs' claim for relief.
>
> It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here – describing the lack of good faith as a "necessary condition to liability" – is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.
>
> This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."
>
> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

Stone v. Ritter was a "demand-excused" case in which the plaintiffs did not demand that the directors commence the derivative action because allegedly the directors breached their oversight duty and, as a result, faced a "substantial likelihood of liability" as a result of their "utter failure" to act in good faith to put into place policies and procedures to ensure compliance with regulatory obligations. The Court of Chancery found that the plaintiffs did not plead the existence of "red flags" – "facts showing that the board ever was aware that company's internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed." In dismissing the derivative complaint, the Court of Chancery concluded:

> This case is not about a board's failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls.... With the benefit of hindsight, it is beyond question that AmSouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine--$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible.

The adequacy of the plaintiffs' assertion that demand was excused turned on whether the complaint alleged facts sufficient to show that the defendant directors were potentially personally liable for the failure of non-director bank employees to file the required Suspicious Activity Reports. In affirming the Chancery Court, the Supreme Court wrote:

> For the plaintiffs' derivative complaint to withstand a motion to dismiss, "only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." As the *Caremark* decision noted:
>
> > Such a test of liability – lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight – is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.
>
> The KPMG Report – which the plaintiffs explicitly incorporated by reference into their derivative complaint – refutes the assertion that the directors "never took the necessary steps ... to ensure that a reasonable BSA compliance and reporting system existed." KPMG's findings reflect that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.
>
> With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs' argument is a failure to

> recognize that the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham, Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome. Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs' derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.

d. **Candor.**

Where directors approve an SEC report that materially misrepresents the nature of benefits provided by a corporation to its controlling shareholder, Chancellor Chandler explained in 2007 that the directors can breach their fiduciary duties of candor and good faith, which are subsets of the duty of loyalty, when they allow their companies to issue deceptive or incomplete communications to their stockholders:

> When a Delaware corporation communicates with its shareholders, even in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith. Communications that depart from this expectation, particularly where it can be shown that the directors involved issued their communication with the knowledge that it was deceptive or incomplete, violate the fiduciary duties that protect shareholders. Such violations are sufficient to subject directors to liability in a derivative claim.
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> * * *
>
> Although directors have a responsibility to communicate with complete candor in all shareholder communications, those that are issued with respect to a request for shareholder action are especially critical. Where, as here, the directors sought shareholder approval of an amendment to a stock option plan that could potentially enrich themselves and their patron, their concern for complete and honest disclosure should make Caesar appear positively casual about his wife's infidelity.[82]

In another case later in 2007, Chancellor Chandler further explained the contours of the duty of candor:

> Generally, directors have a duty to disclose all material information in their possession to shareholders when seeking shareholder approval for some corporate action. This "duty of disclosure" is not a separate and distinct fiduciary

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82 *In Re: INFOUSA, Inc. Shareholders Litigation*, CA No. 1956-CC (Del. Ch. August 20, 2007); *see infra* notes 280 and 671 and related text.

> duty, but it clearly does impose requirements on a corporation's board. Those requirements, however, are not boundless. Rather, directors need only disclose information that is material, and information is material only "if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote." It is not sufficient that information might prove helpful; to be material, it must "significantly alter the total mix of information made available." The burden of demonstrating a disclosure violation and of establishing the materiality of requested information lies with the plaintiffs.[83]

In 2009 in *Gantler v. Stephens*,[84] the Delaware Supreme Court addressed duty of candor issues in the context of a proxy statement for a stockholder vote on a going private proposal in which common stock held by small stockholders would be converted by an amendment to the certificate of incorporation into non-voting preferred stock. With respect to the plaintiffs' claims that the proxy statement for the reclassification failed to disclose the circumstances of one bidder's withdrawal and insufficient deliberations by the Board before deciding to reject another's bid, the Court wrote:

> It is well-settled law that "directors of Delaware corporations [have] a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." That duty "attaches to proxy statements and any other disclosures in contemplation of stockholder action." The essential inquiry here is whether the alleged omission or misrepresentation is material. The burden of establishing materiality rests with the plaintiff, who must demonstrate "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."
>
> In the Reclassification Proxy, the Board disclosed that "[a]fter careful deliberations, the board determined in its business judgment that the [rejected merger] proposal was not in the best interest of the Company or our shareholders and rejected the [merger] proposal." Although boards are "not required to disclose all available information[,] ..." "once [they] travel[] down the road of partial disclosure of … [prior bids] us[ing] … vague language …, they ha[ve] an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events."
>
> By stating that they "careful[ly] deliberat[ed]," the Board was representing to the shareholders that it had considered the Sales Process on its objective merits and had determined that the Reclassification would better serve the Company than a merger. * * * [This] disclosure was materially misleading.
>
> The Reclassification Proxy specifically represented that the [company] officers and directors "ha[d] a conflict of interest with respect to the

[83] *In re CheckFree Corp.*, No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007). *See infra* notes 114, 267-280, 378, 651-655, 662-677 and accompanying text.

[84] ___ A.2d ___, 2009 WL 188828 (Del. 2009).

> [Reclassification] because he or she is in a position to structure it in a way that benefits his or her interests differently from the interests of unaffiliated shareholders." Given the defendant fiduciaries' admitted conflict of interest, a reasonable shareholder would likely find significant—indeed, reassuring—a representation by a conflicted Board that the Reclassification was superior to a potential merger which, after "careful deliberations," the Board had "carefully considered" and rejected. In such circumstances, it cannot be concluded as a matter of law, that disclosing that there was little or no deliberation would not alter the total mix of information provided to the shareholders.
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> * * *
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> We are mindful of the case law holding that a corporate board is not obligated to disclose in a proxy statement the details of merger negotiations that have "gone south," since such information "would be [n]either viably practical [n]or material to shareholders in the meaningful way intended by … case law." Even so, a board cannot properly claim in a proxy statement that it had carefully deliberated and decided that its preferred transaction better served the corporation than the alternative, if in fact the Board rejected the alternative transaction without serious consideration.

2. 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'."[85]

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.[86] Directors are not required, however, "to read <u>in</u> <u>haec</u> <u>verba</u> every contract or legal document,"[87] or to "know all particulars of the legal documents [they] authorize[ ] for execution."[88]

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

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85 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). *See infra* notes 315-343 and related text.

86 *See Technicolor I*, 634 A.2d at 367; *Van Gorkom*, 488 A.2d at 872.

87 *Smith v. Van Gorkom*, 488 A.2d 858, 883 n.25.

88 *Moran v. Household Int'l, Inc.,* 490 A.2d 1059, 1078 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

gross negligence.[89] "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason."[90]

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.[91]

b. Business Judgment Rule Not Applicable When Board Conflicted.

In *Gantler v. Stephens*,[92] 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. The complaint (which the Court accepted as true because the decision was on defendants' motion to dismiss) alleged that the director defendants improperly rejected a value-maximizing merger bid and terminated the sales process to preserve personal benefits, including retaining their positions and pay as directors, as well as valuable outside business opportunities. The complaint further alleged that the Board failed to deliberate before deciding to reject the bid and to terminate the sales process, yet repeatedly disregarded its financial advisor's advice.

The Court noted that "[a] board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework," but:

> [T]he business judgment presumption is two pronged. First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly? For the Board's decision here to be entitled to the business judgment presumption, both questions must be answered affirmatively.

* * *

89 *See Van Gorkom*, 488 A.2d at 873.

90 *McPadden v. Sidhu*, C.A. No. 3310-CC, 2008 WL 4017052 (Del. Ch. August 29, 2008).

91 *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004) (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.")

92 ___ A.2d ___, 2009 WL 188828 (Del. 2009).

> Here, the plaintiffs allege that the Director Defendants had a disqualifying self-interest because they were financially motivated to maintain the status quo. A claim of this kind must be viewed with caution, because to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological. By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.

The Supreme Court found that the plaintiffs had pled facts sufficient to establish disloyalty of at least three (*i.e.*, a majority) of the remaining directors, which sufficed to rebut the business judgment presumption. With respect to the CEO, the Court noted that in addition to losing his long held positions, the plaintiffs alleged a duty of loyalty violation when they pled that the CEO never responded to the due diligence request which had caused one bidder to withdraw its bid and that this bidder had explicitly stated in its bid letter that the incumbent Board would be terminated if it acquired the company. The Court held that it may be inferred that the CEO's unexplained failure to respond promptly to the due diligence request was motivated by his personal financial interest, as opposed to the interests of the shareholders, and that same inference can be drawn from his attempt to "sabotage" another bidder's due diligence request in a similar manner.

Another director was the president of a heating and air conditioning company that provided heating and air conditioning services to the bank and he may have feared that if the company were sold his firm would lose the bank as a client, which to him would be economically significant. A third director was a principal in a small law firm that frequently provided legal services to the company and was also the sole owner of a real estate title company that provided title services in nearly all of the Bank's real estate transactions. In summary, the Supreme Court concluded the plaintiffs had alleged facts sufficient to establish, for purposes of a motion to dismiss, that a majority of the Board acted disloyally and that a cognizable claim of disloyalty rebuts the business judgment presumption and is subject to entire fairness review.

The Supreme Court in *Gantler* set forth two reasons for rejecting the Chancery Court's dismissal of the case on the ground that a disinterested majority of the shareholders had "ratified" the reclassification by voting to approve it:

> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.

* * *

> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (*i.e.*, obviating all judicial review of the challenged action).

c. Inaction.

In many cases, of course, the directors' decision may be not to take any action. To the extent 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.[93]

d. Reliance on Reports and Records.

The DGCL provides two important statutory protections to directors relating to the duty of care. The first statutory protection is DGCL § 141(e) which provides statutory protection to directors who rely in good faith upon corporate records or reports in connection with their efforts to be fully informed, and reads as follows:

> 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.[94]

Significantly, as discussed below, DGCL § 141(e) provides protection to directors only if they acted in good faith.

e. Limitation on Director Liability.

The second statutory protection is DGCL § 102(b)(7), which 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.[95] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty,

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93 In *Stone v. Ritter,* 911 A.2d 362, 2006 WL 3169168 (Del. 2006), the Delaware Supreme Court held that "the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty." *See supra* notes 64-80 and related text.

94 DGCL § 141(e).

95 *See infra* notes 180-183 and related text.

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.[96]

E. Fiduciary Duties of Officers.

Under both Texas and Delaware law, a corporate officer owes fiduciary duties of care, good faith and loyalty to the corporation, and may be sued in a corporate derivative action just as a director may be.[97] In *Gantler v. Stephens*,[98] the Delaware Supreme Court held "that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors."[99]

For an officer to be held liable for a breach of fiduciary duty, "it will have to be concluded for each of the alleged breaches that [the officer] had the discretionary authority in a relevant functional area and the ability to cause or prevent a complained-of-action."[100] Derivative claims against officers for failure to exercise due care in carrying out their responsibilities as assigned by the Board are uncommon.

An individual is entitled to seek the best possible employment arrangements for himself before he becomes a fiduciary, but once the individual becomes an officer or director, his ability to pursue his individual self interest becomes restricted. *In re The Walt Disney Co. Derivative Litigation*,[101] which resulted from the failed marriage between Disney and its former President Michael Ovitz, is instructive as to the duties of an officer.[102] Ovitz was elected president of Disney on October 1, 1995 prior to finalizing his employment contract, which was executed on December 12, 1995, and he became a director in January 1996. Ovitz's compensation package was lucrative, including a $40 million termination payment for a no-fault separation. Ovitz'

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96 DGCL § 102(b)(7); *see also Zirn v. VLI Corp*., 621 A.2d 773, 783 (Del. 1993) (DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

97 *Faour v. Faour*, 789 S.W.2d 620,621 (Tex. App.—Texarkana 1990, writ denied); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *see Lifshutz v. Lifshutz*, 199 S.W.3d 9, 18 (Tex. App.–San Antonio 2006) ("Corporate officers owe fiduciary duties to the corporations they serve. [citation omitted]. A corporate fiduciary is under a duty not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so."); *Cotton v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006) ("While corporate officers owe fiduciary duties to the corporation they serve, they do not generally owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them in addition to the corporate relationship.").

98 ___ A.2d ___, 2009 WL 188828 (Del. 2009).

99 In *Gantler v. Stephens* (an opinion on a motion to dismiss for failure to state a cause of action) allegations that the CEO and Treasurer had breached their fiduciary duty of loyalty by failing to timely provide due diligence materials to two prospective buyers of the company as authorized by the Board (which led the bidders to withdraw their bids) at a time that the officers were supporting their competing stock reclassification proposal (which the Board ultimately approved over a merger proposal from an unaffiliated third party) were found sufficient to state a claim for breach of the fiduciary duty of loyalty.

100 *Pereira v. Cogan*, 294 B.R. 449, 511 (SDNY 2003), *reversed on other grounds and remanded*, *Pereira v. Farace*, 413 F.3d 330 (2nd Cir. 2005); see *Fletcher Cyclopedia of the Law of Private Corporations*, § 846 (2002) ("The Revised Model Business Corporation Act provides that a non-director officer with discretionary authority is governed by the same standards of conduct as a director.").

101 906 A.2d 27 (Del. 2006).

102 *See* the discussion of the *Disney* case in *infra* notes 256-262 and related text in respect of director duties when approving executive officer compensation.

tenure as an officer was mutually unsatisfying, and a year later he was terminated on a no-fault basis. Derivative litigation ensued against Ovitz and the directors approving his employment and separation arrangements.

The Delaware Supreme Court affirmed the Chancery Court rulings that (i) as to claims based on Ovitz entering into his employment agreement with Disney, officers and directors become fiduciaries only when they are officially installed and receive the formal investiture of authority that accompanies such office or directorship, and before becoming a fiduciary, Ovitz had the right to seek the best employment agreement possible for himself and (ii) as to claims based on actions after he became an officer, (a) an officer may negotiate his or her own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner, (b) Ovitz made the decision that a faithful fiduciary would make by abstaining from attendance at a Compensation Committee meeting [of which he was an ex officio member] where a substantial part of his own compensation was to be discussed and decided upon, (c) Ovitz did not breach any fiduciary duties by executing and performing his employment agreement after he became an officer since no material change was made in it from the form negotiated and approved prior to his becoming an officer, and (d) Ovitz did not breach any fiduciary duty in receiving no-fault termination payments because he played no part in the determination that he would be terminated or that his termination would not be for cause.

A corporate officer is an agent of the corporation.[103] If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions.[104] The corporation may also be liable under *respondeat superior*.

F. Derivative Actions.

The fiduciary duties of directors and officers are owed to the corporation they serve. Thus, typically an action against a director or officer for breach of fiduciary duty would be

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103 *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350 (Del. Ch. 193l); *Hollaway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). *See* Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 BUS. LAW 147, 148-151 (Nov. 2007):

> In thirty-four states there are both statutory and common law sources for officer fiduciary duties. The remaining sixteen states [including Delaware and Texas] have only common law. The primary common law source is the law of agency—officers being agents—and the recent *Restatement (Third) of Agency* ("*Restatement*") is the most authoritative and thorough source of agency law principles. * * *
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> [T]he *Restatement* states explicitly that an agent's duty of loyalty is a "fiduciary duty." Interestingly, however, the *Restatement* describes the agent's duties of care, competence, and diligence as "performance" duties, deliberately avoiding the descriptor of "fiduciary," while noting, however, that other sources do refer to such duties as fiduciary in nature. Also, the *Restatement* establishes as the standard applicable to the duties of care, competence, and diligence that level of conduct "normally exercised by agents in similar circumstances."
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> * * *
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> Finally, the *Restatement* states that a "general or broad" advance release of an agent from the agent's "general fiduciary obligation to the principal [i.e., the duty of loyalty] is not likely to be enforceable." As to the duties of care, competence, and diligence, however, the *Restatement* states that a "contract may, in appropriate circumstances, raise or lower the standard" applicable to those duties and that such duties can be "contractually shaped," but it does not indicate whether they can be eliminated altogether.

104 Dana M. Muir & Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?* 1996 U. ILL. L. REV. 1059, 1078-1079 (1996).

brought by or in the right of the corporation. Since the cause of action belongs to the corporation and the power to manage the business and affairs of a corporation generally resides in its Board, a disinterested Board would have the power to determine whether to bring a breach of fiduciary duty claim for the corporation.[105]

Both Delaware[106] and Texas[107] law authorize an action brought in the right of the corporation by a shareholder against directors or officers for breach of fiduciary duty.[108] Such an action is called a "derivative action." In deference to the power of the Board, a shareholder would ordinarily be expected to demand that the Board commence the action before commencing a derivative action.[109] An independent and disinterested Board could then decide whether commencing the action would be in the best interest of the corporation and could decide to have the action dismissed.[110] Delaware and Texas differ in cases in which making such a demand upon the Board is likely to have little or no effect, generally because a majority of the Board lacks independence or is otherwise interested in the actions being disputed.

Delaware recognizes that a Board may not be disinterested and does not require demand when it would be futile. Chancellor Chandler explained when demand will not be required in Delaware in *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*:[111]

> The first hurdle facing any derivative complaint is Rule 23.1, which requires that the complaint "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Rule 23.1 stands for the proposition in Delaware corporate law that the business and affairs of a corporation, absent exceptional circumstances, are to be managed by its board of directors. To this end, Rule 23.1 requires that a plaintiff who asserts that demand would be futile must "comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings" normally governed by Rule 8(a). Vague or conclusory allegations do not suffice to upset the presumption of a director's capacity to consider demand. As famously explained in *Aronson v. Lewis*, plaintiffs may establish that demand was futile by showing that there is a reason to doubt either (a) the distinterestedness and independence of a majority of the board upon whom demand would be made, or (b) the possibility that the transaction could have been an exercise of business judgment.

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105 *See Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990) ("Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders . . . ."); *Pace v. Jordan*, 999 S.W.2d 615, 622 (Tex. App. – Houston [1st Dist.] 1999, pet. denied) (noting that "[a] corporation's directors, not its shareholders, have the right to control litigation of corporate causes of action").

106 Del. Court of Chancery Rule 23.1.

107 TBCA art. 5.14 and TBOC §§ 21.551-21.563.

108 TBCA art. 5.14 and TBOC §§ 21.551-21.563.

109 Del. Court of Chancery Rule 23.1; TBCA art. 5.14C; TBOC § 21.553.

110 TBCA art. 5.14.F and TBOC § 21.558; *see* discussion of *In re Oracle Corp. Derivative Litigation* in *infra* note 152.

111 919 A.2d 563, 2007 WL 416132 (Del.Ch. Feb. 6, 2007).

> There are two ways that a plaintiff can show that a director is unable to act objectively with respect to a pre-suit demand. Most obviously, a plaintiff can assert facts that demonstrate that a given director is personally interested in the outcome of litigation, in that the director will personally benefit or suffer as a result of the lawsuit in a manner that differs from shareholders generally. A plaintiff may also challenge a director's independence by alleging facts illustrating that a given director is dominated through a "close personal or familial relationship or through force of will," or is so beholden to an interested director that his or her "discretion would be sterilized." Plaintiffs must show that the beholden director receives a benefit "upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively."

The Chancellor further elaborated on demand futility in *Ryan v. Gifford*,[112] as follows:

> Defendants state that plaintiff has failed to make demand or prove demand futility. That is, defendants contend that the complaint lacks particularized facts that either establish that a majority of directors face a "substantial likelihood" of personal liability for the wrongdoing alleged in the complaint or render a majority of the board incapable of acting in an independent and disinterested fashion regarding demand.
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> When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that shareholder to first make demand on that corporation's board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation. This demand requirement works "to curb a myriad of individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation, which may tie up the corporation's governors in constant litigation and diminish the board's authority to govern the affairs of the corporation."
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> This Court has recognized, however, that in some cases demand would prove futile. Where the board's actions cause the shareholders' complaint, "a question is rightfully raised over whether the board will pursue these claims with 100% allegiance to the corporation, since doing so may require that the board sue *itself* on behalf of the corporation." Thus, in an effort to balance the interest of preventing "strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery [with the interest of encouraging] suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to

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[112] 918 A.2d 341 (Del. Ch. Feb. 6, 2007); *see also London v. Tyrrell*, CA 3321-CC (Del. Ch. June 24, 2008) (in case where options were allegedly granted with exercise prices below the fair market value of the shares on the date of grant because projections given to valuation firm omitted revenues from anticipated contracts that were in projections furnished to issuer's lender, demand was excused because the defendant directors stood on both sides of the challenged transaction – they both granted and received options).

> objectively pursue on the corporation's behalf," Delaware law recognizes two instances where a plaintiff is excused from making demand. Failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent or (2) the challenged acts were the product of the board's valid exercise of business judgment.
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> The analysis differs, however, where the challenged decision is not a decision of the board in place at the time the complaint is filed. * * * Accordingly, where the challenged transaction was not a decision of the board upon which plaintiff must seek demand, plaintiff must "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."
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> * * * Where at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, [demand may be excused].

In Delaware a derivative plaintiff must have been a stockholder continuously from the time of the transaction in question through the completion of the lawsuit.[113] Stockholders who obtained their shares in a merger lack derivative standing to challenge pre-merger actions.[114]

In Texas a shareholder bringing a derivative suit on behalf of a Texas corporation *must* file a written demand in order to maintain the suit, and no showing of futility can excuse this requirement.[115] Additionally, a 90-day waiting period is required from the delivery of the

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113 *Id.*; 8 Del. Code § 327.

114 *Cf. Louisiana Municipal Police Employees' Retirement Sys. v. Crawford*, Civil Action No. 2635-N (Del. Ch. February 13, 2007) and *Express Scripts, Inc. v. Crawford*, Civil Action No. 2663-N (Del. Ch. February 13, 2007), in which the Chancellor delayed a stockholders meeting to vote on the proposed Caremark Rx/CVS merger from February 20, 2007 to March 9, 2007 to allow disclosures that (i) Caremark had three times discussed a possible transaction with Express Scripts even though after its agreement with CVS, Caremark was arguing that antitrust concerns even precluded talking to this higher bidder, and (ii) any merger of Caremark could cause other plaintiffs to lose standing to sue Caremark Rx directors for breach of fiduciary duty in respect of alleged options backdating; *but cf. In re CheckFree Corp.*, No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) in which Chancellor Chandler denied a claim that management failed to disclose the effect of a merger on a pending derivative action and that the merger would likely extinguish the claim and free one of the directors from liability, holding that "directors need not [give legal advice and] tell shareholders that a merger will extinguish pending derivative claims." Though such information may be helpful in an abstract sense, the Court found it unlikely the disclosure would "alter the total mix of information available."

115 The Texas Corporate Statutes apply to corporations formed under the laws of a jurisdiction other than Texas (a "*foreign corporation*") transacting business in Texas. TBOC §§ 21.001(2) and 21.001(7); TBCA art. 1.02A(14). In a derivative proceeding brought in Texas in the right of a foreign corporation, the requirement that the shareholder make written demand is governed by the laws of the jurisdiction where the foreign corporation is incorporated. TBOC § 21.562(a); TBCA art. 5.14K. Even though the substantive law of the jurisdiction where the foreign corporation is incorporated applies, Texas procedural law governs matters of remedy and procedure. *Connolly v. Gasmire*, 257 S.W.3d 831 (Tex.App.—Dallas 2008).

Under Texas procedural law, a party is generally required to file a special exception to challenge a defective pleading. Tex.R. Civ. P. 90, 91 provide the means for a party to specifically except to an adverse party's pleadings, and provide that a special exception shall point out the pleading excepted to and, with particularity, the defect or insufficiency in the allegations of the pleading. The purpose of special exceptions is to furnish a party with a medium by which to force clarification of an adverse party's pleadings when they are not clear or sufficiently specific. *Id.*

demand notice until the commencement of a suit.[116] This waiting period can only be avoided if the shareholder is earlier notified that the Board has rejected their demand, or if "irreparable harm to the corporation is being suffered or would result by waiting for the expiration of the 90-day period."[117]

The written demand must meet a stringent set of particularity requirements in order to satisfy the Texas Corporate Statutes.[118] Though much of the analysis done by the courts to evaluate potential "irreparable harm" may be similar to the analysis required for demand futility claims in Delaware, the fact that the Texas Corporate Statutes focus on the harm to the corporation, rather than the apparent futility of demand, presents a slightly different set of issues than are normally addressed in cases involving Delaware corporations.

Federal Rule of Civil Procedure 23.1 also provides that a plaintiff may bring a shareholder derivative suit if the requirements for Federal Court jurisdiction are satisfied and the following additional two requirements are met: (1) the plaintiff must have owned shares in the corporation at the time of the disputed transaction; and (2) the plaintiff must allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors.[119] Case law further requires that the plaintiff remain a shareholder throughout the course of the derivative action.[120] This demand requirement may be excused if the facts show that demand would have been futile.[121]

Questions arise with respect to the effect of a merger in which the corporation is not the surviving entity on a derivative action. Under Delaware law, in the absence of fraud, "the effect of a merger . . . is normally to deprive a shareholder of the merged corporation of standing to maintain a derivative action,"[122] but the result may not be the same under Texas law. Like Delaware, the Federal Rules of Civil Procedure and Texas' prior derivative action provisions in

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When a trial court sustains a party's special exceptions, the trial court must give the pleader an opportunity to amend his pleadings before dismissing the case. When a petition fails to satisfy the requirements for demand futility under the laws of a foreign jurisdiction, the proper remedy under Texas procedural law is to sustain the special exceptions and allow the plaintiff an opportunity to amend the petition, even if dismissal is the proper remedy under the laws of the foreign jurisdiction. *Id.*

116 TBCA art. 5.14(C)(2); TBOC § 21.553(a).

117 TBCA art. 5.14(C)(2); TBOC § 21.553(b).

118 *Marron v. Ream*, Civil Action No. H-06-1394, 2006 U.S. Dist. LEXIS 72831, at *18–20 (S.D. Tex. May 8, 2006); *Equitec-Cole Roesler v. McClanahan*, 251 F. Supp. 2d 1347, 1350 (S.D. Tex. 2003).

119 Fed. R. Civ. Pr. (2009).

120 *See infra* note 123 and related text.

121 *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008).

122 *Lewis v. Anderson*, 477 A.2d 1040, 1047–49 (Del. 1984); *see Elloway v. Pate*, 238 S.W.3d 882, 900 (Tex.App.—Houston [14th Dist.] 2007) in which a Texas court applying Delaware law held that a merger eliminated standing to bring a derivative action, but not a direct action, and explained: "A derivative claim is brought by a stockholder, on behalf of the corporation, to recover harm done to the corporation. *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031, 1036 (Del. 2004). A stockholder's direct claim must be independent of any alleged injury to the corporation. *Id.* at 1039. If the stockholder's claim is derivative, the stockholder loses standing to pursue his claim upon accomplishment of the merger. *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1244-45 (Del. 1999). A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such claim even after the merger at issue has been consummated. *Id.* at 1245. To state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty in unfair dealing and/or unfair price. *Id.* at 1245." *Cf. Pate v. Elloway*, No. 01-03-00187-CV, 2003 WL 22682422 (Tex.App.—Houston [1st Dist.] Nov. 13, 2003, pet. denied).

the TBCA have been interpreted to require that the claimant in a derivative case remain a shareholder throughout the course of the derivative claim,[123] which requirement would not be satisfied where a derivative plaintiff's shares in the corporation are converted in the merger into cash or securities of another entity. A Texas court has not ruled on the merger survival issue under the derivative provisions in the current Texas Corporate Statutes.[124] Whereas Delaware law explicitly allows for direct suit in such cases, *Gearhart* held that under Texas law fiduciary claims in connection with a merger are the right of the corporation itself, not individual shareholders.[125]

G. Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties.

1. Overview.

Responding to problems in corporate governance, SOX and related changes to SEC rules and stock exchange listing requirements[126] have implemented a series of reforms that require all public companies[127] to implement or refrain from specified actions,[128] some of which are

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123 Fed. R. Civ. P. 23.1 (2009); *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) ("the [stock] ownership requirement continues throughout the life of the suit. . . ."); *Romero v. US Unwired, Inc.*, No. 04-2312, 2006 WL 2366342, at *5 (E.D. La. Aug. 11, 2006) (slip op.) (holding that merger divested shareholder plaintiff of standing to pursue derivative claim under Fed. R. Civ. P. 23.1 and dismissing suit); *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 937-938 (Tex. Civ. App. 1979) ("The requirement in article [TBCA] 5.14(B) [as it existed in 1979] that in order to bring a derivative suit a plaintiff must have been a shareholder at the time of the wrongful transaction, is only a minimum requirement. The federal rule governing derivative suits, which contains similar requirements to article 5.14(B), has been construed to include a further requirement that shareholder status be maintained throughout the suit. [citations omitted] The reasoning behind allowing a shareholder to maintain a suit in the name of the corporation when those in control wrongfully refuse to maintain it is that a shareholder has a proprietary interest in the corporation. Therefore, when a shareholder sues, he is protecting his own interests a well as those of the corporation. If a shareholder voluntarily disposes of his shares after instituting a derivative action, he necessarily destroys the technical foundation of his right to maintain the action. [citation omitted] If, on the other hand, a shareholder's status is involuntarily destroyed, a court of equity must determine whether the status was destroyed without a valid business purpose; for example, was the action taken merely to defeat the plaintiff's standing to maintain the suit? * * * If no valid business purpose exists, a court of equity will consider the destruction of a stockholder's status a nullity and allow him to proceed with the suit in the name of the corporation. Therefore, on remand of this suit, a finding that appellant has failed to maintain his status as shareholder is dependent upon findings that the disposition of the stock was voluntary or, though involuntary, that the corporation's termination proceeding was instituted to accomplish a valid business purpose, rather than to dispose of the derivative suit by a reverse stock split.").

124 TBCA art. 5.03(M) provides that for the purposes of TBCA art. 5.03: "To the extent a shareholder of a corporation has standing to institute or maintain derivative litigation on or behalf of the corporation immediately before a merger, nothing in this article may be construed to limit or extinguish the shareholder's standing." The impact of this provision has not been directly tested in a Texas court, but at least one federal court interpreting Texas law has suggested that under TBCA art. 5.03(M) a shareholder who could have properly brought a derivative suit prior to a merger will maintain that right, even after a merger has rendered the corporation in question nonexistent. *See Marron v. Ream*, Civil Action No. H-06-1394, 2006 U.S. Dist. LEXIS 72831, at *23 (S.D. Tex. May 8, 2006). Substantially the same language is included in TBOC § 21.552(b).

125 *Gearhart Indus., Inc. v. Smith Int'l. Inc.*, 741 F.2d 707,721 (5th Cir. 1984).

126 On November 4, 2003, the SEC issued Release No. 34-48745, titled "Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes [citations omitted]," which can be found at http://www.sec.gov/rules/sro/34-48745.htm, pursuant to which the SEC approved the rule changes proposed by the NYSE and NASD to comply with SOX. These rule changes are now effective for all NYSE and NASDAQ listed companies. Any references to the rules in the NYSE Listed Company Manual (the *"NYSE Rules"*) or the marketplace rules in the NASD Manual (the *"NASD Rules"*) are references to the rules as approved by the SEC on November 4, 2003.

127 The SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act (*"reporting companies"*) or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, *"public companies"* or *"issuers"*). Some of the SOX provisions apply only to companies listed on a

expressly permitted by state corporate laws, subject to general fiduciary principles. Several examples of this interaction of state law with SOX or new SEC or stock exchange requirements are discussed below.

2. Shareholder Causes of Action.

SOX does not create new causes of action for shareholders, with certain limited exceptions, and leaves enforcement of its proscriptions to the SEC or federal criminal authorities.[129] The corporate plaintiffs' bar, however, can be expected to be creative and aggressive in asserting that the new standards of corporate governance should be carried over into state law fiduciary duties, perhaps by asserting that violations of SOX constitute violations of fiduciary duties of obedience or supervision.[130]

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national securities exchange (*"listed companies"*), such as the New York Stock Exchange (*"NYSE"*), the American Stock Exchange (*"AMEX"*) or the NASDAQ Stock Market (*"NASDAQ"*) (the national securities exchanges and NASDAQ are referred to collectively as *"SROs"*), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary. SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the *"1940 Act"*) and (ii) public companies domiciled outside of the U.S. (*"foreign companies"*), although many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the *"foreign private issuer,"* which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as:

- More than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer's assets are not located in the U.S.; and;
- The issuer's business is not administered principally in the U.S.

128 *See* **Appendix A**; Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=505; Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); Byron F. Egan, *Communications with Accountants After the Sarbanes-Oxley Act (including Attorney Letters to Auditors re Loss Contingencies, Attorney Duties under SOX §§ 303 and 307, Options Backdating)* (Oct. 24, 2006), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=624; and Byron F. Egan, *Responsibilities of Attorneys and Other M&A Professionals After the Sarbanes-Oxley Act* (November 7, 2008), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1035.

129 "Except in the case of recovery of profits from prohibited sales during a blackout period and suits by whistleblowers, the Sarbanes-Oxley Act does not expressly create new private rights of action for civil liability for violations of the Act. The Sarbanes-Oxley Act, however, potentially affects existing private rights of action under the Exchange Act by: (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation; and (2) expanding reporting and disclosure requirements that could potentially expand the range of actions that can be alleged to give rise to private suits under Section 10(b) and Section 18 of the Exchange Act and SEC Rule 10b-5." Patricia A. Vlahakis et al., *Understanding the Sarbanes-Oxley Act of 2002*, CORP. GOVERNANCE REFORM, Sept.-Oct. 2002, at 16.

130 See William B. Chandler III and Leo E. Strine Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* (February 26, 2002), which can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367720, at 43-48.

3. Director Independence.

a. Power to Independent Directors.

(1) *General*. The SEC rules under SOX and related stock exchange listing requirements are shifting the power to govern public companies to outside directors. Collectively, they will generally require that listed companies have:

- A board of directors, a majority of whom are independent;[131]
- An audit committee[132] composed entirely of independent directors;[133]
- A nominating/corporate governance committee composed entirely of independent directors;[134] and
- A compensation committee composed entirely of independent directors.[135]

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[131] *See* NYSE Rules 303A.01 and 303A.02; NASD Rules 4350(c)(1) and 4200(a)(15).

[132] 1934 Act § 3(a)(58) added by SOX § 2(a)(3) provides:

(58) *Audit Committee*. The term "audit committee" means –

(A) A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

(B) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

[133] On April 9, 2003, the SEC issued Release No. 33-8220 (the *"SOX §301 Release"*) adopting, effective April 25, 2003, 1934 Act Rule 10A-3, titled "Standards Relating to Listed Company Audit Committees" (the *"SOX §301 Rule"*), which can be found at http://www.sec.gov/rules/final/33-8220.htm, to implement SOX §301. Under the SOX §301 Rule, each SRO must adopt rules conditioning the listing of any securities of an issuer upon the issuer being in compliance with the standards specified in SOX §301, which may be summarized as follows:

- Oversight. The audit committee must have direct responsibility for the appointment, compensation, and oversight of the work (including the resolution of disagreements between management and the auditors regarding financial reporting) of any registered public accounting firm employed to perform audit services, and the auditors must report directly to the audit committee.
- Independence. The audit committee members must be independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees: (i) accept any consulting, advisory or other compensation, directly or indirectly, from the issuer or (ii) be an officer or other affiliate of the issuer.
- Procedures to Receive Complaints. The audit committee is responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of the issuer (*"whistleblowers"*) of concerns regarding questionable accounting or auditing matters.
- Funding and Authority. The audit committee must have the authority to hire independent counsel and other advisers to carry out its duties, and the issuer must provide for funding, as the audit committee may determine, for payment of compensation of the issuer's auditor and of any advisors that the audit committee engages.

SROs may adopt additional listing standards regarding audit committees as long as they are consistent with SOX and the SOX §301 Rule. The NYSE and NASD have adopted such rules, which are discussed below. *See* NYSE Rules 303A.06 and 303A.07 and NASD Rule 4350(d).

[134] *See* NYSE Rule 303A.04; NASD Rule 4350(c)(4).

[135] *See* NYSE Rule 303A.05; NASD Rule 4350(c)(3). The compensation committee typically is composed of independent directors and focuses on executive compensation and administration of stock options and other incentive plans. While the duties of the compensation committee will vary from company to company, the *ALI's Principles of Corporate Governance* § 3A.05 (Supp 2002) recommend that the compensation committee should:

These independent directors will be expected to actively participate in the specified activities of the board of directors and the committees on which they serve.

State law authorizes boards of directors to delegate authority to committees of directors. Texas and Delaware law both provide that boards of directors may delegate authority to committees of the board subject to limitations on delegation for fundamental corporate transactions.[136] Among the matters that a committee of a board of directors will not have the authority to approve are (i) charter amendments, except to the extent such amendments are the result of the issuance of a series of stock permitted to be approved by a board of directors, (ii) a plan of merger or similar transaction, (iii) the sale of all or substantially all of the assets of the corporation outside the ordinary course of its business, (iv) a voluntary dissolution of the corporation and (v) amending bylaws or creating new bylaws of the corporation.[137] In addition, under Texas law, a committee of a board of directors may not fill any vacancy on the board of directors, remove any officer, fix the compensation of a member of the committee or amend or repeal a resolution approved by the whole board to the extent that such resolution by its terms is not so amendable or repealable.[138] Further, under both Texas and Delaware law, no committee of a board of directors has the authority to authorize a distribution (a dividend in the case of Delaware law) or authorize the issuance of stock of a corporation unless that authority is set forth in the charter or bylaws of the corporation.[139] Alternative members may also be appointed to committees under both states' laws.[140]

(2) *NYSE*. NYSE Rule 303A.01 requires the board of directors of each NYSE listed company to consist of a majority of independent directors.

(a) <u>NYSE Base Line Test</u>. Pursuant to NYSE Rule 303A.02, no director qualifies as "independent" unless the board affirmatively determines that the director has no

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(1) Review and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect, of the senior executives.

(2) Review new executive compensation programs; review on a periodic basis the operation of the corporation's executive compensation programs to determine whether they are properly coordinated; establish and periodically review policies for the administration of executive compensation programs; and take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance.

(3) Establish and periodically review policies in the area of management perquisites.

Under SEC Rule 16b-3 under the 1934 Act, the grant and exercise of employee stock options, and the making of stock awards, are generally exempt from the short-swing profit recovery provisions of § 16(b) under the 1934 Act if approved by a committee of independent directors. Further, under Section 162(m) of the Internal Revenue Code of 1980, as amended, corporations required to be registered under the 1934 Act are not able to deduct compensation to specified individuals in excess of $1,000,000 per year, except in the case of performance based compensation arrangements approved by the shareholders and administered by a compensation committee consisting of two or more "outside directors" as defined. Treas. Reg. § 1.162-27 (2002).

136 TBOC § 21.416; TBCA art. 2.36; DGCL § 141(c). These restrictions only apply to Delaware corporations that incorporated prior to July 1, 1996, and did not elect by board resolution to be governed by DGCL § 141(c)(2). If a Delaware corporation is incorporated after that date or elects to be governed by DGCL § 141(c)(2), then it may authorize a board committee to declare dividends or authorize the issuance of stock of the corporation.

137 TBOC § 21.416; TBCA art. 2.36; DGCL § 141(c).

138 TBOC § 21.416; TBCA art. 2.36.B.

139 TBOC § 21.416(d); TBCA art. 2.36.C; DGCL § 141(c)(1). In Texas such authorization may alternatively appear in the resolution designating the committee. TBOC § 21.416(d); TBCA art. 2.36.C.

140 TBOC § 21.416(a); TBCA art. 2.36.A; DGCL § 141(c)(1).

material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). The company is required to disclose the basis for such determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In complying with this requirement, the company's board is permitted to adopt and disclose standards to assist it in making determinations of independence, disclose those standards, and then make the general statement that the independent directors meet those standards.

(b) <u>NYSE Per Se Independence Disqualifications</u>. In addition to the general requirement discussed above, NYSE Rule 303A.02 considers a number of relationships to be an absolute bar on a director being independent as follows:

> <u>First</u>, a director who is an employee, or whose immediate family member is an executive officer, of the company would not be independent until three years after the end of such employment (employment as an interim Chairman or CEO will not disqualify a director from being considered independent following that employment).
>
> <u>Second</u>, a director who has received, or whose immediate family member has received, more than $120,000 in any twelve-month period within the last three years in direct compensation from the NYSE listed company, except for certain payments, would not be independent.
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> <u>Third</u>, a director who is, or who has an immediate family member who is, a current partner of a firm that is the NYSE listed company's internal or external auditor; a director who is a current employee of such a firm; a director who has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or a director who was, or who has an immediate family member who was, within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the NYSE listed company's audit within that time.
>
> <u>Fourth</u>, a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the NYSE listed company's present executives served on that company's compensation committee at the same time can not be considered independent until three years after the end of such service or the employment relationship.
>
> <u>Fifth</u>, a director who is a current employee, or whose immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the NYSE listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues. Charitable organizations are not considered "companies" for purposes of the exclusion from independence described in the previous sentence, provided that the NYSE listed company discloses in its annual proxy statement, or if the NYSE listed company does not file an annual proxy statement, in its annual report on Form 10-K filed

with the SEC, any charitable contributions made by the NYSE listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, such contributions in any single year exceeded the greater of $1 million or 2% of the organization's consolidated gross revenues.

(3) *NASDAQ*. NASD Rule 4350(c)(1) requires a majority of the directors of a NASDAQ-listed company to be "*independent directors*," as defined in NASD Rule 4200.[141]

(a) NASDAQ Base Line Test. NASD Rule 4350(c)(1) requires each NASDAQ listed company to disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) those directors that the board has determined to be independent as defined in NASD Rule 4200.[142]

(b) NASDAQ Per Se Independence Disqualifications. NASD Rule 4200(a)(15) specifies certain relationships that would preclude a board finding of independence as follows:

First, a director who is, or at anytime during the past three years was, employed by the NASDAQ listed company or by any parent or subsidiary of the company (the "*NASDAQ Employee Provision*").

Second, a director who accepted or has a family member who accepted any payments from the NASDAQ listed company, or any parent or subsidiary of the company, in excess of $60,000 during any period of twelve consecutive months within the three years preceding the determination of independence other than certain permitted payments (the "*NASDAQ Payments Provision*"). NASDAQ states in the interpretive material to the NASD Rules (the "*NASDAQ Interpretive Material*") that this provision is generally intended to capture situations where a payment is made directly to, or for the benefit of, the director or a family member of the director. For example, consulting or personal service contracts with a director or family member of the director or political contributions to the campaign of a director or a family member of the director prohibit independence.

Third, a director who is a family member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer (the "*NASDAQ Family of Executive Officer Provision*").

141 NASD Rule 4350, which governs qualitative listing requirements for NASDAQ National Market and NASDAQ SmallCap Market issuers (other than limited partnerships), must be read in tandem with NASD Rule 4200, which provides definitions for the applicable defined terms.

142 If a NASDAQ listed company fails to comply with the requirement that a majority of its board of directors be independent due to one vacancy, or one director ceases to be independent due to circumstances beyond a company's reasonable control, NASD Rule 4350(c)(1) requires the issuer to regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the compliance failure. Any issuer relying on this provision must provide notice to NASDAQ immediately upon learning of the event or circumstance that caused the non-compliance.

Fourth, a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than certain permitted payments (the "*NASDAQ Business Relationship Provision*"). The NASDAQ Interpretive Material states that this provision is generally intended to capture payments to an entity with which the director or family member of the director is affiliated by serving as a partner (other than a limited partner), controlling shareholder or executive officer of such entity. Under exceptional circumstances, such as where a director has direct, significant business holdings, the NASDAQ Interpretive Material states that it may be appropriate to apply the NASDAQ Business Relationship Provision in lieu of the NASDAQ Payments Provision described above, and that issuers should contact NASDAQ if they wish to apply the rule in this manner. The NASDAQ Interpretive Material further notes that the NASDAQ Business Relationship Provision is broader than the rules for audit committee member independence set forth in 1934 Act Rule 10A-3(e)(8).

The NASDAQ Interpretive Material further states that under the NASDAQ Business Relationship Provision, a director who is, or who has a family member who is, an executive officer of a charitable organization may not be considered independent if the company makes payment to the charity in excess of the greater of 5% of the charity's revenues or $200,000. The NASDAQ Interpretive Material also discusses the treatment of payments from the issuer to a law firm in determining whether a director who is a lawyer may be considered independent. The NASDAQ Interpretive Material notes that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee.

Fifth, a director who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the NASDAQ listed company serves on the compensation committee of such other entity ("*NASDAQ Interlocking Directorate Provision*").

Sixth, a director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor, and worked on the company's audit, at any time, during the past three years ("*NASDAQ Auditor Relationship Provision*").

Seventh, in the case of an investment company, a director who is an "*interested person*" of the company as defined in section 2(a)(19) of the Investment Company Act, other than in his or her capacity as a member of the board of directors or any board committee.

With respect to the look-back periods referenced in the NASDAQ Employee Provision, the NASDAQ Family of Executive Officer Provision, the NASDAQ Interlocking Directorate

Provision, and the NASDAQ Auditor Relationship Provision, "*any time*" during any of the past three years should be considered. The NASDAQ Interpretive Material states that these three year look-back periods commence on the date the relationship ceases. As an example, the NASDAQ Interpretive Material states that a director employed by the NASDAQ listed company would not be independent until three years after such employment terminates. The NASDAQ Interpretive Material states that the reference to a "*parent or subsidiary*" in the definition of independence is intended to cover entities the issuer controls and consolidates with the issuer's financial statements as filed with the SEC (but not if the issuer reflects such entity solely as an investment in its financial statements). The NASDAQ Interpretive Material also states that the reference to "*executive officer*" has the same meaning as the definition in Rule 16a-1(f) under the 1934 Act.

b. Audit Committee Member Independence.

(1) *SOX*. To be "*independent*" and thus eligible to serve on an issuer's audit committee under the SOX §301 Rule, (i) audit committee members may not, directly or indirectly, accept any consulting, advisory or other compensatory fee from the issuer or a subsidiary of the issuer, other than in the member's capacity as a member of the board of directors and any board committee (this prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments; indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a general partner, managing member, executive officer or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer or any subsidiary; receipt of fixed retirement plan or deferred compensation is not prohibited)[143] and (ii) a member of the audit committee of an issuer may not be an "*affiliated person*" of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee (subject to the safe harbor described below).[144]

Since it is difficult to determine whether someone controls the issuer, the SOX §301 Rule creates a safe harbor regarding whether someone is an "*affiliated person*" for purposes of meeting the audit committee independence requirement. Under the safe harbor, a person who is not an executive officer, director or 10% shareholder of the issuer would be deemed not to control the issuer. A person who is ineligible to rely on the safe harbor, but believes that he or she does not control an issuer, still could rely on a facts and circumstances analysis. This test is similar to the test used for determining insider status under §16 of the 1934 Act.

The SEC has authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the

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143 The SOX §301 Rule restricts only current relationships and does not extend to a "look back" period before appointment to the audit committee, although SRO rules may do so.

144 The terms *"affiliate"* and *"affiliated person"* are defined consistent with other definitions of those terms under the securities laws, such as in 1934 Act Rule 12b-2 and 1933 Act Rule 144, with an additional safe harbor. In the SOX §301 Release, the SEC clarified that an executive officer, general partner and managing member of an affiliate would be deemed to be an affiliate, but outside directors, limited partners and others with no policy making function would not be deemed affiliates. Similarly, a member of the audit committee of an issuer that is an investment company could not be an *"interested person"* of the investment company as defined in 1940 Act §2(a)(19).

circumstances. Because companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the SOX §301 Rule provides an exception for non-investment company issuers that requires only one fully independent member at the time of the effectiveness of an issuer's initial registration statement under the 1933 Act or the 1934 Act, a majority of independent members within 90 days and a fully independent audit committee within one year.

For companies that operate through subsidiaries, the composition of the boards of the parent company and subsidiaries are sometimes similar given the control structure between the parent and the subsidiaries. If an audit committee member of the parent is otherwise independent, merely serving on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent of the subsidiary except for the member's seat on the parent's board. Therefore, SOX §301 Rule exempts from the "*affiliated person*" requirement a committee member that sits on the board of directors of both a parent and a direct or indirect subsidiary or other affiliate, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary or affiliate, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the parent, subsidiary or affiliate. Any issuer taking advantage of any of the exceptions described above would have to disclose that fact.

(2) *NYSE.*

(i) Audit Committee Composition. NYSE Rules 303A.06 and 303A.07 require each NYSE listed company to have, at a minimum, a three person audit committee composed entirely of directors that meet the independence standards of both NYSE Rule 303A.02 and 1934 Act Rule 10A-3. The Commentary to NYSE Rule 303A.06 states: "The [NYSE] will apply the requirements of SEC Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the [NYSE] will provide companies with the opportunity to cure defects provided in SEC Rule 10A-3(a)(3)."

The Commentary to NYSE Rule 303A.07 requires that each member of the audit committee be financially literate, as such qualification is interpreted by the board in its business judgment, or become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the NYSE listed company's board interprets such qualification in its business judgment. While the NYSE does not require an NYSE listed company's audit committee to include a person who satisfies the definition of audit committee financial expert set forth in Item 401(h) of Regulation S-K, a board may presume that such a person has accounting or related financial management experience.

If an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE listed company does not limit the number of audit committees on which its audit committee members serve to three or less, each board is required to determine that such simultaneous service does not impair the ability of such board member to effectively serve on the NYSE listed company's audit committee and to disclose such determination.

(ii) Audit Committee Charter and Responsibilities. NYSE Rule 303A.07(c) requires the audit committee of each NYSE listed company to have a written audit committee charter that addresses: (i) the committee's purpose; (ii) an annual performance evaluation of the audit committee; and (iii) the duties and responsibilities of the audit committee ("*NYSE Audit Committee Charter Provision*").

The NYSE Audit Committee Charter Provision provides details as to the duties and responsibilities of the audit committee that must be addressed. These include, at a minimum, those set out in 1934 Act Rule 10A-3(b)(2), (3), (4) and (5), as well as the responsibility to at least annually obtain and review a report by the independent auditor; meet to review and discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the NYSE listed company's specific disclosures under MD&A; discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies; discuss policies with respect to risk assessment and risk management; meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors; review with the independent auditors any audit problems or difficulties and management's response; set clear hiring policies for employees or former employees of the independent auditors; and report regularly to the board. The commentary to NYSE Rule 303A.07 explicitly states that the audit committee functions specified in NYSE Rule 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

Each NYSE listed company must have an internal audit function. The commentary to NYSE Rule 303A.07 states that listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the NYSE listed company's risk management processes and system of internal control. A NYSE listed company may choose to outsource this function to a third party service provider other than its independent auditor.

(3) NASDAQ.

(i) Audit Committee Composition. NASD Rule 4350(d) requires each NASDAQ listed issuer to have an audit committee composed of at least three members. In addition, it requires each audit committee member to: (1) be independent, as defined under NASD Rule 4200(a)(15); (2) meet the criteria for independence set forth in 1934 Act Rule 10A-3 (subject to the exceptions provided in 1934 Act Rule10A-3(c)); (3) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and (4) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement ("NASDAQ Audit Committee Provision").

One director who is not independent as defined in NASD Rule 4200(a)(15) and meets the criteria set forth in 1934 Act § 10A(m)(3) and the rules thereunder, and is not a current officer or employee of the company or a family member of such person, may be appointed to the audit committee if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the company and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for that determination. A member appointed under this exception would not be permitted to serve longer than two years and would not be permitted to chair the audit committee. The NASDAQ Interpretive Material recommends that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the safe harbor provisions of SEC Rule 10A-3(e)(1)(ii).

At least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(ii) Audit Committee Charter and Responsibilities. NASD Rule 4350(d) requires each NASDAQ listed company to adopt a formal written audit committee charter and to review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify: (1) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements; (2) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; (3) the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer; and (4) other specific audit committee responsibilities and authority set forth in NASD Rule 4350(d)(3). NASDAQ states in the NASDAQ Interpretive Material to NASD Rule 4350(d) that the written charter sets forth the scope of the audit committee's responsibilities and the means by which the committee carries out those responsibilities; the outside auditor's accountability to the committee; and the committee's responsibility to ensure the independence of the outside auditors.

c. Nominating Committee Member Independence.

(1) *NYSE*. NYSE Rule 303A.04 requires each NYSE listed company to have a nominating/corporate governance committee composed entirely of independent directors. The nominating/corporate governance committee must have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual performance evaluation of the nominating/corporate governance committee ("*NYSE Nominating/Corporate Governance Committee Provision*"). The committee is required to identify individuals qualified to become board members, consistent with the criteria approved by the board.

(2) *NASDAQ*. NASD Rule 4350(c)(4)(A) requires director nominees to be selected, or recommended for the board's selection, either by a majority of independent directors, or by a nominations committee comprised solely of independent directors ("*NASDAQ Director Nomination Provision*").

If the nominations committee is comprised of at least three members, one director, who is not independent (as defined in NASD Rule 4200(a)(15)) and is not a current officer or employee or a family member of such person, is permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in its next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under such exception is not permitted to serve longer than two years.

Further, NASD Rule 4350(c)(4)(B) requires each NASDAQ listed company to certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws. The NASDAQ Director Nomination Provision does not apply in cases where either the right to nominate a director legally belongs to a third party, or the company is subject to a binding obligation that requires a director nomination structure inconsistent with this provision and such obligation pre-dates the date the provision was approved.

d. **Compensation Committee Member Independence.**

(1) *NYSE*. NYSE Rule 303A.05 requires each NYSE listed company to have a compensation committee composed entirely of independent directors. The compensation committee must have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual performance evaluation of the compensation committee ("*NYSE Compensation Committee Provision*"). The Compensation Committee is required to produce a compensation committee report on executive compensation, as required by SEC rules, to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC. NYSE Rule 303A.05 provides that either as a committee or together with the other independent directors (as directed by the Board), the committee will determine and approve the CEO's compensation level based on the committee's evaluation of the CEO's performance. The commentary to this rule indicates that discussion of CEO compensation with the board generally is not precluded.

(2) *NASDAQ*. NASD Rule 4350(c)(3) requires the compensation of the CEO of a NASDAQ listed company to be determined or recommended to the board for determination either by a majority of the independent directors, or by a compensation committee comprised solely of independent directors ("*NASDAQ Compensation of Executives Provision*"). The CEO may not be present during voting or deliberations. In addition, the compensation of all other officers has to be determined or recommended to the Board for determination either by a majority of the independent directors, or a compensation committee comprised solely of independent directors.

Under these NASD Rules, if the compensation committee is comprised of at least three members, one director, who is not "*independent*" (as defined in NASD Rule 4200(a)(15)) and is not a current officer or employee or a family member of such person, is permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the Board discloses, in the next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under such exception would not be permitted to serve longer than two years.

e. **State Law.**

Under state law and unlike the SOX rules, director independence is not considered as a general status, but rather is tested in the context of each specific matter on which the director is called upon to take action.

Under Texas common law, a director is generally considered "*interested*" only in respect of matters in which he has a financial interest. The Fifth Circuit in *Gearhart* summarized Texas law with respect to the question of whether a director is "*interested*" as follows:

> A director is considered 'interested' if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . .; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated . . .; or (4) transacts business in his director's capacity with a family member.[145]

In the context of the dismissal of a derivative action on motion of the corporation, those making the decision on behalf of the corporation to dismiss the proceeding must lack both any disqualifying financial interest and any relationships that would impair independent decision making. The Texas Corporate Statues provide that a court shall dismiss a derivative action if the determination to dismiss is made by directors who are both disinterested and independent.[146] For this purpose, a director is considered "*disinterested*"[147] if he lacks any disqualifying financial

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145 *Gearhart*, 741 F.2d at 719-20 (citations omitted).

146 TBOC § 21.554, 21.558; TBCA art. 5.14.F and 5.14.H.

147 TBOC § 1.003 defines *"disinterested"* as follows:

Sec. 1.003. DISINTERESTED PERSON.

(a) For purposes of this code, a person is disinterested with respect to the approval of a contract, transaction, or other matter or to the consideration of the disposition of a claim or challenge relating to a contract, transaction, or particular conduct, if the person or the person's associate:

(1) is not a party to the contract or transaction or materially involved in the conduct that is the subject of the claim or challenge; and

(2) does not have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge.

(b) For purposes of Subsection (a), a person is not materially involved in a contract or transaction that is the subject of a claim or challenge and does not have a material financial interest in the outcome of a contract or transaction or the disposition of a claim or challenge solely because:

(1) the person was nominated or elected as a governing person by a person who is:

interest in the matter, and is considered "*independent*"[148] if he is both disinterested and lacks any other specified relationships that could be expected to materially and adversely affect his judgment as to the disposition of the matter.

(A) interested in the contract or transaction; or

(B) alleged to have engaged in the conduct that is the subject of the claim or challenge;

(2) the person receives normal fees or customary compensation, reimbursement for expenses, or benefits as a governing person of the entity;

(3) the person has a direct or indirect equity interest in the entity;

(4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;

(5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding, or deciding on the disposition of the claim or challenge; or

(6) in the case of a review by the person of the alleged conduct that is the subject of the claim or challenge:

(A) the person is named as a defendant in the derivative proceeding regarding the matter or as a person who engaged in the alleged conduct; or

(B) the person, acting as a governing person, approved, voted for, or acquiesced in the act being challenged if the act did not result in a material personal or financial benefit to the person and the challenging party fails to allege particular facts that, if true, raise a significant prospect that the governing person would be held liable to the entity or its owners or members as a result of the conduct.

TBCA art. 1.02.A(12) provides substantially the same.

148 TBOC § 1.004 defines *"independent"* as follows:

Sec. 1.004. INDEPENDENT PERSON.

(a) For purposes of this code, a person is independent with respect to considering the disposition of a claim or challenge regarding a contract or transaction, or particular or alleged conduct, if the person:

(1) is disinterested;

(2) either:

(A) is not an associate, or member of the immediate family, of a party to the contract or transaction or of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge; or

(B) is an associate to a party or person described by Paragraph (A) that is an entity if the person is an associate solely because the person is a governing person of the entity or of the entity's subsidiaries or associates;

(3) does not have a business, financial, or familial relationship with a party to the contract or transaction, or with another person who is alleged to have engaged in the conduct, that is the subject of the claim or challenge that could reasonably be expected to materially and adversely affect the judgment of the person in favor of the party or other person with respect to the consideration of the matter; and

(4) is not shown, by a preponderance of the evidence, to be under the controlling influence of a party to the contract or transaction that is the subject of the claim or challenge or of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge.

(b) For purposes of Subsection (a), a person does not have a relationship that could reasonably be expected to materially and adversely affect the judgment of the person regarding the disposition of a matter that is the subject of a claim or challenge and is not otherwise under the controlling influence of a party to a contract or transaction that is the subject of a claim or challenge or that is alleged to have engaged in the conduct that is the subject of a claim or challenge solely because:

(1) the person has been nominated or elected as a governing person by a person who is interested in the contract or transaction or alleged to be engaged in the conduct that is the subject of the claim or challenge;

(2) the person receives normal fees or similar customary compensation, reimbursement for expenses, or benefits as a governing person of the entity;

Under Delaware law, an "*independent director*" is one whose decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence.[149] The Delaware Supreme Court's teachings on independence can be summarized as follows:

> At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity.[150]

The Delaware focus includes both financial and other disabling interests.[151] In the words of the Chancery Court:

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.[152]

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(3) the person has a direct or indirect equity interest in the entity;

(4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;

(5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding, or deciding on the disposition of the claim or challenge; or

(6) the person, an associate of the person, other than the entity or its associates, or an immediate family member has a continuing business relationship with the entity that is not material to the person, associate, or family member.

TBCA art. 1.02.A(15) provides substantially the same.

149 *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (overruled as to standard of appellate review); *Odyssey Partners v. Fleming Companies*, 735 A.2d 386 (Del. Ch. 1999).

150 *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001) (footnotes omitted) (emphasis in original), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 123 S. Ct. 2076 (2003).

151 *See In Re: INFOUSA, Inc. Shareholders Litigation*, CA No. 1956-CC (Del. Ch. August 20, 2007) (mere allegations of personal liability in respect of challenged activities are not sufficient to impair independence, but independence may be found lacking where there is a substantial likelihood that liability will be found).

152 *In Re Oracle Corp. Derivative Litigation*, 824 A.2d 917, 2003 WL 21396449 (Del. Ch. 2003). In *Oracle*, the Chancery Court denied a motion by a special litigation committee of Oracle Corporation to dismiss pending derivative actions which accused four Oracle directors and officers of breaching their fiduciary duty of loyalty by misappropriating inside information in selling Oracle stock while in possession of material, nonpublic information that Oracle would not meet its projections. These four directors were Oracle's CEO, its CFO, the Chair of the Executive, Audit and Finance Committees, and the Chair of the Compensation Committee who was also a tenured professor at Stanford University. The other members of Oracle's board were accused of a breach of their *Caremark* duty of oversight through indifference to the deviation between Oracle's earnings guidance and reality.

In response to this derivative action and a variety of other lawsuits in other courts arising out of its surprising the market with a bad earnings report, Oracle created a special litigation committee to investigate the allegations and decide whether Oracle should assume the prosecution of the insider trading claims or have them dismissed. The committee consisted of two new outside directors, both tenured Stanford University professors, one of whom was former SEC Commissioner Joseph Grundfest. The new directors were recruited by the defendant CFO and the

Delaware draws a distinction between director disinterest and director independence. A director is "***interested***" when he or she stands on both sides of a transaction, or will benefit or experience some detriment that does not flow to the corporation or the stockholders generally. Absent self-dealing, the benefit must be material to the individual director.[153] In contrast, a director is not "***independent***" where the director's decision is based on "extraneous considerations or influences" and not on the "corporate merits of the subject."[154] Employment or consulting relationships can impair independence.[155] A director who is a partner of a law firm

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defendant Chair of Compensation Committee/Stanford professor after the litigation had commenced and to serve as members of the special litigation committee.

The Chancery Court held that the special committee failed to meet its burden to prove that no material issue of fact existed regarding the special committee's independence due to the connections that both the committee members and three of four defendants had to Stanford. One of the defendants was a Stanford professor who taught special committee member Grundfest when he was a Ph.D. candidate, a second defendant was an involved Stanford alumnus who had contributed millions to Stanford, and the third defendant was Oracle's CEO who had donated millions to Stanford and was considering a $270 million donation at the time the special committee members were added to the Oracle board. The two Stanford professors were tenured and not involved in fund raising for Stanford, and thus were not dependent on contributions to Stanford for their continued employment.

The Court found troubling that the special litigation committee's report recommending dismissal of the derivative action failed to disclose many of the Stanford ties between the defendants and the special committee. The ties emerged during discovery.

Without questioning the personal integrity of either member of the special committee, the Court found that interrelationships among Stanford University, the special committee members and the defendant Oracle directors and officers necessarily would have colored in some manner the special committee's deliberations. The Court commented that it is no easy task to decide whether to accuse a fellow director of the serious charge of insider trading and such difficulty was compounded by requiring the committee members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law.

The Chancery Court wrote that the question of independence "turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind." That is, the independence test ultimately "focus[es] on impartiality and objectivity." While acknowledging a difficulty in reconciling Delaware precedent, the Court declined to focus narrowly on the economic relationships between the members of the special committee and the defendant officers and directors - *i.e.* "treating the possible effect on one's personal wealth as the key to an independence inquiry." Commenting that "*homo sapiens* is not merely *homo economicus*," the Chancery Court wrote, "Whether the [special committee] members had precise knowledge of all the facts that have emerged is not essential, what is important is that by any measure this was a social atmosphere painted in too much vivid Stanford Cardinal red for the [special committee] members to have reasonably ignored."

153 *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002).

154 *Id.*

155 *See In re Ply Gem Indus., Inc. S'holders Litig.*, C.A. No. 15779-NC, 2001 Del. Ch. LEXIS 84 (Del. Ch. 2001) (holding plaintiffs raised reasonable doubt as to directors' independence where (i) interested director as Chairman of the Board and CEO was in a position to exercise considerable influence over directors serving as President and COO; (ii) director was serving as Executive Vice President; (iii) a director whose small law firm received substantial fees over a period of years; and (iv) directors receiving substantial consulting fees); *Goodwin v. Live Entertainment, Inc.*, 1999 WL 64265 (Del. Ch. 1999) (stating on motion for summary judgment that evidence produced by plaintiff generated a triable issue of fact regarding whether directors' continuing employment relationship with surviving entity created a material interest in merger not shared by the stockholders); *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002) (questioning the independence of one director who had a consulting contract with the surviving corporation and questioning the disinterestedness of another director whose company would earn a $3.3 million fee if the deal closed); *In re The Ltd., Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28, 2002 WL 537692 (Del. Ch. March 27, 2002) (finding, in context of demand futility analysis, that the plaintiffs cast reasonable doubt on the independence of certain directors in a transaction that benefited the founder, Chairman, CEO and 25% stockholder of the company, where one director received a large salary for his management positions in the company's wholly-owned subsidiary, one director received consulting fees, and another director had procured, from the controlling stockholder, a $25 million grant to the university where he formerly served as president); *Biondi v. Scrushy*, C.A. No. 19896, 2003 Del. Ch. LEXIS 7 (Del. Ch. Jan. 16, 2003) (questioning the independence of two members of a special committee formed to investigate charges against the CEO because committee members served with the CEO as directors of two sports organizations and because the CEO and one committee member had "long-standing personal ties" that included making large

that receives substantial fees from the corporation may not be independent.[156] Family relationships can also impair independence.[157] Other business relationships may also prevent independence.[158]

A controlled director is not an independent director.[159] Control over individual directors is established by facts demonstrating that "through personal or other relationships the directors are beholden to the controlling person."[160]

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contributions to certain sports programs); *In Re: INFOUSA, Inc. Shareholders Litigation*, CA No. 1956-CC (Del. Ch. August 20, 2007) (in case where self dealing transactions by 41% stockholder were challenged on duty of loyalty grounds, independence found lacking as to (i) director who was a professor in university business school named after the 41% stockholder and received substantial compensation from the university and (ii) directors who received free office space from the company for non-company uses).

156 *In Re: INFOUSA, Inc. Shareholders Litigation*, CA No. 1956-CC (Del. Ch. August 20, 2007) (The threat of withdrawal of legal business found to be enough to raise a reasonable doubt as to a director's independence where annual payments listed in the complaint come close to or exceed a reasonable estimate of the annual yearly income per partner of the law firm; the Court commented:

> Legal partnerships normally base the pay and prestige of their members upon the amount of revenue that partners (and, more importantly, their clients) bring to their firms. Indeed, with law becoming an ever-more competitive business, there is a notable trend for partners who fail to meet expectations to risk a loss of equity in their firms. The threat of withdrawal of one partner's worth of revenue from a law firm is arguably sufficient to exert considerable influence over a named partner such that . . . his independence may be called into question.)

157 See *Chaffin v. GNI Group, Inc.*, C.A. No. 16211, 1999 Del. Ch. LEXIS 182 (Del. Ch. Sept. 3, 1999) (finding that director lacked independence where a transaction benefited son financially); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999) (holding that director who was brother-in-law of CEO and involved in various businesses with CEO could not impartially consider a demand adverse to CEO's interests); *Mizel v. Connelly*, C.A. No. 16638, 1999 Del. Ch. LEXIS 157 (Del. Ch. July 22, 1999) (holding director could not objectively consider demand adverse to interest of grandfather).

158 See *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (holding members of special committee had significant prior business relationship with majority stockholder such that the committee lacked independence triggering entire fairness); *Heineman v. Datapoint Corp.,* 611 A.2d 950 (Del. 1992) (holding that allegations of "extensive interlocking business relationships" did not sufficiently demonstrate the necessary "nexus" between the conflict of interest and resulting personal benefit necessary to establish directors' lack of independence) (overruled as to standard of appellate review); and see *Citron v. Fairchild Camera & Instr. Corp.*, 569 A.2d 53 (Del. 1989) (holding mere fact that a controlling stockholder elects a director does not render that director non-independent).

159 *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995) ("To be considered independent, a director must not be dominated or otherwise controlled by an individual or entity interested in the transaction.").

160 *Aronson*, 473 A.2d at 815; *compare In re The Limited, Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28, 2002 WL 537692 (Del. Ch. Mar. 27, 2002) (concluding that a university president who had solicited a $25 million contribution from a corporation's President, Chairman and CEO was not independent of that corporate official in light of the sense of "owingness" that the university president might harbor with respect to the corporate official), *and Lewis v. Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985) (finding that a special litigation committee member was not independent where the committee member was also the president of a university that received a $10 million charitable pledge from the corporation's CEO and the CEO was a trustee of the university), *with In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998) (deciding that the plaintiffs had not created reasonable doubt as to a director's independence where a corporation's Chairman and CEO had given over $1 million in donations to the university at which the director was the university president and from which one of the CEO's sons had graduated), *aff'd in part, rev'd in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) *and Beam v. Martha Stewart*, 845 A.2d 1040 (Del. 2004) ("bare social relationships clearly do not create reasonable doubt of independence"; the Supreme Court in distinguishing *Beam* from *Oracle*, wrote "[u]nlike the demand-excusal context [of *Beam*], where the board is presumed to be independent, the SLC [special litigation committee in *Oracle*] has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife' – 'above reproach.' Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.").

4. Compensation.

***a.* Prohibition on Loans to Directors or Officers.**

SOX §402 generally prohibits, effective July 30, 2002, a corporation from directly or indirectly making or arranging for personal loans to its directors and executive officers.[161] Four categories of personal loans by an issuer to its directors and officers are expressly exempt from SOX §402's prohibition:[162]

(1) any extension of credit existing before the SOX's enactment as long as no material modification or renewal of the extension of credit occurs on or after the date of SOX's enactment (July 30, 2002);

(2) specified home improvement and consumer credit loans if:

- made in the ordinary course of the issuer's consumer credit business,
- of a type generally made available to the public by the issuer, and
- on terms no more favorable than those offered to the public;

(3) loans by a broker-dealer to its employees that:

- fulfill the three conditions of paragraph (2) above,
- are made to buy, trade or carry securities other than the broker-dealer's securities, and
- are permitted by applicable Federal Reserve System regulations; and

(4) loans made or maintained by depository institutions that are insured by the U.S. Federal Deposit Insurance Corporation "if the loans are subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."[163]

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161 SOX §402(a) provides: "It shall be unlawful for any issuer (as defined in [SOX §2]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment."

162 SEC Release No. 34-48481 (September 11, 2003), which can be found at http://www.sec.gov/rules/proposed/34-48481.htm.

163 This last exemption applies only to an "insured depository institution," which is defined by the Federal Deposit Insurance Act (*"FDIA"*) as a bank or savings association that has insured its deposits with the Federal Deposit Insurance Corporation (*"FDIC"*). Although this SOX §402 provision does not explicitly exclude foreign banks from the exemption, under current U.S. banking regulation a foreign bank cannot be an "insured depository institution" and, therefore, cannot qualify for the bank exemption. Since 1991, following enactment of the Foreign Bank Supervision Enhancement Act (*"FBSEA"*), a foreign bank that seeks to accept and maintain FDIC-insured retail deposits in the United States must establish a U.S. subsidiary, rather than a branch, agency or other entity, for that purpose. These U.S. subsidiaries of foreign banks, and the limited number of grandfathered U.S. branches of foreign banks that had obtained FDIC insurance prior to FBSEA's enactment, can engage in FDIC-insured, retail deposit activities and, thus, qualify as "insured depository institutions." But the foreign banks that own the U.S. insured depository subsidiaries or operate the grandfathered insured depository branches are not themselves "insured depository institutions" under the FDIA. The SEC, however, has proposed a rule to address this disadvantageous situation for foreign banks.

The SEC to date has not provided guidance as to the interpretation of SOX §402, although a number of interpretative issues have surfaced. The prohibitions of SOX §402 apply only to an extension of credit "in the form of a personal loan" which suggests that all extensions of credit to a director or officer are not proscribed. While there is no legislative history or statutory definition to guide, it is reasonable to take the position that the following in the ordinary course of business are not proscribed: travel and similar advances, ancillary personal use of company credit card or company car where reimbursement is required; advances of relocation expenses ultimately to be borne by the issuer; stay and retention bonuses subject to reimbursement if the employee leaves prematurely; advancement of expenses pursuant to typical charter, bylaw or contractual indemnification arrangements; and tax indemnification payments to overseas-based officers.[164]

SOX §402 raises issues with regard to cashless stock option exercises and has led a number of issuers to suspend cashless exercise programs. In a typical cashless exercise program, the optionee delivers the notice of exercise to both the issuer and the broker, and the broker executes the sale of some or all of the underlying stock on that day (T). Then, on or prior to the settlement date (T+3), the broker pays to the issuer the option exercise price and applicable withholding taxes, and the issuer delivers (i.e., issues) the option stock to the broker. The broker transmits the remaining sale proceeds to the optionee. When and how these events occur may determine the level of risk under SOX §402.[165] The real question is whether a broker-administered same-day sale involves "an extension of credit in the form of a personal loan" made or arranged by the issuer. The nature of the arrangement can affect the analysis.[166]

Some practitioners have questioned whether SOX §402 prohibits directors and executive officers of an issuer from taking loans from employee pension benefit plans, which raised the further question of whether employers could restrict director and officer plan loans without violating the U.S. Labor Department's antidiscrimination rules. On April 15, 2003, the Labor Department issued Field Assistance Bulletin 2003-1 providing that plan fiduciaries of public

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164 See outline dated October 15, 2002, authored jointly by a group of 25 law firms and posted at www.TheCorporateCounsel.net as "Sarbanes-Oxley Act: Interpretative Issues Under §402 – Prohibition of Certain Insider Loans."

165 See *Cashless Exercise and Other SOXmania*, The Corporate Counsel (September-October 2002).

166 If the issuer delivers the option stock to the broker before receiving payment, the issuer may be deemed to have loaned the exercise price to the optionee, perhaps making this form of program riskier than others. If the broker advances payment to the issuer prior to T+3, planning to reimburse itself from the sale of proceeds on T+3, that advance may be viewed as an extension of credit by the broker, and the question then becomes whether the issuer "arranged" the credit. The risk of this outcome may be reduced where the issuer does not select the selling broker or set up the cashless exercise program, but instead merely confirms to a broker selected by the optionee that the option is valid and exercisable and that the issuer will deliver the stock upon receipt of the option exercise price and applicable withholding taxes. Even where the insider selects the broker, the broker cannot, under Regulation T, advance the exercise price without first confirming that the issuer will deliver the stock promptly. In that instance, the issuer's involvement is limited to confirming facts, and therefore is less likely to be viewed as "arranging" the credit.

Where both payment and delivery of the option stock occur on the same day (T+3), there arguably is no extension of credit at all, in which case the exercise should not be deemed to violate SOX §402 whether effected through a designated broker or a broker selected by the insider.

If the insider has sufficient collateral in his or her account (apart from the stock underlying the option being exercised) to permit the broker to make a margin loan equal to the exercise price and applicable withholding taxes, arguably the extension of credit is between the broker and the insider, and does not violate SOX §402 assuming the issuer is not involved in arranging the credit.

companies could deny participant loans to directors and officers without violating the Labor Department rules.

b. **Stock Exchange Requirements.**

The stock exchanges require shareholder approval of many equity compensation plans.[167] In contrast, state law generally authorizes such plans and leaves the power to authorize them generally with the power of the board of directors to direct the management of the affairs of the corporation.

c. **Fiduciary Duties.**

In approving executive compensation, directors must act in accordance with their fiduciary duties. The fiduciary duties discussed elsewhere herein, including the duties of care, loyalty and disclosure, are all applicable when directors consider executive compensation matters.[168] As in other contexts, process and disinterested judgment are critical.

5. Related Party Transactions.

a. **Stock Exchanges.**

(1) *General*. Stock exchange listing requirements generally require all related party transactions to be approved by a committee of independent directors.[169]

(2) *NYSE*. The NYSE, in NYSE Rule 307, takes the general position that a publicly-owned company of the size and character appropriate for listing on the NYSE should be able to operate on its own merit and credit standing free from the suspicions that may arise when business transactions are consummated with insiders. The NYSE feels that the company's management is in the best position to evaluate each such relationship intelligently and objectively.

However, there are certain related party transactions that do require shareholder approval under the NYSE Rules. Therefore, a review of NYSE Rule 312 should be done whenever related party transactions are analyzed by a NYSE listed company.

(3) *NASDAQ*. NASD Rule 4350(h) requires each NASDAQ listed company to conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and all such transactions must be approved by the company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "*related party transaction*" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.

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167 *See* NYSE Rule 312; NASD Rule 4350(i).

168 *See infra* notes 251-294 and related text.

169 *See* NYSE Rules 307 and 312; NASD Rule 4350(h).

b. Interested Director Transactions —TBOC § 21.418; TBCA Art. 2.35-1; and DGCL § 144.

Both Texas and Delaware have embraced the principle that a transaction or contract between a director and the director's corporation is presumed to be valid and will not be voidable solely by reason of the director's interest as long as certain conditions are met.

DGCL § 144 provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.[170] In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.[171] The question remains, however, whether approval by a majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions <u>and</u>, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.[172]

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,[173] the predecessor to TBOC § 21.418. In general, these Texas Corporate Statues provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the

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170 DGCL § 144(a).

171 *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

172 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, ___ A.2d ___, 2009 WL 188828 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal approved by a conflicted Board did not effectively ratify or cleanse the transaction for two reasons:

> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.
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> * * *
>
> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action).

173 TBOC § 21.418; TBCA art. 2.35-1.

transaction is otherwise fair.[174] Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler*'s interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.[175] TBOC § 21.418 mirrors these clarifications. Under the Texas Corporate Statues, if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.[176] These provisions rely heavily on the statutory definitions of "*disinterested*" contained in TBCA art. 1.02 and TBOC § 1.003. Under these definitions, a director will be considered "*disinterested*" if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.[177]

Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met, a change retained by TBOC § 21.418. Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are structured. However, these Texas Corporate Statutes do not eliminate a director's or officer's fiduciary duty to the corporation.

H. Contractual Limitation of Corporate Fiduciary Duties.

Unlike the statutes governing partnerships and limited liability companies ("*LLCs*"),[178] neither the Texas Corporate Statutes nor the DGCL include provisions generally recognizing the principle of freedom of contract.[179] The Texas Corporate Statutes nor the DGCL do, however,

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174 *Id*; TBOC § 21.418; *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002).

175 TBCA art. 2.35-1.

176 *Id.* art. 2.35-1(A); TBOC § 21.418(b).

177 *Id*.

178 *See infra* notes 811, 834-842 and 849-854 and related text.

179 *See* Edward P. Welch and Robert S. Saunders, "*Freedom and its Limits in the Delaware General Corporation Law*," 33 Del. J. Corp. L. 845 (2008); *cf.* DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2007). The Delaware Limited Liability Company Act aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement as follows:

> **18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.**
>
> (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

allow fiduciary duties or the consequences thereof to be modified by charter provision or contract in some limited circumstances.

1. Limitation of Director Liability.

Both the DGCL and the Texas Corporate Statutes allow corporations to provide limitations on (or partial elimination of) director liability in relation to the duty of care in their certificates of incorporation. DGCL § 102(b)(7) reads as follows:

> **102 CONTENTS OF CERTIFICATE OF INCORPORATION.**
>
> * * *
>
> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> * * *
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty

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> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
>
> (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.
>
> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable 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 for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person 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; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.
>
> (f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§ 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. *See* DEL. CODE ANN. tit. 6, § 17-1101 (2007). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context..

> to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

DGCL § 102(b)(7) in effect permits a corporation to include a provision in its certificate of incorporation limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.[180] The liability of directors may not be so limited or eliminated, however, 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.[181] Delaware courts have routinely enforced DGCL § 102(b)(7) provisions and held that, pursuant to such provisions, directors cannot be held monetarily liable for damages caused by alleged breaches of the fiduciary duty of care.[182]

The Texas Corporate Statutes contain provisions which are comparable to DGCL § 102(b)(7) and permit a corporation to include a provision in its charter limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.[183]

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180 DGCL § 102(b)(7).

181 DGCL § 102(b)(7); *see also Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

182 A DGCL § 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, rather it operates to defeat a plaintiff's ability to recover monetary damages. *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2000). In determining when a DGCL § 102(b)(7) provision should be evaluated by the Court of Chancery to determine whether it exculpates defendant directors, the Delaware Supreme Court recently distinguished between cases invoking the business judgment presumption and those invoking entire fairness review (these standards of review are discussed below). *Id.* at 92-3. The Court determined that if a stockholder complaint unambiguously asserts solely a claim for breach of the duty of care, then the complaint may be dismissed by invocation of a DGCL § 102(b)(7) provision. *Id.* at 92. The Court held, however, that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided." *Id.* at 94. In such a circumstance, defendant directors can avoid personal liability for paying monetary damages only if they establish that their failure to withstand an entire fairness analysis was exclusively attributable to a violation of the duty of care. *Id.* at 98.

183 The Texas analogue to DGCL § 102(b)(7) is TBOC § 7.001, which provides in relevant part:

> (b) The certificate of formation or similar instrument of an organization to which this section applies [generally, corporations] 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. Renunciation of Corporate Opportunities.

Both Texas and Delaware law permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.[184] While this allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.[185]

3. Interested Director Transactions.

Both Texas and Delaware have embraced the principle that a transaction or contract between a director and the director's corporation is presumed to be valid and will not be void or voidable solely by reason of the director's interest as long as certain conditions are met.

DGCL § 144 provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.[186] In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.[187] The question remains, however, whether approval by a majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions and, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.[188]

> (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.

TMCLA art. 1302-7.06 provides substantially the same.

184 TBCA art. 2.02(20), TBOC § 2.101(21); DGCL § 122(17).

185 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 2.1 (2d ed. 1997); *see generally id.* at § 4.36.

186 DGCL § 144(a).

187 *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

188 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, ___ A.2d ___, 2009 WL 188828 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction for two reasons:

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,[189] the predecessor to TBOC § 21.418. In general, these Texas Corporate Statues provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.[190] Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler*'s interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.[191] TBOC § 21.418 mirrors these clarifications. Under the Texas Corporate Statues, if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.[192] These provisions rely heavily on the statutory definitions of "*disinterested*" contained in TBCA art. 1.02 and TBOC § 1.003. Under these definitions, a director will be considered "*disinterested*" if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.[193]

Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met, a change retained by TBOC § 21.418. Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant

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> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.
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> * * *
>
> [T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action).

189 TBOC § 21.418; TBCA art. 2.35-1.

190 *Id*; TBOC § 21.418; *see Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666 (Tex. App.—Eastland 2002).

191 TBCA art. 2.35-1.

192 *Id.* art. 2.35-1(A); TBOC § 21.418(b).

193 *Id*.

and provides more certainty as transactions are structured. However, these Texas Corporate Statutes do not eliminate a director's or officer's fiduciary duty to the corporation.

III. Shifting Duties When Company on Penumbra of Insolvency.

A. Insolvency Can Change Relationships.

While creditors' power over the corporate governance of a solvent company is limited to the rights given to them by their contracts, their influence expands as the company approaches the zone of insolvency. As a troubled company approaches bankruptcy, its creditors may organize into ad hoc committees to negotiate with, and perhaps attempt to dictate to, the company about its future and its restructuring efforts.[194] They may become aggressive in asserting that the company's resources should be directed toward getting them paid rather than taking business risks that could create value for the shareholders.[195] Once a troubled company enters formal proceedings under the Bankruptcy Code, statutory committees of unsecured creditors are appointed and given by the Bankruptcy Code formal standing to appear and be heard on any matter in the bankruptcy case, and are entitled to advance notice of any proposed corporate action outside the ordinary course of the company's business, including an opportunity to object to any such action.[196] These creditor groups on occasion seek to impose their will by suing, or threatening to sue, directors for breaches of fiduciary duty if they believe that the company did not act appropriately in responding to the creditors' demands.[197] In the troubled company context, directors often face vocal and conflicting claims to their attention and allegiance from multiple constituencies as they address issues that affect the groups differently.

Directors owe fiduciary duties to the corporation and its owners.[198] When the corporation is solvent, the directors owe fiduciary duties to the corporation and the shareholders of the corporation.[199] The creditors relationship to the corporation is contractual in nature. A solvent corporation's directors do not owe any fiduciary duties to the corporation's creditors, whose rights in relation to the corporation are those that they have bargained for and memorialized in their contracts.[200]

In Texas a corporation's directors continue to owe shareholders, not creditors, fiduciary duties "so long as [the corporation] continues to be a going concern, conducting its business in

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194 D.J. (Jan) Baker, John Wm. (Jack) Butler, Jr., and Mark A. McDermott, *Corporate Governance of Troubled Companies and the Role of Restructuring Counsel*, 63 Bus. Law. 855 (May 2008).

195 *Id.*

196 *Id.*

197 Myron M. Sheinfeld and Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 Bus. Law. 79 (Nov. 2004).

198 Comments of Delaware Vice Chancellor Leo E. Strine in Galveston, Texas on February 22, 2002 at the 24th Annual Conference on Securities Regulation and Business Law Problems sponsored by University of Texas School of Law, et al.

199 *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 101, 2007 WL 1453705 (Del. 2007) ("The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners,'" quoting from *Malone v. Brincat*, 722 A.2d 5 (1998)).

200 *See Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ) ("[O]fficers and directors of a corporation owe to it duties of care and loyalty. . . . Such duties, however, are owed to the corporation and not to creditors of the corporation.")

the ordinary way, without some positive act of insolvency, such as the filing of a bill to administer its assets, or the making of a general assignment."[201] When the corporation is both insolvent and has ceased doing business, the corporation's creditors become its owners and the directors owe fiduciary duties to the creditors as the owners of the business in the sense they have a duty to administer the corporation's remaining assets as a trust fund for the benefit of all of the creditors.[202] The duties of directors of an insolvent corporation to its creditors, however, do not require that the directors must abandon their efforts to direct the affairs of the corporation in a manner intended to benefit the corporation and its shareholders and that they lose the protections of the business judgment rule.[203] However, owing a duty of loyalty means that "a self-interested director cannot orchestrate the sale of a corporation's assets for his benefit below the price that diligent marketing efforts would have obtained."[204] The trust fund doctrine in Texas requires the directors and officers of an insolvent corporation to deal fairly with its creditors without preferring one creditor over another or themselves to the injury of other creditors.[205] Even where they are not direct beneficiaries of fiduciary duties, the creditors of an insolvent corporation may benefit from the fiduciary duties which continue to be owed to the corporation.[206]

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201 *Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir. 1939); *see Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006); *Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); but see *Carrieri v. Jobs.com*, 393 F.3d 508, 534 n.24 (5th Cir. 2004) ("[o]fficers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' … have expanded fiduciary duties to include the creditors of the corporation.").

202 *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006); *Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); *see also Hixson v. Pride of Texas Distrib. Co.*, 683 S.W.2d 173, 176 (Tex.App.–Fort Worth 1985, no writ); *State v. Nevitt*, 595 S.W.2d 140, 143 (Tex.App.–Dallas 1980, writ ref'd n.r.e.); and *Fagan v. La Gloria Oil & Gas. Co.*, 494 S.W.2d 624, 628 (Tex.App.–Houston [14th Dist.] 1973, no writ).

203 *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006), in which Judge Melinda Harmon concludes that "Texas law does not impose fiduciary duties in favor of creditors on the directors of an insolvent, but still operating, corporation, [but] it does require those directors to act as fiduciaries of the corporation itself" and that *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984), remains the controlling statement of Texas director fiduciary duty law; *see* Glenn D. West & Emmanuel U. Obi, *Corporations*, 60 SMU L. REV. 885, 910-911 (2007). *Floyd v. Hefner* was not followed by *In Re: Vartec Telecom, Inc.*, Case No. 04-81694-HDH-7 2007 WL 2872283 (U.S. Bkr. Ct. N.D. Tex. September 24, 2007), in which the Bankruptcy Court wrote:

> [A] cause of action based on a company's directors' and officers' fiduciary duty to creditors when the company is in the "vicinity" or "zone" of insolvency is recognized in both states [Texas and Delaware].

204 *Id.*; *cf. In re Performance Nutrition, Inc.*, 237 B.R. 93 (Bankr. N.D. Tex. 1999); *In re General Homes Corp.*, 199 B.R. 148 (S.D. Tex. 1996).

205 *Plas-Tex v. Jones*, 2000 WL 632677 (Tex. App.-Austin 2002; not published in S.W.3d) ("As a general rule, corporate officers and directors owe fiduciary duties only to the corporation and not to the corporation's creditors, unless there has been prejudice to the creditors. . . . However, when a corporation is insolvent, a fiduciary relationship arises between the officers and directors of the corporation and its creditors, and creditors may challenge a breach of the duty. . . . Officers and directors of an insolvent corporation have a fiduciary duty to deal fairly with the corporation's creditors, and that duty includes preserving the value of the corporate assets to pay corporate debts without preferring one creditor over another or preferring themselves to the injury of other creditors. . . . However, a creditor may pursue corporate assets and hold directors liable only for 'that portion of the assets that would have been available to satisfy his debt if they had been distributed pro rata to all creditors.'"); *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 787 (Del.Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . . e.g., fraud, insolvency or a violation of a statute….' [citation omitted]. Furthermore, [no one] seriously disputes that when the insolvency does arise, it creates fiduciary duties for directors for the benefit of creditors. Therefore, the issue…is when do directors' fiduciary duties to creditors arise via insolvency."); *see* Terrell and Short, *Directors Duties in Insolvency: Lessons From Allied Riser*, 14 BNA Bkr. L. Reptr. 293 (March 14, 2002).

206 *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006).

In Delaware, the corporation need not have ceased doing business for that trust fund to arise and the directors to owe duties to creditors.[207] However, the Delaware formulation of the trust fund doctrine would not afford relief if the self-dealing was fair:

> [C]reditors need protection even if an insolvent corporation is not liquidating, because the fact of insolvency shifts the risk of loss from the stockholders to the creditors. While stockholders no longer risk further loss, creditors become at risk when decisions of the directors affect the corporation's ability to repay debt. This new fiduciary relationship is certainly one of loyalty, trust and confidence, but it does not involve holding the insolvent corporation's assets in trust for distribution to creditors or holding directors strictly liable for actions that deplete corporate assets.[208]

The trust fund doctrine does not preclude the directors from allowing the corporation to take on economic risk for the benefit of the corporation's equity owners.[209] Rather, the shifting merely exonerates the directors who choose to maintain the corporation's long term viability by considering the interests of creditors.[210]

B. When is a Corporation Insolvent or in the Vicinity of Insolvency?

There are degrees of insolvency (e.g., a corporation may be unable to pay its debts as they come due because of troubles with its lenders or its liabilities may exceed the book value of its assets, but the intrinsic value of the entity may significantly exceed its debts).[211] Sometimes it is unclear whether the corporation is insolvent. In circumstances where the corporation is on the penumbra of insolvency, the directors may owe fiduciary duties to the "whole enterprise."[212]

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207 *Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 787 (Del.Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . . e.g., fraud, insolvency or a violation of a statute….' [citation omitted]. Furthermore, [no one] seriously disputes that when the insolvency does arise, it creates fiduciary duties for directors for the benefit of creditors. Therefore, the issue…is when do directors' fiduciary duties to creditors arise via insolvency."); *see* Terrell and Short, *Directors Duties in Insolvency: Lessons From Allied Riser*, 14 BNA Bkr. L. Reptr. 293 (March 14, 2002).

208 *Decker v. Mitchell (In re JTS Corp)*, 305 B.R. 529, 539 (Bankr. N.D. Cal. 2003).

209 *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 2007 WL 1453705 (Del. 2007); *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006); *see* Rutheford B. Campbell, Jr. and Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 492 (Spring 2007).

210 *Id.*; *see Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 n.2 (Del. Ch. 1997) ("[W]here foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the 'corporation.'").

211 *See* Rutheford B. Campbell, Jr. and Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. Corp. L. 491 (2007).

212 *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992) ("The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when the shareholders' wishes should not be the directors only concern"); *see Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150, 1991 Del. Ch. LEXIS 215 at n.55 (Del. Ch. 1991) in which Chancellor Allen expressed the following in *dicta*:

> n. 55 The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is

Owing fiduciary duties to the "whole enterprise" puts the directors in the uncomfortable position of owing duties to the corporation that multiple constituencies having conflicting interests may claim the right to enforce on behalf of the corporation.[213]

In Delaware it is the fact of insolvency, rather than the commencement of statutory bankruptcy or other insolvency proceedings, that causes the shift in the focus of director duties.[214] Delaware courts define insolvency as occurring when the corporation "is unable to pay its debts as they fall due in the usual course of business . . . or it has liabilities in excess of a reasonable market value of assets held."[215]

Under the "balance sheet" test used for bankruptcy law purposes, insolvency is defined as when an entity's debts exceed the entity's property at fair valuation,[216] and the value at which the assets carried for financial accounting or tax purposes is irrelevant.

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on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:

	Expected Value
25% chance of affirmance ($51mm)	$12.75
70% chance of modification ($4 mm)	2.8
5% chance of reversal ($0)	0
Expected value of Judgment on Appeal	$15.55

Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal $12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million - $12 million $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

213 *See Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386 (Del. Ch. 1999).

214 *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992).

215 *Id.*

216 11 U.S.C. § 101(32) (2008). A "balance sheet" test is also used under the fraudulent transfer statutes of Delaware and Texas. *See* DEL. CODE ANN. tit. 6, § 1302 and TEX. BUS. & COM. CODE § 24.003. For general corporate purposes, TBOC § 1.002(39) defines insolvency as the "inability of a person to pay the person's debts as they become due in the usual course of business or affairs." TBCA art. 1.02A(16) provides substantially the same. For transactions covered by the U.C.C., TEX. BUS. & COM. CODE 1.201(23) (2001) defines an entity as "insolvent" who either has ceased to pay its

Fair value of assets is the amount that would be realized from the sale of assets within a reasonable period of time.[217] Fair valuation is not liquidation or book value, but is the value of the assets considering the age and liquidity of the assets, as well as the conditions of the trade.[218] For liabilities, the fair value assumes that the debts are to be paid according to the present terms of the obligations.

The directors duties, however, do not shift before the moment of insolvency. The Delaware Supreme Court has explained: "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[219] In cases where the corporation has been found to be in the vicinity of insolvency, the entity was in dire financial straits with a bankruptcy petition likely in the minds of the directors.[220]

C. Director Liabilities to Creditors.

The issue of creditor rights to sue directors for breach of fiduciary duty was resolved (at least of Delaware corporations) in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla* in 2007.[221] In *Gheewalla*, the Delaware Supreme Court held "that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors," but the creditors of an insolvent corporation may bring a derivative action on behalf of the corporation against its directors.[222] The Supreme Court elaborated on this holding as follows:

> It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms."

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debts in the ordinary course of business or cannot pay its debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

217 *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004); *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

218 *In re United Finance Corporation*, 104 F.2d 593 (7th Cir. 1939).

219 *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 2007 WL 1453705 (Del. 2007); *but cf. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150 Mem. Op., Del. Ch. LEXIS 215 (Del. Ch. 1991).

220 In the *Credit Lyonnais* case, *supra*, a bankruptcy petition had recently been dismissed, but the corporation continued to labor "in the shadow of that prospect" *Id. See also Equity-Linked Investors LP v. Adams*, 705 A.2d 1040, 1041 (Del. Ch. 1997) (corporation found to be on "lip of insolvency" where a bankruptcy petition had been prepared and it had only cash sufficient to cover operations for one more week).

221 930 A.2d 92, 2007 WL 1453705 (Del. 2007).

222 930 A.2d at 94.

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In this case, the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners. Therefore, we hold the Court of Chancery properly concluded that Count II of the NACEPF Complaint fails to state a claim, as a matter of Delaware law, to the extent that it attempts to assert a direct claim for breach of fiduciary duty to a creditor while Clearwire was operating in the zone of insolvency.

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It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

* * *

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation. Accordingly, we hold that individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim, as discussed earlier in this opinion, that may be available for individual creditors.[223]

While creditors of an insolvent corporation may not be able to assert direct claims for breach of fiduciary duty against directors, the government can sue both directors and officers if they cause the company to pay other creditors ahead of the government.[224] They may also be personally liable to the government for amounts withheld from employees' salaries for taxes and not paid to the government.[225]

D. Business Judgment Rule/DGCL § 102(b)(7) During Insolvency.

The business judgment rule is applicable to actions of directors even while the corporation is insolvent or on the penumbra thereof in circumstances where it would otherwise have been applicable.[226] Courts have found the business judgment rule inapplicable where the party challenging the decision can show that the director or officer failed to consider the best interests of the insolvent corporation or its creditors or breached the duty of loyalty.[227]

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223 930 A.2d at 99-103.

224 31 U.S.C. §3713 (2008) provides:

(a)(1) A claim of the United States Government shall be paid first when—

(A) a person indebted to the Government is insolvent and—

(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;

(ii) property of the debtor, if absent, is attached; or

(iii) an act of bankruptcy is committed; or

(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

(2) This subsection does not apply to a case under title 11.

(b) A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

See Michael J. Gomez, *True Zone of Insolvency Liability for Directors, Officers and Controlling Shareholders*, ABI Journal 30 (December/January 2009).

225 26 U.S.C. 6672 (2008); *see Swinger v. U.S.*, 652 F. Supp. 464 (1987).

226 *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 2007 WL 1453705 (Del. 2007); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004); *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11; *Floyd v. Hefner*, 2006 WL 2844245 (S.D. Tex. Sept. 29, 2006); *Fleet Nat. Bank v. Boyle*, 2005 WL 2455673 (E.D. Pa. 2005); *In re Hechinger Inv. Co. of Del.*, 327 B.R. 537 (D. Del. 2005); *Growe v. Bedard*, 2004 WL 2677216 (D. Me. 2004); *Roselink Investors, L.L.C. v. Shenkman*, 386 F.Supp.2d 209 (S.D.N.Y. 2004); *Official Committee of Bond Holders of Metricom, Inc. v. Derrickson*, 2004 WL 2151336 (N.D. Cal. 2004); *In re Verestar, Inc.*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006); *but see Weaver v. Kellog*, 216 B.R. 563 (S.D. Tex. 1997); *Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

227 *RSL Communications PLC ex rel. Jervis v. Bildirici*, 2006 WL 2689869 (S.D.N.Y. 2006) (directors who served on board of parent and subsidiary breached duty by failing to take into consideration interests of creditors of subsidiary); *Greater Southwest Community Hospital Corp. I v. Tuft*, 353 B.R. 324 (Bank. D. Dist. Col. 2006) (business judgment rule inapplicable where (1) the defendants benefited from the incurrence of debt because they received personal benefits, including bonuses and repayment of loans, (2) the defendant authorized the incurrence of debt in order to generate work for an affiliated law firm, and (3) the defendant served as a director for the lender that made the

Where directors of an insolvent corporation are interested, their conduct will likewise be judged by the standards that would have otherwise been applicable.[228] A director's stock ownership may call into question a director's independence where the creditors are the beneficiaries of the director's fiduciary duties, for the stock ownership would tend to ally the director with the interests of the shareholders rather than the creditors, but relatively insubstantial amounts of stock ownership should not impugn director independence.[229]

In *Pereira v. Cogan*,[230] a Chapter 7 trustee bought an adversary proceeding against Marshall Cogan, the former CEO of a closely held Delaware corporation of which he was the founder and majority stockholder, and the corporation's other officers and directors for their alleged self-dealing or breach of fiduciary duty.[231] The U.S. District Court for the Southern District of New York ("*SDNY*") held *inter alia*, that (1) ratification by board of directors that was not independent[232] of compensation that the CEO had previously set for himself, without

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allegedly wrongful loans); *In re Enivid, Inc.*, 345 B.R. 426 (Bankr. D. Mass. 2006) (complaint held to state claims for breach of the duty of loyalty under Delaware law where it contained allegations that (i) the CEO's principal motivation in the performance of his duties was his desire to maintain his position and office as the Company's chief executive officer and committed to a business strategy that was not in the best interests of the corporation, and (ii) the other officers were dominated by or beholden to the CEO, even though there was no allegation that the defendants were interested in or personally benefited from the transactions at issue); *In re Dehon, Inc.*, 334 B.R. 55 (Bank. D. Mass. 2005) (directors authorized the payment of dividends when they knew the corporation was insolvent or in the vicinity of insolvency); *Roth v. Mims*, 298 B.R. 272 (N.D. Texas 2003) (officer not disinterested in sale transaction because he had negotiated employment agreement with purchaser prior to consummation and failed to disclose negotiations with board).

228 *Id.*

229 *In re IT Group Inc.*, 2005 WL 3050611 (D. Del. 2005) (plaintiff sufficiently alleged breach of loyalty based upon allegation that directors were "beholden" to shareholders that received transfers in the vicinity of insolvency); *Healthco International, Inc. v. Hicks, Muse & Co. (In re Healthco Intern. Inc.)*, 195 B.R. 971 (Bank. D. Mass. 1966) (court refused to dismiss breach of fiduciary duty claims against director of the corporation arising from failed leverage buyout because director was also controlling shareholder who benefited from leveraged buyout); *cf. Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

230 294 B.R. 449 (SDNY 2003).

231 "Once Cogan created the cookie jar—and obtained outside support for it—he could not without impunity take from it.

"The second and more difficult question posed by this lawsuit is what role the officers and directors should play when confronted by, or at least peripherally aware of, the possibility that a controlling shareholder (who also happens to be their boss) is acting in his own best interests instead of those of the corporation. Given the lack of public accountability present in a closely held private corporation, it is arguable that such officers and directors owe a greater duty to the corporation and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies or private companies that are not so dominated by a founder/controlling shareholder. They cannot turn a blind eye when the controlling shareholder goes awry, nor can they simply assume that all's right with the corporation without any exercise of diligence to ensure that that is the case.

"As discussed later, it is found as a matter of fact that Trace was insolvent or in the vicinity of insolvency during most of the period from 1995 to 1999, when Trace finally filed for bankruptcy. Trace's insolvency means that Cogan and the other director and officer defendants were no longer just liable to Trace and its shareholders, but also to Trace's creditors. In addition, the insolvency rendered certain transactions illegal, such as a redemption and the declaring of dividends. It may therefore be further concluded that, in determining the breadth of duties in the situation as described above, officers and directors must at the very least be sure that the actions of the controlling shareholder (and their inattention thereto) do not run the privately held corporation into the ground." *Pereira v. Cogan*, 294 B.R. at 463.

232 "Cogan also failed in his burden to demonstrate that the Committee or the Board was "independent" in connection with the purported ratification of his compensation. Sherman, the only member of the Board not on Trace's payroll, was a long-time business associate and personal friend of Cogan, with whom he had other overlapping business interests. Nelson, the only other member of the Committee, was Trace's CFO and was dependent on Cogan both for his employment and the amount of his compensation, as were Farace and Marcus, the other Board members who approved the Committee's ratification of Cogan's compensation. There is no evidence that any member of the Committee or the

adequate information-gathering, was insufficient to shift from CEO the burden of demonstrating entire fairness of transaction; (2) corporate officers with knowledge of debtor's improper redemption of preferred stock from an unaffiliated stockholder and unapproved loans to the CEO and related persons could be held liable on breach of fiduciary duty theory for failing to take appropriate action; (3) directors, by abstaining from voting on challenged corporate expenditures, could not insulate themselves from liability; (4) directors did not satisfy their burden of demonstrating "entire fairness" of transactions, and were liable for any resulting damages; (5) report prepared by corporation's compensation committee on performance/salary of CEO, which was prepared without advice of outside consultants and consisted of series of conclusory statements concerning the value of services rendered by the CEO in obtaining financing for the corporation was little more than an *ipse dixit*, on which corporate officers could not rely;[233] (6) term "redeem," as used in DGCL § 160, providing that no corporation shall redeem its shares when the capital of the corporation is impaired, was broad enough to include transaction whereby corporation loaned money to another entity to purchase its shares, the other entity used money to purchase shares, and the corporation then accepted shares as collateral for loan; (7) officers and directors could not assert individual-based offsets as defenses to breach of fiduciary duty claims; (8) the exculpatory clause in the corporation's certificate of incorporation which shields directors from liability to the corporation for breach of the duty of care, as authorized by DGCL § 102(b)(7), was inapplicable because the trustee had brought the action for the benefit of the creditors rather than the corporation; and (9) the business judgment rule was not applicable because a majority of the challenged transactions were not the subject of board action. The SDNY concluded that the trustee's fiduciary duty and DGCL claims were in the nature of equitable restitution, rather than legal damages, and denied defendants' request for a jury trial. The CEO was found liable for $44.4 million and then settled with the trustee. The remaining defendants appealed to the Second Circuit.

On appeal the defendants raised a "sandstorm" of claims and ultimately prevailed. The Second Circuit held in *Pereira v. Farace*[234] that the defendants were entitled to a jury trial because the trustee's claims were principally a legal action for damages, rather than an equitable claim for restitution or unjust enrichment, because the appealing defendants never possessed the

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Board negotiated with Cogan over the amount of his compensation, much less did so at arm's length." *Pereira v. Cogan*, 294 B.R. at 478.

233 "With regard to the ratification of Cogan's compensation from 1988 to 1994, there is no evidence that the Board met to discuss the ratification or that the Board actually knew what level of compensation they were ratifying. While Nelson delivered a report on Cogan's 1991-1994 compensation approximately two years prior to the ratification, on June 24, 1994, there is no evidence that the directors who ratified the compensation remembered that colloquy, nor that they relied on their two-year-old memories of it in deciding to ratify Cogan's compensation. The mere fact that Cogan had successfully spearheaded extremely lucrative deals for Trace in the relevant years and up to the ratification vote is insufficient to justify a blind vote in favor of compensation that may or may not be commensurate with those given to similarly situated executives. Any blind vote is suspect in any case given the fact that Cogan dominated the Board.

"The most that the Board did, or even could do, based on the evidence presented, was to rely on the recommendation of the Compensation Committee. They have not established reasonable reliance on the advice of the Compensation Committee, then composed of Nelson and Sherman (two of the four non-interested Board members who ratified the compensation). The Compensation Committee had never met. It did not seek the advice of outside consultants. The "report" to the Board consisted of several conclusory statements regarding Cogan's performance, without reference to any attachments listing how much the compensation was or any schedule pitting that level of compensation against that received by executives the Compensation Committee believed to be similarly situated. The "report" was little more than an *ipse dixit* and it should have been treated accordingly by the Board. As a result, the director-defendants cannot elude liability on the basis of reliance on the Compensation Committee's report." *Pereira v. Cogan*, 294 B.R. at 528.

234 413 F.3d 330 (2nd Cir. 2005).

funds at issue (the CEO who had received the funds had previously settled with the trustee and was not a party to the appeal). In remanding the case for a jury trial, the Second Circuit also held (i) that the bankruptcy trustee stood in the shoes of the insolvent corporation and as such was bound by the exculpatory provision in the corporation's certificate of incorporation pursuant to DGCL § 102(b)(7) which precluded shareholder claims based on mismanagement (i.e., the duty of care)[235] and (ii) that the SDNY did not properly apply the Delaware definition of insolvency when it used a cash flow test of insolvency which projected into the future whether the corporation's capital will remain adequate over a period of time rather than the Delaware test which looks solely at whether the corporation has been paying its bills on a timely basis and/or whether its assets exceed its liabilities.

When the conduct of the directors is being challenged by the creditors on fiduciary duty of loyalty grounds, the directors do not have the benefit of the statutes limiting director liability in duty of care cases.[236]

E. Deepening Insolvency.

Deepening insolvency as a legal theory can be traced to dicta in a 1983 Seventh Circuit opinion that "the corporate body is ineluctably damaged by the deepening of its insolvency," which results from the "fraudulent prolongation of a corporation's life beyond insolvency."[237] While bankruptcy and other federal courts are frequently the forum in which deepening insolvency claims are litigated, the cause of action or theory of damages (if recognized) would be a matter of state law.[238] In recent years some federal courts embraced deepening insolvency claims and predicted that Delaware would recognize such a cause of action.[239] In *Trenwick America Litigation Trust v. Ernst & Young LLP, et al.*,[240] the Delaware Court of Chancery in 2006 for the first time addressed a cause of action for deepening insolvency and, confounding the speculation of the federal courts, held that "put simply, under Delaware law, 'deepening

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235 Other cases have held that director exculpation charter provisions adopted under DGCL § 102(b)(7) protect directors from duty of care claims brought by creditors who were accorded standing to pursue fiduciary duty claims against directors because the company was insolvent. *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004) ("[T]he fact of insolvency does not change the primary object of the director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury."); *Continuing Creditors' Committee of Star Telecommunications Inc. v. Edgecomb*, 385 F.Supp.2d 449 (D. Del. 2004); *In re Verestar, Inc.*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006); *In re Greater Southeast Community Hospital Corp.*, 333 B.R. 506 (Bankr. Dist. Colo. 2005).

236 *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992).

237 *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir 1983); *see* Sabin Willett, *The Shallows of Deepening Insolvency*, 60 Bus. Law 549 (Feb. 2005).

238 *In re CITX Corp. Inc.*, 448 F.3d 672 (3d Cir. 2006), in which a Bankruptcy Trustee sued the debtor's accountant for malpractice that deepened the debtor's insolvency, breach of fiduciary duty and negligent misrepresentation; the Third Circuit held that only fraudulent conduct would suffice to support a deepening insolvency claim (with fraud requiring proof of "a representation of material fact, falsity, scienter, reliance and injury") and declined to allow a claim alleging that negligent conduct caused a deepening insolvency; the Third Circuit also held that deepening insolvency was not a valid theory of damages supporting a professional malpractice claim against the accounting firm.

239 *Official Comm. of Unsecured Creditors v. R.F. Lafferty Co., Inc.*, 267 F.3d 340, 351 (3d Cir. 2001) (applying Pennsylvania law); *In re Exide v. Credit Suisse First Boston*, 299 B.R. 732 (Bankr. D. Del. 2003); *In re Scott Acq. Corp.*, 344 B.R. 283 (Bankr. D. Del.); *Stanziale v. Pepper Hamilton, LLP, (In re Student Fin. Corp.)*, 355 B.R. 539, 548 (D. Del. 2005).

240 906 A.2d 168 (Del. Ch. 2006).

insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent." This holding, which was affirmed by the Delaware Supreme Court on August 4, 2007, "on the basis of and for the reasons assigned by the Court of Chancery in its opinion," arose in the aftermath of two flawed public company acquisitions which were blamed for the company's troubles. In granting a motion to dismiss a claim for deepening insolvency, Vice Chancellor Strine explained his reasoning as follows:

> In the complaint, the [plaintiff] also has attempted to state a claim against the former subsidiary directors for "deepening insolvency." * * * Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.
>
> Refusal to embrace deepening insolvency as a cause of action is required by settled principles of Delaware law. So, too, is a refusal to extend to creditors a solicitude not given to equityholders. Creditors are better placed than equityholders and other corporate constituencies (think employees) to protect themselves against the risk of firm failure.
>
> The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure. With the prospect of profit often comes the potential for defeat.
>
> The general rule embraced by Delaware is the sound one. So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective.[241]

[241] 906 A.2d at 174-175.

The strength of the *Trenwick* holding is diluted by the Vice Chancellor's finding that "the complaint fails to plead facts supporting an inference that the subsidiary was insolvent before or immediately after the challenged transactions."

Also elucidating was the Vice Chancellor's statement of the fiduciary duties of the directors of a wholly owned subsidiary:

> Likewise, the complaint fails to plead facts suggesting that the subsidiary directors were less than diligent or misunderstood their roles. A wholly-owned subsidiary is to be operated for the benefit of its parent. A subsidiary board is entitled to support a parent's business strategy unless it believes pursuit of that strategy will cause the subsidiary to violate its legal obligations. Nor does a subsidiary board have to replicate the deliberative process of its parent's board when taking action in aid of its parent's acquisition strategies.[242]

The plaintiff's complaints in *Trenwick* against the failed insurance company's accountants, actuaries and lawyers for aiding and abetting a fiduciary duty breach and for malpractice were also summarily dismissed:

> At bottom, the complaint simply alleges that big-dog advisors were on the scene when Trenwick acquired Chartwell and LaSalle, that Trenwick ultimately failed, and that in the post-Enron era, big-dog advisors should pay when things go wrong with their clients, even when a plaintiff cannot articulate what it is that the advisors did that was intentionally wrongful or even negligent.
>
> Each of the defendant advisors has moved to dismiss the complaint against it on various grounds. I grant those motions for reasons that will be stated tersely.
>
> First, because the complaint fails to state a claim for breach of fiduciary duty against the Trenwick [the parent] or Trenwick America [a wholly owned subsidiary that held principally U.S. based insurance subsidiaries] directors, the claims that the defendant advisors aided and abetted any underlying breach of fiduciary duty fails. As important, a claim for aiding and abetting involves the element that the aider and abettor have "knowingly participated" in the underlying breach of fiduciary duty. The complaint is devoid of facts suggesting that any of the defendant advisors had any reason to believe they were assisting in a breach of fiduciary duty against Trenwick America, a wholly-owned subsidiary of Trenwick, by acting in the capacities they did for Trenwick, in particular in connection with non-self dealing mergers involving Trenwick's acquisition of other public companies.
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> Second, for identical reasons, the count in the complaint purporting to state a claim for "conspiracy to breach fiduciary duties" is equally defective.

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242 906 A.2d at 174.

> Next, the malpractice claims fail to plead facts supporting an inference that the defendant advisors breached the standard of professional care owed by them. For example, as to defendant Milliman, an actuarial firm, the complaint simply states that Milliman's estimate that Chartwell's reserves at the time of its acquisition would be sufficient, when supplemented with $100 million in additional coverage, was wrong. The inflammatory allegations that Milliman must have known they were wrong or manipulated its certification are entirely conclusory and are not accompanied by factual context giving rise to the odor of purposeful wrongdoing or professional slack. Notably, the Litigation Trust has not pled that Milliman warranted that if its estimates were wrong, it would be strictly liable. Indeed, to the contrary, the public documents the complaint draws upon contain heavy caveats regarding these estimates. In addition, as the Second Circuit recognized, regardless of the actuarial method used, calculations of net worth for casualty risk reinsurers are not as firmly determinable as other financial line items.[243]

While it established (at least in Delaware) that deepening insolvency is not a cause of action, *Trenwick* expressly left the door open for claims based on existing causes of action such as breach of fiduciary duty, fraud, fraudulent conveyance and breach of contract. Creditors looking for other pockets to satisfy their claims have attempted to plead their claims relating to actions by directors, officers and professionals that, while attempting to save the business, only prolonged its agony and delayed its demise to fit the opening left by *Trenwick.* These attempts have met with mixed results. In *Radnor Holdings*,[244] a Bankruptcy Court in Delaware dismissed claims that directors had breached their fiduciary duties to the company by authorizing it to borrow to "swing for the fences" in an aggressive new venture as no more than a "disguised" deepening insolvency claim. Then in *Brown Schools*,[245] another Bankruptcy Court in Delaware dismissed a cause of action for deepening insolvency based on *Trenwick*, but declined to dismiss duty of loyalty claims for self-dealing against a controlling stockholder/creditor and its representatives in causing the company to take actions intended to elevate their claims as creditors.[246]

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243 Citing *Delta Holdings, Inc. v. Nat'l Distillers & Chem. Corp.*, 945 F.2d 1226, 1231 (2d Cir. 1991).

244 *Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.)*, 353 B.R. 820 (Bankr. D. Del. 2006).

245 *Miller v. McCown De Leeuw & Co. (In re Brown Schools)*, 2008 Bankr. LEXIS 1226, at *19-23 (Bankr. D. Del. Apr. 24, 2008).

246 In distinguishing *Radnor*, the Bankruptcy Court wrote in *Brown Schools*:

> The *Radnor* Court noted that the plaintiff's complaint against the board only alleged duty of care violations, not duty of loyalty breaches as alleged in this case. *Radnor*, 353 B.R. at 842. Under Delaware law, a plaintiff asserting a dut of care violation must prove the defendant's conduct was grossly negligent in order to overcome the deferential business judgment rule. * * * Duty of care violations more closely resemble causes of action for deepening insolvency because the alleged injury in both is the result of the board of directors' poor business decision. To defeat such an action, a defendant need only prove that the process of reaching the final decision was not the result of gross negligence. Therefore, claims alleging a duty of care violation could be viewed as a deepening insolvency claim by another name.
>
> For breach of the duty of loyalty claims, on the other hand, the plaintiff need only prove that the defendant was on both sides of the transaction. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to

F. Conflicts of Interest.

Conflicts of interest are usually present in closely held corporations where the shareholders are also directors and officers. While the Texas Corporate Statues and the DGCL allow transactions with interested parties after disclosure and disinterested director or shareholder approval,[247] the conflict of interest rules may change in an insolvency situation.[248]

A developing issue involves the application of the conflict of interest rules to parties that are related to the director or officer. While the courts are not uniform in their definition, the conflict of interest rules usually extend to family members.

G. Fraudulent Transfers.

Both state and federal law prohibit fraudulent transfers.[249] All require insolvency at the time of the transaction. The Texas and Delaware fraudulent transfer statutes are identical to the Uniform Fraudulent Transfer Act, except Delaware adds the following provision: "Unless displaced by the provisions of this chapter, the principles of law and equity, including the law merchant and the law relating to principal and agent, estoppel, laches, fraud, misrepresentation, duress, coercion, mistake, insolvency or other validating or invalidating cause, supplement its provisions."[250]

The applicable statute of limitation varies with the circumstances and the applicable law. Generally, the statute of limitations for state laws may extend to four years, while bankruptcy law dictates a one year limitation starting with the petition filing date.

IV. Executive Compensation Process.

A. Fiduciary Duties.

Decisions regarding the compensation of management are among the most important and controversial decisions that a Board can make.[251] The shareholders and management both want

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> demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."). The burden then shifts to the defendant to prove that the transaction was entirely fair. *Id.* This burden is greater than meeting the business judgment rule inherent in duty of care cases. Further, duty of loyalty breaches are not indemnifiable under the Delaware law. 8 Del. C. § 102(b)(7).
>
> Therefore, the Court concludes that the Trustee's claims for breach of the fiduciary duty of loyalty in the form of self-dealing are not deepening insolvency claims in disguise. Consequently, the *Trenwick* and *Radnor* decisions are not controlling.

The Court in *Brown Schools* also allowed (i) deepening insolvency to stand as a measure of damages for duty of loyalty claims, but not duty of care claims; (ii) claims against the controlling stockholder for fraudulent transfers in respect of fees allegedly collected for which the debtor received no benefit, but not claims against directors and company counsel serving the debtor at the stockholder's behest for aiding and abetting the fraudulent transfers; and (iii) against the directors and counsel for aiding and abetting the alleged self-dealing.

247 *See supra* discussion of TBOC § 21.418, TBCA art. 2.35-1 and DGCL § 144 in notes 171-177 and related text.

248 *See Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

249 TEX. BUS. & COM. CODE CHAP. 24; DEL. CODE ANN. tit. 6, § 1301 et seq.; 11 U.S.C. § 548; *see* Byron F. Egan, et al, , *Special Issues in Asset Acquisitions*, ABA 13th Annual National Institute on Negotiating Business Acquisitions, Las Vegas, NV, November 6, 2008, at pages 123-125, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1043.

250 DEL. CODE ANN. tit. 6, § 1310.

251 *See* Bruce F. Dravis, *The Role of Independent Directors after Sarbanes-Oxley* 79 (2007).

management to be compensated sufficiently so they feel amply rewarded for their efforts in making the entity a profitable investment for the shareholders, are motivated to work hard for the success of the entity, and are able to attract and retain other talented executives. Executives are naturally concerned that they be fully rewarded and provided significant incentives. The shareholders, however, are also mindful that amounts paid to management reduce the profits available for the shareholders, want pay to be linked to performance, and may challenge compensation that they deem excessive in the media, in elections of directors and in the courts.

As the situation is fraught with potential conflicts, Boards often delegate the power and responsibility for setting executive compensation to a committee of directors (a "*compensation committee*"), typically composed of independent directors.[252] The objective is to follow a process that will resolve the inherent conflicts of interest,[253] comply with the requirements of SOX and other applicable laws,[254] and satisfy the fiduciary duties of all involved.

The fiduciary duties discussed elsewhere herein, including the duties of care, loyalty and disclosure, are all applicable when directors consider executive compensation matters.[255] As in other contexts, process and disinterested judgment are critical.

B. Specific Cases.

1. Walt Disney.

In respect of directors' fiduciary duties in approving executive compensation, the Delaware Supreme Court's opinion dated June 8, 2006, in *In re The Walt Disney Co. Derivative Litigation*,[256] which resulted from the failed marriage between Disney and its former President Michael Ovitz, and the Chancery Court decisions which preceded it are instructive. The Supreme Court affirmed the Court of Chancery's determination after a 37-day trial[257] that Disney's

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252 *Id.* at 82; *see also supra* notes 145-159 and related text.

253 In *Wal-Mart Stores, Inc. v. Coughlin*, 255 S.W.3d 424 (April 12, 2007), Wal-Mart was able to set aside a very expensive settlement and release agreement with a former executive vice president and director after a whistleblower induced internal investigation found he had effectively misappropriated hundreds of thousands of dollars in cash and property. The Arkansas Supreme Court held that the settlement and release was unambiguous and by its terms would have released the claims (the agreement provided that all claims "of any nature whatsoever, whether known or unknown," were released). In a case of first impression in Arkansas, the Arkansas Supreme Court held that the settlement was voidable because, in not disclosing to the corporation that he had been misappropriating corporate assets for his personal benefit prior to entering into the release, the former director/officer (1) breached his fiduciary duty of good faith and loyalty to Wal-Mart and (2) fraudulently induced Wal-Mart to enter into the release. After surveying the law from other jurisdictions, the Court wrote:

> We are persuaded … that the majority view is correct, which is that the failure of a fiduciary to disclose material facts of his fraudulent conduct to his corporation prior to entering into a self-dealing contract with that corporation will void that contract and that material facts are those facts that could cause a party to act differently had the party known of those facts. We emphasize, however, that this duty of a fiduciary to disclose is embraced within the obligation of a fiduciary to act towards his corporation in good faith, which has long been the law in Arkansas. Stated differently, we are not adopting a new principle of fiduciary law by our holding today but simply giving voice to an obvious element of the fiduciary's duty of good faith.

254 *See supra* notes 135-177 and related text, and *infra* notes 256-294 and related text.

255 *See supra* notes 21-104, 145-168 and related text.

256 906 A.2d 27 (Del. 2006).

257 907 A.2d 693 (Del. Ch. 2005).

directors had not breached their fiduciary duties in connection with the hiring or termination of Michael Ovitz as President of The Walt Disney Company. In so ruling, the Supreme Court clarified the parameters of the obligation of corporate fiduciaries to act in good faith and offered helpful guidance about the types of conduct that constitute "bad faith." This *Disney* litigation also emphasizes the importance of corporate minutes and their contents in a Court's determination whether directors have satisfied their fiduciary duties.[258]

a. **Facts.**

The facts surrounding the *Disney* saga involved a derivative suit against Disney's directors and officers for damages allegedly arising out of the 1995 hiring and the 1996 firing of Michael Ovitz. The termination resulted in a non-fault termination payment to Ovitz under the terms of his employment agreement valued at roughly $140 million (including the value of stock options). The shareholder plaintiffs alleged that the Disney directors had breached their fiduciary duties both in approving Ovitz's employment agreement and in later allowing the payment of the non-fault termination benefits.

b. **May 28, 2003 Chancery Court Opinion.**

In a May 28, 2003 opinion,[259] the Chancery Court denied the defendants' motions to dismiss an amended complaint alleging that Disney directors breached their fiduciary duties when they approved a lucrative pay package, including a $40 million no-fault termination award and stock options, to Ovitz. "It is rare when a court imposes liability on directors of a corporation for breach of the duty of care," Chancellor Chandler said. However, the allegations in the new complaint "do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."

c. **September 10, 2004 Chancery Court Opinion (Ovitz' Fiduciary Duties Regarding His Employment Agreement).**

On September 10, 2004, the Chancery Court ruled on defendant Ovitz' motion for summary judgment[260] as follows: (i) as to claims based on Ovitz entering into his employment agreement with Disney, the Court granted summary judgment for Ovitz confirming that "before becoming a fiduciary, Ovitz had the right to seek the best employment agreement possible for himself and endorsing a bright line rule that officers and directors become fiduciaries only when they are officially installed, and receive the formal investiture of authority that accompanies such office or directorship . . ."; and (ii) as to claims based on actions after he became an officer, (a) "an officer may negotiate his or her own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner"; (b) "Ovitz made the decision that a faithful fiduciary would make by abstaining from attendance at a [Compensation Committee] meeting [of which he was an ex officio member] where a substantial part of his own

258 Cullen M. "Mike" Godfrey, *In re The Walt Disney Company Derivative Litigation – A New Standard for Corporate Minutes*, Business Law Today, Volume 17, Number 6 (July/August 2008).

259 825 A.2d 275 (Del. Ch. 2003).

260 2004 WL 2050138 (Del. Ch. 2004).

compensation was to be discussed and decided upon"; (c) Ovitz did not breach any fiduciary duties by executing and performing his employment agreement after he became an officer since no material change was made in it from the form negotiated and approved prior to his becoming an officer; (d) in negotiating his no fault termination, his conduct should be measured under DGCL §144 [interested transactions not void if approved by disinterested board or shareholders after full disclosure]; but (e) since his termination involved some negotiation for additional benefits, there was a fact question as to whether he improperly colluded with other side of table in the negotiations and "whether a majority of any disinterested group of independent directors ever authorized the payment of Ovitz severance payments . . . . Absent a demonstration that the transaction was fair to Disney, the transaction may be voidable at the discretion of the company."

d. **August 9, 2005 Chancery Court Post Trial Opinion.**

On August 9, 2005, the Chancery Court rendered an opinion[261] after a 37-day trial on the merits in this Disney case in which he concluded that the defendant directors did not breach their fiduciary duties or commit waste in connection with the hiring and termination of Michael Ovitz. The opinion commented that the Court was charged with the task of determining whether directors have breached their fiduciary duties, and not whether directors have acted in accordance with the best practices of ideal corporate governance, and distinguished between the role of the Court to provide a remedy for breaches of fiduciary duty and the role of the market to provide a remedy for bad business decisions, the Court reasoned as follows:

> [T]here are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance. Recognizing the protean nature of ideal corporate governance practices, particularly over an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.
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> Unlike ideals of corporate governance, a fiduciary's duties do not change over time. How we understand those duties may evolve and become refined, but the duties themselves have not changed, except to the extent that fulfilling a fiduciary duty requires obedience to other positive law. This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices, any more than a common-law court deciding a medical malpractice dispute can impose a standard of liability based on ideal—rather than competent or standard—medical treatment practices, lest the average medical practitioner be found inevitably derelict.
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> Fiduciaries are held by the common law to a high standard in fulfilling their stewardship over the assets of others, a standard that (depending on the

[261] 907 A.2d 693 (Del. Ch. 2005).

circumstances) may not be the same as that contemplated by ideal corporate governance. Yet therein lies perhaps the greatest strength of Delaware's corporation law. Fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximize shareholders' investment. Times may change, but fiduciary duties do not. Indeed, other institutions may develop, pronounce and urge adherence to ideals of corporate best practices. But the development of aspirational ideals, however worthy as goals for human behavior, should not work to distort the legal requirements by which human behavior is actually measured. Nor should the common law of fiduciary duties become a prisoner of narrow definitions or formulaic expressions. It is thus both the province and special duty of this Court to measure, in light of all the facts and circumstances of a particular case, whether an individual who has accepted a position of responsibility over the assets of another has been unremittingly faithful to his or her charge.

Because this matter, by its very nature, has become something of a public spectacle—commencing as it did with the spectacular hiring of one of the entertainment industry's best-known personalities to help run one of its iconic businesses, and ending with a spectacular failure of that union, with breathtaking amounts of severance pay the consequence—it is, I think, worth noting what the role of this Court must be in evaluating decision-makers' performance with respect to decisions gone awry, spectacularly or otherwise. It is easy, of course, to fault a decision that ends in a failure, once hindsight makes the result of that decision plain to see. But the essence of business is risk—the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known. The decision-makers entrusted by shareholders must act out of loyalty to those shareholders. They must in good faith act to make informed decisions on behalf of the shareholders, untainted by self-interest. Where they fail to do so, this Court stands ready to remedy breaches of fiduciary duty.

Even where decision-makers act as faithful servants, however, their ability and the wisdom of their judgments will vary. The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision-makers are held strictly to their fiduciary abilities, but within the boundaries of those duties are free to act as their judgment and duties dictate, free of post hoc penalties from a reviewing court using perfect hindsight. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased.

On the issue of good faith, the Court suggested that the concept of good faith is not an independent duty, but a concept inherent in a fiduciary's duties of due care and loyalty:

> Decisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith. Good faith has been said to require an "honesty of purpose," and a genuine care for the fiduciary's constituents, but, at least in the corporate fiduciary context, it is probably easier to define bad faith rather than good faith. This may be so because Delaware law presumes that directors act in good faith when making business judgments. Bad faith has been defined as authorizing a transaction "for some purpose *other than* a genuine attempt to advance corporate welfare or [when the transaction] is *known to constitute* a violation of applicable positive law." In other words, an action taken with the intent to harm the corporation is a disloyal act in bad faith. * * * It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.
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> * * *
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> Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.
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> * * *

e. **June 8, 2006 Supreme Court Opinion.**

The Delaware Supreme Court affirmed the Court of Chancery's conclusion that the shareholder plaintiffs had failed to prove that the defendants had breached any fiduciary duty.[262] With respect to the hiring of Ovitz and the approval of his employment agreement, the Supreme Court held that the Court of Chancery had a sufficient evidentiary basis from which to conclude, and had properly concluded, that the defendants had not breached their fiduciary duty of care and had not acted in bad faith. As to the ensuing no-fault termination of Ovitz and the resulting termination payment pursuant to his employment agreement, the Supreme Court affirmed the Chancery Court's holdings that the full board did not (and was not required to) approve Ovitz's termination, that Michael Eisner, Disney's CEO, had authorized the termination, and that neither Eisner, nor Sanford Litvack, Disney's General Counsel, had breached his duty of care or acted in bad faith in connection with the termination.

In its opinion, the Supreme Court acknowledged that the contours of the duty of good faith remained "relatively uncharted" and were not well developed. Mindful of the considerable debate that the Court of Chancery's prior opinions in the *Disney* litigation had generated and the increased recognition of the importance of the duty of good faith in the current corporate law

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[262] 906 A.2d 27 (Del. 2006). The Supreme Court wrote: "We conclude … that the Chancellor's factual findings and legal rulings were correct and not erroneous in any respect."

environment, the Supreme Court determined that "some conceptual guidance to the corporate community [about the nature of good faith] may be helpful" and provided the following color as to the meaning of "good faith" in Delaware fiduciary duty jurisprudence:

> The precise question is whether the Chancellor's articulated standard for bad faith corporate fiduciary conduct—intentional dereliction of duty, a conscious disregard for one's responsibilities—is legally correct. In approaching that question, we note that the Chancellor characterized that definition as "an appropriate (*although not the only*) standard for determining whether fiduciaries have acted in good faith." That observation is accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label.
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> The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic. We need not dwell further on this category, because no such conduct is claimed to have occurred, or did occur, in this case.
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> The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent. In this case, appellants assert claims of gross negligence to establish breaches not only of director due care but also of the directors' duty to act in good faith. Although the Chancellor found, and we agree, that the appellants failed to establish gross negligence, to afford guidance we address the issue of whether gross negligence (including a failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.
>
> From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty…." But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.
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> The Delaware General Assembly has addressed the distinction between bad faith and a failure to exercise due care (*i.e.*, gross negligence) in two separate contexts. The first is Section 102(b)(7) of the DGCL, which authorizes Delaware

corporations, by a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care. That exculpatory provision affords significant protection to directors of Delaware corporations. The statute carves out several exceptions, however, including most relevantly, "for acts or omissions not in good faith…." Thus, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission "not in good faith," would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7).

A second legislative recognition of the distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith, is Delaware's indemnification statute, found at 8 *Del. C.* § 145. To oversimplify, subsections (a) and (b) of that statute permit a corporation to indemnify (*inter alia*) any person who is or was a director, officer, employee or agent of the corporation against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement of specified actions, suits or proceedings, where (among other things): (i) that person is, was, or is threatened to be made a party to that action, suit or proceeding, and (ii) that person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation…." Thus, under Delaware statutory law a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.

Section 145, like Section 102(b)(7), evidences the intent of the Delaware General Assembly to afford significant protections to directors (and, in the case of Section 145, other fiduciaries) of Delaware corporations. To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly's intent. There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.

That leaves the third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor's definition of bad faith—intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be, for at least two reasons.

First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith. The Chancellor implicitly so recognized in his Opinion, where he identified different examples of bad faith as follows:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

Those articulated examples of bad faith are not new to our jurisprudence. Indeed, they echo pronouncements our courts have made throughout the decades.

Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." By its very terms that provision distinguishes between "intentional misconduct" and a "knowing violation of law" (both examples of subjective bad faith) on the one hand, and "acts…not in good faith," on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for "acts…not in good faith" must encompass the intermediate category of misconduct captured by the Chancellor's definition of bad faith.

For these reasons, we uphold the Court of Chancery's definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith. We need go no further.

In addition to the helpful discussion about the contours of the duty of good faith, the Supreme Court's opinion offers guidance on several other issues. For example, the Supreme Court affirmed the Chancellor's rulings relating to the power of Michael Eisner, as Disney's CEO, to terminate Mr. Ovitz as President. The Supreme Court also adopted the same practical view as the Court of Chancery regarding the important statutory protections offered by DGCL

§ 141(e), which permits corporate directors to rely in good faith on information provided by fellow directors, board committees, officers, and outside consultants.

The Court also found plaintiffs had "not come close to satisfying the high hurdle required to establish waste" as the Board's approval of Ovitz's employment agreement "had a rational business purpose: to induce Ovitz to leave [his prior position], at what would otherwise be a considerable cost to him, in order to join Disney."

2. Integrated Health.

The May 28, 2003 Chancery Court decision on the motion to dismiss in *Disney* influenced the denial of a motion to dismiss many of the allegations that a corporation's board breached its fiduciary duties in connection with an extensive and multifaceted compensation package benefiting its founder and CEO in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*.[263] Integrated Health had been founded by the CEO in the mid-1980s to operate a national chain of nursing homes and to provide care to patients typically following discharge from hospitals, and prospered and grew substantially. Radical changes in Medicare reimbursement in 1997 led to Integrated Health's decline and commencement of Chapter 11 Bankruptcy Code proceedings in February 2000. After the Bankruptcy Court abstained from adjudicating fiduciary claims against the CEO and directors, plaintiff brought suit in the Delaware Chancery Court, alleging that CEO breached his fiduciary duties of loyalty and good faith to the corporation by improperly obtaining certain compensation arrangements. The plaintiff also alleged that the directors (other than the CEO) breached their duties of loyalty and *good faith* by (1) subordinating the best interests of Integrated Health to their allegiance to the CEO, by failing to exercise independent judgment with respect to certain compensation arrangements, (2) failing to select and rely on an independent compensation consultant to address the CEO's compensation arrangements, and (3) participating in the CEO's breaches of fiduciary duty by approving or ratifying his actions. The plaintiff also alleged that each of the defendant directors breached his fiduciary duty of care by (i) approving or ratifying compensation arrangements without adequate information, consideration or deliberation, (ii) failing to exercise reasonable care in selecting and overseeing the compensation expert, and (iii) failing to monitor how the proceeds of loans to the CEO were utilized by him. These actions were alleged to have constituted waste.

In *Integrated Health*, the defendants attempted to defend the breach of loyalty claims by arguing that a Board consisting of a majority of disinterested, independent directors had approved all compensation arrangements. Addressing first the question of whether a majority of the members of the Board were "interested" in the challenged transactions or were "beholden" to one who was interested in the challenged transactions, the Chancery Court noted the distinction between "interest," which requires that a person receive a personal financial benefit from a transaction that is not equally shared by stockholders, and "independence," which requires the pleading of facts that raise sufficient doubt that a director's decision was based on extraneous considerations or influences rather than on the corporate merits of the transaction. The Chancery Court wrote that this inquiry was fact specific (requiring the application of a subjective "actual person" standard, rather than an objective "reasonable director" standard) and that it would not

[263] 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

deem a director to lack independence unless the plaintiff alleged, in addition to someone's control over a company, facts that would demonstrate that through personal or other relationships the directors were beholden to the controlling person. The Chancery Court concluded that under Delaware law (i) personal friendships, without more, (ii) outside business relationships, without more, and (iii) approving or acquiescing in a challenged transaction, in each case without more, were insufficient to raise a reasonable doubt of a directors' ability to exercise independent business judgment. The court stated that while domination and control are not tested merely by economics, the plaintiff must allege some facts showing a director is "beholden" to an interested director in order to show a lack of independence. The critical issue was whether the director was conflicted in his loyalties with respect to the challenged board action. The Chancery Court found that the directors were not interested in the CEO's compensation transactions and found that most of the directors were not beholden to the CEO. Focusing specifically on a lawyer who was a founding partner of a law firm that provided legal services to the corporation, the court said such facts, without more, were not enough to establish that the lawyer was beholden to the CEO. One director who had been an officer of a subsidiary during part of the time period involved was assumed to have lacked independence from the CEO, but there were enough other directors who were found not to be interested and found to be independent so that all the transactions were approved by a board consisting of a majority of independent, disinterested directors.

The defendants responded to the plaintiff's duty of care claims with three separate arguments: (i) to the extent the defendants relied on the compensation expert's opinions in approving the challenged transaction, they were insulated from liability by DGCL § 141(e), which permits good faith reliance on experts; (ii) to the extent DGCL § 141(e) did not insulate the defendants from liability, Integrated Health's DGCL § 102(b)(7) exculpation provision did so; and (iii) regardless of the DGCL § 141(e) and DGCL § 102(b)(7) defenses, plaintiff had failed to plead facts that showed gross negligence, which the defendants said was a necessary minimum foundation for a due care claim.

The Chancery Court declined to dismiss the *bad faith* and breach of loyalty claims against the CEO himself, adopting the May 28, 2003 *Disney* standard that once an employee becomes a fiduciary of an entity, he had a duty to negotiate further compensation arrangements "honestly and in good faith so as not to advantage himself at the expense of the [entity's] shareholders," but that such requirement did not prevent fiduciaries from negotiating their own employment agreements so long as such negotiations were "performed in an adversarial and arms-length manner."

As to whether any of the challenged transactions was authorized with the kind of intentional or conscious disregard that avoided the DGCL § 102(b)(7) exculpatory provision defense, the court wrote that in the May 28, 2003 *Disney* decision the Chancellor determined that the complaint adequately alleged that the defendants consciously and intentionally disregarded their responsibilities, and wrote that while there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation was not one of those instances: "The board must exercise its own business judgment in approving an executive compensation transaction."[264] Since the case involved a motion to dismiss based on the DGCL § 102(b)(7) provision in the corporation's certificate of incorporation, the plaintiff must plead

[264] *Id.* at *12.

facts that, if true, would show that the board consciously and intentionally disregarded its responsibilities (as contrasted with being only grossly negligent). Examining each of the specific compensation pieces attacked in the pleadings, the court found that the following alleged facts met such conscious and intentional standard: (i) loans from the corporation to the CEO that were initiated by the CEO were approved by the compensation committee and the board only after the loans had been made; (ii) the compensation committee gave approval to loans even though it was given no explanation as to why the loans were made; (iii) the Board, without additional investigation deliberation, consultation with an expert or determination as to what the compensation committee's decision process was, ratified loans (loan proceeds were received prior to approval of loans by the compensation committee); (iv) loan forgiveness provisions were extended by unanimous written consent without any deliberation or advice from any expert; (v) loans were extended without deliberation as to whether the corporation received any consideration for the loans; and (vi) there were no identified corporate authorizations or analysis of the costs to the corporation or the corporate reason therefor performed either by the compensation committee or other members of the Board with respect to the provisions in CEO's employment contract that gave him large compensation if he departed from the company.

Distinguishing between the alleged total lack of deliberation discussed in the May 28, 2003 *Disney* opinion and the alleged inadequate deliberation in *Integrated Health*, the Chancery Court wrote:

> Thus a change in characterization from a *total* lack of deliberation (and for that matter a difference between the meaning of discussion and deliberation, if there is one), to even a short conversation may change the outcome of a *Disney* analysis. Allegations of non-deliberation are different from allegations of not enough deliberation.[265]

Later in the opinion, in granting a motion to dismiss with respect to some of the compensation claims, the Chancery Court suggested that arguments as to what would be a reasonable length of time for board discussion or what would be an unreasonable length of time for the Board to consider certain decisions were not particularly helpful in evaluation a fiduciary duty claim:

> As long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends. The Court does not look at the *reasonableness* of a Board's actions in this context, as long as the Board exercised *some* business judgment.[266]

In the end, the Chancery Court upheld claims alleging that no deliberation occurred concerning certain elements of compensation to Elkins, but dismissed claims alleging that some (but inadequate) deliberation occurred. Further, the decision upheld claims alleging a failure to consult with a compensation expert as to some elements of compensation, but dismissed claims alleging that the directors consulted for too short a period of time with the compensation expert who had been chosen by the CEO and whose work had been reviewed by the CEO in at least

[265] *Id.* at *13 n.58.

[266] *Id.* at *14. Vice Chancellor Noble wrote: "The Compensation Committee's signing of unanimous written consents in this case raises a concern as to whether it acted with knowing and deliberate indifference."

some instances prior to being presented to directors. Thus, it appears that directors who give some attention to an issue, as opposed to none, will have a better argument that they did not consciously and intentionally disregard their responsibilities.

3. Sample v. Morgan.

In *Sample v. Morgan*,[267] the plaintiff alleged a variety of breaches of director fiduciary duties, including the duties of disclosure and loyalty, in connection with the Board's action in seeking approval from the company's stockholders for a certificate of incorporation amendment (the "*Charter Amendment*") and a Management Stock Incentive Plan (the "*Incentive Plan*") that reduced the par value of the company stock from a dollar per share to a tenth of a cent each and authorized a 200,000 share (46%) increase in the number of shares for the purpose of "attracting and retaining" key employees. The same day as the stockholder vote, the Board formed a Compensation Committee, consisting of the Board's two putatively independent directors, to consider how to implement the Incentive Plan. At its very first meeting, which lasted only 25 minutes, the two member Compensation Committee considered a proposal by the company's outside counsel to grant all the newly authorized shares to just three employees of the company – the CEO, the CFO, and the Vice President of Manufacturing – all of whom were directors of the company and who collectively comprised the majority of the company's five member board of directors (the "*Insider Majority*"). Within ten days, the board approved a version of that proposal at a 20 minute meeting. Although the Compensation Committee adopted a vesting schedule for the grants that extended for some years and required the Insider Majority members to remain with the company, all of the newly authorized shares could be voted by the Insider Majority immediately and would receive dividends immediately. The Committee only required the Insider Majority to pay a tenth of a penny per share. Soon thereafter, the Compensation Committee authorized the company to borrow approximately $700,000 to cover the taxes owed by the Insider Majority on the shares they received, although the company's net sales were less than $10 million and it lost over $1.7 million before taxes. In determining the Insider Majority's tax liability, the Compensation Committee estimated the value of the shares granted to be $5.60 apiece, although the Insider Majority only paid a tenth of a penny per share to get them. Throughout the process, the only advisor to the Compensation Committee was the company's outside counsel, who had structured the transactions for the Insider Majority.

When the use of the Incentive Plan shares was disclosed, plaintiff filed suit in the Delaware Chancery Court, alleging that the grant of the new shares was a wasteful entrenchment scheme designed to ensure that the Insider Majority would retain control of the company and that the stockholders' approval of the Charter Amendment and the Incentive Plan were procured through materially misleading disclosures. The complaint noted that the directors failed to disclose that the Charter Amendment and Incentive Plan had resulted from planning between the company's outside counsel – the same one who eventually served as the sole advisor to the Compensation Committee that decided to award all of the new shares to the Insider Majority at the cheapest possible price and with immediate voting and dividend rights – and the company's CEO. In memoranda to the CEO, the company's outside counsel articulated that the Incentive Plan was inspired by the Insider Majority's desire to own "a significant equity stake in the company as incentive for them to grow the company and increase stockholder value, as well as

[267] 914 A.2d 647 (Del. Ch. Jan. 23, 2007).

to provide them with protection against a third party ... gaining significant voting control over the company." Those memoranda also contained other material information, including the fact that the company counsel had advised the CEO that a plan constituting 46% of the then-outstanding equity was well above the range of typical corporate equity plans.

Also not disclosed to the stockholders was the fact that the company had entered into a contract with the buyer of the company's largest existing bloc of shares simultaneously with the Board's approval of the Charter Amendment and the Incentive Plan which provided that for five years thereafter the company would not issue any shares in excess of the new shares that were to be issued if the Charter Amendment and Incentive Plan were approved. Thus, the stockholders were not told that they were authorizing the issuance to management of the only equity the company could issue for five years, nor were they told that the Board knew this when it approved the contract, the Charter Amendment, and the Incentive Plan all at the same meeting.

In denying defendants' motion to dismiss, Vice Chancellor Strine wrote:

> The complaint plainly states a cause of action. Stockholders voting to authorize the issuance of 200,000 shares comprising nearly a third of the company's voting power in order to "attract and retain key employees" would certainly find it material to know that the CEO and company counsel who conjured up the Incentive Plan envisioned that the entire bloc of shares would go to the CEO and two other members of top management who were on the board. A rational stockholder in a small company would also want to know that by voting yes on the Charter Amendment and Incentive Plan, he was authorizing management to receive the only shares that the company could issue during the next five years due to a contract that the board had simultaneously signed with the buyer of another large bloc of shares.
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> In view of those non-disclosures, it rather obviously follows that the brief meetings at which the Compensation Committee, relying only the advice of the company counsel who had helped the Insider Majority develop a strategy to secure a large bloc that would deter takeover bids, bestowed upon the Insider Majority all 200,000 shares do not, as a matter of law, suffice to require dismissal of the claim that those acts resulted from a purposeful scheme of entrenchment and were wasteful. The complaint raises serious questions about what the two putatively independent directors who comprised the Compensation Committee knew about the motivation for the issuance, whether they were complicitous with the Insider Majority and company counsel's entrenchment plans, and whether they were adequately informed about the implications of their actions in light of their reliance on company counsel as their sole source of advice.
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> As important, the directors do not explain how subsequent action of the board in issuing shares to the Insider Majority could cure the attainment of stockholder approval through disclosures that were materially misleading. To that point, the directors also fail to realize that the contractual limitation they placed on their ability to raise other equity capital bears on the issue of whether the complaint states a claim for relief. Requiring the Insider Majority to relinquish

their equity in order to give the company breathing room to issue other equity capital without violating the contract is a plausible remedy that might be ordered at a later stage.

Finally, although the test for waste is stringent, it would be error to determine that the board could not, as a matter of law, have committed waste by causing the company to go into debt in order to give a tax-free grant of nearly a third of the company's voting power and dividend stream to existing managers with entrenchment motives and who comprise a majority of the board in exchange for a tenth of a penny per share. If giving away nearly a third of the voting and cash flow rights of a public company for $200 in order to retain managers who ardently desired to become firmly entrenched just where they were does not raise a pleading-stage inference of waste, it is difficult to imagine what would.

After the Court's decision on the motion to dismiss, the plaintiff amended the complaint to state claims for aiding and abetting breaches of fiduciary duty against the company counsel who had structured the challenged transactions for the Insider Majority, Baker & Hostetler LLP and a Columbus, Ohio based partner who led the representation. The law firm and partner moved to dismiss the claims against them solely on the grounds that the Delaware court lacked personal jurisdiction over them. In denying this motion to dismiss, the Court determined that the non-Delaware lawyer and his non-Delaware law firm who provided advice on Delaware law to the Delaware corporation and caused a charter amendment to be filed with the Delaware Secretary of State are subject to personal jurisdiction in Delaware courts.[268] The Court summarized the issues as follows:

> The question presented is a straightforward one. May a corporate lawyer and his law firm be sued in Delaware as to claims arising out of their actions in providing advice and services to a Delaware public corporation, its directors, and its managers regarding matters of Delaware corporate law when the lawyer and law firm: i) prepared and delivered to Delaware for filing a certificate amendment under challenge in the lawsuit; ii) advertise themselves as being able to provide coast-to-coast legal services and as experts in matters of corporate governance; iii) provided legal advice on a range of Delaware law matters at issue in the lawsuit; iv) undertook to direct the defense of the lawsuit; and v) face well-pled allegations of having aided and abetted the top managers of the corporation in breaching their fiduciary duties by entrenching and enriching themselves at the expense of the corporation and its public stockholders? The answer is yes.

The Court noted that the lawyers were paid by the company, but the beneficiaries of the entrenchment plan were the Insider Majority and the losers were the other shareholders who suffered serious dilution and the company which had the pay the costs. In rejecting the lawyers' arguments that neither the Delaware long-arm statute nor the U.S. Constitution permitted lawyers who did their work outside of Delaware for a corporation headquartered outside of Delaware, the Court wrote:

[268] *Sample v. Morgan*, 2007 WL 4207790 (Del. Ch. Nov. 27, 2007).

> Delaware has no public policy interest in shielding corporate advisors from responsibility for consciously assisting the managers of Delaware corporations in breaching their fiduciary duties. If well-pled facts can be pled that support the inference that a corporate advisor knowingly assisted corporate directors in breaching their fiduciary duties, Delaware has a public policy interest in ensuring that its courts are available to derivative plaintiffs who wish to hold that advisor accountable to the corporation. The precise circumstances when corporate advisors should be deemed responsible to the corporation or its stockholders for their role in advising directors and officers should be determined by decisions addressing the merits of aiding and abetting claims, not by decisions about motions to dismiss for lack of personal jurisdiction. Lawyers and law firms, like other defendants, can be sued in this state if there is a statutory and constitutional foundation for doing so.
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> For sophisticated counsel to argue that they did not realize that acting as a de facto outside general counsel to a Delaware corporation and regularly providing advice about Delaware law about matters important to that corporation and its stockholders might expose it to this Court's jurisdiction fails the straight-face test. The moving defendants knew that the propriety of the corporate action taken in reliance upon its advice and through its services would be determined under Delaware corporate law and likely in a Delaware court.

The Court acknowledged that the facts in the case were "highly unusual" and that in "most fiduciary duty cases, it will be exceedingly difficult for plaintiffs to state an aiding and abetting claim against corporate counsel."

4. Ryan v. Gifford.

Ryan v. Gifford[269] was a derivative action involving options backdating, a practice that involves the granting of options under a stock option plan approved by the issuer's stockholders which requires that the option exercise price not be less than the market price of the underlying stock on the date of grant and increasing the management compensation by fixing the grant date on an earlier date when the stock was trading for less than the market price on the date of the corporate action required to effect the grant.[270] Plaintiff alleged that defendants breached their fiduciary duties of due care and loyalty by approving or accepting backdated options that violated the clear terms of the stockholder approved option plans. Chancellor William B. Chandler III denied defendants' motion to discuss the derivative action because plaintiff failed to first demand that the issuer commence the proceedings, ruling that because "one half of the current board members approved each challenged transaction," asking for board approval was not required.[271] The Chancellor also denied defendants' motion to transfer the case to California

269 918 A.2d 341 (Del. Ch. Feb. 6, 2007).

270 *See* **Appendix B** for a discussion of options backdating issues; *see* C. Stephen Bigler & Pamela H. Sudell, *Delaware Law Developments: Stock Option Backdating and Spring-Loading*, 40 Rev. Sec. & Comm. Reg. 115 (May 16, 2007).

271 *See Conrad v. Blank*, C.A. No. 2611-VCL (Del. Ch. September 7, 2007) (derivative claims that 17 past and current board members of Staples Inc. breached their fiduciary duties and committed corporate waste by authorizing or

where other backdating cases involving Maxim are pending, or stay the Delaware proceedings pending resolution of the California cases, basing his decision on the absence of Delaware precedent on options backdating and the importance of there being Delaware guidance on the issues.[272]

Turning to the substance of the case, the Chancellor held "that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith."[273] The Chancellor further commented:

> A director who approves the backdating of options faces at the very *least* a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty. Backdating options qualifies as one of those "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." Plaintiff alleges that three members of a board *approved* backdated options, and another board member accepted them. These are sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering demand.
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> * * *
>
> I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.[274]

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wrongly permitting the secret backdating of stock option grants to corporate executives; the court held that demand was excused as these "same directors" had already conducted an investigation and took no action even though company took a $10.8 million charge in 2006 (covering 10 years), cryptically stating only that certain options had been issued using "incorrect measuring dates"; the court explained: "after finding substantial evidence that options were, in fact, mispriced, the company and the audit committee ended their 'review' without explanation and apparently without seeking redress of any kind. In these circumstances, it would be odd if Delaware law required a stockholder to make demand on the board of directors before suing on those very same theories of recovery.")

272 *See also Brandin v. Deason*, 2123-VCL (Del. Ch. July 20, 2007), in which the Court denied a motion to stay a derivative action in favor of a later-filed parallel proceeding in a Texas federal district court, citing the fact that the proceedings had already begun in Delaware and the involvement of unsettled aspects of Delaware law as justifications for denying the stay.

273 *Ryan*, 918 A.2d at 358.

274 *Id.* The Chancellor's focus on the inability of directors consistently with their fiduciary duties to grant options that deviate from the provisions of a stockholder is consistent with the statement that "Delaware law requires that the terms and conditions of stock options be governed by a written, board approved plan" in *First Marblehead Corp. v. House*, 473 F.3d 1, 6 (1st Cir. 2006), a case arising out of a former employee attempting to exercise a stock option more than three months after his resignation. In *First Marblehead* the option plan provided that no option could be exercisable more than three months after the optionee ceased to be an employee, but the former employee was never given a copy

The Chancellor dismissed claims concerning transactions that occurred before the plaintiff owned shares.

The Chancellor's refusal to dismiss the suits on procedural grounds opened up the discovery phase of the litigation, which was marked by numerous disputes concerning jurisdiction over additional defendants and access to documents. The plaintiffs sought access to a report prepared by an outside law firm which the Special Committee engaged as Special Counsel to investigate the stock-option-backdating charges. The Chancellor rejected arguments that various communications and notes between the Special Committee and its Special Counsel were protected by the attorney-client privilege, which allows attorneys and clients to confer confidentially, or by the work product doctrine, which protects draft versions of documents related to preparation for lawsuits.[275] The Court ruled that when the Special Committee presented the internal investigation report to the full Board, the report and related communications were not protected because (1) only the Special Committee was the client of Special Counsel and not the full Board, which included the defendant CEO and CFO whose actions were being investigated by the Special Committee, and (2) the presentation to the full Board constituted a waiver of any privileges that would have otherwise attached.[276] The

of the option plan nor told of this provision. The Court held that the employee's breach of contract claim was barred by Delaware law because it conflicted with the plan, but that under the laws of Massachusetts the issuer's failure to disclose this term constituted negligent misrepresentation.

275 *Ryan v. Gifford*, 2007 WL 4259557 (Del. Ch. Dec. 3, 2007).

276 In so ruling, the Chancellor explained:

> There appears to be no dispute that, absent waiver or good cause, the attorney-client privilege protects communications between Orrick [Special Counsel] and its client, the Special Committee. Maxim, however, also asserts attorney-client privilege for its communications with Orrick relating to the Special Committee's findings, reports, presentations, and other communications, contending that, because the Special Committee was formed at its direction in direct response to the litigation challenging Maxim's grants of stock options, Maxim and its Special Committee share a joint privilege. As a result of this purported joint privilege, communications between not only the Special Committee and Orrick, but also Maxim and Orrick would be protected. Maxim further contends that it has not waived this privilege. Even assuming that Maxim can assert the privilege between the Special Committee and Orrick to protect communications between Maxim and Orrick about the investigation and report, I conclude that the privilege does not apply here because plaintiffs' showing of good cause vitiates it. Applying the factors set forth in *Garner v. Wolfinbarger* [430 F.2d 1093, 1103–04 (5th Cir. 1970), *cert denied*, 401 U.S. 974 (1971)], and particularly the three identified in *Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.* [No. 8853, 1987 WL 12500, at *4 (Del. Ch. June 19, 1987)], I conclude that no privilege has attached to the communications between Maxim and Orrick regarding the investigation and report. Plaintiffs have demonstrated: (1) a colorable claim; (2) the unavailability of information from other sources, including the lack of written final report, the inability to depose witnesses regarding the report or investigation because of assertions of privilege, and the unavailability of witnesses due to invocation of the Fifth Amendment privilege not to testify; and (3) the specificity with which the information is identified. Of particular importance is the unavailability of this information from other sources when information regarding the investigation and report of the Special Committee is of paramount importance to the ability of plaintiffs to assess and, ultimately prove, that certain fiduciaries of the Company breached their duties. Consequently, I conclude that no attorney-client privilege attached to the communications between Maxim and Orrick regarding the investigation and, therefore, these communications must be produced.
>
> Even if, however, Maxim and its Special Committee do share a joint privilege, as to certain communications between Orrick and the Special Committee, I conclude that plaintiffs have demonstrated that the privilege has been waived. Plaintiffs appear to seek discovery of all communications between Orrick and the Special Committee related to the investigation and report, in addition to discovery of the presentation of the Special Committee's investigation and final report to the Special Committee and Maxim's board of directors. Though plaintiffs have demonstrated waiver of the privilege only as to the presentation of the report, this partial waiver operates as a complete waiver for

Chancellor ordered the defendants to include all the metadata associated with the documents because it was needed to determine when and how the stock-option grant dates were altered and when the Board had reviewed the metadata.

On September 16, 2008 after years of litigation, several opinions by the Chancellor, extensive discovery, four mediations and intense negotiations, the parties to the *Ryan v. Gifford* action entered into a stipulation of settlement which provided that (i) defendants and their insurance carriers would pay to the company approximately $28.5 million in cash (of which the insurance carriers would pay $21 million and the balance would be paid by the individual defendants; out of this sum approximately $10 million was awarded to plaintiff's counsel for fees and expenses), (ii) mispriced options would be cancelled or repriced and (iii) governance changes would be instituted to address the conditions that led to the backdating of options, including changes in the structure of the Board and its committees and strengthened internal controls. On January 2, 2009 the Chancellor approved this settlement.[277]

5. *In re Tyson Foods, Inc. Consolidated Shareholder Litigation.*

A 1997 settlement arising out of transactions between minority shareholders of Tyson Foods, Inc. and the family of its largest stockholder, Don Tyson, and a 2004 SEC consent order arising out of SEC allegations that Tyson Foods' proxy statements from 1997 to 2003 mislabeled payments as travel and entertainment expenses underlay the plaintiffs' fiduciary duty claims in *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*.[278] Plaintiffs' complaint alleged

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> all communications regarding this subject matter. Therefore, I conclude that plaintiffs are entitled to all communications between Orrick and the Special Committee related to the investigation and final report. Communications made in the presence of third persons not for the purpose of seeking legal advice operates as a waiver of the attorney-client privilege. On January 18 and 19, 2007, the Special Committee presented its final oral report to Maxim's board of directors. This report appears to be more than a mere acknowledgement of the existence of the report and instead disclosed such details that, for example, attendees were directed to turn in any notes taken during the presentation at the end of the meeting. In addition to the Special Committee and Orrick, other members of the board of directors and attorneys from Quinn Emmanuel were also in attendance. The presentation of the report constitutes a waiver of privilege because the client, the Special Committee, disclosed its communications concerning the investigation and final report to third parties—the individual director defendants and Quinn Emmanuel—whose interests are not common with the client, precluding application of the common interest exception to protect the disclosed communications. The individual defendants, though directors on the board of Maxim, cannot be said to have interests that are so parallel and non-adverse to those of the Special Committee that they could reasonably be characterized "joint venturers." The Special Committee was formed to investigate wrongdoing and in response to litigation in which certain directors were named as individual defendants. This describes a relationship more akin to one adversarial in nature. Though the presence of counsel that seemingly acts in a dual capacity as counsel for both Maxim (before the SEC) and the individual defendants in this litigation may confuse the issue of whether the director defendants attended the January meetings in a fiduciary—not individual—capacity, any apparent confusion may now be dismissed because the individual director defendants specifically rely on the findings of the report for exculpation as individuals defendants. Thus, there can be no doubt that the common interest exception is inapplicable to extend the protection of the attorney-client privilege to the communications disclosed at the January board meetings. Therefore, those communications relating to the final report, including any materials distributed or collected at meetings between the Board members and the Special Committee, must be produced.

See Byron F. Egan, *Responsibilities of M&A Professionals After the Sarbanes-Oxley Act* (Oct. 4, 2007) at A-2, A-3, which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=838.

[277] 41 BNA Sec. Reg. & L. Rept. 133-134 (January 26, 2009).

[278] 2007 WL 416132 (Del.Ch. Feb. 6, 2007).

three particular types of Board malfeasance: (1) approval of consulting contracts that provided lucrative and undisclosed benefits to corporate insiders; (2) grants of "spring-loaded" stock options to insiders;[279] and (3) acceptance of related-party transactions that favored insiders at the expense of shareholders.

In a February 6, 2007 opinion denying a motion to dismiss allegations that the directors breached their fiduciary duties in approving compensation, Chancellor Chandler wrote:

> Plaintiffs' complaint as to the approval of the compensation amounts to a claim for excessive compensation. To maintain such a claim, plaintiffs must show either that the board or committee that approved the compensation lacked independence (in which case the burden shifts to the defendant director to show that the compensation was objectively reasonable), or to plead facts sufficient to show that the board or committee lacked good faith in making the award. Assuming that this standard is met, plaintiffs need only allege some specific facts suggesting unfairness in the transaction in order to shift the burden of proof to defendants to show that the transaction was entirely fair.
>
> * * *
>
> The report of the Compensation Committee in the same proxy, however, discusses salaries, bonuses, options and stock, but remains conspicuously silent about other annual compensation.
>
> It is thus reasonable to infer at this stage that the Compensation Committee did not approve or review the other annual compensation. Plaintiffs easily meet their further burden to allege some fact suggesting that the transactions were unfair to shareholders: the transactions and their related lack of disclosure undeniably exposed the company to SEC sanctions.

With respect to the option spring-loading issues, the Chancellor wrote:

> Whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating, a practice that has attracted much journalistic, prosecutorial, and judicial thinking of late. At their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date on which the grant was actually made. Allegations of spring-loading implicate a much more subtle deception.
>
> Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception. A director's duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary. It is inconsistent with such a duty for a board of directors to ask for

279 *See* **Appendix B** for discussions of "backdated" and "spring-loaded" stock options; *see* C. Stephen Bigler & Pamela H. Sudell, *Delaware Law Developments: Stock Option Backdating and Spring-Loading*, 40 Rev. Sec. & Comm. Reg. 115 (May 16, 2007).

> shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. This remains true even if the board complies with the strict letter of a shareholder-approved plan as it relates to strike prices or issue dates.
>
> The question before the Court is not, as plaintiffs suggest, whether spring-loading constitutes a form of insider trading as it would be understood under federal securities law. The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he knows those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.
>
> This conclusion, however, rests upon at least two premises, each of which should be (and, in this case, has been) alleged by a plaintiff in order to show that a spring-loaded option issued by a disinterested and independent board is nevertheless beyond the bounds of business judgment. First, a plaintiff must allege that options were issued according to a shareholder-approved employee compensation plan. Second, a plaintiff must allege that the directors that approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options. Such allegations would satisfy a plaintiff's requirement to show adequately at the pleading stage that a director acted disloyally and in bad faith and is therefore unable to claim the protection of the business judgment rule. Of course, it is conceivable that a director might show that shareholders have expressly empowered the board of directors (or relevant committee) to use backdating, spring-loading, or bullet-dodging as part of employee compensation, and that such actions would not otherwise violate applicable law. But defendants make no such assertion here.
>
> Plaintiffs' have alleged adequately that the Compensation Committee violated a fiduciary duty by acting disloyally and in bad faith with regard to the grant of options. I therefore deny defendants' motion to dismiss Count III as to the seven members of the committee who are implicated in such conduct.

With the several related party transactions, the plaintiffs did not challenge the disinterestedness or independence of the special committee and thus the Chancellor focused on whether the plaintiffs alleged sufficient facts to show that "the board knew that material decisions were being made without adequate deliberation in a manner that suggests they did not care that shareholders would suffer a loss." Elaborating on this scienter-based test, the Chancellor wrote:

> There is an important distinction between an allegation of non-deliberation and one of inadequate deliberation. It is easy to conclude that a director who fails to consider an issue at all has violated at the very least a duty of due care. In alleging inadequate deliberation, however, a successful complaint will need to make detailed allegations with regard to the process by which a committee conducted its deliberations: the amount of time a committee took in considering a specific motion, for instance, or the experts relied upon in making a decision.

In declining to dismiss disclosure violation claims based on the DGCL § 102(b)(7) exculpatory clause in the certificate of incorporation of Tyson Foods, the Chancellor commented:

> Disclosure violations may, but do not always, involve violations of the duty of loyalty. A decision violates only the duty of care when the misstatement or omission was made as a result of a director's erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty.
>
> It is too early for me to conclude that the alleged failures to disclose do not implicate the duty of loyalty.

Thereafter, the outside directors moved for a judgment on the pleadings. The Chancellor denied this motion in an opinion dated August 15, 2007 that clarified that Tyson's shareholder-approved stock option plan permitted the grant of both "incentive stock options," which under IRS rules must be granted at not less than fair market value on the date of grant, and "non-qualified stock options," which Tyson's Compensation Committee might make exercisable at any price. In denying this motion to dismiss on duty of loyalty grounds, the Chancellor explained:

> Delaware law sets forth few bright-line rules guiding the relationship between shareholders and directors. Nor does the law require corporations to adopt complex sets of articles and bylaws that govern the method by which corporate decisions will be made. Instead, shareholders are protected by the assurance that directors will stand as fiduciaries, exercising business judgment in good faith, solely for the benefit of shareholders.
>
> Case law from the Supreme Court, as well as this Court, is replete with language describing the nature of this relationship. The affairs of Delaware corporations are managed by their board of directors, who owe to shareholders duties of *unremitting loyalty*. This means that their actions must be taken in the good faith belief that they are in the best interests of the corporation and its stockholders, especially where conflicts with the individual interests of directors are concerned. The question whether a corporation should pursue a lawsuit against an errant director belongs to the board, and will not be taken from *disinterested* directors, or those who retain their *independence* from those who

might not have shareholder interests firmly at heart. When those same directors communicate with shareholders, they also must do so with *complete candor*.

Loyalty. Good faith. Independence. Candor. These are words pregnant with obligation. The Supreme Court did not adorn them with half-hearted adjectives. Directors should not take a seat at the board table prepared to offer only conditional loyalty, tolerable good faith, reasonable disinterest or formalistic candor. It is against these standards, and in this spirit, that the alleged actions of spring-loading or backdating should be judged.

* * *

When directors seek shareholder consent to a stock incentive plan, or any other quasi-contractual arrangement, they do not do so in the manner of a devil in a dime-store novel, hoping to set a trap with a particular pattern of words. Had the 2000 Tyson Stock Incentive Plan never been put to a shareholder vote, the nature of a spring-loading scheme would constitute material information that the Tyson board of directors was obligated to disclose to investors when they revealed the grant. By agreeing to the Plan, shareholders did not implicitly forfeit their right to the same degree of candor from their fiduciaries.

Defendants protest that deceptive or deficient proxy disclosures cannot form the basis of a derivative claim challenging the grant of these options, asserting that "Tyson's later proxy disclosures concerning the challenged option grants are temporally and analytically distinct from the option grants themselves." * * * Where a board of directors intentionally conceals the nature of its earlier actions, it is reasonable for a court to infer that the act concealed was itself one of disloyalty that could not have arisen from a good faith business judgment. The gravamen of Count III lies in the charge that defendants intentionally and *deceptively* channeled corporate profits to chosen executives (including members of Don Tyson's family). Proxy statements that display an uncanny parsimony with the truth are not "analytically distinct" from a series of improbably fortuitous stock option grants, but rather raise an inference that directors engaged in later dissembling to hide earlier subterfuge. The Court may further infer that grants of spring-loaded stock options were both inherently unfair to shareholders and that the long-term nature of the deceit involved suggests a scheme inherently beyond the bounds of business judgment.

In retrospect, the test applied in the February 6, 2007 Opinion was, although appropriate to the allegations before the Court at the time, couched in too limited a manner. Certainly the elements listed describe a claim sufficient to show that spring-loading would be beyond the bounds of business judgment. Given the additional information now presented by the parties, however, I am not convinced that allegations of an implicit violation of a shareholder-approved stock incentive plan are absolutely necessary for the Court to infer that the decision to spring-load options lies beyond the bounds of business judgment. Instead, I find that where I may reasonably infer that a board of directors later concealed the true nature of a grant of stock options, I may further conclude that those options were not granted consistent with a fiduciary's duty of utmost loyalty.[280]

6. Desimone v. Barrows

Following the Delaware Chancery Court decisions in *Ryan v. Gifford*[281] and *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*[282] in which derivative claims involving backdated and spring-loaded options survived motions to dismiss, the Delaware Chancery court decision in *Desimone v. Barrows*[283] demonstrates that cases involving such options issues can be very fact specific and may not result in director liability, even where there have been internal, SEC and Department of Justice investigations finding option granting irregularities. In *Desimone v. Barrows*, the issuer (Sycamore Networks, Inc.) essentially admitted in its SEC filings that many of its option grants were backdated and this truth was not disclosed until after an internal investigation. Based on allegations in an internal memorandum that options granted to six rank and file employees were backdated and the issuer's restatement of earnings after an internal investigation following that memorandum was revealed to the Board, plaintiff brought a derivative action against recipients of allegedly improper grants. The action involved a plan that permitted grants of options below market, which distinguished it from the plan in *Ryan v. Gifford* that required that options be granted at fair market value. Plaintiff endeavored to stigmatize three distinct classes of grants: (1) grants to rank and file employees that may have been effected by officers without Board or Compensation Committee approval, (2) grants to officers which involved Compensation Committee approval, although no particular facts were alleged that the Compensation Committee knew of the backdating, and (3) grants to outside directors that were awarded annually after the annual meeting of stockholders pursuant to specific stockholder approval of both the amount and the timing of the grants but that allegedly had fortuitous timing.. The Court dismissed plaintiff's complaint on the basis that the complaint did not plead particularized facts establishing demand excusals as to the grants to rank and file employees and to officers because there were no specific facts plead that a majority of the Board was unable to independently decide whether to pursue the claims.[284] Because a majority of the directors received the director options and, thus, likely would be unable to act independently of their interest therein, demand was excused with respect to the director option claims, but the complaint did not survive the motion to dismiss because there were no particular allegations that the regular director option grants did not conform to non-discriminatory arrangement approved by the stockholders. In explaining, in a section captioned "Proceed With Care: The Legal Complexities Raised By Various Options Practices," how the allegations in the *Desimone v. Barrows* complaint differed from those in *Ryan* and *Tyson*, Vice Chancellor Strine wrote:

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280 *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, C.A. No. 1106-CC (Del. Ch. August 15, 2007); *see Elloway v. Pate*, 238 S.W.3d 882 (Tex.App.—Houston [14th Dist.] 2007) (a Texas court applying Delaware law affirmed jury verdicts in favor of the defendant directors, holding that the directors did not breach their fiduciary duties in approving broad based option grants during confidential merger negotiations at exercise prices below the merger price).

281 *See supra* notes 269-276 and related text.

282 *See supra* notes 278-280 and related text.

283 C.A. No. 2210-VCS (Del. Ch. June 7, 2007).

284 *See supra* notes 109 and 110 regarding demand excusal standard under Delaware Chancery Court Rule 23.1.

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As in *Ryan* and *Tyson*, issues of backdating and spring loading are presented here. But there are some very important differences between the allegations made here about the Employee, Officer, and Outside Director Grants, and those that were made in *Ryan* and *Tyson*. The first is that the Incentive Plan, the stockholder-approved option plan under which all of the Employee and Officer Grants were made, did not by its terms require that all options be priced at fair market value on the date of the grant. Rather, the Incentive Plan gave Sycamore's directors discretion to set the exercise price of the options and expressly permitted below-market-value options to be granted. This case thus presents a different question than those involved in *Ryan* and *Tyson*, which is whether corporate officials breach their fiduciary duties when they, despite having express permission under a stockholder-approved option plan to grant below-market options, represent to shareholders, markets, and regulatory authorities that they are granting fair-market-value options when in fact they are secretly manipulating the exercise price of the option.

As to that question, there is also the subsidiary question of whether the means matters. For example, do backdating and spring loading always have the same implications? In this respect, the contraventions of stockholder-approved option plans that allegedly occurred in *Ryan* and *Tyson* are not the only cause for concern. The tax and accounting fraud that flows from acts of concealed options backdating involve clear violations of positive law. But even in such cases, there are important nuances about *who* bears responsibility when the corporation violates the law, nuances that turn importantly on the state of mind of those accused of involvement.

That point highlights the second important difference between this case and *Ryan* and *Tyson*. In contrast to the plaintiff in *Ryan*, plaintiff Desimone has pled no facts to suggest even the hint of a culpable state of mind on the part of any director. Likewise, Desimone has not, as was done in *Tyson*, pled any facts to suggest that any director was incapable of acting independently of the recipients of any of the Employee or Officer Grants. The absence of pled facts of these kinds underscores the utility of a cautious, non-generic approach to addressing the various options practices now under challenge in many lawsuits. The various practices have jurisprudential implications that are also diverse, not identical, and the policy purposes of different bodies of related law (corporate, securities, and tax) could be lost if courts do not proceed with prudence. Indeed, within the corporate law alone, there are subtle issues raised by options practices.[285]

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[285] Slip Opinion pp. 34-36; *see In Re: F5 Networks Derivative Litigation*, 2007 U.S.Dist. LEXIS 56390 (W.D. Wash., Aug. 1, 2007), *In re CNET Networks Inc. Derivative Litigation*, No. C-06-3817 WHA, 2007 WL 1089690 (N.D. Cal. Apr. 11, 2007), *In re Linear Technology Corp. Derivative Litigation*, 2006 WL 3533024 (N.D.Cal. Dec. 7, 2006), and each of which was an options-backdating derivative action in which the plaintiff's complaint was dismissed for failure to plead with particularity that demand on the board was excused as futile under FRCP 23.1 and which also recognized that, even in the options-backdating context, in order to allege breach of fiduciary duty with the necessary particularity, derivative plaintiffs must allege more than that improper backdating occurred and that the defendant directors had such involvement that they breached their fiduciary duties; *but see In re Zoran Corporation Derivative Litigation*, 2007 WL 1650948 (N.D. Cal. June 5, 2007), in which the same district court as in the *CNET* case found that facts alleging

7. Teachers' Retirement System of Louisiana v. Aidinoff

In *Teachers' Retirement System of Louisiana v. Aidinoff*,[286] the plaintiff brought suit on behalf of American International Group ("*AIG*") against Maurice R. Greenberg (AIG's former CEO) and others, relating to an alleged compensation scheme, pursuant to which senior AIG executives became stockholders of a separate company which collected substantial commissions and other payments from AIG, effectively for no separate services rendered. In upholding the complaint as against defendants' motions to dismiss, the Delaware Court of Chancery rejected as determinative the defense that the relevant arrangements were approved annually by the Board and focused upon the complaint's allegations that the Board relied "blindly" on Greenberg, an interested defendant, to approve the relationship "after hearing a short song-and-dance from him annually." The Court also noted that the outside directors "did not employ any integrity-enhancing device, such as a special committee, to review the…relationship and to ensure that the relationship was not tainted by the self-interest of AIG executives who owned large stakes" in the second company. While stressing that the "informed approval of a conflict transaction by an independent Board majority remains an important cleansing device under our law and can insulate the resulting decision from fairness review under the appropriate circumstances," the Court also made clear that to avail itself of that cleansing device, "the conflicted insider gets no credit for bending a curve ball past a group of uncurious Georges who fail to take the time to understand the nature" of the transactions at issue.

8. Valeant Pharmaceuticals v. Jerney

In *Valeant Pharmaceuticals International v. Jerney*,[287] the Delaware Court of Chancery in a post-trial opinion found that compensation received by a former director and president of ICN Pharmaceuticals, Inc. (now known as Valeant Pharmaceuticals International), Adam Jerney, was not entirely fair, held him liable to disgorge a $3 million transaction bonus paid to him, and also held Jerney liable for (i) his 1/12 share (as one of 12 directors) of the costs of the special litigation committee investigation that led to the litigation and (ii) his 1/12 share of the bonuses paid by the Board to non-director employees. The Court further ordered him to repay half of the $3.75 million in defense costs that ICN paid to Jerney and the primary defendant, ICN Chairman and CEO Milan Panic. Pre-judgment interest at the legal rate, compounded monthly, was granted on all amounts.

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backdating *were* sufficiently pled, and that demand was, therefore, excused; in *Zoran*, the plaintiffs based their strategy on the *CNET* opinion, providing exactly the sort of method and pedigree information for the backdating claims whose absence the *CNET* court used as a basis for rejecting the *CNET* plaintiffs. *Cf. Indiana Electrical Workers Pension Fund v. Millard*, S.D.N.Y., No. 07 Civ. 172 (JGK), 7/24/07) (breach of fiduciary duty class action originally brought by a pension fund against officers and directors of a company in which the fund invested held not preempted by the 1998 Securities Litigation Uniform Standards Act ("*SLUSA*") due to the "Delaware carve-out," which exempts specified class actions based on the statutory or common law of the issuer's state of incorporation; the fund contended in the class action it brought in a New York state court that the defendant officers and directors breached their fiduciary duty of disclosure under Delaware law by making misrepresentations and failing to disclose material facts about an improper stock option backdating scheme, thereby persuading shareholders to authorize an increase in the number of shares available in the company's stock option plan; Lee G. Dunst, *Private Civil Litigation: The Other Side of Stock Option Backdating*, 39 Sec. Reg. & L. Rep. (BNA) 1344 (Sept. 3, 2007).

286 900 A.2d 654 (Del. Ch. 2006).

287 2007 WL 704935 (Del. Ch. March 1, 2007).

The *Valeant* case illustrates how compensation decisions by a Board can be challenged after a change in control by a subsequent Board. The litigation was initiated by dissident stockholders as a stockholder derivative action but, following a change in control of the Board, a special litigation committee of the Board chose to realign the corporation as a plaintiff. As a result, with the approval of the Court, ICN took over control of the litigation. During the course of discovery, ICN reached settlement agreements with all of the non-management directors, leaving Panic and Jerney as the only remaining defendants at the trial. After trial, ICN reached a settlement agreement with Panic, leaving only Jerney.

The transaction on which the bonus was paid was a reorganization of ICN into three companies; a U.S. unit, an international unit and a unit holding the rights to its antiviral medication, shares of which would be sold to the public in a registered public offering ("*IPO*"). After the IPO but before the reorganization was completed, control of the Board changed as a result of the election of additional dissident directors.

The ensuing litigation illustrates the risks to all involved when the compensation committee is not independent and disinterested. Executive compensation is like any other transaction between a corporation and its management – it is voidable unless the statutory requirements for validation of interested director transactions are satisfied.[288] In Delaware a contract between a director and the director's corporation is voidable due to the director's interest unless (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved or ratified by the directors or shareholders of the corporation.[289] Neither the ICN compensation committee nor the ICN Board was disinterested because all of the directors were receiving some of the questioned bonuses.[290] Since the compensation had not been approved by the stockholders, the court applied the "entire fairness" standard[291] in reviewing the compensation

288 *See supra* notes 170-177 and related text.

289 *Id.*

290 The Court noted that each of the three directors on the compensation committee received a $330,500 cash bonus and "were clearly and substantially interested in the transaction they were asked to consider." Further, the Court commented "that at least two of the committee members were acting in circumstances which raise questions as to their independence from Panic. Tomich and Moses had been close personal friends with Panic for decades. Both were in the process of negotiating with Panic about lucrative consulting deals to follow the completion of their board service. Additionally, Moses, who played a key role in the committee assignment to consider the grant of 5 million options to Panic, had on many separate occasions directly requested stock options for himself from Panic."

291 In *Julian v. Eastern States Construction Service, Inc.*, C.A. No. 1892-VCP, 2008 WL 2673300 (Del. Ch. July 8, 2008), the Delaware Chancery Court ordered the disgorgement of director compensation bonuses after its determination that the bonuses did not pass the entire fairness standard and explained:

> Self-interested directorial compensation decisions made without independent protections, like other interested transactions, are subject to entire fairness review. Directors of a Delaware corporation who stand on both sides of a transaction have "the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts." They "are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." The two components of entire fairness are fair dealing and fair price. Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the

arrangements, which placed the burden on the defendant director and officer of establishing both components of entire fairness: fair dealing and fair price. "Fair dealing" addresses the "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[292] "Fair price" requires that the transaction be substantively fair by examining "the economic and financial considerations."[293]

The fair dealing prong of the entire fairness led the Court to scrutinize processes of the compensation committee. The compensation committee had obtained a report supporting the bonuses from Towers Perrin, a well-regarded compensation consultant, and claimed that it was protected in relying on the report of this expert. However, the compensation consultant who prepared the compensation report on which the compensation committee was relying was initially selected by management, was hired to justify a plan developed by management, had initially criticized the amounts of the bonuses and then only supported them after further meetings with management, and opined in favor of the plan despite being unable to find any comparable transactions. As a result, the Court held that reliance on the compensation report did not provide Jerney with a defense under DGCL § 141(e), which provides that a director will be "fully protected" in relying on experts chosen with reasonable care.[294] The Court explained: "To hold otherwise would replace this court's role in determining entire fairness under 8 Del. C. sec. 144 with that of various experts hired to give advice...." The Court also separately examined the consultant's work and concluded that it did not meet the standard for DGCL § 141(e) reliance.

The Court rejected an argument that the Company's senior officers merited bonuses comparable to those paid by outside restructuring experts: "Overseeing the IPO and spin-off were clearly part of the job of the executives at the company. This is in clear contrast to an outside restructuring expert..."

The Court held that doctrines of common law and statutory contribution would not apply to a disgorgement remedy for a transaction that was voidable under DGCL § 144. Hence Jerney was required to disgorge the entirety of his bonus without any ability to seek contribution from other defendants or a reduction in the amount of the remedy because of the settlements executed by the other defendants.

The ICN opinion shows the significant risks that directors face when entire fairness is the standard of review. The opinion also shows the dangers of transactions that confer material benefits on outside directors, thereby resulting in the loss of business judgment rule protection. Although compensation decisions made by independent boards are subject to great deference, that deference disappears when there is not an independent board and entire fairness is the

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> stockholders were obtained." Fair price "assures the transaction was substantively fair by examining 'the economic and financial considerations.'"

In *Julian*, the Court found it significant that the bonuses were much larger than in prior years (the subject bonus was 22% of adjusted income compared with 3.36% in prior years) and that the bonus reduced the company's book value at a time when book value was the basis for determining the purchase price for the company's purchase of the shares of a terminated founder.

292 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

293 *Id.*

294 *See infra* notes 706-708 and related text.

standard. The Court in *Valeant* explained: "Where the self-compensation involves directors or officers paying themselves bonuses, the court is particularly cognizant to the need for careful scrutiny."

C. Non-Profit Corporations.

The compensation of directors and officers of non-profit corporations can raise conflict of interest issues[295] comparable to those discussed above in respect of the compensation of directors and officers of for-profit corporations.[296] Further, since non-profit corporations often seek to qualify for exemption from federal income taxation under § 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "***IRC***"), as organizations organized and operated exclusively for charitable, religious, literary or scientific purposes and whose earnings do not inure to the benefit of any private shareholders or individuals, the compensation of directors and officers of non-profit corporations can be subject to scrutiny by the Internal Revenue Service ("***IRS***").[297] Excessive compensation can be deemed the sort of private inurement that could cause the

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[295] TBOC § 22.230 parallels Article 2.30 of the Texas Non-Profit Corporation Act and provides as follows:

> Sec. 22.230. CONTRACTS OR TRANSACTIONS INVOLVING INTERESTED DIRECTORS, OFFICERS, AND MEMBERS. (a) This section applies only to a contract or transaction between a corporation and:
>
> (1) one or more of the corporation's directors, officers, or members; or
>
> (2) an entity or other organization in which one or more of the corporation's directors, officers, or members:
>
> (A) is a managerial official or a member; or
>
> (B) has a financial interest.
>
> (b) An otherwise valid contract or transaction is valid notwithstanding that a director, officer, or member of the corporation is present at or participates in the meeting of the board of directors, of a committee of the board, or of the members that authorizes the contract or transaction, or votes to authorize the contract or transaction, if:
>
> (1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed to or known by:
>
> (A) the corporation's board of directors, a committee of the board of directors, or the members, and the board, the committee, or the members in good faith and with ordinary care authorize the contract or transaction by the affirmative vote of the majority of the disinterested directors, committee members or members, regardless of whether the disinterested directors, committee members or members constitute a quorum; or
>
> (B) the members entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith and with ordinary care by a vote of the members; or
>
> (2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the members.
>
> (c) Common or interested directors or members of a corporation may be included in determining the presence of a quorum at a meeting of the board, a committee of the board, or members that authorizes the contract or transaction.

[296] *See* American Law Institute, *Principals of the Law of Nonprofit Organizations* § 330 (Tentative Draft No. 1 March 19, 2007); ABA Guidebook for Directors of Nonprofit Corporations (1933).

[297] See IRS Report on Exempt Organizations Executive Compensation Compliance Project--Parts I and II (March 2007), which can be found at http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.

organization to lose its status as an exempt organization under the IRC and subject the recipient to penalties and other sanctions under the IRC.[298]

The fiduciary duties of directors applicable to compensation process are comparable to those of a for-profit corporation discussed elsewhere herein.[299] Like directors of for-profit corporations, directors of non-profit corporations are increasingly subject to scrutiny under fiduciary duty principles with respect to how they handle the compensation of management.

In *People ex rel Spitzer v. Grasso*,[300] the New York Attorney General challenged the compensation paid or payable to Richard Grasso, the former CEO of the New York Stock Exchange (which at the relevant times was organized under the New York Not-for-Profit Law) as unreasonable, unlawful and ultra vires.[301] The litigation ensued after disclosures by the NYSE

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298 *Id.* On February 2, 2007, the IRS issued voluntary guidelines for exempt corporations entitled Good Governance Practices for 501(c)(3) Organizations, which can be found at http://www.irs.gov/charities/charitable/article/0,,id=167626,00.html and which are intended to help organizations comply with the requirements for maintaining their tax exempt status under the IRC. In addition to having a Board composed of informed individuals who are active in the oversight of the organization's operations and finances, the guidelines suggest the following nine specific practices that, taken together, the IRS believes every exempt organization should adopt in order to avoid potential compliance problems:

- Adopt a clearly articulated mission statement that makes manifest its goals and activities.
- Adopt a code of ethics setting ethical standards for legal compliance and integrity.
- The directors exercise that degree of due diligence that allows them to ensure that each such organization's charitable purpose is being realized in the most efficient manner possible.
- Adopt a conflicts of interest policy and require the filing of a conflicts of interest disclosure form annually by all of its directors.
- Post on its website or otherwise make available to the public all of its tax forms and financial statements.
- Ensure that its fund-raising activities comply fully with all federal and state laws and that the costs of such fund-raising are reasonable.
- Operate in accordance with an annual budget, and, if the organization has substantial assets or revenues, an annual audit should be conducted. Further, the Board should establish an independent audit committee to work with and oversee any outside auditor hired by the organization.
- Pay no more than reasonable compensation for services rendered and generally either not compensate persons for serving on the board of directors or do so only when an appropriate committee composed of persons not compensated by the organization determines to do so.
- Adopt a policy establishing standards for document integrity, retention, and destruction, including guidelines for handling electronic files.

299 TBOC § 22.221 parallels Article 2.26 of the Texas Non-Profit Corporation Act and provides as follows with respect to the duties of directors of a non-profit corporation organized under the TBOC:

> Sec. 22.221. GENERAL STANDARDS FOR DIRECTORS.
>
> (a) A director shall discharge the director's duties, including duties as a committee member, in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation.
>
> (b) A director is not liable to the corporation, a member, or another person for an action taken or not taken as a director if the director acted in compliance with this section. A person seeking to establish liability of a director must prove that the director did not act:
>
> (1) in good faith;
>
> (2) with ordinary care; and
>
> (3) in a manner the director reasonably believed to be in the best interest of the corporation.

300 13 Misc. 3rd 1227A, 2006 WL 3016952 (N.Y. Sup. Oct. 18, 2006).

301 The Texas Attorney General has also been active in respect of compensation paid to officers and directors of Texas non-profit corporations. *See* John W. Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 ST. MARY'S L.J. 243 (2004).

of a new employment contract with Grasso providing for an immediate lump sum payment of $139.5 million, which led to the Chairman of the SEC writing to the NYSE that Grasso's pay package "raises serious questions regarding the effectiveness of the NYSE's current governance structure." The resulting furor led the NYSE's Board to request Grasso's resignation, which he tendered.[302] An internal investigation led by special independent counsel was highly critical of Grasso's level of compensation and suggested he had played an improper role in setting his own compensation by selecting the Board members who set his compensation. The Court denied cross motions for summary judgment as to the reasonableness of Grasso's compensation generally, but found that the acceleration of certain deferred compensation arrangements was not in strict conformity with the plans[303] and, thus, resulted in illegal loans which Grasso was obligated to repay. The Court found that Grasso had breached his fiduciary duties of care and loyalty in failing to fully inform the Board as to the amount of his accumulated benefits as it was considering granting him additional benefits.

On appeal, the New York Appellate Division,[304] in a 4-to-1 decision, held the New York Attorney General did not have authority to assert four of the six causes of action in which the trial court had allowed recovery from Grasso on a showing that compensation was excessive. The other two causes of action, which were not subject to the appeal, required a showing of fault: (1) the payments were unlawful (i.e. not reasonable) and Grasso knew of their unlawfulness; and (2) violation of fiduciary duty by influencing and accepting excessive compensation.

V. Standards of Review in M&A Transactions.

A. Texas Standard of Review.

Possibly because the Texas business judgment rule, as articulated in *Gearhart*, protects so much director action, the parties and the courts in the two leading cases in the takeover context have concentrated on the duty of loyalty in analyzing the propriety of the director conduct. This focus should be contrasted with the approach of the Delaware courts which often concentrates on the duty of care.

To prove a breach of the duty of loyalty, it must be shown that the director was "*interested*" in a particular transaction.[305] In *Copeland*, the court interpreted *Gearhart* as indicating that "[a]nother means of showing interest, when a threat of takeover is pending, is to demonstrate that actions were taken with the goal of director entrenchment."[306]

Both the *Gearhart* and *Copeland* courts assumed that the defendant directors were interested, thus shifting the burden to the directors to prove the fairness of their actions to the

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302 Grasso tendered his resignation without giving the written notice required under his employment agreement for a termination by the NYSE without cause or by Grasso for good reason, which would have entitled him to additional severance payments. The Court held that Grasso's failure to give this written notice was fatal to his claim for these additional severance payments under both his contract and New York law.

303 The plans could have been amended by the Board directly, but the parties had attempted to effect the changes by separate agreements with Grasso, which the Court found not to be in conformity with the plans. The Court's holding seems harsh and teaches that formalities can be important when dealing with compensation issues.

304 *People ex rel Spitzer v. Grasso*, 2007 NY Slip Op 03990 (Supreme Court, Appellate Division, May 8, 2007).

305 *Gearhart*, 741 F.2d. at 719; *Copeland*, 706 F. Supp. at 1290.

306 *Copeland*, 706 F. Supp. at 1290-91.

corporation.[307] Once it is shown that a transaction involves an interested director, the transaction is "subject to strict judicial scrutiny but [is] not voidable unless [it is] shown to be unfair to the corporation."[308] "[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation."[309]

In analyzing the fairness of the transaction at issue, the Fifth Circuit in *Gearhart* relied on the following criteria set forth by Justice Douglas in *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939):

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.[310]

In *Gearhart*, the court also stated that a "challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of stockholders."[311]

In setting forth the test for fairness, the *Copeland* court also referred to the criteria discussed in *Pepper v. Litton* and cited *Gearhart* as controlling precedent.[312] In analyzing the shareholder rights plan (also known as a "*poison pill*") at issue, however, the court specifically cited Delaware cases in its after-the-fact analysis of the fairness of the directors' action.[313] Whether a Texas court following *Gearhart* would follow Delaware case law in its fairness analysis remains to be seen, especially in light of the Fifth Circuit's complaint in *Gearhart* that the lawyers focused on Delaware cases and failed to deal with Texas law:

> We are both surprised and inconvenienced by the circumstance that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these

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307 *Gearhart*, 741 F.2d at 722; *Copeland*, 706 F. Supp. at 1291-92.

308 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

309 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

310 *Gearhart*, 741 F.2d at 723 (citations omitted).

311 *Id*. at 720 (citation omitted).

312 *Copeland*, 706 F. Supp. at 1290-91.

313 *Id*. at 1291-93.

> aspects of this case under Texas law. We note that two cases cited to us as purported Texas authority were both decided under Delaware law. . . .[314]

Given the extent of Delaware case law dealing with director fiduciary duties, it is certain, however, that Delaware cases will be cited and argued by corporate lawyers negotiating transactions and handling any subsequent litigation. The following analysis, therefore, focuses on the pertinent Delaware cases.

B. Delaware Standard of Review.

An examination only of the actual substantive fiduciary duties of corporate directors provides somewhat of an incomplete picture. Compliance with those duties in any particular circumstance will be informed by the standard of review that a court would apply when evaluating a board decision that has been challenged.

Under Delaware law, there are generally three standards against which the courts will measure director conduct. As articulated by the Delaware courts, these standards provide important guidelines for directors and their counsel as to the process to be followed for director action to be sustained. In the context of considering a business combination transaction, these standards are:

(i) *business judgment rule* -- for a decision to remain independent or to approve a transaction not involving a sale of control;

(ii) *enhanced scrutiny* -- for a decision to adopt or employ defensive measures[315] or to approve a transaction involving a sale of control; and

(iii) *entire fairness* -- for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumptions of the business judgment rule.

1. Business Judgment Rule.

The Delaware business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[316] "A hallmark of the business judgment rule is 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'."[317]

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314 *Gearhart*, 741 F.2d. at 719 n.4.

315 In *Williams v. Geier*, 671 A.2d 1368 (Del. 1996), the Delaware Supreme Court held that an antitakeover defensive measure will not be reviewed under the enhanced scrutiny standard when the defensive measure is approved by stockholders. The court stated that this standard "should be used only when a board unilaterally (i.e. without stockholder approval) adopts defensive measures in reaction to a perceived threat." *Id*. at 1377.

316 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citation omitted); *see also Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1997); *cf.* David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. of Corp. Law 301 (Winter 2007).

317 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); *see* Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L.

The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors must satisfy their duty of care even when they act in the good faith belief that they are acting only in the interests of the corporation and its stockholders. Their decision must be an informed one. "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[318] In *Van Gorkom*, notwithstanding a transaction price substantially above the current market, directors were held to have been grossly negligent in, among other things, acting in haste without adequately informing themselves as to the value of the corporation.[319]

2. Enhanced Scrutiny.

When applicable, enhanced scrutiny places on the directors the burden of proving that they have acted reasonably. The key features of enhanced scrutiny are:

(1) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and

(2) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing.

The directors have the burden of proving that they were adequately informed and acted reasonably.[320]

The reasonableness required under enhanced scrutiny falls within a range of acceptable alternatives, which echoes the deference found under the business judgment rule.

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[321]

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769 (2006); Andrew G.T. Moore II, *The Birth of Unocal—A Brief History*, 31 DEL. J. CORP. L. 865 (2006); A. Gilchrist Sparks III, *A Comment upon "Unocal at 20,"* 31 DEL. J. CORP. L. 887 (2006).

318 *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *see* Bernard S. Sharfman, *Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years after Van Gorkom*, 62 Bus. Law. 135 (Nov. 2006).

319 *Id*. at 874.

320 *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994); *see also Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1290 (Del. 1998).

321 *QVC*, 637 A.2d at 45.

a. Defensive Measures.

In *Unocal Corp. v. Mesa Petroleum Co.*,[322] 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."[323] The court reviewed such actions with enhanced scrutiny even though a traditional conflict of interest was absent. In refusing to enjoin a selective exchange offer adopted by the board to respond to a hostile takeover attempt, the *Unocal* court held that the 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)[324] 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).[325]

In *Gantler v. Stephens*,[326] the Delaware Supreme Court held that *Unocal* did not apply to the rejection of a merger proposal in favor of a going private reclassification in which the certificate of incorporation was amended to convert common stock held by persons owning less than 300 shares into non-voting preferred stock because the reclassification was not a defensive action.

b. Sale of Control.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[327] the Delaware Supreme Court imposed an affirmative duty on the Board to seek the highest value reasonably obtainable to the stockholders when a sale of the company becomes inevitable.[328] Then in *Paramount*

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322 493 A.2d 946 (Del. 1985).

323 *Unocal*, 493 A.2d at 954.

324 *Id*. at 954-55.

325 *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

326 ___ A.2d ___, 2009 WL 188828 (Del. 2009).

327 506 A.2d 173 (Del. 1985).

328 While *Revlon* placed paramount importance on directors' duty to seek the highest sale price once their corporation is on the block, simply pointing to a reduced purchase price because of contingent liabilities is not enough to trigger heightened scrutiny of the directors' actions during the sale process. In *Globis Partners, L.P. v. Plumtree Software, Inc.*, C.A. No. 1577-VCP (Del. Ch. Nov. 30, 2007), the Court of Chancery dismissed at the pleading stage claims that directors failed to fulfill their duties under *Revlon* because the purchase price negotiations were complicated when the Plumtree board learned that target was in breach of a contract with the U.S. General Services Administration (the "*GSA contract*"), and that a significant liability would likely result from the breach. Accordingly, target lowered its selling price in order to induce buyer to proceed with the purchase.

After the merger was announced, plaintiff sued target and its directors derivatively, claiming that the directors breached their fiduciary duties in agreeing to the lower sales price in order to avoid personal liability in connection with the breached GSA contract and additional personal benefits from the merger. In dismissing the complaint, the Court first summarized the bedrock principles of Delaware corporate law relating to directors' fiduciary duties:

- Directors owe a duty of "unremitting loyalty" to shareholders, and in particular, when the board has determined to sell the company for cash or engage in a change of control transaction, it must, under *Revlon*, act reasonably in order to secure the highest price reasonably available;
- In making their decisions, however, directors enjoy the protection of the "business judgment rule" - the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company"; and

Communications Inc. v. QVC Network Inc.,[329] when the issues were whether a poison pill could be used selectively to favor one of two competing bidders (effectively precluding shareholders from accepting a tender offer) and whether provisions of the merger agreement (a "no-shop" clause, a "lock-up" stock option, and a break-up fee) were appropriate measures in the face of competing bids for the corporation, the Delaware Supreme Court sweepingly explained the possible extent of enhanced scrutiny:

> The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.[330]

The rule announced in *QVC* places a burden on the directors to obtain the *best value reasonably available* once the board determines to sell the corporation in a change of control transaction. This burden entails more than obtaining a fair price for the shareholders, one within the range of fairness that is commonly opined upon by investment banking firms. In *Cede & Co. v. Technicolor, Inc.*,[331] the Delaware Supreme Court found a breach of duty even though the transaction price exceeded the value of the corporation determined under the Delaware appraisal statute: "[I]n the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances."[332]

Although *QVC* mandates enhanced scrutiny of board action involving a sale of control, certain stock transactions are considered not to involve a change in control for such purpose. In *Arnold v. Soc'y for Sav. Bancorp*, the Delaware Supreme Court considered a merger between

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- If a "proper" decision-making process is followed by the directors, a court will not review the wisdom of the decision itself; the plaintiff must *plead* facts challenging the directors' decision making in order to rebut the business judgment rule's presumption.

As to the allegations that directors approved the merger at a sub-optimal price to avoid derivative liability, the Court held that the plaintiff must plead facts showing: (i) that the directors faced substantial liability; (ii) that the directors were motivated by such liability; and (iii) that the merger was pretextual. The Court chided plaintiff for failing to even identify which fiduciary duty the directors might have breached in connection with the GSA contract, and for failing to plead any facts at all suggesting that any board member took (or failed to take) any direct action with respect to the GSA contract. As to whether the directors faced substantial liability due to the problems with the GSA contract, the Court analyzed it as a *Caremark* "duty of oversight" claim which failed because the plaintiff did not allege "either that [target] had no system of controls that would have prevented the GSA overcharges or that there was sustained or systemic failure of the board to exercise oversight." *See supra* notes 63-81 and accompanying text. Turning to the last two prongs of the analysis, the Court concluded that because the merger negotiations were well underway before the Board became aware of the GSA contract breach, it was unlikely that the merger was motivated by this liability, or was a pretext without a valid business purpose.

As to the second possibility, while the Court acknowledged that there was no "bright-line rule" for determining when merger-related benefits compromise a director's loyalty, it found list of supposed benefits to the directors and determined that they were either immaterial (in the case of the directors' indemnification rights and the CEO director's severance), untainted by conflicts of interest (acceleration of options, the value of which would increase as the purchase price rose) or shared by all shareholders (option cash-outs).

329 637 A.2d 34 (Del. 1994).

330 *QVC*, 637 A.2d at 43 (footnote omitted).

331 634 A.2d 345 (Del. 1993).

332 *Id*. at 361.

Bancorp and Bank of Boston in which Bancorp stock was exchanged for Bank of Boston stock.[333] The shareholder plaintiff argued, among other things, that the board's actions should be reviewed with enhanced scrutiny because (i) Bancorp was seeking to sell itself and (ii) the merger constituted a change in control because the Bancorp shareholders were converted to minority status in Bank of Boston, losing the opportunity to enjoy a control premium.[334] The Court held that the corporation was not for sale because no active bidding process was initiated and the merger was not a change in control and, therefore, that enhanced scrutiny of the board's approval of the merger was not appropriate.[335] Citing *QVC*, the Court stated that "there is no 'sale or change in control' when '[c]ontrol of both [corporations] remain[s] in a large, fluid, changeable and changing market.'"[336] As continuing shareholders in Bank of Boston, the former Bancorp shareholders retained the opportunity to receive a control premium.[337] The Court noted that in *QVC* a single person would have control of the resulting corporation, effectively eliminating the opportunity for shareholders to realize a control premium.[338]

3. Entire Fairness.

Both the business judgment rule and the enhanced scrutiny standard should be contrasted with the "*entire fairness*" standard applied in transactions with affiliates.[339] In reviewing board action in transactions involving management, board members or a principal shareholder, the Delaware Supreme Court has imposed an "entire fairness" standard.[340] Under this standard the burden is on directors to show both (i) fair dealing and (ii) a fair price:

> The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[341]

The burden shifts to the challenger to show the transaction was unfair where (i) the transaction is approved by the majority of the minority shareholders, though the burden remains on the directors to show that they completely disclosed all material facts relevant to the transaction,[342]

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333 650 A.2d 1270, 1273 (Del. 1994).

334 *Id.* at 1289.

335 *Id*. at 1289-90.

336 *Id*. at 1290.

337 *Id*.

338 *Id.*; *see also Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

339 Directors also will have the burden to prove the entire fairness of the transaction to the corporation and its stockholders if a stockholder plaintiff successfully rebuts the presumption of valid business judgment. *Aronson v. Lewis*, 473 A.2d at 811-12.

340 *See Weinberger v. UOP, Inc*., 457 A.2d 701, 710-11 (Del. 1983); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988).

341 *Weinberger*, 457 A.2d at 711.

342 *Id* at 703.

or (ii) the transaction is negotiated by a special committee of independent directors that is truly independent, not coerced and has real bargaining power.[343]

C. Action Without Bright Lines.

Whether the burden will be on the party challenging board action, under the business judgment rule, or on the directors, under enhanced scrutiny, clearly the care with which the directors acted in a change of control transaction will be subjected to close review. For this review there will be no "bright line" tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances. Thus directors, and counsel advising them, should heed the Delaware Supreme Court in *Barkan v. Amsted Indus., Inc.*:[344] "[T]here is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today's corporate environment." In the absence of bright lines and blueprints that fit all cases, the process to be followed by the directors will be paramount. The elements of the process should be clearly understood at the beginning, and the process should be guided and well documented by counsel throughout.

VI. M&A Transaction Process.

A. Statutory Framework: Board and Shareholder Action.

Both Texas and Delaware law permit corporations to merge with other corporations by adopting a plan of merger and obtaining the requisite shareholder approval.[345] Under Texas law, approval of a merger will generally require approval of the holders of at least two-thirds of the outstanding shares entitled to vote on the merger, while Delaware law provides that mergers may be approved by a vote of the holders of a majority of the outstanding shares.[346] As with other transactions, the Texas Corporate Statues permit a corporation's certificate of formation to reduce the required vote to an affirmative vote of the holders of a majority of the outstanding shares.[347]

Both Texas and Delaware permit a merger to be effected without shareholder approval if the corporation is the sole surviving corporation, the shares of stock of the corporation are not changed as a result of the merger and the total number of shares of stock issued pursuant to the merger does not exceed 20% of the shares of the corporation outstanding immediately prior to the merger.[348]

Board action on a plan of merger is required under both Texas and Delaware law. However, Texas law does not require that the board of directors approve the plan of merger, but

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343 *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

344 567 A.2d 1279, 1286 (Del. 1989).

345 *See* TBOC §§ 10.001, 21.452; TBCA art. 5.01; DGCL §§ 251-58; see generally Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109 (1989).

346 TBOC §§ 21.452, 21.457; TBCA art. 5.03E; DGCL § 251(c).

347 TBOC § 21.365(a); TBCA art. 2.28.

348 TBOC § 21.459; TBCA art. 5.03G; DGCL § 251(f).

rather it need only adopt a resolution directing the submission of the plan of merger to the corporation's shareholders.[349] Such a resolution must either recommend that the plan of merger be approved or communicate the basis for the board's determination that the plan be submitted to shareholders without any recommendation.[350] The Texas Corporate Statues' allowance of directors to submit a plan of merger to shareholders without recommendation is intended to address those few circumstances in which a board may consider it appropriate for shareholders to be given the right to vote on a plan of merger but for fiduciary or other reasons the board has concluded that it would not be appropriate for the board to make a recommendation.[351] Delaware law has no similar provision and requires that the board approve the agreement of merger and declare its advisability, and then submit the merger agreement to the stockholders for the purpose of their adopting the agreement.[352] Delaware and Texas permit a merger agreement to contain a provision requiring that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.[353]

B. Management's Immediate Response.

Serious proposals for a business combination require serious consideration. The CEO and management will usually be called upon to make an initial judgment as to seriousness. A written, well developed proposal from a credible prospective acquiror should be studied. In contrast, an oral proposal, or a written one that is incomplete in material respects, should not require management efforts to develop the proposal further. In no event need management's response indicate any willingness to be acquired. In *Citron v. Fairchild Camera and Instrument Corp.*,[354] for example, the Delaware Supreme Court sanctioned behavior that included the CEO's informing an interested party that the corporation was not for sale, but that a written proposal, if made, would be submitted to the board for review. Additionally, in *Matador Capital Management Corp. v. BRC Holdings, Inc.*,[355] the Delaware Chancery Court found unpersuasive the plaintiff's claims that the board failed to consider a potential bidder because the board's decision to terminate discussion was "justified by the embryonic state of [the potential bidder's] proposal."[356] In particular, the court stated that the potential bidder did not provide evidence of any real financing capability and conditioned its offer of its ability to arrange the participation of certain members of the target company's management in the transaction.[357]

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349 TBOC § 21.452(b)(2)(B); TBCA art. 5.03B(1).

350 TBOC § 21.452(d); TBCA art. 5.03B(1).

351 Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249, 282 (Winter 2001).

352 *See* DGCL § 251(b), (c).

353 DGCL § 146; TBOC §§ 21.452(f), (g); TBCA art. 5.01C(3).

354 569 A.2d 53 (Del. 1989).

355 729 A.2d 280 (Del. Ch. 1998).

356 *Id*. at 292.

357 *Id*.

C. The Board's Consideration.

"When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."[358] Just as all proposals are not alike, board responses to proposals may differ. A proposal that is incomplete in material respects should not require serious board consideration. On the other hand, because more developed proposals may present more of an opportunity for shareholders, they ought to require more consideration by the board.[359]

1. Matters Considered.

Where an offer is perceived as serious and substantial, an appropriate place for the board to begin its consideration may be an informed understanding of the corporation's value. This may be advisable whether the board's ultimate response is to "say no," to refuse to remove pre-existing defensive measures, to adopt new or different defensive measures or to pursue another strategic course to maximize shareholder value. Such a point of departure is consistent with *Van Gorkom* and *Unocal*. In *Van Gorkom*, the board was found grossly negligent, among other things, for not having an understanding of the intrinsic value of the corporation. In *Unocal*, the inadequacy of price was recognized as a threat for which a proportionate response is permitted.[360]

That is not to say, however, that a board must "price" the corporation whenever a suitor appears. Moreover, it may be ill advised even to document a range of values for the corporation before the conclusion of negotiations. However, should the decision be made to sell or should a defensive reaction be challenged, the board will be well served to have been adequately informed of intrinsic value during its deliberations from the beginning.[361] In doing so, the board may also establish, should it need to do so under enhanced scrutiny, that it acted at all times to maintain or seek "the best value reasonably available to the stockholders."[362] This may also be advisable even if that value derives from remaining independent.

There are, of course, factors other than value to be considered by the board in evaluating an offer. The Delaware judicial guidance here comes from the sale context and the evaluation of competing bids, but may be instructive:

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358 *Unocal,* 493 A.2d at 954.

359 *See Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289, 1300 (N.D. Ill. 1988) (applying Delaware law) ("The Board did not breach its fiduciary duty by refusing to negotiate with Desert Partners to remove the coercive and inadequate aspects of the offer. USG decided not to bargain over the terms of the offer because doing so would convey the image to the market place 'that (1) USG was for sale – when, in fact, it was not; and (2) $42/share was an 'in the ballpark' price - when, in fact, it was not.'"); and *Citron*, 569 A.2d at 63, 66-67 (validating a board's action in approving one bid over another that, although higher on its face, lacked in specifics of its proposed back-end which made the bid impossible to value). *Compare Golden Cycle, LLC v. Allan*, 1998 WL 892631, at *15-16 (Del. Ch. December 10, 1998) (board not required to contact competing bidder for a higher bid before executing a merger agreement where bidder had taken itself out of the board process, refused to sign a confidentiality agreement and appealed directly to the stockholders with a consent solicitation).

360 *Unocal*, 493 A.2d at 955; *see also Unitrin Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1384 (Del. 1995), noting as a threat "substantive coercion . . . the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value."

361 *See Technicolor*, 634 A.2d at 368.

362 *QVC*, 637 A.2d at 45.

> In assessing the bid and the bidder's responsibility, a board may consider, among various proper factors, the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.[363]

2. *Being Adequately Informed.*

Although there is no one blueprint for being adequately informed,[364] the Delaware courts do value expert advice, the judgment of directors who are independent and sophisticated, and an active and orderly deliberation.

a. **Investment Banking Advice.**

Addressing the value of a corporation generally entails obtaining investment banking advice.[365] The analysis of value requires the "techniques or methods which are generally considered acceptable in the financial community. . . ."[366] Clearly, in *Van Gorkom*, the absence of expert advice prior to the first Board consideration of a merger proposal contributed to the determination that the Board "lacked valuation information adequate to reach an informed business judgment as to the fairness [of the price]" and the finding that the directors were grossly negligent.[367] Although the Delaware Supreme Court noted that "fairness opinions by independent investment bankers are [not] required as a matter of law,"[368] in practice, investment banking advice is typically obtained for a decision to sell and often for a decision not to sell. In the non-sale context, such advice is particularly helpful where there may be subsequent pressure to sell or disclosure concerning the board's decision not to sell is likely. In either case, however, the fact that the board of directors relies on expert advice to reach a decision provides strong support that the Board acted reasonably.[369]

The advice of investment bankers is not, however, a substitute for the judgment of the directors.[370] As the court pointed out in *Citron*, "in change of control situations, sole reliance on

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363 *Macmillan*, 559 A.2d at 1282 n.29 (citations omitted).

364 *See Goodwin v. Live Entertainment, Inc.*, 1999 WL 64265, at *21 (Del. Ch. 1999) (citing *Barkan*, 567 A.2d at 1286).

365 *See, e.g., In re Talley Indus., Inc. Shareholders Litig.*, 1998 WL 191939, at *11-12 (Del. Ch. 1998).

366 *Weinberger*, 457 A.2d at 713.

367 *Van Gorkom*, 488 A.2d at 878.

368 *Id*. at 876.

369 *See Goodwin*, 1999 WL 64265, at *22 ("The fact that the Board relied on expert advice in reaching its decision not to look for other purchasers also supports the reasonableness of its efforts."); *In re Vitalink Communications Corp. Shareholders Litig.*, 1991 WL 238816, at *12 (Del. Ch. 1991) (citations omitted) (board's reliance on the advice of investment bankers supported a finding that the board had a "reasonable basis" to conclude that it obtained the best offer).

370 *See In re IXC Commc'ns, Inc. S'holders Litig.,* C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999), in which Vice Chancellor Steele stated that "[n]o board is obligated to heed the counsel of any of its advisors and with good reason. Finding otherwise would establish a procedure by which this Court simply substitutes advise

hired experts and management can 'taint the design and execution of the transaction'."[371] In addition, the timing, scope and diligence of the investment bankers may affect the outcome of subsequent judicial scrutiny. The following cases, each of which involves a decision to sell, nevertheless may be instructive for board deliberations concerning a transaction that does not result in a sale decision:

(1) In *Weinberger*,[372] the Delaware Supreme Court held that the board's approval of an interested merger transaction did not meet the test of fairness.[373] The fairness analysis prepared by the investment bankers was criticized as "hurried" where due diligence was conducted over a weekend and the price was slipped into the opinion by the banking partner (who was also a director of the corporation) after a quick review of the assembled diligence on a plane flight.[374]

(2) In *Macmillan*,[375] the court enjoined defensive measures adopted by the board, including a lock-up and no-shop granted to an acquiror, to hinder competing bids from Mills. The court questioned an investment bank's conclusion that an $80 per share cash offer was inadequate when it had earlier opined that the value of the company was between $72 and $80 per share and faulted the investment bankers, who were retained by and consulted with financially interested management, for lack of independence.[376]

(3) In *Technicolor*,[377] the court faulted the valuation package prepared by the investment bankers because they were given limited access to senior officers and directors of Technicolor.

Often all or part of the investment banker's fee is payable only in the event of success in the transaction. If there is a contingent component in the banker's fee, the Board should recognize the possible effect of that incentive and, if a transaction is ultimately submitted for shareholder vote, include information about the contingent element among the disclosures to shareholders.[378]

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from Morgan Stanley or Merrill Lynch for the business judgment of the board charged with ultimate responsibility for deciding the best interests of shareholders."

371 *Citron*, 569 A.2d at 66 (citation omitted).

372 *Weinberger*, 457 A.2d 701.

373 *Id*. at 715.

374 *Id*. at 712.

375 *Macmillan*, 559 A.2d 1261 (Del. 1988).

376 *Id*. at 1271.

377 *Technicolor*, 634 A.2d 345.

378 In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 2007 WL 582510 (Del. Ch. Feb. 23, 2007) and *Express Scripts, Inc. v. Crawford*, 2007 WL 707550 (Del. Ch. Feb. 23, 2007), the Court of Chancery held that a postponement of the stockholder vote was necessary to provide the target stockholders with additional disclosure that the major part of the financial advisors' fee was contingent upon the consummation of a transaction by target with its merger partner or a third party. The target's proxy statement disclosure was found misleading because it did not clearly state that its financial advisors were entitled to the fee only if the initial merger was approved. The Court concluded that disclosure of these financial incentives to the financial advisors was material to the stockholder deliberations on the merger.

b. Value of Independent Directors, Special Committees.

One of the first tasks of counsel in a takeover context is to assess the independence of the Board.[379] In a sale of control transaction, "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial."[380] As pointed out by the Delaware Supreme Court in *Unocal*, when enhanced scrutiny is applied by the court, "proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted [in good faith and after a reasonable investigation]."[381]

(1) *Characteristics of an Independent Director*. An independent director has been defined as a non-employee and non-management director.[382] To be effective, outside directors cannot be dominated by financially interested members of management or a controlling stockholder.[383] Care should also be taken to restrict the influence of other interested directors, which may include recusal of interested directors from participation in certain board deliberations.[384]

(2) *Need for Active Participation*. Active participation of the independent members of the board is important in demonstrating that the Board did not simply follow management. In *Time*,[385] the Delaware Supreme Court considered Time's actions in recasting its previously negotiated merger with Warner into an outright cash and securities acquisition of Warner financed with significant debt to ward off Paramount's surprise all-cash offer to acquire Time. Beginning immediately after Paramount announced its bid, the Time board met repeatedly to discuss the bid, determined the merger with Warner to be a better course of action, and declined to open negotiations with Paramount. The outside directors met independently, and the Board sought advice from corporate counsel and financial advisors. Through this process the Board reached its decision to restructure the combination with Warner. The Court viewed favorably the participation of certain of the Board's 12 independent directors in the analysis of Paramount's bid. The Time Board's process contrasts with *Van Gorkom*, where although one-half of Trans Union's Board was independent, an absence of any inquiry by those directors as to the basis of management's analysis and no review of the transaction documents contributed to the court's finding that the board was grossly negligent in its decision to approve a merger.[386]

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379 *See, e.g., Kahn v. MSB Bancorp, Inc.*, 1998 WL 409355, at *3 (Del. Ch. 1998), *aff'd* 734 A.2d 158 (Del. 1999) ("[T]he fact that nine of the ten directors are not employed by MSB, but are outside directors, strengthens the presumption of good faith.")

380 *QVC*, 637 A.2d at 44; *see also Macmillan*, 559 A.2d 1261.

381 *Unocal*, 493 A.2d at 955.

382 *Unitrin*, 651 A.2d at 1375; *see supra* notes 145-160 and related text.

383 *See Macmillan*, 559 A.2d at 1266.

384 *See Technicolor*, 634 A.2d at 366 n.35. *See also Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (in evaluating charge that directors breached fiduciary duties in approving employment and subsequent severance of a corporation's president, the Delaware Supreme Court held that the "issues of disinterestedness and independence" turn on whether the directors were "incapable, due to personal interest or domination and control, of objectively evaluating" an action).

385 571 A.2d 1140 (Del. 1989).

386 *See also Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997), where the Delaware Supreme Court found that the three member special committee of outside directors was not fully informed, not active, and did not appropriately

(3) *Use of Special Committee.* When directors or shareholders with fiduciary obligations have a conflict of interest with respect to a proposed transaction, the use of a special committee is recommended. A special committee is also recommended where there is the potential for a conflict to develop.[387] Accordingly, use of a special committee should be considered in connection with any going-private transaction (i.e., management buy-outs or squeeze-out mergers), asset sales or acquisitions involving entities controlled by or affiliated with directors or controlling shareholders, or any other transactions with majority or controlling shareholders.[388] If a majority of the Board is disinterested and independent with respect to a proposed transaction (other than a freeze out merger proposal by a controlling stockholder), a special committee may not be necessary, since the Board's decision will be accorded deference under the business judgment rule (assuming, of course, that the disinterested directors are not dominated or otherwise controlled by the interested party(ies)). In that circumstance, the disinterested directors may act on behalf of the company and the interested directors should abstain from deliberating and voting on the proposed transaction.[389]

Although there is no legal requirement under Delaware law that an interested Board make use of a special committee, the Delaware courts have indicated that the absence of such a committee in connection with an affiliate or conflict transaction may evidence the transaction's unfairness (or other procedural safeguards, such as a majority of mino`rity vote requirement).[390]

(i) Formation of the Committee

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simulate an arm's-length transaction, given that two of the three members permitted the other member to perform the committee's essential functions and one of the committee members did not attend a single meeting of the committee.

387 *See In re Western National Corp. Shareholders Litig.*, 2000 WL 710192 at *26 (Del. Ch. May 22, 2000)(use of special committee where the transaction involved a 46% stockholder; court ultimately held that because the 46% stockholder was not a controlling stockholder, the business judgment rule would apply: "[w]ith the aid of its expert advisors, the Committee apprised itself of all reasonably available information, negotiated ... at arm's length and, ultimately, determined that the merger transaction was in the interests of the Company and its public shareholders.").

388 *See In re Digex, Inc. Shareholders Litig.*, 789 A.2d 1176 (Del. Ch. 2000) (special committee of a company with a controlling corporate shareholder formed to consider potential acquisition offers); *Kohls v. Duthie*, 765 A.2d 1274, 1285 (Del. Ch. 2000)(special committee formed in connection with a management buyout transaction); *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536 (Del. Ch. 2000) (special committee used to consider shared service agreements among corporation and its chief competitor, both of which were controlled by the same entity); *In re MAXXAM, Inc./Federated Development Shareholders Litig.*, 1997 Del. Ch. LEXIS 51 (Del. Ch. Apr. 4, 1997) (special committee formed to consider a purchase of assets from the controlling stockholder); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990) (majority shareholder purchase of minority shares); *Lynch I* (involving controlling shareholder's offer to purchase publicly held shares); *In re Resorts International Shareholders Litig.*, 570 A.2d 259 (Del. 1990) (special committee used to evaluate controlling shareholder's tender offer and competing tender offer); *Kahn v. Sullivan*, 594 A.2d 48, 53 (Del. 1991) (special committee formed to evaluate corporation's charitable gift to entity affiliated with the company's chairman and CEO); *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *18-19 (Del. Ch. March 29, 1996) (special committee formed to consider management LBO); *Kahn v. Roberts*, 679 A.2d 460, 465 (Del. 1996) (special committee formed to evaluate stock repurchase from 33% shareholder).

389 *See* DGCL § 144 (providing that interested director transactions will not be void or voidable solely due to the existence of the conflict if certain safeguards are utilized, including approval by a majority of the disinterested directors, assuming full disclosure).

390 *See Seagraves v. Urstady Property Co.*, 1996 Del. Ch. LEXIS 36, at *16 (Del. Ch. Apr. 1, 1996) (failure to use a special committee or other procedural safeguards "evidences the absence of fair dealing"); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) (lack of independent committee is pertinent factor in assessing whether fairness was accorded to the minority); *Boyer v. Wilmington Materials, Inc.*, 1997 Del. Ch. LEXIS 97, at *20 (Del. Ch. June 27, 1997) (lack of special committee is an important factor in a court's "overall assessment of whether a transaction was fair").

Where a majority of the Board is disinterested, a special committee may be useful if there are reasons to isolate the deliberations of the noninterested directors.[391] Where a majority of the directors have some real or perceived conflict, however, and in the absence of any other procedural safeguards, the formation of a special committee is critical. Ideally, the special committee should be formed prior to the first series of negotiations of a proposed transaction, or immediately upon receipt of an unsolicited merger or acquisition proposal. Formation at a later stage is acceptable, however, if the special committee is still capable of influencing and ultimately rejecting the proposed transaction.[392] As a general rule, however, the special committee should be formed whenever the conflicts of fellow directors become apparent in light of a proposed or contemplated transaction. To the extent possible, however, the controlling stockholder or the CEO, if interested, should not select, or influence the selection of, the members of the special committee or its chairperson.[393]

(ii) Independence and Disinterestedness

In selecting the members of a special committee, care should be taken to ensure not only that the members have no financial interest in the transaction, but that they have no financial ties, or are otherwise beholden, to any person or entity involved in the transaction.[394] In other words, all committee members should be independent and disinterested. To be disinterested, the member cannot derive any personal (primarily financial) benefit from the transaction not shared by the stockholders.[395] To be independent, the member's decisions must be "based on the corporate

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391 *See Spiegal v. Buntrock*, 571 A.2d 767, 776 n.18 (Del. 1990) ("Even when a majority of a board of directors is independent, one advantage of establishing a special negotiating committee is to isolate the interested directors from material information during either the investigative or decisional process"); *Moore Business Forms, Inc. v. Cordant Holdings Corp.*, 1996 Del. Ch. LEXIS 56, at *18-19 (Del. Ch. June 4, 1996) (recommending use of a special committee to prevent shareholder's board designee's access to privileged information regarding possible repurchase of shareholder's preferred stock; "the special committee would have been free to retain separate legal counsel, and its communications with that counsel would have been properly protected from disclosure to [the shareholder] and its director designee"); *Kohls v. Duthie*, 765 A.2d at 1285 (forming a special committee to isolate the negotiations of the noninterested directors from one director that would participate in a management buyout).

392 *See In re SS&C Technologies, Inc. Shareholder Litigation*, 911 A.2d 816 (Del. Ch. 2006), a case in which the settlement of litigation challenging a management led cash-out merger was disapproved in part because he Court was concerned that the buyer's proposal was solicited by the CEO without prior Board approval as part of informal "test the waters" process to find a buyer who would pay a meaningful premium while allowing the CEO to make significant investment in the acquisition vehicle and continue managing the target. After being satisfied with the buyer's proposal but before all details had been negotiated, the CEO advised the Board about the deal. The Board then formed special committee that hired independent legal and financial advisers and embarked on a program to solicit other buyers, but the Court was concerned that this process was perhaps too late to affect outcome. The Court expressed concern whether the CEO had misused confidential information and resources of corporation in talking to his selected buyer and engaging an investment banker before Board approval and whether the CEO's precommitment to a deal with the buyer and his conflicts (i.e., receiving cash plus an interest in the acquisition vehicle and continuing management role) prevented the Board from considering whether a sale should take place and, if so, to negotiating the best terms reasonably available. *See infra* note 660 and related text.

393 *See Macmillan*, 559 A.2d at 1267 (in case where special committee had no burden-shifting effect, court noted that the interested CEO "hand picked" the members of the committee); *In re Fort Howard Corp. Shareholders Litig.*, 1988 WL 83147 (Del. Ch. 1988) ("It cannot ... be the best practice to have the interested CEO in effect handpick the members of the Special Committee as was, I am satisfied, done here.").

394 *See Katell v. Morgan Stanley Group, Inc.*, 1995 Del. Ch. LEXIS 76, at * 21, Fed. Sec. L. Rep. (CCH) 98861 (Del. Ch. June 15, 1995) ("[w]hen a special committee's members have no personal interest in the disputed transactions, this Court scrutinizes the members' relationship with the interested directors"); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 Bus. Law. 2065, 2079 ("the members of the committee should not have unusually close personal or business relations with the conflicted directors").

395 *Pogostin v. Rice*, 480 A.2d 619, 624, 627 (Del. 1984) (overruled as to standard of appellate review).

merits of the subject before the [committee] rather than extraneous considerations or influences."[396] To establish non-independence, a plaintiff has to show that the committee members were "beholden" to the conflicted party or "so under [the conflicted party's] influence that their discretion would be sterilized."[397] In a recent case in which committee members appeared to abdicate their responsibilities to another member "whose independence was most suspect," the Delaware Supreme Court reemphasized that:

> "[i]t is the care, attention and sense of individual responsibility to the performance of one's duties...that generally touches on independence."[398]

If a committee member votes to approve a transaction to appease the interested director/shareholder, to stay in the interested party's good graces, or because he/she is beholden to the interested party for the continued receipt of consulting fees or other payments, such committee member will not be viewed as independent.[399]

(iii) Selection of Legal and Financial Advisors

Although there is no legal requirement that a special committee retain legal and financial advisors, it is highly advisable that the committee retain advisors to help them carry out their duties.[400] The selection of advisors, however, may influence a court's determinations of the independence of the committee and the effectiveness of the process.[401]

Selection of advisors should be made by the committee after its formation. Although the special committee may rely on the company's professional advisors, perception of the special committee's independence is enhanced by the separate retention of advisors who have no prior

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396 *Aronson*, 473 A.2d at 816; *In re MAXXAM, Inc./Federated Development Shareholders Litig.*, 659 A.2d 760, 773 (Del. Ch. 1995) ("To be considered independent, a director must not be 'dominated or controlled by an individual or entity interested in the transaction.'") (*citing Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988) (overruled as to standard of appellate review). *See also Grimes v. Donald*, 673 A.2d 1207, 1219 n.25 (Del. 1996) (parenthetically describing *Lynch I* as a case in which the "'independent committee' of the board did not act independently when it succumbed to threat of controlling stockholder") (overruled as to standard of appellate review).

397 *MAXXAM*, 659 A.2d at 773 (*quoting Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

398 *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (Del. 1997) (citing *Aronson*, 473 A.2d at 816).

399 *Rales*, 634 A.2d at 936-37; *MAXXAM, Inc./Federated Development Shareholders Litig.*, 1997 Del. Ch. LEXIS 51, at *66-71 (Del. Ch. Apr. 4, 1997) (special committee members would not be considered independent due to their receipt of consulting fees or other compensation from entities controlled by the shareholder who controlled the company); *Kahn v. Tremont Corp.*, 694 A.2d at 429-30 (holding that special committee "did not function independently" because the members had "previous affiliations with [an indirect controlling shareholder, Simmons,] or companies which he controlled and, as a result, received significant financial compensation or influential positions on the boards of Simmons' controlled companies."); *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *18-19 (noting that the special committee member was also a paid consultant for the corporation, raising concerns that he was beholden to the controlling shareholder).

400 *See*, *e.g.*, *Strassburger v. Earley*, 752 A.2d 557, 567 (Del. Ch. 2000)(court criticizing a one-man special committee and finding it ineffective in part because it had not been "advised by independent legal counsel or even an experienced investment banking firm").

401 *See Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *22 n.6 (a "critical factor in assessing the reliability and independence of the process employed by a special committee, is the committee's financial and legal advisors and how they were selected"); *In re Fort Howard Corp. Shareholders Litig.*, 1988 WL 83147 (Del. Ch. 1988) ("no role is more critical with respect to protection of shareholder interests in these matters than that of the expert lawyers who guide sometimes inexperienced [committee members] through the process"). *See infra* note 424 and related text.

affiliation with the company or interested parties.[402] Accordingly, the special committee should take time to ensure that its professional advisors have no prior or current, direct or indirect, material affiliations with interested parties.

Retention of legal and financial advisors by the special committee also enhances its ability to be fully informed. Because of the short time-frame of many of today's transactions, professional advisors allow the committee to assimilate large amounts of information more quickly and effectively than the committee could without advisors. Having advisors that can efficiently process and condense information is important where the committee is asked to evaluate proposals or competing proposals within days of their making.[403] Finally, a court will give some deference to the committee's selection of advisors where there is no indication that they were retained for an "improper purpose."[404]

(iv) The Special Committee's Charge: "Real Bargaining Power"

From a litigation standpoint, one of the most important documents when defending a transaction that has utilized a special committee is the board resolution authorizing the special committee and describing the scope of its authority.[405] Obviously, if the board has materially limited the special committee's authority, the work of the special committee will not be given great deference in litigation since the conflicted board will be viewed as having retained ultimate control over the process.[406] Where, however, the special committee is given broad authority and permitted to negotiate the best possible transaction, the special committee's work and business decisions will be accorded substantial deference.[407]

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402 *See, e.g., Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d at 494 (noting that to insure a completely independent review of a majority stockholder's proposal the independent committee retained its own independent counsel rather than allowing management of the company to retain counsel on its behalf); *cf. In re Fort Howard*, 1988 WL 83147 (Del. Ch. 1988) (noting that the interested CEO had selected the committee's legal counsel; "[a] suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary"); *Macmillan*, 559 A.2d at 1267-68 (noting that conflicted management, in connection with an MBO transaction, had "intensive contact" with a financial advisor that subsequently was selected by management to advise the special committee).

403 S*ee, e.g., In re KDI Corp. Shareholders Litig.*, 1990 Del. Ch. LEXIS 201, at *10, Fed. Sec. L. Rep. (CCH) 95727 (Del. Ch. Dec. 13, 1990) (noting that special committee's financial advisor contacted approximately 100 potential purchasers in addition to evaluating fairness of management's proposal).

404 *See Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001) (court brushing aside criticism of choice of local banker where there was valid business reasons for the selection).

405 *See, e.g., In re Digex, Inc. Shareholders Litig.*, 789 A.2d 1176 (Del. Ch. 2000) (quoting board resolution which described the special committee's role); *Strassburger*, 752 A.2d at 567 (quoting the board resolution authorizing the special committee); *Kahn v. Sullivan*, 594 A.2d at 53 (quoting in full the board resolutions creating the special committee and describing its authority).

406 *See*, *e.g.*, *Strassburger*, 752 A.2d at 571 (court noting that the "narrow scope" of the committee's assignment was "highly significant" to its finding that the committee was ineffective and would not shift the burden of proof).

407 *Compare Kohls v. Duthie*, 765 A.2d at 1285 (noting the bargaining power, active negotiations and frequent meetings of the special committee and concluding that the special committee process was effective and that defendants would likely prevail at a final hearing) *with International Telecharge, Inc. v. Bomarko, Inc.*, 766 A.2d 437 (Del. 2000) (affirming the trial court's application of the entire fairness standard where the special committee was misinformed and did not engage in meaningful negotiations).

The requisite power of a special committee was addressed initially in *Rabkin v. Olin Corp.*[408] In *Rabkin*, the court noted that the "mere existence of an independent special committee" does not itself shift the burden of proof with respect to the entire fairness standard of review. Rather, the court stated that at least two factors are required:

> First, the majority shareholder must not dictate the terms of the merger. Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis. The Hunt special committee was given the narrow mandate of determining the monetary fairness of a non-negotiable offer. [The majority shareholder] dictated the terms of the merger and there were no arm's length negotiations. Unanimous approval by the apparently independent Hunt board suffers from the same infirmities as the special committee. The ultimate burden of showing by a preponderance of the evidence that the merger was entirely fair thus remains with the defendants.[409]

Even when a committee is active, aggressive and informed, its approval of a transaction will not shift the entire fairness burden of persuasion unless the committee is free to reject the proposed transaction.[410] As the court emphasized in *Lynch I*:

> The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price.[411]

Accordingly, unless the interested party can demonstrate it has "replicated a process 'as though each of the contending parties had in fact exerted its bargaining power at arm's length,' the burden of proving entire fairness will not shift."[412]

Importantly, if there is any change in the responsibilities of the committee due to, for example, changed circumstances, the authorizing resolution should be amended or otherwise supplemented to reflect the new charge.[413]

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408 1990 Del. Ch. LEXIS 50, at *18, Fed. Sec. L. Rep. (CCH) 95255 (Del. Ch. Apr. 17, 1990), *reprinted in* 16 Del. J. Corp. L. 851 (1991), *aff'd*, 586 A.2d 1202 (Del. 1990) (*"Rabkin"*).

409 *Rabkin*, 1990 Del. Ch. LEXIS 50, at *18-19 (citations omitted); *see also Kahn v. Lynch Comm. Systems, Inc.*, 669 A.2d 79, 82-83 (Del. 1995) (*"Lynch II"*) (noting the Supreme Court's approval of the *Rabkin* two-part test).

410 *Kahn v. Lynch Comm. Systems, Inc.*, 638 A.2d at 1120-21 (*"Lynch I"*) ("[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length"); *see also In re First Boston, Inc. Shareholders Litig.*, 1990 Del. Ch. LEXIS 74, at *20, Fed. Sec. L. Rep. (CCH) 95322 (Del. Ch. June 7, 1990) (holding that although special committee's options were limited, it retained "the critical power: the power to say no").

411 *Lynch I*, 638 A.2d at 1119 (*quoting In re First Boston, Inc. Shareholders Litig.*, 1990 Del. Ch. LEXIS 74, at *20-21, Fed. Sec. L. Rep. (CCH) 95322 (Del. Ch. June 7, 1990)).

412 *Lynch I*, 638 A.2d at 1121 (*quoting Weinberger*, 457 A.2d at 709-710 n.7). *See also In re Digex, Inc. Shareholders Litig.*, 789 A.2d 1176 (Del. Ch. 2000) (inability of special committee to exercise real bargaining power concerning Section 203 issues is fatal to the process).

(v) Informed and Active

A committee with real bargaining power will not cause the burden of persuasion to shift unless the committee exercises that power in an informed and active manner.[414] The concepts of being active and being informed are interrelated. An informed committee will almost necessarily be active and vice versa.[415]

To be informed, the committee necessarily must be knowledgeable with respect to the company's business and advised of, or involved in, ongoing negotiations. To be active, the committee members should be involved in the negotiations or at least communicating frequently with the designated negotiator. In addition, the members should meet frequently with their independent advisors so that they can acquire "critical knowledge of essential aspects of the [transaction]."[416]

Committee members need to rely upon, interact with, and challenge their financial and legal advisors. While reliance is often important and necessary, the committee should not allow an advisor to assume the role of ultimate decision-maker. For example, in *In re Trans World Airlines, Inc. Shareholders Litig.*, the court determined, in connection with a preliminary injunction application, that substantial questions were raised as to the effectiveness of a special committee where the committee misunderstood its role and "relied almost completely upon the efforts of [its financial advisor], both with respect to the evaluation of the fairness of the price offered and with respect to such negotiations as occurred."[417]

Similarly, in *Mills Acquisition Co. v. MacMillan, Inc.*,[418] the court criticized the independent directors for failing to diligently oversee an auction process conducted by the company's investment advisor that indirectly involved members of management. In this regard, the court stated:

> Without board planning and oversight to insulate the self-interested management from improper access to the bidding process, and to ensure the proper conduct of the auction by truly independent advisors selected by, and answerable only to, the

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413 *See, e.g., In re Resorts International Shareholders Litig.*, 570 A.2d 259 (Del. 1990) (where special committee initially considered controlling shareholder's tender offer and subsequently a competing tender offer and proposed settlements of litigation resulting from offers); *Lynch I*, 638 A.2d at 1113 (noting that the board "revised the mandate of the Independent Committee" in light of tender offer by controlling stockholder).

414 *See*, *e.g.*, *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *7 (Del. Ch. March 29, 1996) (despite being advised that its duty was "to seek the best result for the shareholders, the committee never negotiated for a price higher than $15"); *Strassburger*, 752 A.2d at 567 (finding a special committee ineffective where it did not engage in negotiations and "did not consider all information highly relevant to [the] assignment"); *Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001) (court criticizing a special committee for failing to fully understand the scope of the committee's assignment).

415 *Kahn v. Tremont Corp.*, 694 A.2d at 430.

416 *Id.* at 429-430 (committee member's "absence from all meetings with advisors or fellow committee members, rendered him ill-suited as a defender of the interests of minority shareholders in the dynamics of fast moving negotiations"). *See also Macmillan*, 559 A.2d at 1268 n.9 (in case where special committee had no burden-shifting effect, court noted that one committee member "failed to attend a single meeting of the Committee"); *Strassburger*, 752 A.2d at 557 (finding an ineffective committee where its sole member did not engage in negotiations and had less than complete information).

417 1988 Del. Ch. LEXIS 139, at *12, *22 (Del. Ch. Oct. 21, 1988) *reprinted in* 14 Del. J. Corp. L. 870 (1989).

418 559 A.2d at 1281.

independent directors, the legal complications which a challenged transaction faces under [enhanced judicial scrutiny] are unnecessarily intensified.[419]

c. Significant Recent Process Cases.

(1) *In re Tele-Communications, Inc. Shareholders Litig.*,[420] the Chancery Court denied defendants motion for summary judgment on several claims arising out of the 1999 merger of Tele-Communications, Inc. ("*TCI*") with AT&T Corp in large part because the defendants failed to adequately show that a special committee of the TCI board of directors formed to consider the merger proposal was truly independent, fully informed and had the freedom to negotiate at arm's length in a manner sufficient to shift the burden of proving entire fairness of a transaction providing a premium to a class or series of high-vote stock over a class or series of low-vote stock. Citing *FLS Holdings*[421] and *Reader's Digest*,[422] the Chancery Court in *Tele-Communications* found that entire fairness should apply because "a clear and significant benefit . . . accrued primarily . . . to directors controlling a large vote of the corporation, at the expense of another class of shareholders to whom was owed a fiduciary duty."[423] Alternatively, the Court concluded that a majority of the TCI directors were interested in the transaction because they each received a material benefit from the premium accorded to the high vote shares.

In reaching the decision that the defendants failed to demonstrate fair dealing and fair price, the Chancery Court found, based on a review of the evidence in a light most favorable to the plaintiffs, the following special committee process flaws:

- *The Choice of Special Committee Directors*. The special committee consisted of two directors, one of whom held high vote shares and gained an additional $1.4 million as result of the premium paid on those shares, to serve on the special committee. This flaw appears to be of particular importance to the Court's decision and contributed to the other flaws in the committee process.

- *The Lack of a Clear Mandate*. One committee member believed the special committee's job was to represent the interests of the holders of the low vote shares, while the other

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419 *Id.* at 1282.

420 C.A. No. 16470-CC (Del. Ch. Dec. 21, 2005, revised January 10, 2006).

421 *In re FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562 (Del. Ch. Apr. 21, 1993).

422 *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc.*, 803 A.2d 428 (Del. 2002).

423 C.A. No. 16470-CC (Del. Ch. Dec. 21, 2005, revised January 10, 2006); *In re LNR Property Corp. Shareholder Litigation* (Del. Ch., Con. C.A. No. 674-N, November 4, 2005), in which the Chancery Court held that minority shareholders who were cashed out in a merger negotiated by the controlling shareholder – who also ended up with a 20 percent stake in the purchaser – stated allegations sufficient to warrant application of the entire-fairness standard of review and wrote: "When a controlling shareholder stands on both sides of a transaction, he or she is required to demonstrate his or her utmost good faith and most scrupulous inherent fairness of the bargain." The shareholders further alleged that LNR's board of directors breached its fiduciary duties by allowing the controlling stockholder and the CEO, who had "obvious and disabling conflicts of interest," to negotiate the deal. Although the board formed a special independent committee to consider the deal, plaintiffs alleged, the committee was a "sham" because it was "dominated and controlled" by the controlling stockholder and the CEO, and was not permitted to negotiate with the buyer or seek other deals. Additionally, the shareholders claimed that the committee failed to get an independent evaluation of the deal, but relied on a financial advisor that worked with the controlling stockholder and the CEO to negotiate the deal, and that stood to gain an $11 million commission when the transaction was completed.

member believed the special committee's job was to protect the interests of all of the stockholders.

- *The Choice of Advisors*. The special committee did not retain separate legal and financial advisors, and chose to use the TCI advisors. Moreover, the Court criticized the contingent nature of the fee paid to the financial advisors, which amounted to approximately $40 million, finding that such a fee created "a serious issue of material fact, as to whether [the financial advisors] could provide independent advice to the Special Committee." While it agreed with TCI's assertion that TCI had no interest in paying advisor fees absent a deal, the Court wrote:

> A special committee does have an interest in bearing the upfront cost of an independent and objective financial advisor. A contingently paid and possibly interested financial advisor might be more convenient and cheaper absent a deal, but its potentially misguided recommendations could result in even higher costs to the special committee's shareholder constituency in the event a deal was consummated.

Since the advisors were hired to advise TCI in connection with the transaction, a question arises as to whether the Court's concerns about the contingent nature of the fee would have been mitigated if a special committee comprised of clearly disinterested and independent directors hired independent advisors and agreed to a contingent fee that created appropriate incentives.

- *Diligence of Research and Fairness Opinion.* The special committee lacked complete information about the premium at which the high vote shares historically traded and precedent transactions involving high vote stocks. The Court noted that the plaintiffs had presented evidence that showed that the high vote shares had traded at a 10% premium or more only for "a single five-trading day interval." The Court did not find it persuasive that the financial advisor supported the payment of the premium by reference to a call option agreement between the TCI CEO and TCI that allowed TCI to purchase the TCI CEO's high vote shares for a 10% premium, expressing concern about the arm's length nature of that transaction. The Court stated that the special committee should have asked the financial advisor for more information about the precedent transactions, including information concerning the prevalence of the payment of a premium to high-vote stock over low-vote stock. By contrast, the Court noted that the plaintiffs had presented evidence suggesting that a significantly higher number of precedent transactions provided no premium for high-vote stock, and neither the special committee nor its financial advisors considered the fairness of the 10% premium paid on the high vote shares:

> In the present transaction, the Special Committee failed to examine, and [its financial advisors] failed to opine upon, the fairness of the [high vote] premium to the [low vote] holders. [The financial advisors] provided only separate analyses of the fairness of the respective exchange ratios to each corresponding class. The [*Reader's Digest*] Court mandated more than separate analyses that blindly ignore the preferences another class might

> be receiving, and with good intuitive reason: such a doctrine of separate analyses would have allowed a fairness opinion in our case even if the [high vote] holders enjoyed a 110% premium over the [low vote] holders, as long as the [low vote] holders enjoyed a thirty-seven percent premium over the market price. Entire fairness requires an examination of the fairness of such exorbitant premiums to the prices received by the [low vote] holders. This is not to say that the premium received by the [low vote] holders is irrelevant—obviously, it must be balanced with the fairness and magnitude of the 10% [high vote] premium.

- *Result is Lack of Arm's Length Bargaining*. All of the above factors led to a flawed special committee process that created an "inhospitable" environment for arm's length bargaining. The Court found that the unclear mandate, the unspecified compensation plan and the special committee's lack of information regarding historical trading prices of the high vote shares and the precedent merger transactions were relevant to concluding that the process did not result in arm's length bargaining.

(2) In *Gesoff v. IIC Indus. Inc.*,[424] the Court of Chancery made clear that in evaluating whether a going private transaction is entirely fair (or whether the burden of proving entire fairness should be shifted to the plaintiff), it will examine the composition of, and the process undertaken by, an independent committee closely for indicators of fairness. In *Gesoff*, the board of CP Holdings Limited ("*CP*"), an English holding company owning approximately 80% of IIC Industries Inc. ("*IIC*"), determined IIC should be taken private by way of a tender offer followed by a short-form merger. The IIC board appointed a special committee consisting of one member, and formally authorized him to present a recommendation to the IIC board as to the CP tender offer. After some review, the one-person committee approved the tender offer transaction, but the tender offer ultimately failed to provide CP with 90% of the outstanding stock, and CP thereafter instituted a long-form merger. Although no new fairness opinion was sought for the long-form merger, the special committee member supported the transaction. Following the consummation of the transaction, minority stockholders sued, claiming the transaction was not entirely fair and also seeking appraisal.

The Chancery Court evaluated the formation and actions of the special committee to determine whether the process taken with regard to the tender offer and merger was entirely fair. The Chancery Court stated that members of such a committee must be independent and willing to perform their job throughout the entire negotiation, and further indicated that committees should typically be composed of more than one director.

The Chancery Court also reiterated the importance of a committee's mandate, stating that a committee should have a clear understanding of its duties and powers, and should be given the power not only to fully evaluate the transaction, but also to say "no" to the transaction. Although the language of the resolution granting the committee member power in this case was fairly broad (he was given the authority to appoint outside auditors and counsel, and was further authorized to spend up to $100,000 for a fairness opinion), the Chancery Court stated that the

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[424] C.A. Nos. 19473, 19600 (Del. Ch. May 18, 2006)

evidence indicated that his authority was closely circumscribed and that he was deeply confused regarding the structure of the transaction.

The Chancery Court was also critical of the committee's choice of financial and legal advisors, as these advisors were essentially handpicked by CP and the conflicted IIC board. The committee member accepted the appointment of a lawyer recommended by CP management who also served as IIC's outside counsel, was beholden for his job to a board dominated by CP, and had been advising CP on the tender offer. The Chancery Court stated that no reasonable observer would have believed that this attorney was appropriate independent counsel.

Evidence at trial showed that the investment bank retained by the independent committee pitched itself to the committee member prior to his receipt of authority to hire advisors, and that a member of CP's management (who had a prior relationship with the banker) emailed the banker saying he was close to having the bank "signed up" as an advisor to the committee. The committee member, relying on advice of his conflicted legal counsel, then appointed the banker without speaking to any other candidates for the position. Moreover, throughout negotiations, the banker kept CP informed of all of the committee's private valuations, essentially giving the company the upper hand in negotiations. The Chancery Court was also particularly troubled by an email between the committee's lawyer and banker and CP's management describing an orchestrated negotiation process that foreshadowed the negotiation structure that eventually occurred, and found this to be clear evidence that the negotiations were constructed by CP and were thus not at arm's-length.

Having found the process unfair, the Chancery Court then determined that the price paid was also unfair, but found that the committee member was protected by the limitation of liability provision found in IIC's charter (as permitted by DGCL § 102(b)(7).

(3) The importance of procedural safeguards was again emphasized in *Oliver v. Boston University*,[425] and in particular, the Court of Chancery focused on the lack of a representative for the minority stockholders in merger negotiations. Boston University ("*BU*") was the controlling stockholder of Seragen, Inc. ("*Seragen*"), a financially troubled biotechnology company. After going public in 1992, Seragen entered into a number of transactions in order to address its desperate need for capital, and eventually agreed to a merger with Ligand Pharmaceuticals, Inc. ("*Ligand*"). A group of minority stockholders brought a series of claims challenging the transactions preceding the merger and the process by which the merger proceeds were allocated to the respective classes.

The Chancery Court discussed whether the potential derivative claims arising from various transactions preceding the merger were properly valued by the defendants in merger negotiations. Noting that Seragen's board effectively ignored these claims and that the negotiations and approval of these transactions were procedurally flawed because no safeguards were employed to protect the minority, the Court nonetheless found that these potential claims had no actual value.

[425] C.A. No. 16570 (Del. Ch. Apr. 14, 2006)

The Chancery Court then turned to whether the allocation of merger proceeds was entirely fair, focusing on the company's failure to take steps to protect the minority, and stated:

> The Director Defendants treated the merger allocation negotiations with a surprising degree of informality, and, as with many of Seragen's transactions reviewed here, no steps were taken to ensure fairness to the minority common shareholders. More disturbing is that, although representatives of all of the priority stakeholders were involved to some degree in the negotiations, no representative negotiated on behalf of the minority common shareholders.… Clearly the process implementing these negotiations was severely flawed and no person acted to protect the interests of the minority common shareholders.

Although the derivative claims had been found to have no value, the Chancery Court held that the allocation of merger proceeds was unfair due to both the lack of procedures to ensure its fairness and because the price was also found to be unfair. After so holding, the Chancery Court went on to dispose of the plaintiffs' disclosure, voting power dilution, and aiding and abetting claims.

(4) In *Ryan v. Lyondell Chemical Company*,[426] Vice Chancellor Noble emphasized that *Revlon*[427] requires robust Board involvement in sale of control transactions to confirm that, even at arguably a "blowout" market premium,[428] the stockholders are getting the best price reasonably available. In *Lyondell* ten of eleven directors were disinterested and independent (the CEO was the other director). In partially denying the target director-defendants' motion for summary judgment, the Court determined that genuine issues of material fact existed as to (1) whether the independent directors engaged in a satisfactory sale process to acquire the highest available value for stockholders as required by *Revlon* and (2) whether the directors' decision to agree to typical deal protections was reasonable in view of the weakness in the process. In a case reminiscent of *Smith v. Van Gorkom*[429] in that the Board acted quickly on a merger proposal negotiated by an informed CEO without Board involvement, the Court found that the directors' conduct could implicate the good faith component of the duty of loyalty, which would preclude exculpation under Lyondell's DGCL § 102(b)(7) charter provision[430] and could therefore leave the directors exposed to personal liability (and possible monetary damages) for their conduct.

Facts. Basell AF first expressed interest in acquiring Lyondell in April 2006, sending a letter proposing a price of $26.50 to $28.50 per share. At that time, Lyondell was not for sale and

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426 C.A. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008) ("*Lyondell I*") and on denial of certification of interlocutory appeal 2008 WL 4174038 (Del. Ch. August 29, 2008) ("*Lyondell II*"). The Delaware Supreme Court subsequently accepted an interlocutory appeal of *Lyondell*, heard oral arguments on January 14, 2009, but as of January 27, 2009 the Supreme Court had not issued its ruling on the appeal.

427 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). *See supra* notes 327-328 and related text.

428 45% over market on the day before the bidder's interest became known and 20% above the closing price the day before the merger was announced.

429 *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985); *see supra* notes 318, 367 and 368 and related text; *see Bernard S. Sharfman, Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After Van Gorkom*, 62 Bus. Law. 135 (Nov. 2006).

430 *See supra* notes 180-183 and related text.

was in good financial condition. The Board determined that this price was inadequate and that such a transaction would not be in the best interests of Lyondell or its stockholders.

In the spring of 2007, Basell acquired the right to purchase Occidental Petroleum Corporation's approximately 8% stake in Lyondell. A Basell affiliate subsequently filed a Schedule 13D with the SEC, disclosing its right to purchase the shares held by Occidental and Basell's intent to discuss various transactions with Lyondell. The Board met to discuss this development, but even though the Schedule 13D filing may have effectively put Lyondell in play, the Board did not engage an investment banker, endeavor to determine the value of Lyondell or endeavor to determine alternatives that might be available to Lyondell and decided to wait to see if any suitors would appear and how its stockholders would react.

Apollo Management, L.P., a private equity buyer active in the commodity chemicals segment, contacted Lyondell's CEO to test his interest in a management led leveraged buyout transaction. The CEO rejected the overture, viewing such a transaction as fraught with conflicts for management and the Board. No others suitors emerged.

In early June 2007, Lyondell's CEO conducted preliminary negotiations with Basell's CEO where Basell suggested a purchase price of $40 per share and the CEO suggested a willingness to consider a sale of Lyondell at a price of $48 per share. The Board was unaware of these negotiations. Ultimately Basell made an offer of $48 per share contingent on Lyondell signing a merger agreement within a week and agreeing to a $400 million break-up fee. This offer represented a 45% premium over the closing share price on May 10, 2007, the last trading day before public knowledge of Basell's interest in the Company, and a 20% premium over the closing price on the day before the merger was publicly announced.

At a special meeting of the Board on July 10, 2007, the offer was announced and discussed for 50 minutes. At the conclusion of this meeting, the Board asked the CEO to seek a written offer from Basell and recessed discussions until July 11. At the subsequent discussion between the CEO's of Lyondell and Basel, the latter promised a written offer but requested a firm indication of interest from the Board by July 11 because it was considering acquiring another company in the industry. At a 45-minute meeting on July 11, 2007, the Board authorized the CEO to negotiate with Basell on its proposal, but did not seek to participate actively and directly in negotiations. The CEO requested several concessions from Basell, including an increase in the offer price and a go-shop provision, which Basell's CEO vehemently rejected on the ground that he had made Basell's best offer in accordance with the discussions with Lyondell's CEO, although Basell did agree to a reduction in the break-up fee to $385 million (3% of the transaction value and 2% of Lyondell's enterprise value).

At a subsequent Board meeting, the Board obtained legal and financial advice, including a fairness opinion from Deutsche Bank Securities, Inc., which was retained by the Board only after the final terms of the deal had been set. Deutsche Bank opined that the $48 per share price was fair. The Board voted unanimously to approve the merger and to recommend it to the Company's stockholders. The merger was announced on July 17, 2007, seven days after the Board began its review of Basell's offer. At the special meeting held to consider the merger, 99.33% of the Company's stockholders who voted on the matter voted to approve the merger.

<u>Director Option Acceleration Does Not Compromise Director Independence</u>. The Court rejected plaintiff's arguments that the independent members of the Board breached their fiduciary duty of loyalty because they stood to gain financially through the early vesting of their stock options, holding that "the vesting of stock options in connection with a merger does not create a per se impermissible interest in the transaction." Furthermore, the Court noted that directors are considered interested only when they receive a financial interest that is not equally shared by other stockholders. In this case, no such unequal financial interest existed since "accelerated vesting does not confer a special benefit"; on the contrary, stock options are designed to align the interests of the directors with those of the stockholders. Thus, the court granted summary judgment to the defendants on all of the plaintiff's general duty of loyalty claims.

<u>*Revlon* Claims</u>. The plaintiff claimed that the Board failed to adequately fulfill its duty of care under *Revlon* by (1) engaging in a hasty deliberative process that rendered the Board unable to inform itself as to the Company's value or as to the propriety of the transaction, (2) failing to conduct a market check or to shop the Company and (3) agreeing to unreasonable deal protection devices that served to discourage competing bids.

The Court explained that although a board's actions in managing a business are ordinarily protected from post hoc judicial review by the business judgment rule, in cases of sales of control, directors must fulfill their *Revlon* duties, which require a "singular focus on seeking and attaining the highest value available." In evaluating the Board's performance, the Court examines "the adequacy [of the Board's] decision-making process [and its] actions in light of the circumstances then existing." In many cases, a board's *Revlon* duties are fulfilled by active involvement in a contest with multiple bidders. However, in a one-bidder sale process without a canvass of the market, the Board must show that it had reliable evidence, through either experience or a robust prior knowledge of the market, that it had obtained the best price reasonably available or had negotiated for a post-signing market check.[431] A substantial premium over the pre-deal market price and a fairness opinion are no substitute for process.[432]

In this case, the Court found evidence in the record to suggest that the Board was sophisticated and generally aware of Lyondell's value. This knowledge stemmed from the Board's routine briefings on the Company's financial outlook, its relatively recent negotiations

[431] *See* discussion of *Barkan* in *infra* notes 488-493 and related text.

[432] The Vice Chancellor emphasized that a premium over the pre-deal market price and a fairness opinion are no substitute for process in determining whether directors have fulfilled their *Revlon* duties to seek the best price reasonably available:

> The directors have not suggested that they did not understand that the well-settled value maximization principles of *Revlon* and its progeny would govern the discharge of their fiduciary obligations in this context. Implicit in their flogging of the premium price that happened to land in their laps in July 2007, however, is the directors' apparent belief that they should be relieved of those obligations based upon their disinterest, a premium price, a fairness opinion, and the mere passage of time after the deal is announced. In the case of a board, such as this, that has no "traditional" loyalty conflicts (e.g., improper motive or impermissible pecuniary interest) that argument may have considerable appeal, but that is not the present state of our law. As the Court reads our *Revlon* jurisprudence and understands the principles of a fiduciary relationship, the directors' obligations in connection with a sale of the corporate enterprise do not ebb and flow on the fortuities of an offered deal premium and the ability to secure an expensive fairness opinion that (Quelle surprise!) concludes that the offer is "fair" to the shareholders. *Lyondell II* slip opinion p. 4 note 12.

for the purchase of its refining joint venture, its awareness of the private equity group Apollo Management, L.P.'s negotiations with other companies in the industry, and its knowledge of the position of other players and potential buyers in the market.

However, the Court faulted the Board for the speed with which the deal was negotiated, vetted and signed. The Board's decision-making process occurred over the course of seven days, with six to seven hours devoted to discussing the deal and half of that time devoted to discussing the final terms of the merger agreement and obtaining Board approval. The Court noted that, perhaps because the CEO had engaged in most of his negotiations with Basell without the Board's knowledge, the Board itself did not actually negotiate on the proposal nor did it actively participate in the sale process. The Court also criticized the Board for not involving a financial advisor until after the terms had been agreed upon. In sum, the Court found that despite a likelihood that the Board was sufficiently abreast of the market and was therefore sufficiently certain that it was obtaining a reasonable price and that no other suitors would emerge, as an issue for summary judgment, the process utilized by the Board did not inspire sufficient confidence that the Board had adequately considered all of the alternatives available to the Company.

Ultimately, although the Board may have had sufficient market knowledge and experience to avail itself of the one-bidder strategy, in the execution, the Board was possibly too removed from the process and too hasty in its decision-making to eliminate any genuine issue of material fact as to the fulfillment of its *Revlon* duties.

<u>Deal Protection Measures</u>. The merger agreement contained typical deal protection measures, including a $385 million break-up fee (3% of the transaction value and 2% of Lyondell's enterprise value), a no-shop clause with the requisite fiduciary out, matching rights for Basell, and a carve-out amendment to Lyondell's poison pill to permit the merger. While acknowledging that these measures were perhaps not objectionable standing alone, plaintiff argued that in the aggregate they precluded other bids for Lyondell.

Although it found that the deal protections in this case were not atypical, the Court questioned whether the Board was reasonable in tying its hands with such restrictive deal protections in light of the fact that the deal had not been adequately vetted in the pre-signing stage. Interestingly, the Court distinguished between a "fiduciary out" provision where other suitors approach the Company of their own accord and a "go-shop" provision where the Company could proactively discharge its obligations by reaching out to possible suitors.[433] Although the Court rejected the argument that the stockholders were left with no choice, it found that for purposes of summary judgment, it could exclude neither the inference that the deal protections were unreasonable nor the inference that they served no purpose other than to suppress the possibility of a competing bid. Thus, the Court denied the defendants' motion for summary judgment on the deal protection claim.

<u>*Revlon* Shortcomings Suggest Lack of Good Faith and Preclude DGCL § 102(b)(7) Exculpation</u>. The Court concluded that all of these procedural shortcomings could add up to an overall failure to act in good faith, an element of a board's duty of loyalty, since the Board

[433] *See infra* notes 582-589 and related text.

members appear not to have become fully engaged in an active *Revlon* process. In explaining in *Lyondell II* why the Court had not granted defendant's motion for summary judgment based on Lyondell's DGCL § 102(b)(7) charter exculpation provision, Vice Chancellor Noble explained:

> In *Disney*, the Delaware Supreme Court approved of the Chancellor's formulation of one possible definition of director misconduct amounting to bad faith—"intentional dereliction of duty, a conscious disregard for one's responsibilities." The Supreme Court was clear, however, that liability in those instances is *not* predicated upon the breach of the fiduciary duty of care; rather, liability results from the breach of the separate and distinct duty of good faith. The Supreme Court further explained that although it could demarcate three points in the spectrum of fiduciary conduct deserving of a "'bad faith' pejorative label," the historical and statutory distinction between a violation of the duty of care and a violation of the duty to act in good faith (even though both can be said to fall within the realm of "bad faith") was important because of the potential consequences flowing from that distinction.
>
> At one end of the spectrum, the Supreme Court identified a category of acts involving non-exculpable, "so-called 'subjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm." The Court further described those acts as involving conduct constituting "classic, quintessential" bad faith. In this case, no such acts are alleged. Nor could the facts adduced in the record support any finding of an actual intent to do harm to the corporation and the shareholders.
>
> At the opposite end of the "bad faith" spectrum, the Supreme Court identified acts exhibiting only a lack of due care—"that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent." In that regard, the Court observed that "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith." The Supreme Court explained that the distinction between gross negligence and non-exculpable "bad faith" (i.e., that elusive something "more") has important consequences in Delaware's jurisprudence and corporate statutory scheme because, for example, director conduct amounting *only* to a violation of the duty of care, but otherwise taken in good faith, is exculpable under 8 *Del. C.* § 102(b)(7) or indemnifiable under 8 *Del. C.* § 145.
>
> In between the aforementioned points along the "bad faith" conduct spectrum, however, the Delaware Supreme Court identified a third category of acts—intentional dereliction of duty or a conscious disregard of one's responsibilities. Such misconduct, according to the Court, is "properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith." The Supreme Court explained:
>
>> [T]he "universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the

> corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.

The Court further elaborated that because "Section 102(b)(7)(ii) expressly denies money damage exculpation for 'acts or omissions not in good faith . . . the statutory denial of exculpation for [such acts] must encompass the intermediate category of misconduct . . . ." Thus, one possible (but not the only) formulation of the definition of misconduct falling within this intermediate category is "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

In the context of a motion for summary judgment, it is not necessary (or prudent) for the Court to determine precisely where, on these facts, the line falls between exculpable, "bad faith" conduct (i.e., gross negligence amounting only to a violation of the duty of care) and a non-exculpable, knowing disregard of the directors' known fiduciary obligations in a sale scenario. It suffices that, on this limited record, there exists apparent and unexplained director inaction despite their knowing that the Company was "in play" and their knowing that *Revlon* and its progeny mandated certain conduct or impeccable knowledge of the market in pursuit of the best transaction reasonably available to the stockholders in a sale scenario. As a result of that apparent and unexplained inaction in the face of a well-settled and well-known duty to act, the Court finds itself somewhere in the intermediate grey area of conduct identified by the Delaware Supreme Court as deserving of the "bad faith pejorative label." Whether the directors have crossed the line into a cognizable violation of the good faith component of the duty of loyalty is not clear, but, in any event, the possibility of "bad faith" *on this record* raises questions of material fact regarding the directors' entitlement to exculpation, and the record must be amplified to determine the proper application of Lyondell's exculpatory charter provision under these circumstances.

Under the Defendants' self-serving view of the record, where one simply ignores (1) the fact of the 13D filing in May 2007, (2) the fact the directors acknowledge that the 13D put the Company in play, and (3) the (apparent) fact of the directors' subsequent two months of slothful indifference despite *knowing* that the Company was in play, the Court probably would have to agree that "on [that] record there is simply no issue whatsoever of material fact about intentional or conscious wrongdoing by the Lyondell board." Unfortunately, and notwithstanding Defendants' wishes to the contrary and their trumpeting of the "blowout" premium in an effort to distract from those important facts, that is *not*

> the record that presently exists. In the sale of control context, no case under Delaware law has yet recognized the Lyondell directors' (apparent) "do nothing, hope for an impressive-enough premium, and buy a fairness opinion" approach to discharging a director's fiduciary obligations when selling the corporate enterprise; perhaps, under the circumstances, that process, eventually, will be deemed "reasonable" on a more complete record, but there is nothing in Delaware's corporate law that renders the process so self-evidently reasonable that the directors are per force deemed to have acted in good faith and entitled to summary judgment on what amounts to nothing more than a barebones preliminary injunction record.
>
> The directors, in essence, seek to rely exclusively on the fortuity of an offered deal premium and an after-the-fact fairness opinion to sustain their conduct under the circumstances or, at the very least, their entitlement to exculpation for money damages. They argue that, under the deadline imposed by Basell, they made a reasonable effort to inform themselves about the offer and that, even if they lacked complete knowledge to properly judge the adequacy of the offer, they violated only their duty of care. In the seven days during which the board considered Basell's offer, the Defendants' argument may be correct that only their duty of care is implicated. The problem, however, is that there was a two month window in which the directors knew (or should have known) that the Company was on the market and that they might receive an offer at any time. It is during those two months where they apparently chose not to take any specific action to prepare for a possible offer and sale.
>
> Moreover, after remaining passive for two months while knowing that the Company was "in play," when Basell finally delivered its offer, the directors did nothing (or virtually nothing) to verify the superiority of Basell's offer (aside from recognizing an obvious premium and obtaining a fairness opinion). Thus, when one views the totality of the directors' conduct on this record, that leads the Court to question whether they may have disregarded a known duty to act and may not have faithfully engaged themselves in the sale process in a manner consistent with the teachings of *Revlon* and its progeny. Whether that apparent failure to act ultimately rises to the level of something "more" that constitutes "bad faith" sufficient to deprive the directors' of the protection of Lyondell's exculpatory charter provision remains to be seen. On summary judgment, however, it suffices that Ryan has established an issue of material fact with respect to the directors' diligent and faithful discharge of their known "*Revlon* duties," and for that reason the directors' motion for summary judgment was properly denied to allow the parties to develop a better record of the directors' efforts in connection with the sale to Basell.[434]

The Court's holding in *Lyondell* serves to highlight the importance of robust board involvement in all aspects of acquisitions and sales of control, from negotiation to

434 *Lyondell II* slip opinion pp. 10-20.

consummation, and highlights several important issues surrounding directors obligations under *Revlon*:

- Claims against independent directors can be plead as duty of loyalty claims sufficient to survive summary judgment by alleging particular facts showing that the directors were never fully engaged in the process. This claim potentially implicates the good faith aspect of the duty of loyalty, which would preclude a DGCL § 102(b)(7) charter exculpatory provision and possibly subject the independent directors to personal monetary liability.

- Directors must involve themselves in sale of control transactions, evidencing a deliberate and thoughtful decision-making approach and a proactive process. It is not sufficient to delegate deal design and negotiation to even the most capable of officers.

- Although short time horizons are not presumptively inadequate, directors should reserve sufficient time to demonstrate that all options and considerations have been examined and thus the company and its stockholders are obtaining the best price reasonably available.

- The acquisition of a substantial block of stock should alert directors that they may need to take action and to start making advance preparations such as updating their knowledge of the value of the company. Starting Board evaluation processes when warning signs appear can demonstrate diligence on the part of the Board and support faster action by the Board later.

- Prior to agreeing to a sale of a company, directors must demonstrate competent knowledge of the company's value or have negotiated mechanisms to ensure that the sale process properly canvasses the market.[435]

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[435] In J. Travis Laster and Steven M. Haas, *Reactions and Overreactions to Ryan v. Lyondell Chemical Co.*, 22 INSIGHTS No. 9 (September 2008) 9, 13-14, the authors commented:

> A traditional method for satisfying *Revlon* duties is to agree to a transaction and then test it with a post-agreement market check. Under this approach, the combination of the announcement of a transaction and the opportunity for a competing bidder to emerge is deemed sufficient so long as the merger agreement contains a reasonable fiduciary out to permit the board to respond to unsolicited acquisition proposals, the time period is adequate for a bid to emerge, the target is not otherwise hobbled by other defensive measures, and there are not other contextual factors that would prevent a topping bid from emerging or potentially succeeding. Language in *Lyondell* could be read as raising the bar for using a "single-bidder" strategy by referring to it as a "*limited exception* to the active sale process generally contemplated by *Revlon*" requiring that the directors have "*impeccable knowledge* of the market."
>
> Because of the procedural context of the motion for summary judgment, the Court was not in a position to balance the various deal protection measures in the specific context of Lyondell as an entity to determine whether the "single-bidder" strategy was reasonable. This is particularly true for the plaintiff's argument that because of the abbreviated time frame in which the Board acted and the lack of any Board involvement in the transaction prior to the CEO's presentation of a fully priced proposal, the directors were not in a position to sign off on the single bidder route. On a motion for summary judgment, all the Court could say was that on those facts, the post-agreement market check was not dispositive as a matter of law.

- The Court reaffirmed prior Delaware court decisions holding that the vesting of stock options in connection with a merger is not *per se* impermissible.

(5) *In re Loral Space and Communications Inc. Consolidated Litigation*[436] involved the issuance of preferred stock to the owner of 35.9% of Loral's common stock in a transaction structured to avoid triggering either requirements for a stockholder vote on the transaction or Board duties under *Revlon*. Loral had emerged from bankruptcy with a large stockholder, defendant MHR Fund Management LLC, whose business model involved taking control of distressed companies and positioning itself to reap the benefits of control for itself and its investors. MHR soon used its influence at Loral to place one of its advisors as Loral's CEO with the goal of having MHR make a substantial equity investment into Loral that would permit Loral to pursue acquisitions and invest in growing its existing business lines. Almost as soon as the CEO assumed his position, he proposed that MHR make an investment of $300 million into Loral, an investment that would represent over half of Loral's existing stock market capitalization.

The Loral Board did not consider a sale of the company as a whole. Instead, a "Special Committee" of the Board was formed with a narrow mandate to raise $300 million in equity capital fast through a deal with MHR. The Special Committee's chair was a close friend of MHR's creator, served on three boards at the instance of MHR, and was touted by MHR as one of its investment advisors.

Lyondell should not, however, be read as requiring a formal auction. Nor should it be read as calling into question the post-agreement market check procedure. *Lyondell* merely holds that a board must have a reasonable basis for believing that a particular method of maximizing value is reasonable and appropriate. Indeed, the decision suggests that had the directors done somewhat more, the Court might have viewed the inference the plaintiff requested as unreasonable. For example, if the directors had quietly contacted two or three likely suitors prior to executing the agreement with Basell, the Court might have held differently.

A more serious criticism, however, is the Court's focus on the absence of a go-shop provision in the Lyondell merger agreement. The Court observed as part of its analysis that Lyondell "was not able to negotiate successfully for a post-signing go-shop period and, thus, did nothing post-signing to confirm that a better price could not have been obtained." If this language is read as merely a contextual comment on the overall structure of the Lyondell merger agreement, then it does not raise any significant issues. lf, however, it is construed to mean that Delaware courts increasingly are looking to the presence of go-shops as evidence of an effective post-signing market check, then the language is misguided. Delaware courts have repeatedly approved of post-agreement market checks that did not allow the target corporation to make outgoing calls.

The presence or absence of a go-shop provision also should depend on whether the acquirer is a strategic or a financial bidder. Go-shops were largely a product of a "seller's market" during the recent M&A boom driven by ample liquidity and acquisitive private equity firms. The provisions actively encourage topping bids and thus decrease deal certainty. Financial buyers are more likely to agree to a go-shop because a particular target is rarely essential to their business model. Strategic buyers are in a different position. A strategic acquirer who believes that the "fit" of a particular target is critical to the acquirer's business strategy is highly unlikely to agree to a go-shop period. A perceived go-shop requirement therefore would penalize strategic buyers, who would be more reluctant to agree to such a provision. Strategic buyers would be at a disadvantage both in the bidding process, when they would not be in a position to agree to a go-shop provision the target wanted, and in subsequent litigation, where a no-go-shop deal would be more at risk. The ironic result is that strategic bidders likely would pay less because they would face greater risk of deal failure. The Delaware courts are well aware of these types of issues, and we therefore do not believe that *Lyondell* should be read as creating an implicit go-shop requirement.

See "8. Post Signing Market Check/'Go-Shop'" at *infra* notes 582-589 and related text.

436 C.A. No. 2808-VCS, 2008 WL 4293781 (Del. Ch. September 19, 2008).

The Special Committee never made a market check to see whether capital was available on better terms than MHR was offering. Instead, the Special Committee, which hired an outgunned financial advisor with far less experience than MHR's advisor, did nothing substantial to test the market, and blew off an expression of interest by Goldman Sachs to invest in Loral because Goldman would only provide up to $100 million of the desired $300 million in capital.

The Special Committee struck the basic economic terms of its deal with MHR after less than two weeks of work and after conducting no market check. The deal gave MHR convertible preferred stock with a high dividend rate and low conversion rate compared to the market comparables identified by the Special Committee's advisor. The deal gave MHR extraordinary class voting rights over any action of the Loral Board that could "adversely affect" the holders of the preferred or the common stock into which it was converted, the right to put the convertible preferred to Loral in a Change of Control for a value of at least $450 million, and the potential to acquire a total of 63% of Loral's equity. Although the terms of the "MHR Financing" capped MHR's common stock voting power at 39.99% in an attempt to avoid a change in control which would invoke *Revlon* duties, the class voting rights MHR acquired gave MHR a unilateral veto over any strategic initiative Loral undertook.

Despite the fact that the process dragged on as the final terms of the preferred stock were negotiated, the Special Committee never used that breathing space to subject the MHR Financing to a real market check. Similarly, even though the MHR Financing gave MHR a veto over the company's future, the Special Committee never considered whether Loral should be exposed to a hot market for corporate control, in which private equity buyers were using the availability of easy credit to purchase companies. Instead, the Special Committee simply dealt with MHR, which drove a bargain that left MHR with terms that were better than market.

Vice Chancellor Strine found that if MHR was willing to backstop a public offering of securities, Loral had the chance to raise substantial capital in the public markets, but that MHR refused to consider any deal in which it received anything other than all of the securities Loral was offering. Throughout the process of negotiating the preferred stock issuance, Loral was involved in considering a strategic acquisition of another satellite corporation. The day after the MHR financing documents were signed, Loral put in a bid for that company and within two months had landed it.

The public announcement of the MHR financing outraged Loral investors. The plaintiffs owned a substantial number of Loral shares and alleged "that the MHR Financing was a conflicted, unfair deal approved by an inept and outwitted Special Committee."

The Court concluded that the MHR financing was unfair to Loral. Using its effective control, MHR set in motion a process in which the only option that the Special Committee considered was a deal with MHR itself. Rather than acting as an effective agent for the public stockholders by aggressively demanding a market check or seeking out better-than-market terms from MHR in exchange for no market check, the Special Committee gave MHR terms that were highly favorable to MHR, in comparison to comparable convertible preferred transactions identified by its own advisor. These terms gave MHR a chokehold on Loral's future and 63% of its equity. The negotiation process was also marred by the conduct of its chairman and financial advisor, who undercut Loral's own negotiating position and, during the Special Committee process, was seeking to have MHR invest in his own business.

Holding that *Revlon* was applicable to the transaction[437] and that MHR had failed to meet

[437] The Court explained its *Revlon* analysis as follows:

> Although much of the parties' back-and-forth about the applicability of [the entire fairness] standard focuses on whether MHR was a controlling stockholder, a more mundane reality should not be overlooked. As pointed out earlier, MHR itself told the world that a majority of the Loral board was affiliated with MHR. MHR directly controlled three of Loral's eight directors …. Furthermore, two additional Loral directors, the two directors most responsible for negotiating the MHR Financing, Special Committee Chairman Harkey and CEO Targoff cannot be deemed to be independent of MHR. Targoff was made CEO largely at MHR's instance, going straight from MHR's rent-free tenant and "advisor" to Loral's CEO, and brought with him a plan to have MHR substantially deepen its investment in Loral. Given MHR's "control" position and "dominant role" at Loral, Targoff knew that his continuance as CEO depended in large measure on keeping in MHR's good graces. Not only that, Targoff and Rachesky were so close that Targoff felt free to seek having Rachesky (and Harkey) invest with him and other "friends" in an opportunity that arose during the Special Committee process.
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> Likewise, Harkey cannot be considered as independent of MHR. His business and personal ties to MHR and Rachesky are too material, as is evidenced by Harkey's status alongside Targoff as one of MHR's "Selected Investment Advisors." Harkey and Rachesky were business school classmates and remain close friends. Harkey was on the boards of three public companies precisely because of his relationship with MHR and Rachesky. Like Targoff, Harkey solicited investments in both his own company and another potential transaction from MHR during the Special Committee process. Beyond just the close personal and professional relationships with MHR and Rachesky, Harkey and Targoff were aware that MHR knew how to use its clout to get its way. After all, they were both advisors to MHR, a firm that, as noted, boasted that it "is unusually well-positioned to extract significant control premiums through [among other things] bringing to bear the Managing Principals' wealth of knowledge and experience in effectuating control and influence."
>
> Thus, regardless of whether MHR was a controlling stockholder of Loral, the MHR Financing was an interested transaction, and a majority of the Loral board – five of the eight members at the time the Securities Purchase Agreement was signed – was affiliated with MHR. Given that reality, the entire fairness standard presumptively applies.
>
> Moreover, MHR's belated protestations that it was not a controlling stockholder after all are not convincing. In determining whether a blockholder who has less than absolute voting control over the company is a controlling stockholder such that the entire fairness standard is invoked, the question is whether the blockholder, "as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes." MHR possessed such practical power over Loral, and that power shaped the process for considering and approving the MHR Financing.
>
> Outside of this litigation, MHR and Loral have consistently and publicly maintained that MHR controls Loral. Moreover, even at trial, Targoff admitted that he "would use [the] term" controlling stockholder to describe MHR and that MHR "control[s] de facto in some respects." These admissions comport with the facts regarding MHR's practical power over Loral.
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> MHR seated a majority of Loral directors affiliated with itself, and touted that fact publicly. Rachesky assumed the Chairmanship himself and was also a member of the two-person Compensation Committee. He installed his MHR advisor Targoff as CEO. With 36% of the votes, MHR hardly feared a proxy fight, and although it did not have the power to unilaterally vote in charter changes or effect a merger, it had substantial blocking power. Not only that, MHR had blocking power over Loral's ability to redeem the Skynet Notes and had at least some power to control Loral's ability to conduct an underwritten offering for its own benefit. Both factors played a role in shaping the negotiation of the MHR Financing.
>
> And at the level of basic strategy, it is evident that MHR controlled Loral's decision to pursue the growth strategy that necessitated additional capital financing and the time table for obtaining that capital.
>
> Indeed, early on in the process, when Rachesky and Targoff were causing Loral to embark on the process of considering a large equity investment in MHR, the Loral board recognized that the interested nature of the transaction and MHR's clout would likely subject any resulting transaction to entire fairness review. To address that, the Special Committee was formed with the hope that that device would, at the very least, shift the burden of persuasion as to the issue of fairness.
>
> Given MHR's practical control over Loral and the presence of an MHR-affiliated board majority, I therefore have little difficulty in concluding that the entire fairness standard applies in the first instance

its burden of proving the entire fairness of the transaction (i.e. both fair dealing and fair price), Vice Chancellor Strine entered a remedy reforming the MHR financing to convert MHR's convertible preferred into non-voting common stock using a price that took into account MHR's access to inside information, its insulation of itself from market pressures and its attainment of an unfair $6.75 million fee for placing securities with itself,[438] and that also gave substantial weight to Loral's actual stock trading price. This remedy left MHR with shares of Loral non-voting common stock in place of the preferred stock representing 57% of the total equity of Loral, but remaining at MHR's prior level of voting power (35.9%). This gave MHR both effective control of Loral, and the liquidity option of the market for corporate control. The nature of this remedy made it unnecessary for the Court to undertake a director-by-director liability assessment.[439]

(6) In *McPadden v. Sidhu*,[440] Chancellor Chandler held that a DGCL § 102(b)(7) provision would protect directors against charges that they breached their fiduciary duties in authorizing a sale of a subsidiary for inadequate consideration. In June 2005 the Board of i2 Technologies, Inc. approved the sale for $3 million of a wholly owned subsidiary that it previously purchased with a related company for $100 million to a management team led by an i2 vice president. Two years later, after rejecting an $18.5 million bid six months after the sale,

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> to the MHR Financing. Furthermore, given the performance of the Special Committee, there is no need to consider some of the more intricate, interstitial standard of review issues that might have arisen had the Special Committee process been less desultory.

Slip op. at 44-48.

438 The Court found that MHR's receiving a placement fee for a transaction that it sought out and prevented others from participating in was unfair and overreaching. To ensure that MHR did not benefit from the fee for placing securities with its own controlled company, the Court took the fees into account in fixing the amount of non-voting common stock MHR would receive in the reformed transaction, but did not require any offset for MHR's advisor fees as a payment by Loral for those fees in a fair deal would not have been eyebrow raising.

439 The Court explained why it did not reach plaintiffs' request for a damage award against culpable directors:

> The entire fairness test is one designed to address a transaction's sustainability, against any party other than the interested party, the test is, in itself, not adequate to determine liability for breach of duty. For example, being a non-independent director who approved a conflict transaction found unfair does not make one, without more, liable personally for harm caused. Rather, the court must examine that director's behavior in order to assess whether the director breached her fiduciary duties and, if a § 102(b)(7) clause is in effect, acted with the requisite state of mind to have committed a non-exculpated loyalty breach. Because the remedy is one that can be effected as between MHR and Loral, there is no need to make findings about the extent to which the individual directors would be subject to liability if I awarded Loral monetary damages.

In footnote 163 the Court further commented:

> Given the presence of an exculpatory charter provision, I would have to find that the Special Committee members Harkey and Simon acted in bad faith by approving the Securities Purchase Agreement knowing that it was unfairly advantageous to MHR or engaged in some other conscious misconduct. 8 *Del. C.* § 102(b)(7). As to defendants Rachesky, Goldstein, and Devabhaktuni, who were high-ranking MHR officials, the record provides strong reason to infer that they knew they were extracting unfair value from a less-than-adroit Loral Special Committee. Defendant [CEO] Targoff presents a very interesting question because he largely set the process off on its unproductive course but then seems to have recognized that MHR was getting too sweet a deal and attempted, without any large success, to ameliorate the outcome. Rather than tag these defendants with individual liability at this time, I prefer to rest my judgment on a finding that the MHR Financing was unfair and to impose a fitting remedy against the party who benefited. If MHR or another party has my judgment overturned and the Supreme Court returns the case to me for the entry of a damages award, I can address the individual responsibility of these defendants then. Because the plaintiffs never made a serious effort to address the liability of defendants Olmstead and Stenbit, I do, however, dismiss the claims against them.

Slip op. at 76 note 163.

440 C.A. No. 3321-CC, 2008 WL 4017062 (Del. Ch. August 29, 2008).

the management team sold the subsidiary for $25 million. The defendants were i2's directors and the vice president involved in the buy-out.

The Court questioned the Board's reliance on the vice president to orchestrate the sales process and produce the projections and other information on which it relied in approving the transaction. The Court questioned why the vice president did not contact the subsidiary's competitors, which seemed likely buyers, and commented that the Board engaged in little to no oversight of the sale process, providing no check on the vice president's half hearted or worse efforts in seeking to maximize the value received for the subsidiary. Although the Board did get a fairness opinion on the sale, plaintiff pointed out numerous deficiencies and questioned its reliability. As the *McPadden* case did not involve a change in control of i2 or a sale of substantially all of the assets of i2, *Revlon* duties were not implicated in the Court's decision.

Although it found the Board was grossly negligent[441] in approving the sale, it concluded that there was inadequate pleading that the directors had acted in bad faith through a conscious disregard for their duties and, thus, that the directors' alleged gross negligence was exculpated by the DGCL § 102(b)(7) charter provision. The vice president's motion to dismiss, however, was denied because only directors are entitled to exculpation under DGCL § 102(b)(7).

D. Value of Thorough Deliberation.

The Delaware cases repeatedly emphasize the importance of the process followed by directors in addressing a takeover proposal. The Delaware courts have frowned upon board decision-making that is done hastily or without prior preparation. Counsel should be careful to formulate and document a decision-making process that will withstand judicial review from this perspective.

Early in the process the board should be advised by counsel as to the applicable legal standards and the concerns expressed by the courts that are presented in similar circumstances. Distribution of a memorandum from counsel can be particularly helpful in this regard. Management should provide the latest financial and strategic information available concerning the corporation and its prospects. If a sale is contemplated or the corporation may be put "in play," investment bankers should be retained to advise concerning comparable transactions and market conditions, provide an evaluation of the proposal in accordance with current industry standards, and, if requested, render a fairness opinion concerning the transaction before it is finally approved by the board. The board should meet several times, preferably in person, to review reports from management and outside advisors, learn the progress of the transaction and provide guidance. Directors should receive reports and briefing information sufficiently before meetings so that they can be studied and evaluated. Directors should be active in questioning and analyzing the information and advice received from management and outside advisors. A summary of the material provisions of the merger agreement should be prepared for the directors and explained by counsel.[442]

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441 The Court wrote that "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason."

442 *See, e.g.*, *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995) for an in depth description of a decision-making process that withstood review under enhanced scrutiny.

(1) In *Van Gorkom*,[443] the Trans Union board approved the proposed merger at a meeting without receiving notice of the purpose of the meeting, no investment banker was invited to advise the board, and the proposed agreement was not available before the meeting and was not reviewed by directors. This action contributed to the court's conclusion that the board was grossly negligent.

(2) In *Technicolor*,[444] notice of a special board meeting to discuss and approve an acquisition proposal involving interested management was given to members of the board only one day prior to the meeting, and it did not disclose the purpose of the meeting. Board members were not informed of the potential sale of the corporation prior to the meeting, and it was questioned whether the documents were available for the directors' review at the meeting.

(3) In contrast is *Time*,[445] where the board met often to discuss the adequacy of Paramount's offer and the outside directors met frequently without management, officers or directors.[446]

E. The Decision to Remain Independent.

A board may determine to reject an unsolicited proposal. It is not required to exchange the benefits of its long-term corporate strategy for short-term gain. However, like other decisions in the takeover context, the decisions to "say no" must be adequately informed. The information to be gathered and the process to be followed in reaching a decision to remain independent will vary with the facts and circumstances, but in the final analysis the board should seek to develop reasonable support for its decision.

A common ground for rejection is that the proposal is inadequate. Moreover, the proposal may not reflect the value of recent or anticipated corporate strategy. Another ground is that continued independence is thought to maximize shareholder value. Each of these reasons seems founded on information about the value of the corporation and points to the gathering of information concerning value.

A decision based on the inadequacy of the proposal or the desirability of continuing a pre-existing business strategy is subject to the business judgment rule, in the absence of the contemporaneous adoption of defensive measures or another response that proposes an alternative means to realize shareholder value.[447] Defensive measures are subject to enhanced

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443 488 A.2d 858.

444 634 A.2d 345.

445 571 A.2d 1140.

446 *See also Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985), where (i) before considering a rights plan as a preventative mechanism to ward off future advance, the board received material on the potential takeover problem and the proposed plan, (ii) independent investment bankers and counsel attended the board meeting to advise the directors, and (iii) ten of the board's sixteen members were outside directors; and *MSB Bancorp*, 1998 WL 409355, where during the period in question, the board met weekly, considered the offers, consulted with its legal and financial advisors, and then made its conclusion as to which offer to pursue. For a summary of guidelines for counsel to develop a suitable process for the board's deliberations, *see* Frankle, *Counseling the Board of Directors in Exploring Alternatives*, 1101 PLI/Corp. 261 (1998).

447 Whether the standards of review for a decision to remain independent are the same in the face of a cash bid that potentially involves "Revlon duties" or a stock transaction that does not is unsettled. *Compare, e.g.*, Wachtell, Lipton, Rosen & Katz, *Takeover Law and Practice*, 1212 PLI/Corp. 801, 888, citing no authority: "If the proposal calls for a

scrutiny, with its burden on the directors to demonstrate reasonableness. An alternative transaction can raise an issue as to whether the action should be reviewed as essentially a defensive measure. Moreover, the decision not to waive the operation of a poison pill or the protection of a state business combination statute such as DGCL § 203 can be viewed as defensive.[448] A merger agreement that requires the merger to be submitted to shareholders, even if the board has withdrawn its recommendation of the merger, as permitted by DGCL § 146, may also be analyzed as defensive. In any case, and especially where it is likely that the suitor or a shareholder will turn unfriendly, the authorized response should be based on a developed record that demonstrates its reasonableness.

1. Judicial Respect for Independence.

Delaware cases have acknowledged that directors may reject an offer that is inadequate or reach an informed decision to remain independent. In a number of prominent cases, the Delaware courts have endorsed the board's decision to remain independent:

a. In *Time*,[449] the Delaware Supreme Court validated the actions of Time's board in the face of an all-shares cash offer from Paramount. The board had concluded that the corporation's purchase of Warner "offered a greater long-term value for the stockholders and, unlike Paramount's offer, did not pose a threat to Time's survival and its 'culture'."[450] In approving these actions, the court determined that the board, which "was adequately informed of the potential benefits of a transaction with Paramount," did not have to abandon its plans for corporate development in order to provide the shareholders with the option to realize an immediate control premium.[451] "Time's board was under no obligation to negotiate with Paramount."[452] According to the court, this conclusion was consistent with long-standing Delaware law: "We have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment."[453]

b. In *Unitrin*,[454] the Delaware Supreme Court considered defensive actions taken by Unitrin's board in response to American General's overtures. The board rejected the offer as financially inadequate and presenting antitrust complications, but did not adopt defensive

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transaction that does not involve a change in control within the meaning of *QVC*, it would appear that the traditional business judgment rule would apply to the directors' decision. If the acquisition proposal calls for a transaction that would involve a change within the meaning of *QVC*, the enhanced-scrutiny *Unocal* test would apply." Such a conclusion would subject all director decisions to a reasonableness standard merely because of what transaction has been proposed. In *Time*, 571 A.2d 1140, however, the Delaware Supreme Court suggested that a well-informed, fully independent board ought to be accorded more deference than this where it has not initiated a sale, even though the consideration for the sale presents advantages that are reasonable. On the other hand, in practice, it may be difficult to avoid the defensive responses to a proposal, which would involve a reasonableness review, where the bidder is persistent.

448 *See e.g., Moore*, 907 F. Supp. at 1556 (failure to redeem poison pill defensive).

449 571 A.2d 1140.

450 *Id*. at 1149.

451 *Id*. at 1154.

452 *Id*.

453 *Id*. at 1152 (citing *Macmillan*, 559 A.2d at 1285 n.35; *Van Gorkom*, 448 A.2d at 881; and *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

454 651 A.2d 1361.

measures to protect against a hostile bid until American General issued a press release announcing the offer.[455] Unitrin's board viewed the resulting increase in Unitrin's stock price as a suggestion that speculative traders or arbitrageurs were buying up Unitrin stock and concluded that the announcement constituted a "hostile act designed to coerce the sale of Unitrin at an inadequate price."[456] In response, the board adopted a poison pill and an advance notice bylaw provision for shareholder proposals.[457] The directors then adopted a repurchase program for Unitrin's stock.[458] The directors owned 23% of the stock and did not participate in the repurchase program.[459] This increased their percentage ownership and made approval of a business combination with a shareholder without director participation more difficult.[460] The Delaware Court of Chancery ruled that the poison pill was a proportionate defensive response to American General's offer, but that the repurchase plan exceeded what was necessary to protect shareholders from a low bid. The poison pill was not directly at issue when the Delaware Supreme Court reviewed the case. The Supreme Court determined that the Court of Chancery used an incorrect legal standard and substituted its own business judgment for that of the board.[461] The Supreme Court remanded to the Court of Chancery to reconsider the repurchase plan and determine whether it, along with the other defensive measures, was preclusive or coercive and, if not, "within the range of reasonable defensive measures available to the Board."[462]

c. In *Revlon*,[463] the Delaware Supreme Court looked favorably on the board's initial rejection of Pantry Pride's offer and its adoption of a rights plan in the face of a hostile takeover at a price it deemed inadequate.[464] The court did not suggest that Revlon's board had a duty to negotiate or shop the company before it "became apparent to all that the break-up of the company was inevitable" and the board authorized negotiation of a deal, thus recognizing that the company was for sale.[465]

d. In *Desert Partners*,[466] the court approved the USG board's refusal to redeem a poison pill to hinder an inadequate hostile offer and noted that the board had no duty to negotiate where it had neither put the company up for sale nor entertained a bidding contest.[467] "Once a Board decides to maintain a company's independence, Delaware law does not require a board of directors to put their company on the auction block or assist a potential acquiror to formulate an adequate takeover bid."[468]

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455 *Id*. at 1370.

456 *Id*.

457 *Id*.

458 *Id*. at 1370-71.

459 *Id*. at 1370.

460 *Id*. at 1371-72.

461 *Id*. at 1389.

462 *Id*. at 1390.

463 506 A.2d 173.

464 *Id*. at 180-81.

465 *Id*. at 182.

466 686 F. Supp. 1289 (applying Delaware law).

467 *Id*. at 1300.

468 *Id*. at 1300.

e. In *MSB Bancorp*,[469] the Delaware Chancery Court upheld the Board's decision to purchase branches of another bank in furtherance of its long-held business strategy rather than to negotiate an unsolicited merger offer that would result in short-term gain to the shareholders.[470] In reaching its conclusion, the Chancery Court applied the business judgment rule because it determined that there was no defensive action taken by the Board in merely voting not to negotiate the unsolicited merger offer which did not fit within its established long-term business plan.[471]

2. Defensive Measures.

When a Board makes a decision to reject an offer considered inadequate, the Board may adopt defensive measures in case the suitor becomes unfriendly. Such a response will be subjected to the proportionality test of *Unocal*, that the responsive action taken is reasonable in relation to the threat posed.[472] This test was further refined in *Unitrin* to make clear that defensive techniques that are "*coercive*" or "*preclusive*" will not be considered to satisfy the proportionality test:

> An examination of the cases applying Unocal reveals a direct correlation between findings of proportionality or disproportionality and the judicial determination of whether a defensive response was draconian because it was either coercive or preclusive in character. In *Time*, for example, [the Delaware Supreme Court] concluded that the Time board's defensive response was reasonable and proportionate since it was not aimed at 'cramming down' on its shareholders a management-sponsored alternative, i.e., was not coercive, and because it did not preclude Paramount from making an offer for the combined Time-Warner Company, i.e., was not preclusive.[473]

In *Moran*,[474] the Delaware Supreme Court considered a shareholder rights plan adopted by Household International not during a takeover contest, "but as a preventive mechanism to ward off future advances."[475] The court upheld the pre-planned poison pill but noted that the approval was not absolute.[476] When the board "is faced with a tender offer and a request to redeem the [rights plan], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."[477]

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469 1998 WL 409355.

470 *Id*. at *4.

471 *Id*. at *3.

472 *See, e.g., Quickturn*, 721 A.2d at 1290.

473 *Unitrin*, 651 A.2d at 1387 (citations omitted).

474 500 A.2d 1346.

475 *Id*. at 1349.

476 *Id*. at 1354.

477 *Id*. *See also Moore*, 907 F. Supp. 1545; *Desert Partners*, 686 F. Supp. 1289; *Unitrin*, 651 A.2d 1361; *Ivanhoe Partners v. Newmont Mining Corp.,* 535 A.2d 1334 (Del. 1987); and *Revlon*, 506 A.2d 173, where the court considered favorably a board's defensive measures to protect its decision to remain independent.

F. The Pursuit of a Sale.

When a board decides to pursue a sale of the corporation (involving a sale of control within the meaning of *QVC*), whether on its own initiative or in response to a friendly suitor, it must "seek the best value reasonably available to the stockholders."[478] As the Delaware Supreme Court stated in *Technicolor*: "[I]n the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances."[479]

1. Value to Stockholders.

In *Revlon*, the Delaware Supreme Court imposed an affirmative duty on the Board to seek the highest value reasonably available to the shareholders when a sale became inevitable.[480] The duty established in *Revlon* has been considered by the Delaware courts on numerous occasions, and was restated in *QVC*. According to the Delaware Supreme Court in *QVC*, the duty to seek the highest value reasonably available is imposed on a board in the following situations:

> Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate Revlon duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, Revlon duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company.[481]
>
> [W]hen a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders.[482]

The principles of *Revlon* are applicable to corporations which are not public companies.[483] Directors' *Revlon* duties to secure the highest value reasonably attainable apply not only in the context of break-up, but also in a change in control.[484]

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478 *QVC*, 637 A.2d at 48; *see also Matador*, 729 A.2d at 290.

479 *Technicolor*, 634 A.2d at 361.

480 *See Revlon*, 506 A.2d 173; *Elloway v. Pate*, 238 S.W.3d 882 (Tex.App.—Houston [14th Dist.] 2007).

481 *QVC*, 637 A.2d at 47 (citation omitted).

482 *Id*. at 48.

483 *See Cirrus Holding v. Cirrus Ind.*, 794 A.2d 1191 (Del Ch. 2001).

484 *Cirrus Holding v. Cirrus Ind.*, 794 A.2d 1191 (Del Ch. 2001); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 502 (Del. Ch. 2000); *see also Krim v. ProNet, Inc.*, 744 A.2d 523 (Del. 1999) (Delaware law requires that once a change of control of a company is inevitable the board must assume the role of an auctioneer in order to maximize shareholder value).

2. Ascertaining Value.

When the *Revlon* decision was first announced by the Delaware Supreme Court, many practitioners read the decision to mandate an auction by a target company in order to satisfy the board's fiduciary duties (the so-called "*Revlon duties*").[485] After interpreting *Revlon* in *Barkan, Macmillan, Time, Technicolor*, and *QVC*, however, the Delaware Supreme Court has clearly indicated that an auction is not the only way to satisfy the board's fiduciary duties. As the court in *Barkan* stated:

> Revlon does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest. Revlon is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders.[486]

One court has noted that when the board is negotiating with a single suitor and has no reliable grounds upon which to judge the fairness of the offer, a canvas of the market is necessary to determine if the board can elicit higher bids.[487] However, the Delaware Supreme Court held in *Barkan* that when the directors "possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market."[488]

The following cases indicate situations in which a board was not required to engage in an active survey of the market. Most involve one-on-one friendly negotiations without other bidders, although in some the target had earlier discussions with other potential bidders.

a. In *Barkan*,[489] the corporation had been put "in play" by the actions of an earlier bidder.[490] Instead of taking an earlier offer, the corporation instituted a management buyout (the "*MBO*") through an employee stock ownership program.[491] In holding that the board did not have to engage in a market survey to meet its burden of informed decision-making in good faith, the court listed the following factors: (i) potential suitors had ten months to make some sort of offer (due to early announcements), (ii) the MBO offered unique tax advantages to the corporation that led the board to believe that no outside offer would be as advantageous to the shareholders, (iii) the board had the benefit of the advice of investment bankers, and (iv) the trouble the corporation had financing the MBO, indicating that the corporation would be unattractive to potential suitors.[492] In holding that an active market check was not necessary, however, the court sounded a note of caution:

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485 *See* McBride, *Revisiting Delaware Law and Mergers and Acquisitions: The Impact of QVC v. Paramount*, 2 PLI Course Handbook, 26th Ann. Inst. on Sec. Reg. 86 (1994).

486 *Barkan*, 567 A.2d at 1286.

487 *In re Fort Howard Corp. Shareholders Litig.*, 1988 WL 83147 (Del. Ch. 1988).

488 *Barkan*, 567 A.2d at 1287.

489 567 A.2d 1279 (Del. 1989).

490 *Id*. at 1287.

491 *Id*. at 1282-83.

492 *Id*. at 1287-88.

> The evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured. However, the crucial element supporting a finding of good faith is knowledge. It must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders. *The situations in which a completely passive approach to acquiring such knowledge is appropriate are limited*.[493]

b. In *In re Vitalink*,[494] Vitalink entered a merger agreement with Network Systems Corporation.[495] While Vitalink had also conducted earlier discussions with two other companies, the court found that Vitalink had not discussed valuation with those two companies, and thus did not effectively canvas the market.[496] In holding that the Vitalink board nevertheless met its burden of showing that it acted in an informed manner in good faith, the court looked at the following factors: (i) no bidder came forward in the 45 days that passed between the public announcement of the merger and its closing; (ii) the parties negotiated for a number of months; (iii) the board had the benefit of a fairness opinion from its investment banker; and (iv) the investment banker's fee was structured to provide it an incentive to find a buyer who would pay a higher price.[497]

As the Delaware Supreme Court noted in *Van Gorkom*, failure to take appropriate action to be adequately informed as to a transaction violates the board's duty of due care. Without a firm blueprint to build adequate information, however, the passive market check entails a risk of being judged as "doing nothing" to check the market or assess value.[498]

c. *In re MONY Group Inc. Shareholder Litigation*[499] involved stockholders seeking a preliminary injunction against a stockholder vote on the merger of MONY with AXA. The stockholders of MONY alleged that the defendant Board, having decided to put MONY up for sale, did not fulfill its *Revlon* duty to seek the best transaction reasonably available to the stockholders by forgoing a pre-agreement auction in favor of a process involving a single-bidder negotiation followed by a post-agreement market check. The stockholders challenged (i) the Board's decision that the resulting negotiated merger proposal was the best proposal reasonably available, (ii) the adequacy of the market check utilized and (iii) the adequacy of disclosures made in a proxy statement sent to the stockholders seeking their approval of the merger. The court granted a limited injunction relating solely to proxy statement disclosures concerning payments under certain change-in-control agreements, but denied the request for a preliminary injunction on the allegations as to the failure to get the best transaction.

The MONY Board had recognized that MONY had a number of problems and had received a report from its investment banker listing a number of companies, including AXA, that

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493 *Id*. at 1288 (emphasis added).

494 1991 WL 238816.

495 *Id*. at *3-4.

496 *Id*. at *7.

497 *Id*. at *11-12.

498 *See Barkan*, 567 A.2d at 1287 (there is no single method that a board must employ to become informed).

499 *In re MONY Group Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004).

might acquire MONY. The Board considered and rejected the idea of publicly auctioning MONY out of concern that a failed auction would expose MONY's weaknesses and provide competitors with information they could use to raid MONY's insurance agents. Accordingly, the Board instructed the CEO to quietly explore merger opportunities. After hearing the MONY CEO's report of his meeting with the AXA CEO and of prior discussions with other potential partners, the MONY Board authorized solicitations of interest from AXA, but not from any other potential bidder.

AXA initially proposed a price of $26 to $26.50 per MONY share, which led to negotiations over several months that involved allowing AXA access to confidential information under a confidentiality agreement. During these negotiations, the MONY CEO had advised AXA the MONY change in control agreements would cost the survivor about $120 million. After a period of negotiation, AXA proposed to acquire MONY for $28.50 per share, an aggregate of about $1.368 billion, but later AXA determined that the change in control agreements would actually cost about $163 million, not $120 million, and it lowered its offer to $26.50 per share or $1.272 billion. At the end of these negotiations, the MONY Board rejected a stock-for-stock merger with AXA that purported to reflect the $26.50 per share price by a fixed share exchange ratio that was collared between $17 and $37 per MONY share. The Board also concluded that the change in control agreements were too rich and that AXA's offer price would have been higher if it had not been for the change in control agreements.

Shortly after the AXA offer was rejected, the MONY Board engaged a compensation consultant to analyze the change in control agreements and received a report that change in control agreements costs typically range from 1% to 3% of a proposed transaction price (and sometimes up to 5%), but that MONY's change in control agreements represented 15% of the previously proposed AXA merger price. Ultimately, the Board informed senior management that it would not renew the change in control agreements when they expired, and offered management new change in control agreements that lowered the payout provisions to between 5% and 7% of the AXA transaction's value, which the management parties accepted.

Two months later, the AXA CEO contracted the MONY CEO to ask if MONY would be interested in an all-cash transaction, but the Board would not permit the MONY CEO to engage in sale negotiations until the change in control agreements had been amended, thus postponing the talks. When the AXA CEO then made an offer of $29.50 cash per MONY share, the MONY CEO informed him that the change in control agreements had been modified and that the offer should be $1.50 higher to reflect the change. At the end of this round of negotiations, a merger agreement was signed providing for the payment of $31 cash for each MONY share and a negotiated provision allowing MONY to pay a dividend of $0.25 per share before the merger was consummated. The merger consideration reflected a 7.3% premium to MONY's then-current trading price, as well as valuing MONY's equity at $1.5 billion and the total transaction (including liabilities assumed) at $2.1 billion.

MONY accepted a broad "window shop" provision and a fiduciary-out termination clause which required MONY to pay AXA a termination fee equal to 3.3% of the equity value and 2.4% of the transaction value. In the several months following the announcement of the merger agreement no one made a competing proposal, although there was one expression of interest if the AXA deal failed.

The plaintiff stockholders claimed that the MONY board breached its fiduciary duties under *Revlon* by failing to procure the best possible price for MONY, presumably through a public auction. Citing *Revlon* and *QVC*, the court found that the consequences of a sale of control imposed special obligations on the directors, particularly the obligation of acting reasonably to seek the transaction offering the best value reasonably available for stockholders (i.e., getting the best short-term price for stockholders), but that these requirements did not demand that every change of control be preceded by a heated bidding contest, noting that a board could fulfill its duty to obtain the best transaction reasonably available by entering into a merger agreement with a single bidder, establishing a "floor" for the transaction, and then testing the transaction with a post-agreement market check. The court wrote that the traditional inquiry was whether the board was adequately informed and acted in good faith. Furthermore, in the sale of control context this inquiry was heightened such that the directors had the burden of proving that they were adequately informed and acted reasonably, with the court scrutinizing the adequacy of the decision-making process, including the information on which the directors based their decision and the reasonableness of the directors' action in light of the circumstances then existing. The question was whether the directors made a reasonable decision, not a perfect decision. If a Board selected one of several reasonable alternatives, the court should not second-guess that choice even though it might have decided otherwise or subsequent events might have cast doubt on the board's determination.

The plaintiffs argued that the Board relied too much upon the MONY CEO to determine and explore alternatives, and in doing so that it had breached its fiduciary duties, since the CEO and other members of MONY senior management stood to gain excessive payments under the change in control agreements if MONY was sold. With respect to the plaintiff stockholders argument that the Board should have established a special committee to continue negotiations with AXA, the court held that a board could rely on the CEO to conduct negotiations and that the involvement of an investment bank in the negotiations was not required, particularly since the Board actively supervised the CEO's negotiations and the CEO had acted diligently in securing improvements for MONY. The court further noted that the Board had repeatedly demonstrated its independence and control, first in rejecting the stock for stock transaction and second in reducing the insiders' change in control agreements benefits.

In addressing the contention that there should have been a public auction, the court concluded that a single-bidder approach offered the benefits of protecting against the risk that an auction would fail and avoiding a premature disclosure to the detriment of MONY's then-ongoing business, and noted that the Board had taken into consideration a number of company and industry specific factors in deciding not to pursue a public auction or active solicitation process and not to make out-going calls to potentially interested parties after receiving AXA's cash proposal. The court noted that the Board members were financially sophisticated, knowledgeable about the insurance and financial services industry, and knew the industry and the potential strategic partners available to MONY. The Board had been regularly briefed on MONY's strategic alternatives and industry developments over recent years. The Board was also advised as to alternatives to the merger. The court wrote that this "financially sophisticated Board engaged CSFB for advice in maximizing stockholder value [and] … obtained a fairness opinion from CSFB, itself incentivized to obtain the best available price due to a fee that was set at 1% of transaction value….," noting that CSFB was not aware of any other entity that had an interest in acquiring MONY at a higher price. One witness testified that CSFB did not participate directly in the negotiations due to a reasonable concern that CSFB's involvement could cause AXA to get its own investment banker, which MONY believed would increase the risk of leaks and might result in a more extensive due diligence process to its detriment. The court found that using these resources and the considerable body of information available to it, the Board had determined that, because MONY and AXA shared a similar business model, AXA was a strategic fit for MONY and thus presented an offer that was the best price reasonably available to stockholders.

Under the market check provisions which the court found reasonable and adequate, MONY could not actively solicit offers after announcement of the transaction and before the stockholder vote, but could, subject to a reasonable termination fee, pursue inquiries that could be reasonably expected to lead to a business combination more favorable to stockholders. The court found the five-month period while the transaction pended after it was announced (for SEC filing clearance and vote solicitation) was an adequate time for a competing bidder to emerge and complete its due diligence.

The court concluded that the termination fee (3.3% of MONY's total equity value and 2.4% of the total transaction value) was within the range of reasonableness. Moreover, the court said that the change in control agreements were "bidder neutral" in that they would affect any potential bidder in the same fashion as they affected AXA. Thus, the court found the five-month market check more than adequate to determine if the price offered by AXA was the best price reasonably available, which supported a conclusion that the board acted reasonably and had satisfied its *Revlon* duties.

The plaintiffs alleged that the proxy statement was misleading because it failed to disclose the percentage of transaction value of aggregate payments to be made under the amended change in control agreements as compared to payments in similar transactions. The MONY Board's expert showed that the mean change-in-control payment (as a percentage of deals for selected financial services industry transactions) was 3.37%, with the 25th and 75th percentile for such transactions being .94% and 4.92%, respectively. The base case under the original change in control agreements for MONY would have been over 15% of the original offer and the amended change in control agreements lowered that to 6%, which was still well above the 75th percentile. The court noted the history of AXA's bidding as showing that there was essentially a 1:1 ratio between the value of the change in control agreements and the amount per share offered. Because the change in control agreements' value was above the amount paid in change in control agreements in more than 75% of comparable transactions, the court was persuaded that the proxy statement needed to include disclosure of information available to the board about the size of the change in control agreements payments as compared to comparable transactions, noting that the materiality of such disclosure was heightened by the Board's rejection of the original offer, at least in part because of the original outsized change in control agreements' payment obligations. The court concluded the shareholders were entitled to know that the change in control agreements remained unusually large when deciding whether to vote to approve the $31 per share merger price or vote "no" or demand appraisal under statutory merger appraisal procedures. Moreover, the court said that more disclosure about comparative information was made necessary to the extensive disclosure that was in the proxy statement about steps the Board had taken to lower the payments under the change in control agreements since that disclosure had created the strong impression that the amended change in control agreements were in line with those in comparable transactions. The court said that the proxy statement had misleadingly implied that the payments under the change in control agreements were consistent with current market practice when they were in fact considerably more lucrative than was normal. The court ordered the additional disclosure about the change in control agreements.

After the initial decision in the *MONY Group* case, the board of MONY reset and pushed back the record date for the vote on the merger by several months. The same court held in another decision that the directors did not breach their duties to existing stockholders in so doing even though the extended record date included additional stockholders (arbitrageurs) who had recently purchased shares and who were likely to vote in favor of the merger.[500]

3. Process Changes.

In re Toys "R" Us, Inc. Shareholder Litigation[501] involved a motion to enjoin a vote of the stockholders of Toys "R" Us, Inc. to consider approving a merger with an acquisition vehicle formed by a group led by Kohlberg Kravis Roberts & Co. ("*KKR*") that resulted from a lengthy, publicly-announced search for strategic alternatives and presented merger consideration constituting a 123% premium over the per share price when the strategic process began 18 months previously. During the strategic process, the Toys "R" Us board of directors, nine of whose ten members were independent, had frequent meetings to explore the company's strategic options with an open mind and with the advice of expert advisors.

Eventually, the Board settled on the sale of the company's most valuable asset, its toy retailing business, and the retention of the company's baby products retailing business, as its preferred option after considering a wide array of options, including a sale of the whole company. The company sought bids from a large number of the most logical buyers for the toy business, and it eventually elicited attractive expressions of interest from four competing bidders who emerged from the market canvass. When due diligence was completed, the Board put the bidders through two rounds of supposedly "final bids" for the toys business. In this process, one of the bidders expressed a serious interest in buying the whole company. The Board was presented with a bid that was attractive compared with its chosen strategy in light of the valuation evidence that its financial advisors had presented, and in light of the failure of any strategic or financial buyer to make any serious expression of interest in buying the whole company despite the Board's openly expressed examination of its strategic alternatives. Recognizing that the attractive bids it had received for the toys business could be lost if it extended the process much longer, the Executive Committee of the Board, acting in conformity with direction given to it by the whole Board, approved the solicitation of bids for the entire company from the final bidders for the toys business, after a short period of due diligence.

When those whole company bids came in, the winning bid of $26.75 per share from KKR topped the next most favorable bid by $1.50 per share. After a thorough examination of its alternatives and a final reexamination of the value of the company, the Board decided that the best way to maximize stockholder value was to accept the $26.75 bid.

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500 *In re MONY Group Inc. Shareholders Litigation,* 853 A.2d 661 (Del. Ch. 2004).

501 877 A.2d 975 (Del. Ch. 2005).

In its proposed merger agreement containing the $26.75 offer, KKR asked for a termination fee of 4% of the implied equity value of the transaction to be paid if the company terminated to accept another deal, as opposed to the 3% offered by the company in its proposed draft of merger agreement. Knowing that the only other bid for the company was $1.50 per share or $350 million less, the company's negotiators nonetheless bargained the termination fee down to 3.75% the next day, and bargained down the amount of expenses KKR sought in the event of a naked no vote.

The plaintiffs faulted the Board for failing to fulfill its duty to act reasonably in pursuit of the highest attainable value for the company's stockholders, complaining that the Board's decision to conduct a brief auction for the full company from the final bidders for the toy business was unreasonable and that the Board should have taken the time to conduct a new, full-blown search for buyers and that the Board unreasonably locked up the deal by agreeing to draconian deal termination measures that precluded any topping bid. The Chancery Court rejected those arguments, finding that the Board made reasonable choices in confronting the real world circumstances it faced, was supple in reacting to new circumstances and was adroit in responding to a new development that promised greater value to the stockholders.

Likewise, the Chancery Court found the choice of the Board's negotiators not to press too strongly for a reduction of KKR's desired 4% termination fee all the way to 3% initially proposed by the company was reasonable, given that KKR had topped the next best bid by such a big margin and the Board's negotiators did negotiate to reduce the termination fee from 4% to 3.75%. Furthermore, the size of the termination fee and the presence in the merger agreement of a provision entitling KKR to match any competing bid received did not act as a serious barrier to any bidder willing to pay materially more than KKR's price.

In rejecting the plaintiffs' *Revlon* arguments and finding the Board's decision to negotiate with four bidders who had previously submitted bids to buy part of the company, rather than conduct a wide auction, was reasonable and *Revlon*-compliant, the Chancery Court wrote:

> The plaintiffs, of course, argue that the Toys "R" Us board made a hurried decision to sell the whole Company, after feckless deliberations, rushing headlong into the arms of the KKR Group when a universe of worthier, but shy, suitors were waiting to be asked to dance. The M & A market, as they view it, is comprised of buyers of exceedingly modest and retiring personality, too genteel to make even the politest of uninvited overtures: a cotillion of the reticent.
>
> For that reason, the Company's nearly year long, publicly announced search for strategic alternatives was of no use in testing the market. Because that announced process did not specifically invite offers for the entire Company from buyers, the demure M & A community of potential Cyranos, albeit ones afraid to even speak through front men, could not be expected to risk the emotional blow of rejection by Toys "R" Us. Given its failure to appreciate the psychological barriers that impeded possible buyers from overcoming the emotional paralysis that afflicts them in the absence of a warm, outreached hand, the Company's board wrongly seized upon the KKR Group's bid, without reasonable basis (other

than, of course, its $350 million superiority to the Cerberus bid and its attractiveness when compared to the multiple valuations that the board reviewed).

The plaintiffs supplement this dubious big-picture with a swarm of nits about several of the myriad of choices directors and their advisors must make in conducting a thorough strategic review. Rather than applaud the board's supple willingness to change direction when that was in the stockholders' best interest, the plaintiffs instead trumpet their arguable view that the directors and their advisors did not set out on the correct course in the first instance. Even the reasonable refusal of the Company to confirm or deny rumors in the Wall Street Journal is flown in to somehow demonstrate the board's failure to market the Company adequately.

It is not hyperbole to say that one could spend hundreds of pages swatting these nits out of the air. In the fewer, but still too numerous, pages that follow, I will attempt to explain in a reader-friendly fashion why the board's process for maximizing value cannot reasonably be characterized as unreasonable.

I begin by noting my disagreement with the plaintiffs about the nature of players in the American M & A markets. They are not like some of us were in high school. They have no problem with rejection. The great takeover cases of the last quarter century — like *Unocal, QVC*, and — oh, yeah — *Revlon* — all involved bidders who were prepared, for financial advantage, to make hostile, unsolicited bids. Over the years, that willingness has not gone away.

Given that bidders are willing to make unsolicited offers for companies with an announced strategy of remaining independent, boards like Toys "R" Us know that one way to signal to buyers that they are open to considering a wide array of alternatives is to announce the board's intention to look thoroughly at strategic alternatives. By doing that, a company can create an atmosphere conducive to offers of a non-public and public kind, while not putting itself in a posture that signals financial distress.

In that regard, the defendants plausibly argue that if the Company's board had put a "for sale" sign on Toys "R" Us when its stock price was at $12.00 per share, the ultimate price per share it would have received would likely have begun with a "1" rather than a "2" and not have been anywhere close to $26.75 per share. The board avoided that risk by creating an environment in which it simultaneously recognized the need to unlock value and signaled its openness to a variety of means to accomplish that desirous goal, while at the same time notifying buyers that no emergency required a sale.

By this method, I have no doubt that Toys "R" Us caught the attention of every retail industry player that might have had an interest in a strategic deal with it. That is, in fact, what triggered calls from PETsMART, Home Depot, Office Depot, Staples, and Best Buy, all of whom potentially wanted to buy some of the Company's real estate.

> In a marketplace where strategic buyers have not felt shy about "jumping" friendly deals crafted between their industry rivals, the board's open search for strategic alternatives presented an obvious opportunity for retailers, of any size or stripe, who thought a combination with all or part of the Company made sense for them, to come forward with a proposal. That they did not do so, early or late in the process, is most likely attributable to their inability to formulate a coherent strategy that would combine the Company's toy and baby store chains into another retail operation. The plaintiffs' failure to identify, or cite to any industry analyst touting the existence of, likely synergistic combinations is telling.
>
> The approach that the board took not only signaled openness to possible buyers, it enabled the board to develop a rich body of knowledge regarding the value not only of the Company's operations, but of its real estate assets. That body of knowledge provided the board with a firm foundation to analyze potential strategic options and constituted useful information to convince buyers to pay top dollar.

The Chancery Court further found no fault in the Board's willingness to allow two of the bidders to present a joint bid:

> Likewise, the decision to accede to KKR and Vornado/Bain's request to present a joint bid cannot be deemed unreasonable. The Cerberus consortium had done that earlier, as to the Global Toys business only. Had First Boston told KKR and Vornado/Bain "no," they might not have presented any whole Company bid at all. Their rationale for joining together, to spread the risk that would be incurred by undertaking what the plaintiffs have said is the largest retail acquisition by financial buyers ever, was logical and is consistent with an emerging practice among financial buyers. By banding together, these buyers are able to make bids that would be imprudent, if pursued in isolation. The plaintiffs' continued description of the KKR Group's bid as "collusive," is not only linguistically imprecise, it is a naked attempt to use inflammatory words to mask a weak argument. The "cooperative" bid that First Boston permitted the KKR Group to make gave the Company a powerful bidding competitor to the Cerberus consortium, which included, among others, Goldman Sachs.

In rejecting plaintiffs' other major argument that the Board acted unreasonably because the merger agreement with KKR included deal protection measures that, in the plaintiffs' view, precluded other bidders from making a topping offer, the Chancery Court wrote:

> It is no innovation for me to state that this court looks closely at the deal protection measures in merger agreements. In doing so, we undertake a nuanced, fact-intensive inquiry [that] does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal. Instead, that inquiry examines whether the board granting the deal protections had a reasonable basis to accede to the other side's demand for them in negotiations. In that inquiry, the court must attempt, as far as possible, to view the question from the perspective of

the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections. As *QVC* clearly states, what matters is whether the board acted reasonably based on the circumstances then facing it.

* * *

As the plaintiffs must admit, neither a termination fee nor a matching right is per se invalid. Each is a common contractual feature that, when assented to by a board fulfilling its fundamental duties of loyalty and care for the proper purpose of securing a high value bid for the stockholders, has legal legitimacy.

* * *

Contributing to this negotiating dynamic, no doubt, were prior judicial precedents, which suggested that it would not be unreasonable for the board to grant a substantial termination fee and matching rights to the KKR Group if that was necessary to successfully wring out a high-value bid. Given the Company's lengthy search for alternatives, the obvious opportunity that unsolicited bidders had been afforded to come forward over the past year, and the large gap between the Cerberus and the KKR Group bids, the board could legitimately give more weight to getting the highest value bid out of the KKR Group, and less weight to the fear that an unlikely higher-value bid would emerge later. After all, anyone interested had had multiple chances to present, however politely, a serious expression of interest — none had done so.

Nor was the level of deal protection sought by the KKR Group unprecedented in magnitude. In this regard, the plaintiffs ignore that many deals that were jumped in the late 1990s involved not only termination fees and matching rights but also stock option grants that destroyed pooling treatment, an additional effect that enhanced the effectiveness of the barrier to prevent a later-emerging bidder.

* * *

In view of this jurisprudential reality, the board was not in a position to tell the KKR Group that they could not have any deal protection. The plaintiffs admit this and therefore second-guess the board's decision not to insist on a smaller termination fee, more like 2.5% or 3%, and the abandonment of the matching right. But that, in my view, is precisely the sort of quibble that does not suffice to prove a *Revlon* claim.

* * *

It would be hubris in these circumstances for the court to conclude that the board acted unreasonably by assenting to a compromise 3.75% termination fee in order to guarantee $26.75 per share to its stockholders, and to avoid the

> substantial risk that the KKR Group might somehow glean the comparatively large margin by which it had outbid Cerberus.
>
> * * *
>
> The central purpose of *Revlon* is to ensure the fidelity of fiduciaries. It is not a license for the judiciary to set arbitrary limits on the contract terms that fiduciaries acting loyally and carefully can shape in the pursuit of their stockholders' interest.
>
> * * *
>
> This is not to say that this court is, or has been, willing to turn a blind eye to the adoption of excessive termination fees, such as the 6.3% termination fee in *Phelps Dodge* that Chancellor Chandler condemned, that present a more than reasonably explicable barrier to a second bidder, or even that fees lower than 3% are always reasonable. But it is to say that *Revlon*'s purpose is not to set the judiciary loose to enjoin contractual provisions that, upon a hard look, were reasonable in view of the benefits the board obtained in the other portions of an integrated contract.

In finding that the board's process passed muster and after noting the scrupulous way in which management refused to even discuss future employment prospects with any bidder (or even meet with a bidder in the absence of its financial adviser), the Chancery Court noted that the financial adviser had introduced an unnecessary issue by agreeing (after the merger agreement was signed and with the permission of the board) to provide buy-side financing for KKR:

> First Boston did create for itself, and therefore its clients, an unnecessary issue. In autumn 2004, First Boston raised the possibility of providing buy-side financing to bidders for Global Toys. First Boston had done deals in the past with many of the late-round financial buyers, most notably with KKR. The board promptly nixed that idea. At the board's insistence, First Boston had, therefore, refused to discuss financing with the KKR Group, or any bidder, before the merger was finalized. But, when the dust settled, and the merger agreement was signed, the board yielded to a letter request by First Boston to provide financing on the buy-side for the KKR Group.
>
> That decision was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms. Far better, from the standpoint of instilling confidence, if First Boston had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller's financial advisor. In that respect, it might have been better, in view of First Boston's refusal to refrain, for the board of the

Company to have declined the request, even though the request came on May 12, 2005, almost two months after the board had signed the merger agreement.

My job, however, is not to police the appearances of conflict that, upon close scrutiny, do not have a causal influence on a board's process. Here, there is simply no basis to conclude that First Boston's questionable desire to provide buy-side financing ever influenced it to advise the board to sell the whole Company rather than pursue a sale of Global Toys, or to discourage bidders other than KKR, or to assent to overly onerous deal protection measures during the merger agreement negotiations.

4. Disparate Treatment of Stockholders.

In a merger there are often situations where it is desired to treat shareholders within the same class differently. For example, a buyer may not want to expose itself to the costs and delays that may be associated with issuing securities to shareholders of the target who are not "*accredited investors*" within the meaning of Rule 501(a) of Regulation D under the Securities Act of 1933. In such a situation, the buyer may seek to issue shares only to accredited investors and pay equivalent value on a per share basis in cash to unaccredited investors.

DGCL § 251(b) provides, in relevant part, that "[an] agreement of merger shall state: . . . (5) the manner, if any, of converting the shares of each of the constituent corporations into shares or other securities of the corporation surviving or resulting from the merger or consolidation, or of cancelling some or all of such shares, and, if any shares of any of the constituent corporations are not to remain outstanding, to be converted solely into shares or other securities of the surviving or resulting corporation, or to be cancelled, the cash, property, rights or securities of any other corporation or entity which the holders of such shares are to receive in exchange for, or upon conversion of such shares and the surrender of any certificates evidencing them, which cash, property, rights or securities of any other corporation or entity may be in addition to or in lieu of shares or other securities of the surviving or resulting corporation."[502] Similarly, TBOC § 10.002 provides that "[a] plan of merger must include . . . the manner and basis of converting any of the ownership or membership interests of each organization that is a party to the merger into: (A) ownership interests, membership interests, obligations, rights to purchase securities, or other securities of one or more of the surviving or new organizations; (B) cash; (C) other property, including ownership interests, membership interests, obligations, rights to purchase securities, or other securities of any other person or entity; or (D) any combination of the items described by Paragraphs (A)-(C)."[503] Further, "[i]f the plan of merger provides for a manner and basis of converting an ownership or membership interest that may be converted in a manner or basis different than any other ownership or membership interest of the same class or series of the ownership or membership interest, the manner and basis of conversion must be included in the plan of merger in the same manner as provided by Subsection (a)(5)."[504]

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502 8 Del. C. § 251(b).

503 TBOC § 10.002(a)(5); *see also* TBCA art. 5.01.B.

504 TBOC § 10.002(c); *see also* TBCA art. 5.01.B.

DGCL § 251(b)(5) and the Texas Corporate Statues do not by their literal terms require that all shares of the same class of a constituent corporation in a merger be treated identically in a merger effected in accordance therewith.[505] Certain Delaware court decisions provide guidance. In *Jedwab v. MGM Grand Hotels, Inc.*,[506] a preferred stockholder of MGM Grand Hotels, Inc. ("*MGM*") sought to enjoin the merger of MGM with a subsidiary of Bally Manufacturing Corporation whereby all stockholders of MGM would receive cash. The plaintiff challenged the apportionment of the merger consideration among the common and preferred stockholders of MGM. The controlling stockholder of MGM apparently agreed, as a facet of the merger agreement, to accept less per share for his shares of common stock than the other holders of common stock would receive on a per share basis in respect of the merger. While the primary focus of the opinion in *Jedwab* was the allocation of the merger consideration between the holders of common stock and preferred stock, the Court also addressed the need to allocate merger consideration equally among the holders of the same class of stock. In this respect, the Court stated that "should a controlling shareholder for whatever reason (to avoid entanglement in litigation as plaintiff suggests is here the case or for other personal reasons) elect to sacrifice some part of the value of his stock holdings, the law will not direct him as to how what amount is to be distributed and to whom." According to the Court in *Jedwab*, therefore, there is no per se statutory prohibition against a merger providing for some holders of a class of stock to receive less than other holders of the same class if the holders receiving less agree to receive such lesser amount.[507]

In *Jackson v. Turnbull*,[508] plaintiffs brought an action pursuant to DGCL § 225 to determine the rightful directors and officers of L'Nard Restorative Concepts, Inc. ("*L'Nard*") and claimed, among other things, that a merger between Restorative Care of America, Inc. ("*Restorative*") and L'Nard was invalid. The merger agreement at issue provided that the L'Nard common stock held by certain L'Nard stockholders would be converted into common stock of the corporation surviving the merger and that the common stock of L'Nard held by certain other L'Nard stockholders would be converted into the right to receive a cash payment. The plaintiffs argued that the merger violated DGCL § 251(b)(5) by, *inter alia*, forcing stockholders holding the same class of stock to accept different forms of consideration in a single merger. The Court in *Jackson* ultimately found the merger to be void upon a number of grounds, including what it found to be an impermissible delegation of the L'Nard directors' responsibility to determine the consideration payable in the merger. In respect of the plaintiffs' claims that the merger was void under DGCL § 251, the Chancery Court rejected such a claim as not presenting

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505 *Compare Beaumont v. American Can Co.,* Index No. 28742/87 (N.Y. Sup. Ct. May 8, 1991) (determining that unequal treatment of stockholders violates the literal provisions of N.Y. Bus. Corp. Law § 501(C), which requires that "each share shall be equal to every other share of the same class"); see DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE* § 35.04[1], at 35-11 (1997).

506 509 A.2d 584 (Del. Ch. 1986).

507 See *Emerson Radio Corp. v. International Jensen Inc.*, C.A. No. 15130, slip op. at 33-34 (Del. Ch. Apr. 30, 1996); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 9.10 (2d ed. 1997); DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE* § 35.04[1] (1997); *see also In re Reading Co.*, 711 F.2d 509, 517 (3d Cir. 1983) (applying Delaware law, the Court held that stockholders may be treated less favorably with respect to dividends when they consent to such treatment); *Schrage v. Bridgeport Oil Co., Inc.*, 71 A.2d 882, 883 (Del. Ch. 1950) (in enjoining the implementation of a plan of dissolution, holding that the plan could have provided for the payment of cash to certain stockholders apparently by means of a cafeteria-type plan in lieu of an in-kind distribution of the corporation's assets).

508 C.A. No. 13042 (Del. Ch. Feb. 8, 1994), *aff'd*, 653 A.2d 306 (Del. Dec. 7, 1994).

a statutory issue. The clear implication of the Court's decision in *Jackson* is the decision to treat holders of shares of the same class of stock in a merger differently is a fiduciary, not a statutory, issue.

Even though a merger agreement providing for different treatment of stockholders within the same class appears to be authorized by both DGCL and the Texas Corporate Statues, the merger agreement may still be challenged on grounds that the directors violated their fiduciary duties of care, good faith and loyalty in approving the merger. In *In re Times Mirror Co. Shareholders Litigation*,[509] the Court approved a proposed settlement in connection with claims pertaining to a series of transactions which culminated with the merger of The Times Mirror Company ("*Times Mirror*") and Cox Communications, Inc. The transaction at issue provided for: (i) certain stockholders of Times Mirror related to the Chandler family to exchange (prior to the merger) outstanding shares of Times Mirror Series A and Series C common stock for a like number of shares of Series A and Series C common stock, respectively, of a newly formed subsidiary, New TMC Inc. ("*New TMC*"), as well as the right to receive a series of preferred stock of New TMC; and (ii) the subsequent merger whereby the remaining Times Mirror stockholders (i.e., the public holders of Times Mirror Series A and Series C common stock) would receive a like number of shares of Series A and Series C common stock, respectively, of New TMC and shares of capital stock in the corporation surviving the merger. Although holders of the same class of stock were technically not being disparately treated in respect of a merger since the Chandler family was to engage in the exchange of their stock immediately prior to the merger (and therefore *Times Mirror* did not present as a technical issue a statutory claim under DGCL § 251(b)(5)), the Court recognized the somewhat differing treatment in the transaction taken as a whole. As the Court inquired, "[i]s it permissible to treat one set of shareholders holding a similar security differently than another subset of that same class?" The Court in *Times Mirror* was not required to finally address the issue of disparate treatment of stockholders since the proceeding was a settlement proceeding. Therefore, the Court was merely required to assess the strengths and weaknesses of the claims being settled. The Court nonetheless noted that "[f]or a long time I think that it might have been said that [the discriminatory treatment of stockholders] was not permissible," but then opined that "I am inclined to think that [such differing treatment] is permissible." In addition to noting that *Unocal v. Mesa Petroleum Co.*,[510]-- which permitted a discriminatory stock repurchase as a response to a hostile takeover bid -- would be relevant in deciding such issue, the Court noted that an outright prohibition of discriminatory treatment among holders of the same class of stock would be inconsistent with policy concerns. In this respect, the Court noted "that a controlling shareholder, so long as the shareholder is not interfering with the corporation's operation of the transaction, is itself free to reject any transaction that is presented to it if it is not in its best interests as a shareholder." Therefore, if discriminatory treatment among holders of the same class of stock were not permitted in certain circumstances:

> [T]hen you might encounter situations in which no transaction could be done at all. And it is not in the social interest – that is, the interest of the economy generally – to have a rule that prevents efficient transactions from occurring.

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509 C.A. No. 13550 (Del. Ch. Nov. 30, 1994) (Bench Ruling).

510 493 A.2d 946 (Del. 1985).

> What is necessary, and I suppose what the law is, is that such a discrimination can be made but it is necessary in all events that both sets of shareholders be treated entirely fairly.[511]

5. Protecting the Merger.

During the course of acquisition negotiations, it may be neither practicable nor possible to auction or actively shop the corporation. Moreover, even when there has been active bidding by two or more suitors, it may be difficult to determine whether the bidding is complete. In addition, there can remain the possibility that new bidders may emerge that have not been foreseen. In these circumstances, it is generally wise for the board to make some provision for further bidders in the merger agreement. Such a provision can also provide the board with additional support for its decision to sell to a particular bidder if the agreement does not forestall competing bidders, permits the fact gathering and discussion sufficient to make an informed decision and provides meaningful flexibility to respond to them. In this sense, the agreement is an extension of, and has implications for, the process of becoming adequately informed.

In considering a change of control transaction, a board should consider:

> [W]hether the circumstances afford a disinterested and well motivated director a basis reasonably to conclude that if the transactions contemplated by the merger agreement close, they will represent the best available alternative for the corporation and its shareholders. This inquiry involves consideration *inter alia* of the nature of any provisions in the merger agreement tending to impede other offers, the extent of the board's information about market alternatives, the content of announcements accompanying the execution of the merger agreement, the extent of the company's contractual freedom to supply necessary information to competing bidders, and the time made available for better offers to emerge.[512]

Management will, however, have to balance the requirements of the buyer against these interests in negotiating the merger agreement. The buyer will seek assurance of the benefit of its bargain through the agreement, especially the agreed upon price, and the corporation may run the risk of losing the transaction if it does not accede to the buyer's requirements in this regard. The relevant cases provide the corporation and its directors with the ability, and the concomitant obligation in certain circumstances, to resist.

The assurances a buyer seeks often take the form of a "no-shop" clause, a "lock-up" agreement for stock or assets, a break-up fee, or a combination thereof. In many cases, a court will consider the effect of these provisions together. Whether or not the provisions are upheld may depend, in large measure, on whether a court finds that the board has adequate information about the market and alternatives to the offer being considered. The classic examples of no-shops, lock-ups and break-up fees occur, however, not in friendly situations, where a court is likely to find that such arrangements provide the benefit of keeping the suitor at the bargaining table, but rather in a bidding war between two suitors, where the court may find that such

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511 C.A. No. 13550 (Del. Ch. Nov. 30, 1994) (Bench Ruling).

512 *Roberts v. General Instrument Corp.*, 1990 WL 118356, at *8 (Del. Ch. 1990).

provisions in favor of one suitor prematurely stop an auction and thus do not allow the board to obtain the highest value reasonably attainable.

The fact that a buyer has provided consideration for the assurances requested in a merger agreement does not end the analysis. In *QVC*, the Delaware Supreme Court took the position that provisions of agreements that would force a board to violate its fiduciary duty of care are unenforceable. As the court stated:

> Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the . . . directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.[513]

Although this language provides a basis for directors to resist unduly restrictive provisions, it may be of little comfort to a board that is trying to abide by negotiated restrictive provisions in an agreement and their obligations under Delaware law, especially where the interplay of the two may not be entirely clear.

a. No-Shops

The term "*no-shop*" is used generically to describe both provisions that limit a corporation's ability to actively canvas the market (the "no shop" aspect) or to respond to overtures from the market (more accurately, a "*no talk*" provision). No-shop clauses can take different forms. A strict no-shop allows no solicitation and also prohibits a target from facilitating other offers, all without exception. Because of the limitation that a strict no-shop imposes on the board's ability to become informed, such a provision is of questionable validity.[514] A customary, and limited, no-shop clause contains some type of "*fiduciary out*," which allows a board to take certain actions to the extent necessary for the board to comply with its fiduciary duties to shareholders.[515] Board actions permitted can range from supplying confidential information about the corporation to unsolicited suitors, to negotiating with unsolicited suitors and terminating the existing merger agreement upon payment of a break-up fee, to actively soliciting other offers.[516] Each action is tied to a determination by the board, after advice of counsel, that it is required in the exercise of the board's fiduciary duties. Such "fiduciary outs," even when restrictively drafted, will likely be interpreted by the courts to permit the board to become informed about an unsolicited competing bid. "[E]ven the decision not to

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513 *QVC*, 637 A.2d at 48.

514 *See Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, 1999 WL 1054255, (Del. Ch. 1999); *Ace Ltd. v. Capital Re Corp*., 747 A. 2d 95 (Del. Ch. 1999) (expressing view that certain no-talk provisions are "particularly suspect"); but *see In re IXC Commc'ns, Inc. S'holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999) (no talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty"). For a thorough discussion of these cases, see the article by Mark Morton, Michael Pittenger and Mathew Fischer entitled "*Recent Delaware Law Developments Concerning No-Talk Provisions: From "Just Say No" to "Can't Say Yes*," which was published in V Deal Points No. 1 (The News-Letter of the ABA Bus. L. S. Committee on Negotiated Acquisitions).

515 *See, e.g., Matador*, 729 A.2d at 288-89; and Allen, "*Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*," 55 Bus. Law. 653 (2000).

516 *See id*.

negotiate ... must be an informed one. A target can refuse to negotiate [in a transaction not involving a sale of control] but it should be informed when making such refusal."[517]

See Ace Ltd. v. Capital Re Corp.[518] for a discussion of restrictive "no shop" provisions. In *Ace*, which did not involve a change in control merger, the court interpreted a "no-talk" provision of a "no-shop" to permit the board to engage in continued discussions with a continuing bidder, notwithstanding the signing of a merger agreement, when not to do so was tantamount to precluding the stockholders from accepting a higher offer. The court wrote:

> *QVC* does not say that directors have no fiduciary duties when they are not in "Revlon-land." ...Put somewhat differently, *QVC* does not say that a board can, in all circumstances, continue to support a merger agreement not involving a change of control when: (1) the board negotiated a merger agreement that was tied to voting agreements ensuring consummation if the board does not terminate the agreement; (2) the board no longer believes that the merger is a good transaction for the stockholders; and (3) the board believes that another available transaction is more favorable to the stockholders. The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to set idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about. The logic of *QVC* itself casts doubts on the validity of such a contract.[519]

See also *Cirrus Holding v. Cirrus Ind.*,[520] in which the court wrote in denying the petition by a purchaser who had contracted to buy from a closely held issuer 61% of its equity for a preliminary injunction barring the issuer from terminating the purchase agreement and accepting a better deal that did not involve a change in control:

> As part of this duty [to secure the best value reasonably available to the stockholders], directors cannot be precluded by the terms of an overly restrictive "no-shop" provision from all consideration of possible better transactions. Similarly, directors cannot willfully blind themselves to opportunities that are presented to them, thus limiting the reach of "no talk" provisions. The fiduciary out provisions also must not be so restrictive that, as a practical matter, it would be impossible to satisfy their conditions. Finally, the fiduciary duty did not end when the Cirrus Board voted to approve the SPA. The directors were required to consider all available alternatives in an informed manner until such time as the SPA was submitted to the stockholders for approval.

Although determinations concerning fiduciary outs are usually made when a serious competing suitor emerges, it may be difficult for a board or its counsel to determine just how much of the potentially permitted response is required by the board's fiduciary duties.[521] As a

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517 *Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, 1999 WL 1054255 (Del. Ch. 1999).

518 747 A.2d. 95 (Del. Ch. 1999).

519 *Id*. at 107-08.

520 794 A.2d 1191 (Del. Ch. 2001).

521 *See* Johnston, *Recent Amendments to the Merger Sections of the DGCL Will Eliminate Some - But Not All - Fiduciary Out Negotiation and Drafting Issues*, 1 BNA Mergers & Acquisitions L. Rep. 777 (1998):

consequence, the board may find it advisable to state the "fiduciary out" in terms that do not only address fiduciary duties, but also permit action when an offer, which the board reasonably believes to be "superior," is made.

As the cases that follow indicate, while in some more well-known situations no-shops have been invalidated, the Delaware courts have on numerous occasions upheld different no-shop clauses as not impeding a board's ability to make an informed decision that a particular agreement provided the highest value reasonably obtainable for the shareholders.

b. Lock-ups

Lock-ups can take the form of an option to buy additional shares of the corporation to be acquired, which benefits the suitor if the price for the corporation increases after another bidder emerges and discourages another bidder by making the corporation more expensive or by giving the buyer a head start in obtaining the votes necessary to approve the transaction.[522] Lock-ups can also take the form of an option to acquire important assets (a company's "*crown jewels*") at a price that may or may not be a bargain for the suitor, which may so change the attractiveness of the corporation as to discourage or preclude other suitors. "[L]ock-ups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duty."[523] The Delaware Supreme Court has tended to look askance at lock-up provisions when such provisions, however, impede other bidders or do not result in enhanced bids. As the Delaware Supreme Court stated in *Revlon*,

> Such [lock-up] options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. . . . However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders detriment.[524]

As the cases that follow indicate, the Delaware courts have used several different types of analyses in reviewing lock-ups. In active bidding situations, the courts have examined whether

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> [I]n freedom-of-contract jurisdictions like Delaware, the target board will be held to its bargain (and the bidder will have the benefit of its bargain) only if the initial agreement to limit the target board's discretion can withstand scrutiny under applicable fiduciary duty principles. The exercise of fiduciary duties is scrutinized up front -- at the negotiation stage. If that exercise withstands scrutiny, fiduciary duties will be irrelevant in determining what the target board's obligations are when a better offer, in fact, emerges; at that point its obligations will be determined solely by the contract.

Id. at 779.

522 Such an option is issued by the corporation, generally to purchase newly issued shares for up to 19.9% of the corporation's outstanding shares at the deal price. The amount is intended to give the bidder maximum benefit without crossing limits established by the New York Stock Exchange (see Rule 312.03, NYSE Listed Company Manual) or NASD (see Rule 4310(c)(25)(H)(i), NASD Manual -- The NASDAQ Stock Market) that require shareholder approval for certain large stock issuances. Such an option should be distinguished from options granted by significant shareholders or others in support of the deal. Shareholders may generally grant such options as their self-interest requires. See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994). However, an option involving 15% or more of the outstanding shares generally will trigger DGCL § 203, which section restricts certain transactions with shareholders who acquire such amount of shares without board approval. Any decision to exempt such an option from the operation of DGCL § 203 involves the board's fiduciary duties.

523 *Revlon*, 506 A.2d at 176.

524 *Id.* at 183.

the lock-up resulted in an enhanced bid (in addition to the fact that the lock-up ended an active auction).[525] In situations not involving an auction, the courts have examined whether the lock-up impeded other potential suitors, and if an active or passive market check took place prior to the grant of the lock-up.[526]

c. Break-Up Fees.

Break-up fees generally require the corporation to pay consideration to its merger partner should the corporation be acquired by a competing bidder who emerges after the merger agreement is signed. As with no-shops and lock-ups, break-up fees are not invalid unless they are preclusive or an impediment to the bidding process.[527] As the cases that follow indicate, however, break-up fees are not as disliked by the Delaware courts, and such fees that bear a reasonable relation to the value of a transaction so as not to be preclusive have been upheld.[528] In practice, counsel are generally comfortable with break-up fees that range up to 4% of the equity value of the transaction and a fee of up to 5% may be justified in connection with certain smaller transactions. A court, when considering the validity of a fee, will consider the aggregate effect of that fee and all other deal protections.[529] As a result, a 5% fee may be reasonable in one case and a 2.5% fee may be unreasonable in another case. However, the Delaware jurisprudence was not yet resolved whether the appropriate basis for calculating a termination fee is equity or enterprise value.[530] For this purpose, the value of any lock-up given by the corporation to the bidder should be included.

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525 *See Revlon*, 506 A.2d 173; *Macmillan*, 559 A.2d 1261.

526 *See Matador*, 729 A.2d at 291; *Rand*, 1994 WL 89006; *Roberts*, 1990 WL 118356. For a further discussion of the analytical approaches taken by the Delaware courts, *see* Fraidin and Hanson, *Toward Unlocking Lock-ups*, 103 Yale L. J. 1739, 1748-66 (1994).

527 Alternatively, if parties to a merger agreement expressly state that the termination fee will constitute liquidated damages, Delaware courts will evaluate the termination fee under the standard for analyzing liquidated damages. For example, in *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43 (Del. 1997), Bell Atlantic and NYNEX entered into a merger agreement which included a two-tiered termination fee of $550 million, which represented about 2% of Bell Atlantic's market capitalization and would serve as a reasonable measure for the opportunity cost and other losses associated with the termination of the merger. *Id.* at 45. The merger agreement stated that the termination fee would "constitute liquidated damages and not a penalty." *Id.* at 46. Consequently, the court found "no compelling justification for treating the termination fee in this agreement as anything but a liquidated damages provision, in light of the express intent of the parties to have it so treated." *Id.* at 48. Rather than apply the business judgment rule, the court followed "the two-prong test for analyzing the validity of the amount of liquidated damages: 'Where the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed.'" *Id.* at 48 (citation omitted). Ultimately, the court upheld the liquidated damages provision. *Id.* at 50. The court reasoned in part that the provision was within the range of reasonableness "given the undisputed record showing the size of the transaction, the analysis of the parties concerning lost opportunity costs, other expenses, and the arms-length negotiations." *Id.* at 49.

528 *See Goodwin*, 1999 WL 64265, at * 23; *Matador*, 729 A.2d at 291 n.15 (discussing authorities).

529 *QVC*, 637 A.2d 34.

530 *See In re Pennaco Energy, Inc. Shareholders Litig.*, 787 A. 2d 691, 702 n. 16 (Del. Ch. 2001) (noting that "Delaware cases have tended to use equity value as a benchmark for measuring the termination fee" but adding that "no case has squarely addressed which benchmark is appropriate)."

6. Specific Cases Where No-Shops, Lock-ups, and Break-Up Fees Have Been Invalidated.

a. In *Revlon*,[531] the court held that the no-shop along with a lock-up agreement and a break-up fee effectively stopped an active bidding process and thus was invalid.[532] The court noted that the no-shop is impermissible under the *Unocal* if it prematurely ends an active bidding process because the "board's primary duty [has become] that of an auctioneer responsible for selling the company to the highest bidder."[533] *Revlon* had also granted to Forstmann a "crown jewel" asset lock-up representing approximately 24% of the deal value (and apparently the crown jewel was undervalued), and a break-up fee worth approximately 1.2% of the deal. The court invalidated the lock-up and the break-up fee, noting that Forstmann "had already been drawn into the contest on a preferred basis, so the result of the lock-up was not to foster bidding, but to destroy it."[534]

b. In *Macmillan*,[535] the directors of the corporation granted one of the bidders a lock-up agreement for one of its "crown jewel" assets.[536] As in *Revlon*, the court held that the lock-up had the effect of ending the auction, and held that the lock-up was invalid. The court also noted that if the intended effect is to end an auction, "at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."[537]

> In this case, a lock-up agreement was not necessary to draw any of the bidders into the contest. Macmillan cannot seriously contend that they received a final bid from KKR that materially enhanced general stockholder interests. . . . When one compares what KKR received for the lock-up, in contrast to its inconsiderable offer, the invalidity of the [lock-up] becomes patent.[538]

The court was particularly critical of the "crown jewel" lock-up. "Even if the lock-up is permissible, when it involves 'crown jewel' assets careful board scrutiny attends the decision. . . . Thus, when directors in a *Revlon* bidding contest grant a crown jewel lock-up, serious questions are raised, particularly where, as here, there is little or no improvement in the final bid."[539]

c. In *QVC*,[540] which like *Revlon* involved an active auction, the no-shop provision provided that Paramount would not:

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[531] *Revlon*, 506 A.2d 173.

[532] *Id*. at 182.

[533] *Id*. at 184.

[534] *Id*. at 183.

[535] *Macmillan*, 559 A.2d 1261.

[536] *Id*. at 1286.

[537] *Id*.

[538] *Id*. at 1286.

[539] *Id*.

[540] *QVC*, 637 A.2d 34.

> [S]olicit, encourage, discuss, negotiate, or endorse any competing transaction unless: (a) a third party "makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing"; and (b) the Paramount board determines that discussions or negotiations with the third party are necessary for the Paramount Board to comply with its fiduciary duties.[541]

The break-up fee arrangement provided that Viacom would receive $100 million (between 1% and 2% of the front-end consideration) if (i) Paramount terminated the merger agreement because of a competing transaction, (ii) Paramount's stockholders did not approve the merger, or (iii) Paramount's board recommended a competing transaction.[542] In examining the lock-up agreement between Paramount and Viacom (for 19.9% of the stock of Paramount), the court emphasized two provisions of the lock-up as being both "unusual and highly beneficial" to Viacom: "(a) Viacom was permitted to pay for the shares with a senior subordinated note of questionable marketability instead of cash, thereby avoiding the need to raise the $1.6 billion purchase price" and "(b) Viacom could elect to require Paramount to pay Viacom in cash a sum equal to the difference between the purchase price and the market price of Paramount's stock."[543] The court held that the lock-up, no-shop and break-up fee were "impeding the realization of the best value reasonably available to the Paramount shareholders."[544]

d. In *Holly Farms*,[545] the board of Holly Farms entered into an agreement to sell the corporation to ConAgra which included a lock-up option on Holly Farms' prime poultry operations and a $15 million break-up fee plus expense reimbursement.[546] Tyson Foods was at the same time also negotiating to purchase Holly Farms. In invalidating the lock-up and the break-up fee, the court noted that "[w]hile the granting of a lock up may be rational where it is reasonably necessary to encourage a prospective bidder to submit an offer, lock-ups 'which end an active auction and foreclose further bidding operate to the shareholders' detriment' are extremely suspect."[547] The court further stated that "the lock up was nothing but a 'show stopper' that effectively precluded the opening act."[548] The court also invalidated the break-up fee, holding that it appeared likely "to have been part of the effort to preclude a genuine auction."[549]

7. Specific Cases Where No-Shops, Lock-ups and Break-Up Fees Have Been Upheld.

a. In *Goodwin*,[550] the plaintiff shareholder argued that the board of Live Entertainment violated its fiduciary duties by entering into a merger agreement with Pioneer

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541 *Id*. at 39 (citations omitted).

542 *Id*.

543 *Id*.

544 *Id*. at 50.

545 *In re Holly Farms Corp. Shareholders Litig.*, 564 A. 2d 342 (Del. Ch. 1988).

546 *Id*. at *2.

547 *Id*. at *6 (citations omitted).

548 *Id*.

549 *Id*.

550 *Goodwin*, 1999 WL 64265.

Electronics.[551] The merger agreement contained a 3.125% break-up fee.[552] While the plaintiff did not seek to enjoin the transaction on the basis of the fee and did not attack any other aspect of the merger agreement as being unreasonable, the court noted "this type of fee is commonplace and within the range of reasonableness approved by this court in similar contexts."[553] Ultimately, the Chancery Court upheld the merger agreement.

b. In *Matador*,[554] Business Records Corporation entered into a merger agreement with Affiliated Computer Services which contained four "defensive" provisions, including a no-shop provision with a fiduciary out and termination fee.[555] Three BRC shareholders also entered into lock-up agreements with ACS to tender their shares to ACS within five days of the tender offer of ACS.[556] The Chancery Court upheld these provisions reasoning that "these measures do not foreclose other offers, but operate merely to afford some protection to prevent disruption of the Agreement by proposals from third parties that are neither bona fide nor likely to result in a higher transaction."[557] The court also noted that because the termination fee is not "invoked by the board's receipt of another offer, nor is it invoked solely because the board decides to provide information, or even negotiates with another bidder," it can hardly be said that it prevents the corporation from negotiating with other bidders.[558]

c. In *Rand*,[559] Western had been considering opportunities for fundamental changes in its business structure since late 1985.[560] In the spring of 1986, Western had discussions with both American and Delta, as well as other airlines.[561] When Western entered into a merger agreement with Delta in September 1986, the agreement contained a no-shop clause providing that Western could not "initiate contact with, solicit, encourage or participate in any way in discussions or negotiations with, or provide an information or assistance to, or provide any information or assistance to, any third party . . . concerning any acquisition of . . . [Western]."[562] Western also granted Delta a lock-up agreement for approximately 30% of Western's stock. The court stated that the market had been canvassed by the time the merger agreement was signed, and that by having a lock-up and a no-shop clause Western "gained a substantial benefit for its stockholders by keeping the only party expressing any interest at the table while achieving its own assurances that the transaction would be consummated."[563]

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551 *Id*. at *21.

552 *Id*. at *23.

553 *Id*.

554 *Matador*, 729 A.2d 280.

555 *Id*. at 289.

556 *Id*.

557 *Id*. at 291.

558 *Id*. at 291 n.15.

559 *Rand*, 1994 WL 89006.

560 *Id*. at *1.

561 *Id*.

562 *Id*. at *2.

563 *Id*. at *7.

d. In *Vitalink*,[564] the court held that the break-up fee, which represented approximately 1.9% of the transaction, did not prevent a canvass of the market.[565] The merger agreement in Vitalink also contained a no-shop which prohibited the target from soliciting offers, and a lock-up for NSC to purchase 19.9% of the shares of Vitalink.[566] In upholding the no-shop clause, the court noted that the no-shop clause "was subject to a fiduciary out clause whereby the Board could shop the company so as to comply with, among other things, their *Revlon* duties (i.e., duty to get the highest price reasonably attainable for shareholders)."[567] The court also held that the lock-up at issue did not constitute a "real impediment to an offer by a third party."[568]

e. In *Roberts*,[569] General Instrument entered into a merger agreement with a subsidiary of Forstmann Little & Co.[570] The merger agreement contained a no-shop clause providing that the corporation would not "solicit alternative buyers and that its directors and officers will not participate in discussions with or provide any information to alternative buyers except to the extent required by the exercise of fiduciary duties."[571] General Instrument could terminate the merger agreement if it determined that a third party's offer was more advantageous to the shareholders than Forstmann's offer.[572] Forstmann also agreed to keep the tender offer open for 30 business days, longer than required by law, to allow time for alternative bidders to make proposals. General Instrument was contacted by two other potential acquirors, and provided them with confidential information pursuant to confidentiality agreements.[573] Neither made offers. The court held that the no-shop did not impede any offers, noting that the merger agreement contained a sufficient fiduciary out.[574] The transaction in *Roberts* also included a $33 million break-up fee in the event that the General Instrument board chose an unsolicited bid over that of the bidder in the exercise of the board's fiduciary duties.[575] The court held that the break-up fee was "limited", approximately 2% of the value of the deal, and would not prevent the board from concluding that it had effected the best available transaction.[576]

f. In *Fort Howard*,[577] the board decided to enter into a merger agreement with a subsidiary of the Morgan Stanley Group. The agreement contained a no-shop clause that allowed Fort Howard to respond to unsolicited bids and provide potential bidders with information. Fort Howard received inquiries from eight potential bidders, all of whom were provided with information.[578] None of the eight made a bid.[579] The agreement also contained a

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564 *In re Vitalink*, 1991 WL 238816.

565 *Id*. at *7.

566 *Id*. at *3.

567 *Id*. at *7.

568 *Id*.

569 *Roberts*, 1990 WL 118356.

570 *Id*. at *6.

571 *Id*.

572 *Id*.

573 *Id*.

574 *Id*. at *9.

575 *Id*. at *6.

576 *Id*. at *9.

577 *In re Fort Howard*, 1988 WL 83147.

578 *Id*. at *8.

break-up fee of approximately 1% of the consideration. The court believed that Fort Howard conducted an active market check, noting that the:

> [A]lternative "market check" that was achieved was not so hobbled by lock-ups, termination fees or topping fees, so constrained in time or so administered (with respect to access to pertinent information or manner of announcing "window shopping" rights) as to permit the inference that this alternative was a sham designed from the outset to be ineffective or minimally effective.[580]

The court noted that it was "particularly impressed with the [window shopping] announcement in the financial press and with the rapid and full-hearted response to the eight inquiries received."[581]

8. Post Signing Market Check/"Go-Shop".

A "go-shop" is a provision in a merger agreement that permits a target company, after executing a merger agreement, to continue to actively solicit bids and negotiate with other potential bidders for a defined period of time:

> A typical go-shop provision permits a target company to solicit proposals and enter into discussions or negotiations with other potential bidders during a limited period of time (typically 30-50 days) following the execution of the merger agreement. The target company is permitted to exchange confidential information with a potential bidder, subject to the execution of a confidentiality agreement with terms and conditions substantially the same as the terms and conditions of the confidentiality agreement executed by the initial bidder. Any non-public information provided or made available to a competing bidder typically must also be provided or made available to the initial bidder.
>
> Increasingly, go-shops also provide for a bifurcated termination fee – a lower fee payable if the target terminates for a competing bidder who is identified during the go-shop period and a traditional termination fee if the target terminates for a competing bidder who is identified after the go-shop period ends.[582]

Private equity bidders particularly like go-shop provisions because they allow them to sign up a target without the costs and uncertainties associated with a pre-signing auction. Targets may agree to a go-shop in lieu of an auction because they believe the buyer would be unwilling to bid if the target commenced an auction or because of concerns that an auction might fail to

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579 *Id*. at *8-9.

580 *Id*. at *13.

581 *Id*.

582 Mark A. Morton & Roxanne L. Houtman, *Go-Shops: Market Check Magic or Mirage?*, Vol. XII Deal Points, Issue 2 (Summer 2007) at 2. *See Berg v. Ellison*, CA No. 2949-VCS (Del. Ch. June 12, 2007) in which Vice Chancellor Strine commented that a go-shop period of only 25 days at a lower breakup fee was not enough time for a new bidder to do due diligence, submit a bid and negotiate a merger agreement, particularly if the initial bidder has a right to match the new bidder's offer; Stephen I. Glover and Jonathan P. Goodman, *Go Shops: Are They Here to Stay*, 11 M&A Lawyer No. 6 (June 2007); *see also* Guhan Subramanian, *Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications*, 63 Bus. Law. 729 (May 2008).

produce a satisfactory transaction,[583] thereby leaving the target with the damaged goods image together possible employee or customer losses. While a go-shop gives the Board an opportunity, with a transaction with the first bidder under contract, to canvass the market for a possibly higher bid and thus to have a basis for claiming that it has satisfied its *Revlon* duties[584] to seek the highest price reasonably available when control of the company is being sold, the bidder can take some comfort that the risk that its bid will be jumped is relatively low.[585]

The Delaware courts have long recognized that a pre-signing auction is not the exclusive way for a Board to satisfy its *Revlon* duties and that a post-signing market check can be sufficient.[586] The Chancery Court in *In re Netsmart Technologies*[587] found a post-signing "window-shop" which allowed the target Board to consider only <u>unsolicited</u> third party proposals was not a sufficient market test in the context of a micro-cap company because the Court concluded that a targeted sales effort would be needed to get the attention of potential competing bidders, but found a "go-shop" a reasonable means for a Board to satisfy its *Revlon* duties in the context of a large-cap company in the *In re Lear Corporation Shareholder Litigation*.[588] The *In re Topps Company Shareholder Litigation*[589] produced a colorful Chancery Court validation of a go-shop:

> Although a target might desire a longer Go Shop Period or a lower break fee, the deal protections the Topps board agreed to in the Merger Agreement seem to have left reasonable room for an effective post-signing market check. For 40 days, the Topps board could shop like Paris Hilton. Even after the Go Shop Period expired, the Topps board could entertain an unsolicited bid, and, subject to Eisner's match right, accept a Superior Proposal. The 40-day Go Shop Period and this later right work together, as they allowed interested bidders to talk to Topps and obtain information during the Go Shop Period with the knowledge that if they needed more time to decide whether to make a bid, they could lob in an unsolicited Superior Proposal after the Period expired and resume the process.

G. Dealing with a Competing Acquiror.

Even in the friendly acquisition, a board's obligations do not cease with the execution of the merger agreement.[590] If a competing acquiror emerges with a serious proposal offering greater value to shareholders (usually a higher price), the board should give it due consideration.[591] Generally the same principles that guided consideration of an initial proposal

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583 *See infra* notes 667-671 and related text.

584 *See supra* notes 480-484 and related text.

585 *See* Mark A. Morton & Roxanne L. Houtman, *Go-Shops: Market Check Magic or Mirage?*, Vol. XII Deal Points, Issue 2 (Summer 2007) at 2, 7.

586 *See supra* notes 485-500 and related text.

587 *See infra* notes 662-665 and related text.

588 *See infra* notes 672-677 and related text.

589 *See infra* notes 667-671 and related text.

590 *See e.g., Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 483086 (Del. Ch. 1996) (bidding and negotiations continued more than six months after merger agreement signed).

591 *See Phelps Dodge*, 1999 WL 1054255 and *Ace*, 747 A.2d at 107-108.

(being adequately informed and undertaking an active and orderly deliberation) will also guide consideration of the competing proposal.[592]

1. Fiduciary Outs.

A board should seek to maximize its flexibility in responding to a competing bidder in the no-shop provision of the merger agreement. It will generally be advisable for the agreement to contain provisions permitting the corporation not only to provide information to a bidder with a superior proposal, but also to negotiate with the bidder, enter into a definitive agreement with the bidder and terminate the existing merger agreement upon the payment of a break-up fee. Without the ability to terminate the agreement, the board may find, at least under the language of the agreement, that its response will be more limited.[593] In such circumstances, there may be some doubt as to its ability to negotiate with the bidder or otherwise pursue the bid. This may in turn force the competing bidder to take its bid directly to the shareholders through a tender offer, with a concomitant loss of board control over the process.

Bidders may seek to reduce the board's flexibility by negotiating for an obligation in the merger agreement to submit the merger agreement to stockholders (also known as a "force the vote" provision) even if the board subsequently withdraws its recommendation to the stockholders. Such an obligation is now permitted by DGCL Section 146. The decision to undertake such submission, however, implicates the board's fiduciary duties. Because of the possibility of future competing bidders, this may be a difficult decision.[594]

a. **Omnicare, Inc. v. NCS Healthcare, Inc.**

The Delaware Supreme Court's April 4, 2003 decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*[595] deals with the interrelationship between a "force the vote" provision in the merger agreement, a voting agreement which essentially obligated a majority of the voting power of the target company's shares to vote in favor of a merger and the absence of a "fiduciary termination right" in the merger agreement that would have enabled the board of directors to back out of the deal before the merger vote if a better deal comes along.

The decision in *Omnicare* considered a challenge to a pending merger agreement between NCS Healthcare, Inc. and Genesis Health Ventures, Inc. Prior to entering into the Genesis merger agreement, the NCS directors were aware that Omnicare was interested in acquiring NCS. In fact, Omnicare had previously submitted proposals to acquire NCS in a pre-packaged bankruptcy transaction. NCS, however, entered into an exclusivity agreement with Genesis in early July 2002. When Omnicare learned from other sources that NCS was negotiating with Genesis and that the parties were close to a deal, it submitted an offer that would have paid NCS stockholders $3.00 cash per share, which was more than three times the

592 *See Macmillan*, 559 A.2d at 1282 n.29.

593 *See Van Gorkom*, 488 A.2d at 888 ("Clearly the . . . Board was not 'free' to withdraw from its agreement . . . by simply relying on its self-induced failure to have [negotiated a suitable] original agreement. . . .") *But see also QVC*, 637 A.2d at 51 (a board cannot "contract away" its fiduciary duties) and *Ace*, 747 A.2d at 107-108.

594 *See* John F. Johnston, *Recent Amendments to the Merger Sections of the DGCL Will Eliminate Some - But Not All - Fiduciary Out Negotiation and Drafting Issues*, 1 BNA Mergers & Acquisitions L. Rep. 777 (1998).

595 818 A. 2d 914 (Del. 2003).

value of the $0.90 per share, all stock, proposal NCS was then negotiating with Genesis. Omnicare's proposal was conditioned upon negotiation of a definitive merger agreement, obtaining required third party consents, and completing its due diligence. The exclusivity agreement with Genesis, however, prevented NCS from discussing the proposal with Omnicare.

When NCS disclosed the Omnicare offer to Genesis, Genesis responded by enhancing its offer. The enhanced terms included an increase in the exchange ratio so that each NCS share would be exchanged for Genesis stock then valued at $1.60 per share. But Genesis also insisted that NCS approve and sign the merger agreement as well as approve and secure the voting agreements by midnight the next day, before the exclusivity agreement with Genesis was scheduled to expire. On July 28, 2002, the NCS directors approved the Genesis merger agreement prior to the expiration of Genesis's deadline.

The merger agreement contained a "force-the-vote" provision authorized by the Delaware General Corporation Law, which required the agreement to be submitted to a vote of NCS's stockholders, even if its board of directors later withdrew its recommendation of the merger (which the NCS board later did). In addition, two NCS director-stockholders who collectively held a majority of the voting power, but approximately 20% of the equity of NCS, agreed unconditionally and at the insistence of Genesis to vote all of their shares in favor of the Genesis merger. The NCS board authorized NCS to become a party to the voting agreements and granted approval under Section 203 of the Delaware General Corporation Law, in order to permit Genesis to become an interested stockholder for purposes of that statute. The "force-the-vote" provision and the voting agreements, which together operated to ensure consummation of the Genesis merger, were not subject to fiduciary outs.

The Court of Chancery's Decision in Omnicare. The Court of Chancery declined to enjoin the NCS/Genesis merger. In its decision, the Court emphasized that NCS was a financially troubled company that had been operating on the edge of insolvency for some time. The Court also determined that the NCS board was disinterested and independent of Genesis and was fully informed. The Vice Chancellor further emphasized his view that the NCS board had determined in good faith that it would be better for NCS and its stockholders to accept the fully-negotiated deal with Genesis, notwithstanding the lock up provisions, rather than risk losing the Genesis offer and also risk that negotiations with Omnicare over the terms of a definitive merger agreement could fail.

The Supreme Court Majority Opinion in Omnicare. On appeal, the Supreme Court of Delaware accepted the Court of Chancery's finding that the NCS directors were disinterested and independent and assumed "arguendo" that they exercised due care in approving the Genesis merger. Nonetheless, the majority held that the "force-the-vote" provision in the merger agreement and the voting agreements operated in tandem to irrevocably "lock up" the merger and to preclude the NCS board from exercising its ongoing obligation to consider and accept higher bids. Because the merger agreement did not contain a fiduciary out, the Supreme Court held that the Genesis merger agreement was both preclusive and coercive and, therefore, invalid under *Unocal Corp. v. Mesa Petroleum Co.*:[596]

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[596] 493 A.2d 946 (Del. 1985).

> The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished a *fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect. Those tripartite defensive measures – the Section 251(c) provision, the voting agreements, and the absence of an effective fiduciary out clause – made it "mathematically impossible" and "realistically unattainable" for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal.

As an alternative basis for its conclusion, the majority held that under the circumstances the NCS board did not have authority under Delaware law to completely "lock up" the transaction because the defensive measures "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction." In so holding, the Court relied upon its decision in *Paramount Communications Inc. v. QVC Networks Inc.*,[597] in which the Court held that "[t]o the extent that a [merger] contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."

The Dissents in Omnicare. Chief Justice Veasey and Justice Steele wrote separate dissents. Both believed that the NCS board was disinterested and independent and acted with due care and in good faith – observations with which the majority did not necessarily disagree. The dissenters articulated their view that it was "unwise" to have a bright-line rule prohibiting absolute lock ups because in some circumstances an absolute lock up might be the only way to secure a transaction that is in the best interests of the stockholders. The dissenters would have affirmed on the basis that the NCS board's decision was protected by the business judgment rule. Both Chief Justice Veasey and Justice Steele expressed a hope that the majority's decision "will be interpreted narrowly and will be seen as sui generis."

Impact of the Omnicare Decision. The *Omnicare* decision has several important ramifications with regard to the approval of deal protection measures in the merger context.

First, the decision can be read to suggest a bright-line rule that a "force-the-vote" provision cannot be utilized in connection with voting agreements locking up over 50% of the stockholder vote unless the board of directors of the target corporation retains for itself a fiduciary out that would enable it to terminate the merger agreement in favor of a superior proposal. It is worth noting that the decision does not preclude – but rather seems to confirm the validity of – combining a "force-the-vote" provision with a voting agreement locking up a majority of the stock so long as the board of directors retains an effective fiduciary out. More uncertain is the extent to which the rule announced in *Omnicare* might apply to circumstances in which a merger agreement includes a "force-the-vote" provision along with a fiduciary termination out and contemplates either an option for the buyer to purchase a majority block of stock or a contractual right of the buyer to receive some or all of the upside received by a majority block if a superior proposal is accepted. While neither structure would disable the

[597] 637 A.2d 34, 51 (Del. 1994).

board from continuing to exercise its fiduciary obligations to consider alternative bids, arguments could be made that such a structure is coercive or preclusive, depending upon the particular circumstances.

The *Omnicare* decision also does not expressly preclude coupling a "force-the-vote" provision with a voting agreement locking up less than a majority block of stock, even if the board does not retain a fiduciary termination out. Caution would be warranted, however, if a buyer were to request a "force-the-vote" provision without a fiduciary termination out and seek to couple such a provision with a voting agreement affecting a substantial block of stock, as that form of deal protection could potentially implicate the same concerns expressed by the majority in *Omnicare*. Moreover, existing case law and commentary make clear that a board must retain its ability to make full disclosure to stockholders if a merger agreement contains a "force-the-vote" provision and does not provide the board with a fiduciary termination right.

The extent to which the bright-line rule announced in *Omnicare* may be applicable to other factual circumstances remains to be seen. Powerful arguments can be made, for example, that a similar prohibition should not apply to circumstances in which the majority stockholder vote is obtained by written consents executed after the merger agreement is approved and signed. Likewise, it is doubtful that a similar prohibition should apply to a merger with a majority stockholder who has expressed an intention to veto any transaction in which it is not the buyer.

<u>Second</u>, the majority's decision confirms that *Unocal's* enhanced judicial scrutiny is applicable to a Delaware court's evaluation of deal protection measures designed to protect a merger agreement. Where board-implemented defensive measures require judicial review under *Unocal*, the initial burden is on the defendant directors to demonstrate that they had reasonable grounds for believing that a threat to corporate policy and effectiveness existed and that they took action in response to the threat that was neither coercive nor preclusive and that was within a range of reasonable responses to the threat perceived. Prior to *Omnicare*, there appeared to be a split of authority in the Court of Chancery as to whether deal protection measures in the merger context should be evaluated under *Unocal*. Although the dissenters questioned whether *Unocal* should be the appropriate standard of review, the majority decision confirms that *Unocal* applies to judicial review of deal protection measures.

<u>Third</u>, although the majority assumed "arguendo" that the *Revlon* doctrine was not applicable to the NCS board's decision to approve the Genesis merger, the majority seems to question the basis for the Court of Chancery's determination that *Revlon* was not applicable. When the doctrine announced in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[598] is applicable to a sale or merger of a corporation, the board of directors is charged with obtaining the best price reasonably available to the stockholders under the circumstances, and the board's decision making is subject to enhanced scrutiny judicial review and not automatically protected by the business judgment rule. Prior decisional law has established that *Revlon* is applicable where, among other circumstances, the board has initiated an active bidding process seeking to sell the company or has approved a business combination resulting in a break up or sale of the company or a change of control.

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598 506 A.2d 173, 182 (Del. 1986).

The Court of Chancery determined that *Revlon* was not applicable because the NCS board did not initiate an active bidding contest seeking to sell NCS, and even if it had, it effectively abandoned that process when it agreed to negotiate a stock-for-stock merger with Genesis in which control of the combined company would remain in a large, fluid and changing market and not in the hands of a controlling stockholder. The NCS board, however, had evaluated the fairness of the Genesis merger based on the market price of Genesis' stock and not as a strategic transaction. Accordingly, the Court of Chancery's suggestion that *Revlon* no longer applies if a board approves any form of stock-for-stock merger at the end of an active bidding process could signal that *Revlon* applies in fewer circumstances than many practitioners previously believed. On appeal, the Supreme Court majority explained that whether *Revlon* applied to the NCS board's decision to approve the Genesis merger was not outcome determinative. For purposes of its analysis, the majority assumed "arguendo" that the business judgment rule applied to the NCS board's decision to merge with Genesis. This could be read to signal that the majority disagreed with the trial court's *Revlon* analysis. Thus, whether or not *Revlon* could potentially be applicable to non-strategic stock-for-stock mergers entered into at the end of an auction process remains an open question.

b. **Orman v. Cullman.**

A year after *Omnicare*, the Chancery Court in *Orman v. Cullman (General Cigar)*,[599] upheld a merger agreement in which majority stockholders with high vote stock agreed to vote their shares pro rata in accordance with public stockholders and the majority stockholders also agreed not to vote in favor of another transaction for 18 months following termination. The Chancery Court found that such a transaction was not coercive because there was no penalty to public stockholders for voting against the transaction.

In *Orman*, the court focused on whether the combined effect of the provisions was coercive and upheld the deal protection devices as not being coercive. In this case, the acquiror obtained a voting agreement from stockholders owning a majority of the voting stock of the target entity. The target had two classes of stock (class A and class B), and the approval of the class A stockholders voting as a separate class was required. The voting agreement required the subject stockholders to vote in favor of the transaction, to not sell their shares and to vote their class B shares against any alternative acquisition for a period of up to eighteen months following the termination of the merger agreement. However, the voting agreement also contained a "mirrored voting" provision that required the stockholders subject to voting agreements to vote their shares of class A common stock in accordance with the vote of the other class A stockholders in connection with the vote to approve the transaction. Despite the "mirrored voting" concession with respect to a vote on the proposed transaction, there was an absolute obligation on the parties to the voting agreement to vote against a competing transaction. The terms of the merger agreement allowed the board of directors of the target to consider alternative proposals if the special committee of the board determined the proposal was bona fide and more favorable than the existing transaction. The board was also permitted to withdraw its recommendation of the transaction if the board concluded it was required to do so in order to fulfill its fiduciary duties. However, the merger agreement did contain a "force the vote"

[599] C.A. No. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004).

provision requiring the target to convene a special meeting of stockholders to consider the transaction even if the board withdrew its recommendation.

In upholding the deal protection provisions, the *Orman* court, using reasoning similar to the dissent in *Omnicare*, concluded that the voting agreement and the eighteen month tail provision following the termination of the merger agreement did not undermine the effect that the class A stockholders had the right to vote on a deal on the merits. Thus, unlike in *Omnicare*, the deal protection measures did not result in "*a fait accompli*" where the result was predetermined regardless of the public shareholders' actions. The combination of the shareholders' ability to reject the transaction and the ability of the board to alter the recommendation resulted in the Chancellor concluding that "as a matter of law [that] the deal protection mechanisms present here were not impermissibly coercive." The plaintiff did not argue that the arrangement was "preclusive."

Omnicare and *Orman* emphasize the risk of having deal protection measures that do not contain an effective "fiduciary out" or which would combine a "force the vote" provision with voting agreements that irrevocably lock up a substantial percentage of the stockholder vote. Although under *Omnicare*, voting agreements locking up sufficient voting power to approve a merger are problematic, locking up less than 50% of the voting power could also be an issue in particular circumstances.[600]

c. Optima International of Miami, Inc. v. WCI Steel, Inc.

In *Optima International of Miami, Inc. v. WCI Steel, Inc.*,[601] Vice Chancellor Lamb declined to enjoin a merger that had been approved by the Board of WCI Steel Inc. and adopted by its stockholders later that same day by written consent pursuant to a merger agreement permitting the acquirer to terminate the agreement if stockholder approval was not obtained within 24 hours.

WCI was a closely held company (28 stockholders) that had emerged from bankruptcy only two years before. In connection with WCI's emergence from bankruptcy in March 2006, the bankruptcy court had approved a collective bargaining agreement between WCI and the union representing its employees. The union contract contained a "successorship" provision triggered upon a change-of-control transaction, which the union interpreted the successorship provision as granting it a veto right over any third-party acquisition of WCI, as well as a right-to-bid provision.

In the summer of 2007, WCI began searching for a potential acquirer, since it was suffering from severe liquidity problems and was under pressure to complete a deal or face the

600 Compare *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999) (noting that acquiror's ownership of 12.3% of target's stock and voting agreements with respect to another 33.5%, gave acquiror, as a "virtual certainty," the votes to consummate the merger even if a materially more valuable transaction became available) with *In re IXC Commc'ns, Inc. S'holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210, at *24 (Del. Ch. Oct. 27, 1999) (stating, in reference to a transaction where an independent majority of the target's stockholders owning nearly 60% of the target's shares could freely vote for or against the merger, "'[a]lmost locked up' does not mean 'locked up,' and 'scant power' may mean less power, but it decidedly does not mean 'no power,'" and finding that the voting agreement did not have the purpose or effect of disenfranchising the remaining majority of stockholders).

601 C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT).

prospect of another bankruptcy. WCI's Board formed a special committee (for convenience rather than to address Board conflicts) and hired a financial advisor which solicited 22 potential buyers. By April 2008, only two bidders remained: Optima International of Miami, Inc. and OAO Severstal. Initially, each bidder was proposing an acquisition transaction on similar economic terms.

Severstal and Optima both sought the support of the union in connection with their bids, and the union ultimately decided to support Severstal over Optima. In late April, WCI requested that Optima and Severstal present their best and final bids. Severstal came forward offering $136 million, but demanding that stockholder approval be delivered within 24 hours of signing. Optima initially did not respond to this invitation. Rather than recommending a deal with Severstal at that time, the special committee again requested that Optima submit a bid, offering to assist Optima in its negotiations with the union. On May 1, 2008, Optima submitted a bid of $150 million.

Optima resumed its negotiations with the union, but it quickly became apparent that those negotiations would not be successful. WCI and Optima considered pursuing an alternative transaction that would not trigger the successorship provision under the union contract, but they were unable to find an acceptable solution. Meanwhile, Severstal was pushing to close a deal promptly. On May 14, 2008, with Severstal offering $136 million, WCI approached Severstal with an option: either waive the 24-hour stockholder approval requirement or increase its bid. Severstal increased its bid to $140 million, but demanded that WCI's board act immediately and further demanded that WCI's stockholders adopt the merger agreement by consent promptly after signing. At this time, Optima's bid was $150 million, but it was conditioned on union approval, which Optima had been unable to obtain. After discussions with its legal advisors regarding the risks inherent in the options and receiving a fairness opinion from its financial advisor, WCI's Board approved a merger agreement with Severstal. Shortly thereafter, two stockholders who together owned a majority in voting power of WCI's stock delivered written consents adopting the merger agreement.

Plaintiffs argued that the board "abdicated its authority or delegated its authority to manage the business and affairs of the corporation to the union and that they did so by declining to strenuously challenge the union on its interpretation of the successorship provision." The Court rejected that argument and distinguished the provision in the union contract from an invalid "no-hand poison pill,"[602] or the "force-the-vote provision" in *Omnicare*,[603] noting that the successorship provision was not self-imposed, but rather had been approved by the bankruptcy court as a condition of WCI's emergence from bankruptcy.

Plaintiffs also argued that the stockholder vote was a form of a lockup that either exceeded the board's power or resulted in a breach of its fiduciary duties. Plaintiffs argued that, in agreeing to the provision requiring the stockholder consent to be delivered within 24 hours, the Board improperly contracted away its "fiduciary out" in violation of *Omnicare*. Rejecting this argument, Vice Chancellor Lamb explained:

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602 *See Quickturn Design System Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

603 *See supra* notes 595-598 and related text.

But a stockholder vote is not like the lockup in Omnicare. First, it's really not my place to note this, but Omnicare is of questionable continued vitality. Secondly, the stockholder vote here was part of an executed contract that the board recommended after deciding it was better for stockholders to take Severstal's lower-but-more-certain bid than Optima's higher-but-more-risky bid. In this context, the board's discussion reflects an awareness that the company had severe liquidity problems. Moreover, it was completely unclear that Optima would be able to consummate any transaction. Therefore, the stockholder vote, although quickly taken, was simply the next step in the transaction as contemplated by the statute. Nothing in the DGCL requires any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote. And I don't see how the board's agreement to proceed as it did could result in a finding of a breach of duty.

d. Energy Partners, Ltd. v. Stone Energy Corp.

Whether a buyer may enter into a merger agreement which limits its own right to explore third party proposal for its acquisition if its being acquired could lead to a termination of the merger agreement (i.e., whether a buyer as well as a seller may need a fiduciary out) was presented in *Energy Partners, LTD. v. Stone Energy Corp.*,[604] in which a declaratory judgment was sought as to the meaning and validity of Section 6.2(e) of the merger agreement between Energy Partners, Ltd. ("*Energy Partners*" or "*Parent*") (the acquiror) and Stone Energy Corporation ("*Stone*") (the target) that provided as follows:

> [N]either Parent nor any of its Subsidiaries….shall (e) knowingly take, or agree to commit to take, any action that would or would reasonably be expected to result in the failure of a condition [set forth in the merger agreement], … or that would reasonably be expected to materially impair the ability of Target, Parent, Merger Sub, or the holders of Target Common Shares to consummate the Merger in accordance with the terms hereof or materially delay such consummation….

Although Stone's Board had originally approved a merger agreement pursuant to which Stone would merge into a wholly owned subsidiary of Plains Exploration and Production Company ("*Plains*"), after its later receipt of a proposal from Energy Partners, Stone's Board determined that the Energy Partners proposal satisfied the fiduciary out provision in the Plains merger agreement and initiated negotiations with Energy Partners. The Energy Partners merger agreement (the "*Energy Partners Merger Agreement*") was approved by Stone's Board and Energy Partners agreed to pay a termination fee to Plains pursuant to the Plains merger agreement.

The Energy Partners Merger Agreement negotiated between Energy Partners and Stone contained the provision noted above, as well as an express no-shop provision restricting Stone (the target) from soliciting or entertaining competing offers. The Energy Partners Merger Agreement did not, however, have a parallel no-shop provision restricting Energy Partners (the

[604] C.A. Nos. 2374-N, 2402-N, 2006 Del. Ch. LEXIS 182 (Del. Ch. Oct. 11, 2006); *see* Amy Y. Yeung and Charles B. Vincent, *Delaware's "No-Go" Treatment of No-Talk Provisions: Deal-Protection Devices After Omnicare*, 33 Del. J. Corp. Law 311 (2008).

buyer). After the Energy Partners Merger Agreement was signed, ATS, Inc. ("*ATS*") made a hostile tender offer for Energy Partners conditioned on the Energy Partners stockholders voting down the Energy Partners Merger Agreement. In light of this development, Stone and Energy Partners expressed differing interpretations of Section 6.2(e), and ATS and Energy Partners sued, seeking a declaratory judgment on the matter. ATS argued that Section 6.2(e) was invalid to the extent that it prevented Energy Partners directors from fulfilling their fiduciary duties; Energy Partners argued that the section was neither intended to nor could be construed as a no-shop clause; and Stone argued that the section did not restrict Energy Partners so long as any negotiations, etc., did not materially delay or impair the Stone/Energy Partners merger.

After determining that the issue of whether Energy Partners could explore the ATS tender offer was justiciable, the Chancery Court then outlined the applicable contract interpretation precedents, and ultimately held that the plain language of the Energy Partners Merger Agreement permitted Energy Partners to pursue third party acquisition proposals. In so holding, the Chancery Court stated that when read as a whole, the Energy Partners Merger Agreement acknowledged that Energy Partners could be subject to third party proposals including proposals conditioned on the termination of the Energy Partners Merger Agreement, citing specifically the sections of the Energy Partners Merger Agreement that: (1) allowed Energy Partners or Stone to terminate the Energy Partners Merger Agreement if Stone accepted a superior proposal; (2) provided that Energy Partners could change its recommendation of the merger if necessary to comply with its fiduciary duties; and (3) explicitly recognized that Energy Partners might withdraw or modify its recommendation in reference to a proposal conditioned upon the termination of the merger agreement and abandonment of the merger. The Chancery Court concluded that although it could be argued that a change in recommendation would violate Section 6.2(e) by "materially impair[ing] the ability of [the parties] to consummate the merger," the other provisions of the Energy Partners Merger Agreement made clear that Stone's remedy for an Energy Partners change of recommendation would be to terminate the agreement and receive a termination fee.

The Chancery Court further noted that even if there was ambiguity in the contract (which there was not), extrinsic evidence would resolve that ambiguity against Stone because the parties did not discuss Section 6.2(e) in their negotiations and also because Energy Partners repeatedly refused to agree to be bound by a no-shop provision. Finally, the Chancery Court found that Delaware law supported a construction of Section 6.2(e) that permitted Energy Partners to pursue third party acquisition proposals, stating that a complete ban on Energy Partners' ability to speak to ATS or shop the transaction would "likely be incompatible with the directors' fiduciary duties, and therefore, void." The Chancery Court further stated that "[t]he structure of the no-shop provision applicable to Stone and the clauses in the nature of fiduciary outs in the Stone Merger Agreement demonstrate that Stone and Energy Partners recognized this reality." Thus, the Chancery Court found that Energy Partners and ATS were entitled to a declaratory judgment that the Energy Partners Merger Agreement did not limit the ability of Energy Partners to explore third party acquisition proposals, including the ATS tender offer, in good faith.

e. Johnson & Johnson v. Guidant Corp.

A merger agreement fiduciary out that will enable a Board to evaluate and respond to an <u>unsolicited</u> superior proposal is typically part of a complicated "no shop" provision that generally restricts the ability of the Board to solicit other offers for the company. Litigation arising from the contest between Johnson & Johnson ("*J&J*") and Boston Scientific Corporation ("*BSC*") for the affections of Guidant Corporation illustrates the importance of technical compliance with merger agreement no-shop provisions. In *Johnson & Johnson v. Guidant Corp.*,[605] initial suitor J&J entered into a merger agreement with Guidant that contained a fiduciary out which enabled its Board to respond to an unsolicited proposal that offered the prospect of being a superior proposal. Thereafter, BSC made a topping bid that ultimately Guidant's Board concluded was a superior proposal and accepted, paying a termination fee to exit the merger agreement that Guidant had signed with J&J.

After the merger, J&J learned that Guidant had provided due diligence materials to Abbot Laboratories, which ultimately agreed to acquire part of Guidant's business to enable BSC to avoid antitrust issues with the merger. J&J sued in federal district court in New York for breach of contract damages of $5.5 billion, in addition to the contractually agreed $705 million break-up fee which had been paid, alleging that Guidant's providing of due diligence materials to Abbott (which at that point had not made a bid) amounted to solicitation in violation of the no solicitation provisions in the merger agreement.

The no-shop clause in the J&J/Guidant merger agreement provided that Guidant would not "solicit, initiate or knowingly encourage, or take any other action designed to, or which could reasonably be expected to, facilitate, any Takeover Proposal" or "furnish to any person any information." An exception permitted Guidant, "in response to a bona fide written Takeover Proposal . . . not solicited" by Guidant, to "furnish information . . . to the person making such Takeover Proposal (and its Representatives)." Following announcement of the J&J/Guidant merger agreement, Boston Scientific made a competing bid for Guidant at a higher price, and stated an intention to divest part of Guidant's operations to avoid potential antitrust issues. J&J's complaint alleged that Guidant provided due diligence information to Abbott in violation of the no-shop clause prior to any proposal having been made that named Abbot. BSC did subsequently submit a formal proposal to acquire Guidant, identifying Abbott as the party that would acquire the assets to be divested, and the Abbott portion of the deal was large enough to constitute a Takeover Proposal under the merger agreement.

The defendant argued that J&J's claim "amounts to a bid to grab more compensation than the parties expressly provided was available" based on a technical breach. In denying defendant's motion to dismiss the breach of contract claim on the pleadings, the court rejected the defendant's argument that the breach was immaterial as it could easily have been avoided had BSC named Abbott in its bid letter, and wrote that "an easily preventable breach may nonetheless be material." The court dismissed J&J's tortious interference with contract claims.

2. Level Playing Field.

If a bidding contest ensues, a board cannot treat bidders differently unless such treatment enhances shareholder interests. As the court in *Barkan* stated, "[w]hen multiple bidders are competing for control, this concern for fairness [to shareholders] forbids directors from using

[605] 06 Civ. 7685 (S.D.N.Y. Aug. 29, 2007).

defensive mechanisms to thwart an auction or to favor one bidder over another."[606] In *Macmillan*, however, the court stated that the purpose of enhancing shareholder interests "does not preclude differing treatment of bidders when necessary to advance those interests. Variables may occur which necessitate such treatment."[607] The *Macmillan* court cited a coercive two-tiered bust-up tender offer as one example of a situation that could justify disparate treatment of bidders.[608]

In all-cash transactions disparate treatment is unlikely to be permitted. In the context of keeping bidders on a level playing field, the court in *Revlon* stated that:

> Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions.[609]

The court in *QVC* restated this concept and applied the *Unocal* test in stating that in the event a corporation treats bidders differently, "the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced. In any event the board's action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests."[610]

3. Match Rights.

A buyer which provides a fiduciary out to the target typically seeks to include in the merger agreement a provision giving it an opportunity to match any third party offer which the target's Board concludes is a superior proposal entitling the target Board to terminate the merger agreement. In *Berg v. Ellison*,[611] Vice Chancellor Strine commented that a match right might deter other bidders, but not unacceptably:

> [A]ny kind of matching right is clearly going to chill anything, despite the fact that on multiple occasions, as reflected in Delaware case law and other things, people won out over a match right or topped a match right three times before the original bidder, in a foolish fit of indiscipline, raised their bid to an unsustainable level, and the other bidders went back and giggled and said "Well, you won it now but at 25 percent more than you should have paid."

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606 *Barkan*, 567 A.2d at 1286-87; *see also QVC*, 637 A.2d at 45.

607 *Macmillan*, 559 A.2d at 1286-87.

608 *Id*. at 1287 n.38.

609 *Revlon*, 506 A.2d at 184.

610 *QVC*, 637 A.2d at 45 (quoting *Macmillan*, 559 A.2d at 1288).

611 C.A. No. 2949-VCS (Del. Ch. June 12, 2007).

Match rights have been described in Delaware Chancery Court opinions, but have not been considered preclusive or otherwise inappropriate.[612]

4. Best Value.

In seeking to obtain the "best value" reasonably available, the Delaware Supreme Court has stated *that the "best value" does not necessarily mean the highest price.*

In Citron,[613] Fairchild was the subject of a bidding contest between two competing bidders, Schlumberger and Gould.[614] The Fairchild board had an all cash offer of $66 per share from Schlumberger, and a two-tier offer of $70 per share from Gould, with the terms of the valuation of the back-end of Gould's offer left undefined.[615] The board was also informed by its experts that a transaction with Schlumberger raised substantially less antitrust concern than a transaction with Gould. The board accepted Schlumberger's offer. In upholding the agreement between Fairchild and Schlumberger, the court stated that Gould's failure to present a firm unconditional offer precluded an auction.[616] The court also stated that Fairchild had a duty to consider "a host of factors," including "the nature and timing of the offer," and "its legality, feasibility and effect on the corporation and its stockholders," in deciding whether to accept or reject Gould's claim.[617] Nevertheless, the *Citron* court specifically found that Fairchild "studiously endeavored to avoid 'playing favorites'" between the two bidders.[618]

A decision not to pursue a higher price, however, necessarily involves uncertainty, the resolution of which depends on a court's view of the facts and circumstances specific to the case. In *In re Lukens Inc. Shareholders Litig*.,[619] the court sustained a board decision to sell to one bidder, notwithstanding the known possibility that a "carve up" of the business between the two bidders could result in incremental stockholder value. The court placed great weight on the approval of the transaction by the stockholders after disclosure of the carve-up possibility.[620]

In the final analysis, in many cases, the board may not know that it has obtained the best value reasonably available until after the merger agreement is signed and competing bids are no longer proposed. In several cases, the Delaware courts have found as evidence that the directors obtained the best value reasonably available the fact that no other bidders came forward with a competing offer once the transaction was public knowledge.[621]

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612 *See*, *e.g.*, *In re Topps Company Shareholder Litigation*, C.A. No. 2998-VCS (Del. Ch. June 19, 2007), discussed at *infra* notes 667-670.

613 569 A.2d 53.

614 *Id*. at 54.

615 *Id*.

616 *Id*. at 68-69.

617 *Id*. at 68.

618 *Id*.

619 757 A.2d 720 (Del. Ch. 1999).

620 *Lukens*, 757 A.2d at 738.

621 *See, e.g., Barkan*, 567 A.2d at 1287 ("when it is widely known that some change of control is in the offing and no rival bids are forthcoming over an extended period of time, that fact is supportive of the board's decision to proceed"); *Goodwin*, 1999 WL 64265, at *23 ("Given that no draconian defenses were in place and that the merger was consummated three months after its public announcement, the fact that no bidders came forward is important evidence

H. Postponement of Stockholder Meeting to Vote on Merger.

In *Mercier v. Inter-Tel (Delaware), Inc.*,[622] the Delaware Court of Chancery held that a disinterested Special Committee may postpone for a short duration a stockholders' meeting called to approve the sale of the company because the Committee knew that if not postponed the merger would be voted down. In *Inter-Tel*, the Court held that well-motivated, independent directors may reschedule an imminent special meeting at which the stockholders are to consider a merger when the directors: (1) believe that the merger is in the best interests of the stockholders; (2) know that if the meeting proceeds the stockholders will vote down the merger; (3) reasonably fear that in the wake of the merger's rejection, the acquiror would walk away from the deal and the corporation's stock price would plummet; (4) want more time to communicate with and provide information to the stockholders before the stockholders vote on the merger and risk the irrevocable loss of the pending offer; (5) reschedule the meeting within a reasonable time period; and (6) do not preclude or coerce the stockholders from freely deciding to reject the merger.

In so holding, the Court distinguished *Blasius Indus., Inc. v. Atlas Corp.*[623] and other cases wherein directors manipulate the election process for the purposes of entrenching themselves and for which the Board's action will be upheld only where it can show "compelling justification." Since director elections and board entrenchment were not at issue, the Court applied a *Unocal* "reasonableness" standard of review that places the burden on the Board to identify the proper corporate objectives served by their actions and demonstrate that their actions were reasonable in relationship to their legitimate objectives and did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way.[624]

Following the determination that Inter-Tel's Special Committee had satisfied the *Unocal*-style requirements and even though it concluded that the *Blasius* standard would not apply because he found that the Special Committee's non-preclusive, non-coercive action did not have the primary purpose of disenfranchisement (in part because none of the Committee members had been promised any position following the merger and all expected to lose their Board seats), the Court found that the independent directors had met the *Blasius* "compelling justification" standard by demonstrating that: (i) stockholders were about to reject a third-party merger proposal that the independent directors believed to be in their best interest; (ii) information useful to the stockholders' decision-making process had not been adequately considered or had not yet been publicly disclosed; and (iii) if the stockholders had voted no, the acquiror would have walked away without making a higher bid and the opportunity to receive that bid would have been lost.

The Court, however, criticized the press release issued by the Special Committee in which it announced the reasons for delaying the vote and changing the record date, saying the press release should have been more candid in informing the market that (a) the reason for the

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supporting the reasonableness of the Board's decision."); *Matador*, 729 A.2d at 293 (failure of any other bidder to make a bid within one month after the transaction was announced "is evidence that the directors, in fact, obtained the highest and best transaction reasonably available").

622 *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786 (Del. Ch. 2007).

623 564 A.2d 651 (Del. Ch. 1988).

624 *See supra* notes 322-325.

delayed vote was because it appeared the merger would not be approved and (b) the reason for the change in record date was to allow arbitrageurs and hedge funds an opportunity to buy additional shares at prices below the merger price and vote such shares.

VII. Responses to Hostile Takeover Attempts.

A. Certain Defenses.

Shareholder rights plans and state anti-takeover laws, which developed in response to abusive takeover tactics and inadequate bids, have become a central feature of most major corporations' takeover preparedness. For example, over 2,300 companies have adopted rights plans.

Rights plans and state anti-takeover laws do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. They are intended to cause bidders to deal with the target's board of directors and ultimately extract a higher acquisition premium than would otherwise have been the case. If a bidder takes action that triggers the rights or the anti-takeover laws, however, dramatic changes in the rights of the bidder can result.

In a negotiated transaction the board can let down the defensive screen afforded by a rights plan or state anti-takeover law to allow the transaction to proceed. Doing so, however, requires strict compliance with the terms of the rights plan and applicable statutes, as well as compliance with the directors fiduciary duties.

B. Rights Plans.

The Basic Design. The key features of a rights plan are the "flip-in" and "flip-over" provisions of the rights, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on the acquirer. The risk of dilution, combined with the authority of a board of directors to redeem the rights prior to a triggering event (generally an acquisition of 15% or 20% of the corporation's stock), gives a potential acquirer a powerful incentive to negotiate with the board of directors rather than proceeding unilaterally.

Basic Case Law Regarding Rights Plans. It is a settled principle of Delaware law that a poison pill/shareholder rights plan, if drafted correctly, is valid as a matter of Delaware law. *See Leonard Loventhal Account v. Hilton Hotels Corp.*,[625] in which the Chancery Court, citing *Moran*,[626] wrote:

> The Delaware courts first examined and upheld the right of a board of directors to adopt a poison pill rights plan fifteen years ago in *Moran v. Household International, Inc*. Since that decision, others have followed which affirmed the validity of a board of directors' decision to adopt a poison pill rights plan. Today, rights plans have not only become commonplace in Delaware, but there is not a single state that does not permit their adoption.

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625 C.A. No. 17803, 2000 WL 1528909 (Del. Ch. Oct. 10, 2000).

626 500 A.2d at 1346.

Federal courts applying Texas law have upheld the concept of rights plans.[627]

The litigation concerning rights plans now focuses on whether or not a board of directors 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 of directors not to redeem rights in response to two-tier offers[628] or inadequate 100% cash offers[629] as well as to protect an auction or permit a target to explore alternatives.[630] On the other hand, some decisions have held that the rights may not interfere with shareholder choice at the conclusion of an auction[631] or at the "end stage" of a target's attempt to develop alternatives.[632] *Pillsbury* involved circumstances in which the board of directors, rather than "just saying no," had pursued a restructuring that was comparable to the pending all-cash tender offer.[633]

Many rights plans adopted shortly after creation of these protective measures in 1984 were scheduled to expire and have generally been renewed. Renewal of a rights plan involves essentially the same issues as the initial adoption of a plan.

"*Dead Hand" Pills*. In the face of a "Just Say No" defense, the takeover tactic of choice has become a combined tender offer and solicitation of proxies or consents to replace target's board with directors committed to redeeming the poison pill to permit the tender offer to proceed. Under DGCL § 228, a raider can act by written consent of a majority of the shareholders without a meeting of stockholders, unless such action is prohibited in the certificate of incorporation (under the Texas Corporate Statues, unanimous consent is required for shareholder action by written consent unless the certificate of formation otherwise provides).[634] Under DGCL § 211(d) a raider can call a special meeting between annual meetings only if permitted under the target's bylaws, whereas under the Texas Corporate Statues any holder of at least 10% of the outstanding shares can call a special meeting unless the certificate of formation specifies a higher percentage (not to exceed 50%).[635] If the target has a staggered board, a raider can generally only replace a majority of the target's board by waging a proxy fight at two consecutive annual meetings.

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627 See *Gearhart Industries v. Smith International*, 741 F.2d 707 (5th Cir. 1984); and *A. Copeland Enterprises, Inc. v. Guste*, 706 F. Supp. 1283 (W.D. Tex. 1989).

628 *Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289 (N.D. Ill. 1988).

629 *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp. v. Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988).

630 *CRTF Corp. v. Federated Dept. Stores, Inc.*, 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of poison pill during auction); *In re Holly Farms Corp. Shareholders Litigation*, 564 A.2d 342 (Del. Ch. 1988).

631 *Mills Acquisition Co. v. Macmillan, Inc.*, 1988 WL 108332 [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

632 *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988); *TW Services v. SWT Acquisition Corp.*, C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at 24-25 (Mar. 2, 1989).

633 *See Paramount Communications Inc. v. Time Inc.*, 1988 WL 79880 at *28 (Del. Ch. 1988) [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch. 1988) (in *Pillsbury* and *Interco*, management sought to "'cram down' a transaction that was the functional equivalent of the very leveraged 'bust up' transaction that management was claiming presented a threat to the corporation"), *aff'd*, 571 A.2d 1140 (Del. 1989).

634 TBOC §§ 6.201 and 6.202; TBCA art. 9.10.A.

635 TBOC § 21.352(a)(2); TBCA art. 2.24.C.

A target without a staggered Board cannot rely on an ordinary poison pill to give much protection in the face of a combined tender offer/proxy fight. The predicament faced by such targets has spawned variants of the so-called "continuing director" or "dead hand" pill.

"Pure" dead hand pills permit only directors who were in place prior to a proxy fight or consent solicitation (or new directors recommended or approved by them) to redeem the rights plan. Once these "continuing directors" are removed, no other director can redeem the pill.

Modified dead hand provisions come in a variety of forms. So called "nonredemption" or "no hand" provisions typically provide that no director can redeem the rights plan once the continuing directors no longer constitute a majority of the board. This limitation on redemption may last for a limited period or for the remaining life of the pill. The rights plan at issue in the *Quickturn* case discussed below included such a provision.

Another variant is the "limited duration," or "delayed redemption," dead hand pill. This feature can be attached to either the pure dead hand or no hand rights plan. As the name indicates, these pills limit a dead hand or no hand restriction's effectiveness to a set period of time, typically starting after the continuing directors no longer constitute a majority of the board. These rights plans delay, but do not preclude, redemption by a newly elected board.

The validity of dead hand provisions depends in large part upon the state law that applies. Delaware recently has made clear that dead hand provisions – even of limited duration – are invalid.[636]

The Delaware Supreme Court held that the dead hand feature of the rights plan ran afoul of DGCL § 141(a), which empowers the board of directors to manage the corporation. Relying on the requirement in § 141(a) that any limitation on the board's power must be stated in the certificate of incorporation, the court found that a dead hand provision would prevent a newly elected board "from completely discharging its fundamental management duties to the corporation and its stockholders for six months" by restricting the board's power to negotiate a sale of the corporation. The reasoning behind the *Quickturn* holding leaves little room for dead hand provisions of any type in Delaware.[637]

Not all states have come down against dead hand rights plans.[638] The rights plan upheld in *Copeland*,[639] involved dead hand features, although the opinion did not focus on the validity of the dead hand feature.

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[636] *See Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), which involved a "no hand" pill provision of limited duration that the target's board had adopted in the face of a combined proxy fight and tender offer by raider. The pill provision barred a newly elected board from redeeming the rights plan for six months after taking office if the purpose or effect would be to facilitate a transaction with a party that supported the new board's election.

[637] *See also Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1988).

[638] *See Invacare Corporation v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997) (court rejected the offeror's contention that a dead hand pill impermissibly restricts the power of future boards of directors – including a board elected as part of a takeover bid – to redeem a rights plan, relying upon the "plain language" of a Georgia statute that expressly grants a corporation's board the "sole discretion" to determine the terms contained in a rights plan).

[639] *Copeland*, 706 F.Supp. at 1283.

C. Business Combination Statutes.

Both Delaware and Texas provide protections to shareholders of public companies against interested shareholder transactions that occur after a shareholder has acquired a 15% to 20% ownership interest. The Delaware limitations are found in Section 203 of the DGCL and the Texas limitations are found in Part Thirteen of the TBCA and Chapter 21, Subchapter M of the TBOC (the "*Texas Business Combination Statutes*").

1. DGCL § 203.

DGCL § 203 imposes restrictions on transactions between public corporations and certain stockholders defined as "*interested stockholders*" unless specific conditions have been met. In general, § 203 provides that a publicly held Delaware corporation may not engage in a business combination with any interested stockholder for a period of three years following the date the stockholder first became an interested stockholder unless (i) prior to that date the board of directors of the corporation approved the business combination or the transaction that resulted in the stockholder becoming an interested stockholder, (ii) the interested stockholder became an interested stockholder as a result of acquiring at least 85% of the voting stock of the corporation, excluding shares held by directors and officers and employee benefit plans in which participants do not have the right to determine confidentially whether their shares will be tendered in a tender or exchange offer, or (iii) the transaction is approved by the board of directors and by the affirmative vote of at least two-thirds of the outstanding shares excluding the shares held by the interested stockholder. In the context of a corporation with more than one class of voting stock where one class has more votes per share than another class, "85% of the voting stock" refers to the percentage of the votes of such voting stock and not to the percentage of the number of shares.[640]

An interested stockholder is generally defined under DGCL § 203(c)(5) as any person that directly or indirectly owns or controls or has beneficial ownership or control of at least 15% of the outstanding shares of the corporation.[641] A business combination is defined under DGCL § 203(c)(3) to include (i) mergers, (ii) consolidations, (iii) direct or indirect sales, leases,

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640 *See* DGCL § 203(c)(8).

641 DGCL § 203(c)(9) defines "owner" broadly as follows:

(9) "Owner," including the terms "own" and "owned," when used with respect to any stock, means a person that individually or with or through any of its affiliates or associates:

(i) Beneficially owns such stock, directly or indirectly; or

(ii) Has (A) the right to acquire such stock (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding, or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise; provided, however, that a person shall not be deemed the owner of stock tendered pursuant to a tender or exchange offer made by such person or any of such person's affiliates or associates until such tendered stock is accepted for purchase or exchange; or (B) the right to vote such stock pursuant to any agreement, arrangement or understanding; provided, however, that a person shall not be deemed the owner of any stock because of such person's right to vote such stock if the agreement, arrangement or understanding to vote such stock arises solely from a revocable proxy or consent given in response to a proxy or consent solicitation made to 10 or more persons; or

(iii) Has any agreement, arrangement or understanding for the purpose of acquiring, holding, voting (except voting pursuant to a revocable proxy or consent as described in item (B) of subparagraph (ii) of this paragraph), or disposing of such stock with any other person that beneficially owns, or whose affiliates or associates beneficially own, directly or indirectly, such stock.

exchanges, mortgages, transfers and other dispositions of assets to the interested stockholder having an aggregate market value greater than 10% of the total aggregate market value of the assets of the corporation, (iv) various issuances of stock and securities to the interested stockholder that are not issued to other stockholders on a similar basis and (v) various other transactions in which the interested stockholder receives a benefit, directly or indirectly, from the corporation that is not proportionally received by other stockholders.

The provisions of DGCL § 203 apply only to public corporations (i.e., corporations the stock of which is listed on a national securities exchange, authorized for quotation on interdealer quotation system of a registered national securities association or held of record by more than 2,000 stockholders).[642] The provisions of DGCL § 203 also will not apply to certain stockholders who held their shares prior to the adoption of DGCL § 203. In addition, DGCL § 203 will not apply if the certificate of incorporation of the corporation or the bylaws approved by stockholders provides that the statute will not apply; provided that if the corporation is subject to DGCL § 203 at the time of adoption of an amendment eliminating the application of DGCL § 203, the amendment will not become effective for 12 months after adoption and the section will continue to apply to any person who was an interested stockholder prior to the adoption of the amendment.[643]

A vote to so waive the protection of DGCL § 203 is sometimes referred to as a "*Section 203 waiver*" and requires that the directors act consistently with their fiduciary duties of care and loyalty.[644] Significantly, in transactions involving a controlling stockholder, the board's decision to grant a DGCL § 203 waiver to a buyer may present conflict issues for a board dominated by representatives of the controlling stockholders.[645]

2. Texas Business Combination Statutes.

The Texas Business Combination Statutes, like DGCL § 203, impose a special voting requirement for the approval of certain business combinations and related party transactions between public corporations and affiliated shareholders unless the transaction or the acquisition of shares by the affiliated shareholder is approved by the board of directors prior to the affiliated shareholder becoming an affiliated shareholder.[646]

In general, the Texas Business Combination Statutes prohibit certain mergers, sales of assets, reclassifications and other transactions (defined as business combinations) between shareholders beneficially owning 20% or more of the outstanding stock of a Texas public corporation (such shareholders being defined as affiliated shareholders) for a period of three years following the shareholder acquiring shares representing 20% or more of the corporation's voting power unless two-thirds of the unaffiliated shareholders approve the transaction at a meeting held no earlier than six months after the shareholder acquires that ownership. The provisions requiring the special vote of shareholders will not apply to any transaction with an

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642 DGCL § 203(b).

643 *Id.*

644 *See In re Digex, Inc. Shareholders Litig.*, 789 A.2d 1176 (Del. Ch. 2000).

645 *Id.*

646 *See* TBOC § 21.606; TBCA arts. 13.01-13.08.

affiliated shareholder if the transaction or the purchase of shares by the affiliated shareholder is approved by the board of directors before the affiliated shareholder acquires beneficial ownership of 20% of the shares or if the affiliated shareholder was an affiliated shareholder prior to December 31, 1996, and continued as such through the date of the transaction.[647] The Texas Business Combination Statutes do not contain the Delaware 85% unaffiliated share tender offer exception, which was considered by the drafters to be a major loophole in the Delaware statute, and attempts to attempts to clarify various uncertainties and ambiguities contained in the Delaware statute.

The Texas Business Combination Statutes apply only to an "*issuing public corporation*," which is defined to be a corporation organized under the laws of Texas that has: (i) 100 or more shareholders, (ii) any class or series of its voting shares registered under the 1934 Act or (iii) any class or series of its voting shares qualified for trading in a national market system.[648] For the purposes of this definition, a shareholder is a shareholder of record as shown by the share transfer records of the corporation.[649] The Texas Business Combination Statutes also contains an opt-out provision that allows a corporation to elect out of the statute by adopting a by-law or charter amendment prior to December 31, 1997.[650]

VIII. Going Private Transactions

A. In re Pure Resources Shareholders Litigation

In re Pure Resources Shareholders Litigation[651] was another Delaware Chancery Court opinion involving an 800-pound gorilla with an urgent hunger for the rest of the bananas (i.e., a majority shareholder who desires to acquire the rest of the shares). In this case, the Court of Chancery enjoined Unocal Corp.'s proposed $409 million unsolicited tender offer for the 35% of Midland, Texas-based Pure Resources Inc. that it did not own (the "*Offer*"). The opinion, *inter alia*, (i) explains the kinds of authority that a Board may (should) delegate to a Special Committee in dealing with a buy-out proposal of a controlling shareholder (the full authority of the Board vs. the power to negotiate the price), and (ii) discusses how the standard of review may differ depending on whether the controlling shareholder proposes to acquire the minority via merger or tender offer (entire fairness vs. business judgment).

A Special Committee of Pure's Board voted not to recommend the Offer. The Special Committee requested, but was not "delegated the full authority of the board under Delaware law to respond to the Offer." With such authority, the Special Committee could have searched for alternative transactions, speeded up consummation of a proposed royalty trust, evaluated the feasibility of a self-tender, and put in place a shareholder rights plan (*a.k.a.*, poison pill) to block the Offer. The Special Committee never pressed the issue of its authority to a board vote, the Pure directors never seriously debated the issue at the board table itself, and the Court noted that the "record does not illuminate exactly why the Special Committee did not make this their

647 TBOC §§ 21.606, 21.607(3); TBCA art. 13.03, 13.04.

648 TBOC § 21.601(1); TBCA art. 13.02.A(6).

649 *Id.*

650 TBOC § 21.607(1)(B); TBCA art. 1304.A(1)(b).

651 808 A.2d 421 (Del. Ch. 2002).

Alamo." The Special Committee may have believed some of the broader options technically open to them under their preferred resolution (e.g., finding another buyer) were not practicable, but "[a]s to their failure to insist on the power to deploy a poison pill - the by-now *de rigeur* tool of a board responding to a third-party tender offer - the record is obscure."

The Court commented that its "ability to have confidence in these justifications [for not pressing for more authority] has been compromised by the Special Committee's odd decision to invoke the attorney-client privilege as to its discussion of these issues" and in a footnote stated "in general it seems unwise for a special committee to hide behind the privilege, except when the disclosure of attorney-client discussions would reveal litigation-specific advice or compromise the special committee's bargaining power."

Much of the Court's opinion focuses on whether a tender offer by a controlling shareholder is "governed by the *entire fairness* standard of review," which puts the burden on the controlling shareholder to prove both "*substantive fairness*" (fair price and structure) and "*procedural fairness*" (fair process in approving the transaction). Plaintiffs argued that "entire fairness" should be the applicable standard because "the *structural power* of Unocal over Pure and its board, as well as Unocal's involvement in determining the scope of the Special Committee's authority, make the Offer other than a *voluntary, non-coercive transaction*" and that "the Offer poses the same threat of . . . '*inherent coercion*' that motivated the Supreme Court in *Kahn v. Lynch*."

In response, Unocal asserted that "[b]ecause Unocal has proceeded by way of an exchange offer and not a negotiated merger, the rule of Lynch is inapplicable," and under the *Solomon v. Pathe Communications Corp.*[652] line of cases Unocal "is free to make a tender offer at whatever price it chooses so long as it does not: i) '*structurally coerce*' the Pure minority by suggesting explicitly or implicitly that injurious events will occur to those stockholders who fail to tender; or ii) mislead the Pure minority into tendering by concealing or misstating the material facts." Further, "[b]ecause Unocal has conditioned its Offer on a *majority of the minority* provision and intends to consummate a short-form merger at the same price, the Offer poses no threat of structural coercion and that the Pure minority can make a voluntary decision." Thus, "[b]ecause the Pure minority has a negative recommendation from the Pure Special Committee and because there has been full disclosure (including of any material information Unocal received from Pure in formulating its bid), Unocal submits that the Pure minority will be able to make an informed decision whether to tender."

The Court wrote that "[t]his case therefore involves an aspect of Delaware law fraught with doctrinal tension: what equitable standard of fiduciary conduct applies when a controlling shareholder seeks to acquire the rest of the company's shares? * * * The key inquiry is not what statutory procedures must be adhered to when a controlling stockholder attempts to acquire the rest of the company's shares, [for] [c]ontrolling stockholders counseled by experienced lawyers rarely trip over the legal hurdles imposed by legislation."[653]

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652 672 A.2d 35 (Del. 1996).

653 The Court further commented that "the doctrine of *independent legal significance"* was not of relevance as that "doctrine stands only for the proposition that the mere fact that a transaction cannot be accomplished under one statutory provision does not invalidate it if a different statutory method of consummation exists. Nothing about that

In analyzing cases involving negotiated mergers, Vice Chancellor Strine focused on *Kahn v. Lynch Communications Systems, Inc.*,[654] in which "the Delaware Supreme Court addressed the standard of review that applies when a controlling stockholder attempts to acquire the rest of the corporation's shares in a negotiated merger [and] held that the stringent *entire fairness* form of review governed regardless of whether: i) the target board was comprised of a majority of independent directors; ii) a special committee of the target's independent directors was empowered to negotiate and veto the merger; and iii) the merger was made subject to approval by a majority of the disinterested target stockholders." This is the case because "even a gauntlet of protective barriers like those would be insufficient protection because of the 'inherent coercion' that exists when a controlling stockholder announced its desire to buy the minority's shares. In colloquial terms, the Supreme Court saw the controlling stockholder as the *800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates* like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support) [and] expressed concern that minority stockholders would fear retribution from the gorilla if they defeated the merger . . ." and could not make a genuinely free choice. In two recent cases [*Aquila* and *Siliconix*],[655] the Chancery Court "followed *Solomon's* articulation of the standards applicable to a tender offer, and held that the 'Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders.'"

The differences between the approach of the *Solomon v. Pathe* line of cases and that of *Lynch* were, to the Court, stark: "To begin with, the controlling stockholder is said to have no duty to pay a fair price, irrespective of its power over the subsidiary. Even more striking is the different manner in which the coercion concept is deployed. In the tender offer context addressed by *Solomon* and its progeny, coercion is defined in the more traditional sense as a wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even worse fate later on, a type of coercion" which Vice Chancellor Strine called "*structural coercion*." The "*inherent* coercion" that *Lynch* found to exist when controlling stockholders seek to acquire the minority's stake is not even a cognizable concern for the common law of corporations if the tender offer method is employed.

The Court agonized "that nothing about the tender offer method of corporate acquisition makes the 800-pound gorilla's retributive capabilities less daunting to minority stockholders . . . . many commentators would argue that the tender offer form is more coercive than a merger vote [for in] a merger vote, stockholders can vote no and still receive the transactional consideration if the merger prevails. In a tender offer, however, a non-tendering shareholder individually faces an uncertain fate. That stockholder could be one of the few who holds out, leaving herself in an even more thinly traded stock with little hope of liquidity and subject to a DGCL § 253 merger at a lower price or at the same price but at a later (and, given the time value of money, a less valuable) time. The 14D-9 warned Pure's minority stockholders of just this possibility. For these reasons, some view tender offers as creating a prisoner's dilemma - distorting choice and

doctrine alters the fundamental rule that inequitable actions in technical conformity with statutory law can be restrained by equity."

654 638 A.2d 1110 (Del. 1994).

655 *In re Aquila, Inc.*, 805 A.2d 184 (Del. Ch. 2002); *In re Siliconix*, 2001 WL 716787 (Del. Ch. June 21, 2001).

creating incentives for stockholders to tender into offers that they believe are inadequate in order to avoid a worse fate."

The Court wrote that to avoid "the *prisoner's dilemma* problem, our law should consider an acquisition tender offer by a controlling stockholder non-coercive only when: 1) it is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt § 253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats. * * *

"The informational and timing advantages possessed by controlling stockholders also require some countervailing protection if the minority is to truly be afforded the opportunity to make an informed, voluntary tender decision. In this regard, the majority stockholder owes a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment. For their part, the independent directors have a duty to undertake these tasks in good faith and diligently, and to pursue the best interests of the minority.

"When a tender offer is non-coercive in the sense . . . identified and the independent directors of the target are permitted to make an informed recommendation and provide fair disclosure, the law should be chary about super-imposing the full fiduciary requirement of entire fairness on top of the statutory tender offer process." In response to plaintiffs' argument that the Pure board breached its fiduciary duties by not giving the Special Committee the power to block the Offer by, among other means, deploying a poison pill, the Court wrote, "[w]hen a controlling stockholder makes a tender offer that is not coercive in the sense I have articulated, therefore, the better rule is that there is no duty on its part to permit the target board to block the bid through use of the pill. Nor is there any duty on the part of the independent directors to seek blocking power."

The application of these principles to Unocal's Offer yields the following result: "The Offer . . . is coercive because it includes within the definition of the 'minority' those stockholders who are affiliated with Unocal as directors and officers [and] includes the management of Pure, whose incentives are skewed by their employment, their severance agreements, and their Put Agreements." The Court categorized this as "a problem that can be cured if Unocal amends the Offer to condition it on approval of a majority of Pure's unaffiliated stockholders."

The Court accepted the plaintiffs' argument that the Pure stockholders are entitled to disclosure of all material facts pertinent to the decision they are being asked to make, and that the 14D-9 is deficient because it does not disclose any substantive portions of the work of the investment banker on behalf of the Special Committee, even though the bankers' negative views of the Offer are cited as a basis for the board's own recommendation not to tender. The Court, however, concluded that Unocal did not have to disclose its "*reserve price*" in case its offer was not initially successful.

B. In re Emerging Communications, Inc. Shareholders Litigation

In *In re Emerging Communications, Inc. Shareholders Litigation*,[656] the Delaware Court of Chancery entered a judgment after trial imposing personal liability on outside directors for voting to approve a going-private transaction at an unfair price, where the directors had no personal financial interest in the transaction itself. The transaction had been approved by a special committee of directors advised by independent legal counsel and an independent financial advisor that opined to the fairness of the merger's terms to the public minority, and had been conditioned on a majority-of-the-minority tendering into the first-step tender offer. The process, however was tainted: (i) the controlling stockholder had failed to provide an updated set of projections that forecast substantially higher growth for the controlled subsidiary than the projections on which the special committee and its advisers relied; (ii) the special committee chair communicated with his fellow special committee members by faxing confidential materials (including the financial analysis of the special committee's financial advisor) to the secretary of the controlling stockholder with a request that they be faxed on to the special committee members; (iii) the actual fair value of the shares was found to be over three times the transaction price ($38.05 vs. $10.25); (iv) investment banking firms that had previously been engaged by the directors were "co-opted" by the controlling stockholder to serve as his advisors; (v) the controlling stockholder had "misled" the special committee chair by "falsely representing" that the price of the deal strained the limits of his available financing; and (vi) a majority of the special committee lacked true independence based on lucrative consultancy and directorship fees paid by the controlling stockholder or their expectation of continuing to serve as directors of his controlled entities.

The *Emerging Communications* opinion focused on the culpability and abilities of each director, rather than focusing on the collective decision making process of the board, and found some (but not all) of the directors liable. One of the directors held individually liable was a professional investment advisor, with significant experience in the business sector involved who had previously been a financial analyst for a major investment banking firm and a fund focused in the same industry. The Chancery Court reasoned that this director's "specialized financial expertise" put him in a position where he "knew, or at the very least had strong reasons to believe" that the price was unfair, and he was "in a unique position to know that." The Chancery Court reasoned that, while the other directors could argue that they relied on the fairness opinion of the independent financial advisor to the special committee, the director whose expertise in the industry was "equivalent, if not superior" to that of the committee's financial advisor could not credibly do so. Notwithstanding his lack of financial interest in the transaction, this director's vote to approve the transaction was "explainable in terms of only one of two possible mindsets" – either as a deliberate effort to further his personal interests (he was a consultant to a firm controlled by the controlling stockholder, receiving an annual $200,000 retainer for providing banking/financial advisory services, and could receive a potential $2 million fee for other financial advisory work) or the director had "for whatever reason, consciously and intentionally disregarded his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair." Either motivation, the court held, would render the director personally liable, notwithstanding the DGCL § 102(b)(7) exculpation

[656] C.A. No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004) (V.C. Jacobs now on the Supreme Court sitting by designation on old case from his Chancery Court days).

provision in the certificate of incorporation, for conduct that "amounted to a violation of the duty of loyalty and/or good faith." The Chancery Court's finding a category of non-management director with specialized knowledge liable, while exonerating others without such expertise who approved the same transaction and engaged in essentially the same conduct, seems inconsistent with the thought-to-be Delaware concept that all directors are equally responsible to stockholders and all have the same fiduciary duties, but may be explainable because the facts suggest loyalty and independence concerns.

A second non-management director was held personally liable for a breach of the duty of loyalty because he was found "clearly conflicted" as an attorney whose law firm received virtually all of its fees from the controlling stockholder and he was found to have "actively assisted" the controlling stockholder in carrying out the privatization transaction. Other non-management directors who voted to approve the same transaction were not held individually liable.

C. In re PNB Holding Co. Shareholders Litigation

In re PNB Holding Co. Shareholders Litigation[657] involved the use of vote of a majority of disinterested stockholders condition (a "*majority-of-the-minority*") outside of the context in which a controlling stockholder is on both sides of a merger transaction.[658]

PNB was a bank holding company whose board decided to convert it to an S corporation under the Internal Revenue Code, but had too many stockholders to qualify as an S corporation under the Code. Thus, it proposed a merger transaction to cash out a sufficient number of stockholders to permit PNB to qualify as an S corporation. Any stockholder who owned at least 2,000 shares of stock and was one of the largest 68 stockholders would remain a stockholder, while all other stockholders would be cashed out. The directors controlled a sufficient number of shares such that they would remain stockholders of PNB following the merger.

Several stockholders dissented from the merger and perfected their appraisal rights, while several other stockholders accepted the merger consideration, but commenced an action in the Delaware Court of Chancery alleging that PNB's directors breached their fiduciary duties by approving a merger that was unfair to the minority stockholders.

Vice Chancellor Leo Strine, Jr. first considered the plaintiffs' contentions that the merger was subject to the entire fairness standard of review. The plaintiffs argued that PNB's board should be "considered as a monolith and that given the board's voting power and board control, the merger should be analyzed as if it were a squeeze-out merger proposed by a controlling stockholder." In *Kahn v. Lynch Communications Systems, Inc.*,[659] the Delaware Supreme Court held that the entire fairness standard of review applied *ab initio* in certain special circumstances, *e.g.*, a negotiated going private transaction with a controlling stockholder or a merger of two companies under the common control of one controlling stockholder. In those circumstances in which a controlling stockholder is on both sides of a negotiated transaction, the Delaware

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[657] 2006 WL 2403999 (Del. Ch. Aug. 18, 2006).

[658] *See* Michael K. Reilly & Roxanne L. Houtman, *PNB Holding: "Majority of Minority Clarified,"* Vol. XI Deal Points, Issue 3 (Fall 2006) at 2.

[659] 638 A.2d 1110 (Del. 1994).

Supreme Court has found that the approval of the transaction by disinterested directors (*e.g.*, by a special committee) or by a majority of disinterested stockholders would only shift the burden of proving entire fairness, but would not render the business judgment rule applicable.

In considering the plaintiffs' argument that the merger should be subject to the rule of *Kahn v. Lynch*, the Chancery Court found that the officers and directors were not a "controlling stockholder group." The Court noted that, under Delaware law, a controlling stockholder exists either where the stockholder (i) owns more than 50% of the voting power of the corporation, or (ii) exercises control over the business and affairs of the corporation. Taken as a whole, the officers and directors owned only 33.5% of the voting power of the corporation. Furthermore, the evidence failed to show that the officers, directors, and their respective families operated as a unified controlling bloc. Rather, the Court observed that there were no voting agreements in place between any of the members of the purportedly controlling block (consisting of directors, officers, spouses, children and parents), and that each individual "had the right to, and every incentive to, act in his or her own self-interest as a stockholder." Importantly, of the approximately 20 people that comprised the "supposed controlling stockholder group," the largest block held by any one holder was 10.6%. Thus, the Court reasoned as follows:

> Glomming share-owning directors together into one undifferentiated mass with a single hypothetical brain would result in an unprincipled Frankensteinian version of the already debatable 800-pound gorilla theory of the controlling stockholder that animates the *Lynch* line of reasoning.

The Court, therefore, held that the *PNB* facts did not fit within the *Kahn v. Lynch* line of jurisprudence.

Although concluding that the defendant directors were not controlling stockholders, the Court nevertheless found that the defendant directors were subject to a conflict of interest that was sufficient to invoke the application of the entire fairness standard of review. Each of the defendant directors personally benefited to the extent that departing stockholders were underpaid. Furthermore, each of the defendant directors had a material interest in the merger, which had the effect of yielding an economic benefit that was not shared equally by all of the stockholders of the corporation. In addition, and unlike in the context of determining whether a controlling stockholder group existed, the Court found that the family ties between the directors and the non-director stockholders were relevant. Importantly, several of the directors apparently transferred shares of PNB's stock to family members in order to ensure that they remained stockholders of PNB after the merger. The Court found that fact to be "indicative of the importance they ascribed to continued ownership in" PNB.

Having found that the merger was subject to the entire fairness standard of review, the Vice Chancellor addressed the potential "cleansing" effect of approval by (i) independent and disinterested directors (e.g., a fully-functioning special committee), or (ii) a fully-informed, non-coerced vote of a "majority-of-the-minority." With respect to the former, Vice Chancellor Strine stated as follows:

> In my view, the rule of *Lynch* would not preclude business judgment rule protection for a merger of this kind so long as the transaction was approved by a

> board majority consisting of directors who would be cashed-out or a special committee of such directors negotiated and approved the transaction.

Although the defendant directors created a committee to investigate the feasibility of the conversion of PNB to an S corporation, the committee was not comprised of disinterested directors. As a result, the Committee did not operate to invoke the substantive protections of the business judgment rule.

The Court also noted that the substantive protections of the business judgment rule could be invoked if the merger was approved by a "majority-of-the-minority." The Court found, however, that PNB failed, as a mathematical matter, to obtain the approval of a vote of a "majority-of-the-minority." In that regard, the Court rejected the defendant directors' contention that only those stockholders who returned a proxy should be included in calculating whether a transaction had been approved by an informed, non-coerced "majority-of-the-minority." Clarifying a previously unresolved aspect of Delaware law, the Court held that Delaware law requires a vote of a majority of *all* of the minority shares entitled to vote.

The Court indicated that, outside of the *Kahn v. Lynch* context, the approval of a majority of the disinterested stockholders may be sufficient to invoke the protections of the business judgment rule, even if the challenged transaction is not subject to a non-waivable "majority-of-the-minority" condition. The Vice Chancellor explained as follows:

> Under Delaware law, however, the mere fact that an interested transaction was not made expressly subject to a non-waivable majority-of-the-minority vote condition has not made the attainment of so-called 'ratification effect' impossible. Rather, outside the *Lynch* context, proof that an informed, non-coerced majority of the disinterested stockholders approved an interested transaction has the effect of invoking business judgment rule protection for the transaction and, as a practical matter, insulating the transaction from revocation and its proponents from liability.

The Court ultimately concluded that the defendant directors failed to prove the entire fairness of the merger. The Court awarded the appraisal claimants the fair value of their shares. Other claimants who did not vote in favor of the merger were awarded damages in an amount representing the difference between the merger consideration and the fair value. Claimants who voted in favor of the merger were barred from recovery under the doctrine of acquiescence. Claimants who accepted the merger consideration but did not approve the merger were not similarly barred.

D. In re SS&C Technologies, Inc. Shareholder Litigation

In re SS&C Technologies, Inc. Shareholder Litigation[660] was a case in which Vice Chancellor Lamb disapproved the settlement of litigation challenging a management led cash-out merger for two independent reasons: (i) the parties had been dilatory in presenting the settlement to the Court for approval (they did not seek Court approval of the settlement for eleven months

[660] 911 A.2d 816 (Del. Ch. 2006).

after signing the settlement agreement and nine months after the merger was consummated) and (ii) the fairness of the process for the management led buy-out was not shown. The Court was concerned that the buyer's proposal was solicited by the CEO as part of informal "test the waters" process to find a buyer who would pay a meaningful premium while allowing the CEO to make significant investment in the acquisition vehicle and continue managing the target. After being satisfied with the buyer's proposal but before all details had been negotiated, the CEO advised the Board about the deal. The Board then formed special committee that hired independent legal and financial advisers and embarked on a program to solicit other buyers, but perhaps too late to affect outcome. The Court was concerned whether the CEO had misused confidential information and resources of the corporation in talking to his selected buyer and engaging an investment banker before Board approval and whether the CEO's precommitment to a deal with the buyer and his conflicts (i.e., receiving cash plus an interest in the acquisition vehicle and continuing management role) prevented the Board from considering whether a sale should take place and, if so, from negotiating the best terms reasonably available.[661]

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661 *See In Re: INFOUSA, Inc. Shareholders Litigation*, CA No. 1956-CC (Del. Ch. August 20, 2007), which involved fiduciary duty challenges to a number of transactions with the 41% shareholder after that shareholder had narrowly won a proxy contest, including allegations that the directors had breached their fiduciary duties by forming a Special Committee to consider a going private transaction by the 41% stockholder and then terminating the process after the Special Committee had turned down his bid:

> Plaintiffs assert that the formation, and subsequent dissolution, of the Special Committee constitutes nothing more than a sham, an effort by dominated directors to allow Vinod Gupta [the 41% shareholder] to acquire infoUSA at a lowball price. Defendants respond that this argument is factually incoherent given that the Special Committee rejected the offer and, thus, acted independently from Gupta. If the Court were to find that the Committee was a sham, defendants argue, then the act of the whole board in disbanding the "sham" committee should not be a violation of fiduciary duties.
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> Defendants misstate the thrust of Count I. As alleged in the amended consolidated complaint, a board consisting of dominated directors formed the Special Committee. Given the extensive nature of the related-party transactions recited in the complaint, I may infer that the directors knew, or at least suspected, that any buy-out offer would be subject to protest from independent shareholders. A rational buyer, even one wholly unfaithful to his fiduciary duties, would appoint the most independent members of the board to such a Special Committee in the hopes of the acquisition surviving subsequent litigation. This does not mean that the buyer would expect rejection, but merely that the committee would be constituted such that success in the committee would not obviously lead to failure in court.
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> Properly understood, plaintiffs' allegation is that the infoUSA board of directors, and particularly the members dominated by Vinod Gupta, counted on the Committee to behave like a kitten, and were surprised when it bared its teeth. [The Special Committee members], according to plaintiffs, took their mandate seriously and began to search for potential acquirers for the company. Faced with this insurrection, Gupta and the conflicted members of the board . . . voted to disband the Special Committee. Plaintiffs' contention is that defendant directors should reimburse the company for the cost of instituting a process that from the beginning was intended to allow Vinod Gupta to acquire the company at a discount, and that the dominated directors eliminated as soon as there might be some risk of it attracting a valuable alternative offer for shareholders. The sudden *volte face* between public statements of corporate representatives as to the advisability of a going-private transaction before and after Vinod Gupta's offer was rejected lends some plausibility to this allegation.
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> * * * If defendants actually engaged in this form of wasteful legerdemain in order to help Vinod Gupta acquire the company at an inequitable price, it constitutes a violation of their fiduciary duty of loyalty, even if it did not succeed. Equity may require that the directors of a Delaware corporation reimburse the company for sums spent pursuing such faithless ends—if the evidence at trial bears out such a claim.

E. In re Netsmart Technologies

The Delaware Court of Chancery in *In re Netsmart Technologies*,[662] a case which the Court found "literally involves a microcosm of a current dynamic in the mergers and acquisitions market," enjoined the sale by a $115 million cash merger of a micro-cap public corporation (market capitalization approximately $82 million) to a private equity firm until the target's Board supplemented its proxy statement for the merger to (i) explain why the Board focused solely on private equity buyers to the exclusion of strategic buyers and (ii) to disclose the projections on which its investment bankers had relied in rendering their opinion that the merger was fair to the target's stockholders from a financial point of view.

The context of the opinion was summarized by the Court as follows:

> Netsmart is a leading supplier of enterprise software to behavioral health and human services organizations and has a particularly strong presence among mental health and substance abuse service providers. It has been consistently profitable for several years and has effectively consolidated its niche within the healthcare information technology market. In October 2005, Netsmart completed a multi-year course of acquisitions by purchasing its largest direct competitor, CMHC Systems, Inc. ("CMHC"). After that acquisition was announced, private equity buyers made overtures to Netsmart management. These overtures were favorably received and management soon recommended, in May 2006, that the Netsmart board consider a sale to a private equity firm. Relying on the failure of sporadic, isolated contacts with strategic buyers stretched out over the course of more than a half-decade to yield interest from a strategic buyer, management, with help from its long-standing financial advisor, William Blair & Co., L.L.C., steered the board away from any active search for a strategic buyer. Instead, they encouraged the board to focus on a rapid auction process involving a discrete set of possible private equity buyers. Only after this basic strategy was already adopted was a "Special Committee" of independent directors formed in July 2006 to protect the interests of the company's non-management stockholders. After the Committee's formation, it continued to collaborate closely with Netsmart's management, allowing the company's Chief Executive Officer to participate in its meetings and retaining William Blair as its own financial advisor.
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> After a process during which the Special Committee and William Blair sought to stimulate interest on the part of seven private equity buyers, and generated competitive bids from only four, the Special Committee ultimately recommended, and the entire Netsmart board approved, the Merger Agreement with Insight. As in most private equity deals, Netsmart's current executive team will continue to manage the company and will share in an option pool designed to encourage them to increase the value placed on the company in the Merger.

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662 924 A.2d 171 (Del. Ch. 2007); *see* Blake Rohrbacher and John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 Bus. Law. 881 (May 2008).

The Merger Agreement prohibits the Netsmart board from shopping the company but does permit the board to consider a superior proposal. A topping bidder would only have to suffer the consequence of paying Insight a 3% termination fee. No topping bidder has emerged to date and a stockholder vote is scheduled to be held next month, on April 5, 2007.

A group of shareholder plaintiffs now seeks a preliminary injunction against the consummation of this Merger. As a matter of substance, the plaintiffs argue that the Merger Agreement flowed from a poorly-motivated and tactically-flawed sale process during which the Netsmart board made no attempt to generate interest from strategic buyers. The motive for this narrow search, the plaintiffs say, is that Netsmart's management only wanted to do a deal involving their continuation as corporate officers and their retention of an equity stake in the company going forward, not one in which a strategic buyer would acquire Netsmart and possibly oust the incumbent management team. * * * At the end of a narrowly-channeled search, the Netsmart directors, the plaintiffs say, landed a deal that was unimpressive, ranking at the low end of William Blair's valuation estimates.

The plaintiffs couple their substantive claims with allegations of misleading and incomplete disclosures. In particular, the plaintiffs argue that the Proxy Statement (the "Proxy"), which the defendants have distributed to shareholders in advance of their vote next month, omits important information regarding Netsmart's prospects if it were to remain independent. In the context of a cash-out transaction, the plaintiffs argue that the stockholders are entitled to the best estimates of the company's future stand-alone performance and that the Proxy omits them.

The defendant directors respond by arguing that they acted well within the bounds of the discretion afforded them by Delaware case law to decide on the means by which to pursue the highest value for the company's stockholders. They claim to have reasonably sifted through the available options and pursued a course that balanced the benefits of a discrete market canvass involving only a select group of private equity buyers (e.g., greater confidentiality and the ability to move quickly in a frothy market) against the risks (e.g., missing out on bids from other buyers). In order to stimulate price competition, the Special Committee encouraged submissions of interest from the solicited bidders with the promise that only bidders who made attractive bids would get to move on in the process. At each turning point during the negotiations with potential suitors, the Special Committee pursued the bidder or bidders willing to pay the highest price for the Netsmart equity. In the end, the directors argue, the board secured a deal with Insight that yielded a full $1.50 more per share than the next highest bidder was willing to pay.

Moreover, in order to facilitate an implicit, post-signing market check, the defendants say that they negotiated for relatively lax deal protections. Those measures included a break-up fee of only 3%, a "window shop" provision that

> allowed the board to entertain unsolicited bids by other firms, and a "fiduciary out" clause that allowed the board to ultimately recommend against pursuing the Insight Merger if a materially better offer surfaced. The directors argue that the failure of a more lucrative bid to emerge since the Merger's announcement over three months ago confirms that they obtained the best value available.

In this context the Court delayed the stockholder vote on the merger until additional disclosures were made, but left the ultimate decision on the merger to the stockholders. The Court summarized its holding as follows:

> In this opinion, I conclude that the plaintiffs have established a reasonable probability of success on two issues. First, the plaintiffs have established that the Netsmart board likely did not have a reasonable basis for failing to undertake *any* exploration of interest by strategic buyers. * * * Likewise, the board's rote assumption (encouraged by its advisors) that an implicit, post-signing market check would stimulate a hostile bid by a strategic buyer for Netsmart — a micro-cap company — in the same manner it has worked to attract topping bids in large-cap strategic deals appears, for reasons I detail, to have little basis in an actual consideration of the M&A market dynamics relevant to the situation Netsmart faced. Relatedly, the Proxy's description of the board's deliberations regarding whether to seek out strategic buyers that emerges from this record is itself flawed.
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> Second, the plaintiffs have also established a probability that the Proxy is materially incomplete because it fails to disclose the projections William Blair used to perform the discounted cash flow valuation supporting its fairness opinion. This omission is important because Netsmart's stockholders are being asked to accept a one-time payment of cash and forsake any future interest in the firm. If the Merger is approved, dissenters will also face the related option of seeking appraisal. A reasonable stockholder deciding how to make these important choices would find it material to know what the best estimate was of the company's expected future cash flows.
>
> The plaintiffs' merits showing, however, does not justify the entry of broad injunctive relief. Because there is no other higher bid pending, the entry of an injunction against the Insight Merger until the Netsmart board shops the company more fully would hazard Insight walking away or lowering its price. The modest termination fee in the Merger Agreement is not triggered simply on a naked no vote, and, in any event, has not been shown to be in any way coercive or preclusive. Thus, Netsmart's stockholders can decide for themselves whether to accept or reject the Insight Merger, and, as to dissenters, whether to take the next step of seeking appraisal. In so deciding, however, they should have more complete and accurate information about the board's decision to rule out exploring the market for strategic buyers and about the company's future

> expected cash flows. Thus, I will enjoin the procession of the Merger vote until Netsmart discloses information on those subjects.[663]

This holding reflected the intense scrutiny that Delaware courts give to directors' conduct under the *Revlon* standard[664] when a Board has decided to sell the company for cash and has a fiduciary duty to secure the highest price for the company reasonably achievable. This *Revlon* scrutiny was explained by the Court as follows:

> Having decided to sell the company for cash, the Netsmart board assumed the fiduciary duty to undertake reasonable efforts to secure the highest price realistically achievable given the market for the company. This duty — often

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663 In *In re CheckFree Corp.*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) the Delaware Court of Chancery denied a request for preliminary injunction to block a merger because it failed to satisfy disclosure requirements in three ways: 1) the proxy statement did not disclose management's projections for the company, and the investment banker's fairness opinion relied on those projections; 2) the proxy statement gave insufficient detail on the background of the merger; and 3) the proxy statement did not disclose the nature or effect of the merger on a derivative action pending in Georgia.

In denying the claim that the proxy statement did not disclose management's financial projections, the Court distinguished *Netsmart* because in *Netsmart* the proxy statement disclosed an early version of management's financial projections, which later required management to give "materially complete information," whereas in *CheckFree* the Board never disclosed the projections; thus no further disclosure was necessary. Furthermore, the Court explained that if shareholders receive a fair summary of the substantive work performed by the investment bankers then it does not matter whether the proxy statement disclosed all the information used by the investment bankers to render its fairness opinion. The Court used the standard set forth in *In re Pure Resources Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002) [*see supra* notes 651-655 and accompanying text], to determine whether the shareholders received a "fair summary of the substantive work performed by the investment bankers." The proxy statement disclosed the sources the investment bankers relied on, explained the assumptions, noted comparable transactions, and described management's estimated earning and EBITDA. The proxy statement further conveyed that management and the investment bankers discussed foreseen risks that might affect its estimates. The Court found that CheckFree's proxy statement adequately disclosed material information as required by *In re Pure Resources* by giving a "fair summary" of the work performed by the its investment bankers. The Court found that granting an injunction weighs against public interest because enjoining the "$4.4 billion merger would impose significant costs" on CheckFree's shareholders.

The Court also denied the claim that the proxy statement disclosed insufficient background information because it "span[ned] less than two full pages." The Court noted that it "does not evaluate the adequacy of disclosure by counting words."

Finally, Chancellor Chandler noted that "directors need not tell shareholders that a merger will extinguish pending derivative claims," concluding that "there is no obligation to supply investors with legal advice."

See also Globis Partners, L.P. v. Plumtree Software, Inc. (Del. Ch. Nov. 30, 2007), wherein the Court dismissed at the pleading stage claims that a merger proxy omitted material facts with respect to the rendering of a fairness opinion by the target's investment bankers, emphasizing its that for an omission to be material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by [a] reasonable investor as having significantly altered the 'total mix' of information" and concluding that:

- a disclosure of the investment banker fees that states simply that they are "customary" and contingent in nature was sufficient - the exact amount of the fees need not be further disclosed unless their magnitude makes them material;
- while reliable financial projections should generally be disclosed, and unreliable projections do not need to be disclosed, the omission of *any* projections was not grounds for a disclosure claim, because plaintiff did not allege that there existed any reliable projections that should have been disclosed; and
- the merger proxy did not need to disclose the identity of third parties that were approached by target as alternative merger partners.

Indeed, the Court determined that most of the alleged defects in the merger proxy's fairness opinion were with respect to the substance or quality of the opinion and its analyses and not the adequacy of the disclosure of the facts upon which the fairness opinion was based or the process by which it was reached. The Court noted that any such "quibble with the substance of a banker's opinion does not constitute a disclosure claim."

664 *See supra* notes 327-338 and related text.

called a *Revlon* duty for the case with which it is most commonly associated — does not, of course, require every board to follow a judicially prescribed checklist of sales activities. Rather, the duty requires the board to act reasonably, by undertaking a logically sound process to get the best deal that is realistically attainable. The mere fact that a board did not, for example, do a canvass of all possible acquirers before signing up an acquisition agreement does not mean that it necessarily acted unreasonably. Our case law recognizes that [there] are a variety of sales approaches that might be reasonable, given the circumstances facing particular corporations.

> What is important and different about the *Revlon* standard is the intensity of judicial review that is applied to the directors' conduct. Unlike the bare rationality standard applicable to garden-variety decisions subject to the business judgment rule, the *Revlon* standard contemplates a judicial examination of the reasonableness of the board's decision-making process. Although linguistically not obvious, this reasonableness review is more searching than rationality review, and there is less tolerance for slack by the directors. Although the directors have a choice of means, they do not comply with their *Revlon* duties unless they undertake reasonable steps to get the best deal.

In so holding, the Court found that the Board and its Special Committee did not act reasonably in failing to contact strategic buyers. The Court rejected defendants' attempt to justify this refusal based on unauthorized sporadic contacts with strategic buyers over the half-decade preceding the proposed merger, and held that "[t]he record, as it currently stands, manifests no reasonable, factual basis for the board's conclusion that strategic buyers in 2006 would not have been interested in Netsmart as it existed at that time." In a later discussion, the Court distinguished such informal contacts from a targeted, private sales effort in which authorized representatives seek out a buyer. The Court viewed the record evidence regarding prior contacts as "more indicative of an after-the-fact justification for a decision already made, than of a genuine and reasonably-informed evaluation of whether a targeted search might bear fruit."

Further, the Court rejected a post-agreement market check involving a window-shop and 3% termination fee as a viable method for maximizing value for a micro-cap company:

> Of course, one must confront the defendants' argument that they used a technique accepted in prior cases. The Special Committee used a limited, active auction among a discrete set of private equity buyers to get an attractive "bird in hand." But they gave Netsmart stockholders the chance for fatter fowl by including a fiduciary out and a modest break-up fee in the Merger Agreement. By that means, the board enabled a post-signing, implicit market check. Having announced the Insight Merger in November 2006 without any bigger birds emerging thereafter, the board argues that the results buttress their initial conclusion, which is that strategic buyers simply are not interested in Netsmart.

> The problem with this argument is that it depends on the rote application of an approach typical of large-cap deals in a micro-cap environment. The "no single blueprint" mantra is not a one way principle. The mere fact that a

technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics.

Precisely because of the various problems Netsmart's management identified as making it difficult for it to attract market attention as a micro-cap public company, an inert, implicit post-signing market check does not, on this record, suffice as a reliable way to survey interest by strategic players. Rather, to test the market for strategic buyers in a reliable fashion, one would expect a material effort at salesmanship to occur. To conclude that sales efforts are always unnecessary or meaningless would be almost un-American, given the sales-oriented nature of our culture. In the case of a niche company like Netsmart, the potential utility of a sophisticated and targeted sales effort seems especially high.

* * *

In the absence of such an outreach, Netsmart stockholders are only left with the possibility that a strategic buyer will: (i) notice that Netsmart is being sold, and, assuming that happens, (ii) invest the resources to make a hostile (because Netsmart can't solicit) topping bid to acquire a company worth less than a quarter of a billion dollars. In going down that road, the strategic buyer could not avoid the high potential costs, both monetary (e.g., for expedited work by legal and financial advisors) and strategic (e.g., having its interest become a public story and dealing with the consequences of not prevailing) of that route, simply because the sought-after-prey was more a side dish than a main course. It seems doubtful that a strategic buyer would put much energy behind trying a deal jump in circumstances where the cost-benefit calculus going in seems so unfavorable. Analogizing this situation to the active deal jumping market at the turn of the century, involving deal jumps by large strategic players of deals involving their direct competitors in consolidating industries is a long stretch.

Similarly, the current market trend in which private equity buyers seem to be outbidding strategic buyers is equally unsatisfying as an excuse for the lack of *any* attempt at canvassing the strategic market. Given Netsmart's size, the synergies available to strategic players might well have given them flexibility to outbid even cash-flush private equity investors. Simply because many deals in the large-cap arena seem to be going the private equity buyers' way these days does not mean that a board can lightly forsake any exploration of interest by strategic bidders.

In this regard, a final note is in order. Rightly or wrongly, strategic buyers might sense that CEOs are more interested in doing private equity deals that leave them as CEOs than strategic deals that may, and in this case, certainly, would not. That is especially so when the private equity deals give management … a "second bite at the apple" through option pools. With this impression, a strategic buyer seeking to top Insight might consider this factor in deciding whether to bother with an overture.

The Court was critical of the lack of minutes for key Board and Special Committee meetings (some of which were labeled "informal" because no minutes were taken) relied upon by the Board to justify its process.[665] The Court also was displeased that most of the minutes were prepared in omnibus fashion after the litigation was filed.

The Court criticized the Special Committee for permitting management to conduct the due diligence process without supervision:

> "In easily imagined circumstances, this approach to due diligence could be highly problematic. If management had an incentive to favor a particular bidder (or type of bidder), it could use the due diligence process to its advantage, by using different body language and different verbal emphasis with different bidders. 'She's fine' can mean different things depending on how it is said."

The Court ultimately found no harm, no foul on this issue because management did not have a favored private equity backer and there was no evidence that they tilted the process in favor of any participant.

The Court found that the proxy's disclosures regarding the target's process and its reasons for not pursuing strategic buyers had no basis in fact. The Court also found that the projections relied on by the Special Committee and its financial advisor in its fairness opinion needed to be disclosed in the proxy materials:

> In the Proxy, William Blair's various valuation analyses are disclosed. One of those analyses was a DCF valuation founded on a set of projections running until 2011. Those projections were generated by William Blair based on input from Netsmart management, and evolved out of the earlier, less optimistic, Scalia projections. Versions of those figures were distributed to interested parties throughout the bidding process, and one such chart is reproduced in part in the Proxy. The final projections utilized by William Blair in connection with the fairness opinion, however, have not been disclosed to shareholders. Those final projections, which were presented to the Netsmart board on November 18, 2006 in support of William Blair's final fairness opinion, take into account Netsmart's acquisition of CMHC and management's best estimate of the company's future cash flows.
>
> * * *
>
> But, that was thin gruel to sustain the omission. Even if it is true that bidders never received 2010 and 2011 projections, that explanation does not undercut the materiality of those forecasts to Netsmart's stockholders. They, unlike the bidders, have been presented with William Blair's fairness opinion and

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665 The Court focused on what the Board described as an "informal meeting" that resulted in a "tactical choice … to focus solely on a sale to a private equity buyer" rather than to also concurrently seek strategic buyers. The Court criticized the Board for failing to keep minutes of this important meeting, and subsequently discounted the description of the decision to go private and not focus on strategic buyers set forth in the proxy statement because of the lack of minutes from this meeting, finding "no credible evidence in the record" to support the description. *In re Netsmart*, 924 A.2d 171, at *26-30 (Del. Ch. 2007).

> are being asked to make an important voting decision to which Netsmart's future prospects are directly relevant.
>
> * * *
>
> [T]he Proxy now fails to give the stockholders the best estimate of the company's future cash flows as of the time the board approved the Merger. Because of this, it is crucial that the entire William Blair model from November 18, 2006 — not just a two year addendum — be disclosed in order for shareholders to be fully informed.
>
> Faced with the question of whether to accept cash now in exchange for forsaking an interest in Netsmart's future cash flows, Netsmart stockholders would obviously find it important to know what management and the company's financial advisor's best estimate of those future cash flows would be. In other of our state's jurisprudence, we have given credence to the notion that managers had meaningful insight into their firms' futures that the market did not. Likewise, weight has been given to the fairness-enforcing utility of investment banker opinions. It would therefore seem to be a genuinely foolish (and arguably unprincipled and unfair) inconsistency to hold that the best estimate of the company's future returns, as generated by management and the Special Committee's investment bank, need not be disclosed when stockholders are being advised to cash out. That is especially the case when most of the key managers seek to remain as executives and will receive options in the company once it goes private. Indeed, projections of this sort are probably among the most highly-prized disclosures by investors. Investors can come up with their own estimates of discount rates or (as already discussed) market multiples. What they cannot hope to do is replicate management's inside view of the company's prospects.[666]

The Court did not require that either the fairness opinion or the proxy statement "engage in self-flagellation" over the fact that the merger price was at the low end of the investment banker's analytical ranges of fairness and explained:

> Here, there is no evidence in the record indicating that William Blair ever explained its decision to issue a fairness opinion when the Merger price was at a level that was in the lower part of its analytical ranges of fairness. * * * From this "range of fairness" justification, one can guess that William Blair believed that, given the limited auction it had conducted and the price competition it generated, a price in the lower range was "fair," especially given William Blair's apparent assumption that an implicit, post-signing market check would be meaningful. * * * The one reason in the record is simply that the price fell within, even if at the lower end, of William Blair's fairness ranges. William Blair's bare bones fairness opinion is typical of such opinions, in that it simply states a conclusion that the offered Merger consideration was "fair, from a

666 *See* Blake Rohrbacher and John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 Bus. Law. 881 (May 2008).

financial point of view, to the shareholders" but plainly does not opine whether the proposed deal is either advisable or the best deal reasonably available. Also in keeping with the industry norm, William Blair's fairness opinion devotes most of its text to emphasizing the limitations on the bank's liability and the extent to which the bank was relying on representations of management. Logically, the cursory nature of such an "opinion" is a reason why the disclosure of the bank's actual analyses is important to stockholders; otherwise, they can make no sense of what the bank's opinion conveys, other than as a stamp of approval that the transaction meets the minimal test of falling within some broad range of fairness.

F. In re Topps Company Shareholders Litigation

The Delaware Court of Chancery decision in *In re Topps Company Shareholder Litigation*[667] pitted a late responding competitor whose bid raised financing and antitrust issues against a private equity buyer that would keep management but offered a lower price. In *Topps*, Vice Chancellor Strine granted a preliminary injunction against a stockholder vote on a cash merger at $9.75 per share with a private equity purchaser ("*__Eisner__*") until such time as: (1) the Topps Board discloses several material facts not contained in the corporation's proxy statement, including facts regarding Eisner's assurances that he would retain existing management after the merger and background information regarding approaches by a strategic competitor ("*__Upper Deck__*") which ultimately proposed a cash merger at $10.75 per share ($1.00 more than the Eisner merger price) although it presented antitrust and financing risks not present in the Eisner proposal; and (2) Upper Deck is released from a standstill that it had agreed to in return for non-public information for purposes of (a) publicly commenting on its negotiations with Topps in order to counter negative characterizations of Upper Deck's proposal in the Board's proxy statement, and (b) making a non-coercive tender offer on conditions as favorable or more favorable than those it has offered to the Topps Board. The Court concluded that Upper Deck and a group of stockholder plaintiffs had established a reasonable probability of success in being able to show at trial that the Topps Board breached its fiduciary duties by misusing a standstill to prevent Upper Deck from communicating with the Topps stockholders and presenting a bid that the Topps stockholders could find materially more favorable than the Eisner merger proposal, but found that the Board had not breached its *Revlon* duties.[668]

Topps had two lines of business, both of which had been declining: (i) baseball and other cards and (ii) bubblegum and other old style confections. It had a ten member classified Board, seven of whom had served Topps for many years (five of them were independent directors and one was outside counsel to Topps) (the "*__Incumbent Directors__*") and three of whom were representatives of a small hedge fund who were put on the Board to settle a proxy context (the "*__Dissident Directors__*"). The proxy contest led Topps' management to first (and unsuccessfully) endeavor to sell its confections division through a public auction. Sensing that these circumstances might make the Topps Board receptive to a going private transaction, even though it had announced that Topps was not for sale, Eisner and two other financial buyers (both of whom soon dropped out after submitting low value indication of interest) approached the Board. Although the Dissident Directors wanted an open auction of Topps, the Board decided to

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667 C.A. No. 2998-VCS (Del. Ch. June 19, 2007).

668 *See supra* notes 480-486.

negotiate exclusively with Eisner (perhaps because of the failed auction of the confections division). Ultimately a merger agreement was signed by Eisner that provided a $9.75 per share, a 40-day "go-shop"[669] period with Eisner having the right to match any superior proposal and a fiduciary out with a 3% of transaction value termination fee for a superior bid accepted during the 40-day go-shop period and a 4.6% termination fee for superior proposals accepted after the go-shop period.[670]

Revlon Analysis. In finding that the Topps Board had not violated its *Revlon* duties in deciding not to undertake a pre-signing auction, Vice Chancellor Strine commented:

> The so-called *Revlon* standard is equally familiar. When directors propose to sell a company for cash or engage in a change of control transaction, they must take reasonable measures to ensure that the stockholders receive the highest value reasonably attainable. Of particular pertinence to this case, when directors have made the decision to sell the company, any favoritism they display toward particular bidders must be justified solely by reference to the objective of

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669 Stephen I. Glover and Jonathan P. Goodman, *Go Shops: Are They Here to Stay*, 11 M&A Lawyer No. 6 (June 2007).

670 The Court described the Eisner merger agreement more fully as follows:

> Eisner and Topps executed the Merger Agreement on March 5, 2006, under which Eisner will acquire Topps for $9.75 per share or a total purchase price of about $385 million. The Merger Agreement is not conditioned on Eisner's ability to finance the transaction, and contains a representation that Eisner has the ability to obtain such financing. But the only remedy against Eisner if he breaches his duties and fails to consummate the Merger is his responsibility to pay a $12 million reverse break-up fee.
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> The "Go Shop" provision in the Merger Agreement works like this. For a period of forty days after the execution of the Merger Agreement, Topps was authorized to solicit alternative bids and to freely discuss a potential transaction with any buyer that might come along. Upon the expiration of the "Go Shop Period," Topps was required to cease all talks with any potential bidders unless the bidder had already submitted a "Superior Proposal," or the Topps board determined that the bidder was an "Excluded Party," which was defined as a potential bidder that the board considered reasonably likely to make a Superior Proposal. If the bidder had submitted a Superior Proposal or was an Excluded Party, Topps was permitted to continue talks with them after the expiration of the Go Shop Period.
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> The Merger Agreement defined a Superior Proposal as a proposal to acquire at least 60% of Topps that would provide more value to Topps stockholders than the Eisner Merger. The method in which the 60% measure was to be calculated, however, is not precisely defined in the Merger Agreement, but was sought by Eisner in order to require any topping bidder to make an offer for all of Topps, not just one of its Businesses.
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> Topps was also permitted to consider unsolicited bids after the expiration of the 40-day Go Shop period if the unsolicited bid constituted a Superior Proposal or was reasonably likely to lead to one. Topps could terminate the Merger Agreement in order to accept a Superior Proposal, subject only to Eisner's right to match any other offer to acquire Topps.
>
> The Eisner Merger Agreement contains a two-tier termination fee provision. If Topps terminated the Eisner Merger Agreement in order to accept a Superior Proposal during the Go Shop Period, Eisner was entitled to an $8 million termination fee (plus a $3.5 million expense reimbursement), in total, or approximately 3.0% of the transaction value. If Topps terminates the Merger Agreement after the expiration of the Go Shop Period, Eisner is entitled to a $12 million termination fee (plus a $4.5 million expense reimbursement), or approximately 4.6% of the total deal value.
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> The Eisner Merger Agreement is subject to a number of closing conditions, such as consent to the transaction by regulatory authorities and the parties to certain of Topps's material contracts, such as its licenses with Major League Baseball and other sports leagues.
>
> In connection with the Eisner Merger Agreement, Shorin and Eisner entered into a letter agreement pursuant to which Shorin agreed to retire within sixty days after the consummation of the Merger and to surrender $2.8 million to which he would otherwise be entitled under his existing employment agreement in the event of a change of control of Topps. Shorin would remain a consultant to Topps for several years with sizable benefits, consistent with his existing employment agreement.

maximizing the price the stockholders receive for their shares. When directors bias the process against one bidder and toward another not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty.

* * *

The Stockholder Plaintiffs … argue that the Incumbent Directors unreasonably resisted the desire of the Dissident Directors to conduct a full auction before signing the Merger Agreement, that Greenberg [an Incumbent Director involved in the negotiations with Eisner] capped the price Eisner could be asked to pay by mentioning that a $10 per share price would likely command support from the Incumbent Directors, that the Incumbent Directors unfairly restricted the Dissident Director's ability to participate in the Merger negotiation and consideration process, and that the Incumbent Directors foreclosed a reasonable possibility of obtaining a better bid during the Go Shop Period by restricting that time period and granting Eisner excessive deal protections. For its part, Upper Deck echoes these arguments, and supplements them with a contention that Upper Deck had made its desire to make a bid known in 2005, before Eisner ever made a formal bid, and was turned away.

Although these arguments are not without color, they are not vibrant enough to convince me that they would sustain a finding of breach of fiduciary duty after trial. A close reading of the record reveals that a spirited debate occurred between the two members of the Ad Hoc Committee who were Incumbent Directors … and the two who were Dissident Directors …. After examining the record, I am not at all convinced that [the Incumbent Directors] were wrong to resist the Dissidents' demand for a full auction. Topps had run an auction for its Confectionary Business in 2005, without success.

The market knew that Topps, which had no poison pill in place, had compromised a proxy fight in 2006, with the insurgents clearly prevailing. Thus, although [CEO] Shorin had put out a letter before the settlement of the proxy fight indicating that a "quick fix" sale was not in the interests of stockholders, the pot was stirred and ravenous capitalists should have been able to smell the possibility of a deal. Certainly that was true of Upper Deck, which is Topps's primary competitor. Now, of course, Upper Deck says that its overtures were rebuffed by Lehman, Topps's banker, a year earlier. But one must assume that Upper Deck is run by adults. As Topps's leading competitor, it knew the stress the Dissident Directors would be exerting on [CEO] Shorin to increase shareholder value. If Upper Deck wanted to make a strong move at that time, it could have contacted [CEO] Shorin directly (e.g., the trite lunch at the Four Seasons), written a bear hug letter, or made some other serious expression of interest, as it had several years earlier. The fact that it did not, inclines me toward the view that the defendants are likely correct in arguing that Upper Deck was focused on acquiring and then digesting another company, Fleer, during 2005 and 2006, and therefore did not make an aggressive run at (a clearly reluctant) Topps in those years.

> Given these circumstances, the belief of the Incumbent Directors on the Ad Hoc Committee, and the full board, that another failed auction could damage Topps, strikes me, on this record, as a reasonable one.

The Court found that the 40 day "go-shop" period, with a 3% of transaction value termination fee during that period and a 4.6% termination fee thereafter, provided an effective post-signing market check:

> Although a target might desire a longer Go Shop Period or a lower break fee, the deal protections the Topps board agreed to in the Merger Agreement seem to have left reasonable room for an effective post-signing market check. For 40 days, the Topps board could shop like Paris Hilton. Even after the Go Shop Period expired, the Topps board could entertain an unsolicited bid, and, subject to Eisner's match right, accept a Superior Proposal. The 40-day Go Shop Period and this later right work together, as they allowed interested bidders to talk to Topps and obtain information during the Go Shop Period with the knowledge that if they needed more time to decide whether to make a bid, they could lob in an unsolicited Superior Proposal after the Period expired and resume the process.

<u>Duty of Candor</u>. The Vice Chancellor summarized the Delaware duty of candor as follows:

> When directors of a Delaware corporation seek approval for a merger, they have a duty to provide the stockholders with the material facts relevant to making an informed decision. In that connection, the directors must also avoid making materially misleading disclosures, which tell a distorted rendition of events or obscure material facts. In determining whether the directors have complied with their disclosure obligations, the court applies well-settled standards of materiality, familiar to practitioners of our law and federal securities law.[671]

The proxy statement disclosed that the Topps Board had instructed management not to have any discussions with Eisner regarding post merger employment with Eisner. The Court found that while that disclosure may have been true, the proxy statement should have also made disclosures to the effect that Eisner had explicitly stated that his proposal was "designed to" retain substantially all of Topps' management and key employees. The Court also cited concerns that Topps' financial adviser had manipulated its financial analyses to make Eisner's offer look more attractive after Eisner refused to increase his bid and, thus, that the proxy statement should have included projections of Topps' future cash flows from a presentation which the financial adviser presented to the Topps Board at a meeting over a month before it made its fairness opinion presentation regarding the Eisner proposal that was approved by the Board.

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671 C.A. No. 2998-VCS (Del. Ch. June 19, 2007). *See* Blake Rohrbacher and John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 Bus. Law. 881 (May 2008).

Financing. Although the Upper Deck had not obtained a firm debt financing commitment, the Court found that the Proxy Statement should have disclosed that competing bidder Upper Deck (a private company) did not have a financing contingency.

Antitrust. Upper Deck and Topps were the only competitors in the baseball card business, but the Court felt that Board's proxy statement overstated the antitrust risk in an Upper Deck merger since the Board did not produce expert testimony that there was a significant antitrust risk and Upper Deck was willing to make such regulatory concessions (e.g. divestitures) necessary to get antitrust approval.

Standstill. In enjoining the enforcement of the standstill against Upper Deck, the Court found that standstills may be appropriate in some circumstances, but that the Topps Board had used the Upper Deck Standstill in a way that resulted in the Topps Board breaching its fiduciary duties:

> Standstills serve legitimate purposes. When a corporation is running a sale process, it is responsible, if not mandated, for the board to ensure that confidential information is not misused by bidders and advisors whose interests are not aligned with the corporation, to establish rules of the game that promote an orderly auction, and to give the corporation leverage to extract concessions from the parties who seek to make a bid.
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> But standstills are also subject to abuse. Parties like Eisner often, as was done here, insist on a standstill as a deal protection. Furthermore, a standstill can be used by a target improperly to favor one bidder over another, not for reasons consistent with stockholder interest, but because managers prefer one bidder for their own motives.
>
> In this case, the Topps board reserved the right to waive the Standstill if its fiduciary duties required. That was an important thing to do, given that there was no shopping process before signing with Eisner.
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> The fiduciary out here also highlights a reality. Although the Standstill is a contract, the Topps board is bound to use its contractual power under that contract only for proper purposes. * * * I cannot read the record as indicating that the Topps board is using the Standstill to extract reasonable concessions from Upper Deck in order to unlock higher value. The Topps board's negotiating posture and factual misrepresentations are more redolent of pretext, than of a sincere desire to comply with their *Revlon* duties.
>
> Frustrated with its attempt to negotiate with Topps, Upper Deck asked for a release from the Standstill to make a tender offer on the terms it offered to Topps and to communicate with Topps's stockholders. The Topps board refused. That refusal not only keeps the stockholders from having the chance to accept a potentially more attractive higher priced deal, it keeps them in the dark about Upper Deck's version of important events, and it keeps Upper Deck from

obtaining antitrust clearance, because it cannot begin the process without either a signed merger agreement or a formal tender offer.

Because the Topps board is recommending that the stockholders cash out, its decision to foreclose its stockholders from receiving an offer from Upper Deck seems likely … to be found a breach of fiduciary duty. If Upper Deck makes a tender at $10.75 per share on the conditions it has outlined, the Topps stockholders will still be free to reject that offer if the Topps board convinces them it is too conditional. * * * Given that the Topps board has decided to sell the company, and is not using the Standstill Agreement for any apparent legitimate purpose, its refusal to release Upper Deck justifies an injunction. Otherwise, the Topps stockholders may be foreclosed from ever considering Upper Deck's offer, a result that, under our precedent, threatens irreparable injury.

Similarly, Topps went public with statements disparaging Upper Deck's bid and its seriousness but continues to use the Standstill to prevent Upper Deck from telling its own side of the story. The Topps board seeks to have the Topps stockholders accept Eisner's bid without hearing the full story. That is not a proper use of a standstill by a fiduciary given the circumstances presented here. Rather, it threatens the Topps stockholders with making an important decision on an uninformed basis, a threat that justifies injunctive relief.

G. In re Lear Corporation Shareholder Litigation

Lear I. Again in *In re Lear Corporation Shareholder Litigation*,[672] the Delaware Court of Chancery enjoined a merger vote until additional proxy statement disclosures were made regarding proposed changes in the compensation arrangements for the CEO who served as a lead negotiator for the company, but found that the sales process was reasonable enough to withstand a *Revlon*[673] challenge.

Lear was a major supplier to the troubled American automobile manufacturers and faced the possibility of bankruptcy as the maturity of substantial indebtedness was imminent. A restructuring plan was undertaken to divest unprofitable units and restructure debts. During this process in 2006, Carl Icahn took a large, public position in Lear stock, first through open market purchases and then in a negotiated purchase from Lear, ultimately raising his holdings to 24%.

Icahn's purchase led the stock market to believe that a sale of the company had become likely and bolstered Lear's flagging stock price. Lear's Board had eliminated the corporation's poison pill in 2004.

In early 2007, Icahn suggested to Lear's CEO that a going private transaction might be in Lear's best interest. After a week of discussions, Lear's CEO told the rest of the Board of Icahn's approach, which formed a Special Committee that authorized the CEO to negotiate merger terms with Icahn.

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672 2007 WL 173258 (Del. Ch. June 15, 2007).

673 *See supra* notes 480-486.

During those negotiations, Icahn only moved modestly from his initial offering price of $35 per share, going to $36 per share. He indicated that if the Board desired to conduct a pre-signing auction, he would pull his offer, but that he would allow Lear to freely shop his bid after signing, during a so-called "go-shop" period,[674] but only so long as he received a termination fee of approximately 3%.

The Board approved a merger agreement on those terms. After signing, the Board's financial advisors aggressively shopped Lear to both financial and strategic buyers, none of which made a topping bid.

The plaintiffs moved to enjoin the merger vote, arguing that the Lear Board breached its *Revlon* duties and failed to disclose material facts necessary for the stockholders to cast an informed vote.

Revlon Analysis. Plaintiffs argued that the Board breached its *Revlon* duties to obtain the best price reasonably available because (i) the Board allowed the CEO to lead the negotiations when he had a conflict of interest with respect to his compensation, (ii) the Board approved the merger agreement without a presigning auction and (iii) the merger agreement deal protections were unreasonable.

The Court found that although the Lear Special Committee made an "infelicitous decision" to permit the CEO to negotiate the merger terms without the presence of Special Committee or financial adviser representatives, the Board's efforts to secure the highest possible value appeared reasonable.[675] The Board retained for itself broad leeway to shop the company after signing, and negotiated deal protection measures that did not present an unreasonable barrier to any second-arriving bidder.[676] Moreover, the Board obtained Icahn's agreement to vote his equity position for any bid superior to his own that was embraced by the Board, thus signaling Icahn's own willingness to be a seller at the right price. Given the circumstances faced by Lear, the decision of the Board to lock in the potential for its stockholders to receive $36 per share with the right for the Board to hunt for a higher price appeared as reasonable. The Board's post-signing market check, which was actively conducted by investment bankers, who offered

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674 Stephen I. Glover and Jonathan P. Goodman, *Go Shops: Are They Here to Stay*, 11 M&A Lawyer No. 6 (June 2007).

675 The Court explained a Board's *Revlon* duties as follows:

> The other substantive claim made by the plaintiffs arises under the *Revlon* doctrine. *Revlon* and its progeny stand for the proposition that when a board has decided to sell the company for cash or engage in a change of control transaction, it must act reasonably in order to secure the highest price reasonably available. The duty to act reasonably is just that, a duty to take a reasonable course of action under the circumstances presented. Because there can be several reasoned ways to try to maximize value, the court cannot find fault so long as the directors chose a *reasoned* course of action.

676 The merger agreement provided the Lear Board 45 days after signing (the "go-shop period") to actively solicit a superior proposal and a fiduciary out to accept an unsolicited superior third party bid after the go-shop period ended with a termination fee during the go-shop period of 2.79% of the equity, or 1.9% of the enterprise, value of Lear and thereafter of 3.52% of the equity, or 2.4% of the enterprise valuation. If the stockholders rejected the merger, a termination fee was payable only if a competing proposal was accepted substantially concurrently with the termination of the merger agreement. The merger agreement obligated Ichan to pay a 6.1% reverse breakup fee if he could not arrange financing or otherwise breached the merger agreement and to vote his stock for a superior proposal approved by the Board.

stapled financing and would be compensated for bringing in a superior proposal, provided adequate assurance that there was no bidder willing to materially top Icahn.[677]

Duty of Candor. Since the Special Committee employed the CEO to negotiate deal terms with Icahn, the proxy statement should disclose that shortly before Icahn expressed an interest in making a going private offer, the CEO had asked the Lear Board to change his employment arrangements to allow him to cash in his retirement benefits while continuing to run the company, which the Board was willing to do, but not put into effect due to concerns at negative reactions from institutional investors and from employees who were being asked to make wage concessions. Because the CEO might rationally have expected a going private transaction to provide him with a unique means to achieve his personal objectives of cashing in on his retirement benefits and options while remaining employed by Lear and being able to sell his substantial holdings of Lear stock (which insider trading restrictions and market realities would inhibit him from doing), the court concluded that "the Lear stockholders are entitled to know that the CEO harbored material economic motivations that differed from their own that could have influenced his negotiating posture with Icahn." Thus, the Court issued an injunction preventing the merger vote until Lear shareholders were apprised of the CEO's overtures to the Board concerning his retirement benefits.

Lear II.[678] After the Court's decision in Lear I, the proxy voting advisory services recommended that stockholders vote against the merger and it appeared that the original merger agreement would not be approved. To salvage the deal, the Lear Special Committee (being sensitive to the Court's CEO involvement concerns expressed in Lear I, using its Chair and the CEO negotiating together) negotiated an increase in the merger consideration of $1.25 per share (3.5%) from $36 to $37.25, but in return the buyer got a termination fee of $25 million (0.9% of total deal value) if the stockholders rejected the merger agreement. After the stockholders rejected the amended merger agreement, plaintiff alleged that the Board acted in bath faith in approving the amended merger agreement that the stockholders rejected. In rejecting the plaintiff's theory that "directors who believe in good faith that a merger is good for the stockholders cannot adopt it if stockholder approval is unlikely" and granting the directors' motion to dismiss, Vice Chancellor Strine wrote:

> Directors are entitled to make good faith business decisions even if the stockholders might disagree with them. Where, as here, the complaint itself indicates that an independent board majority used an adequate process, employed reputable financial, legal, and proxy solicitation experts, and had a substantial basis to conclude a merger was financially fair, the directors cannot be faulted for being disloyal simply because the stockholders ultimately did not agree with their recommendation. In particular, where, as here, the directors are protected by an exculpatory [DGCL § 102(b)(7)] charter provision, it is critical that the complaint

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677 The *In re Netsmart Technologies, Inc. Shareholder Litigation* (*see supra* note 662), in which a post-signing market check was found inadequate under *Revlon*, was distinguished on the basis that Lear was a large, well known NYSE company, whereas Netsmart was a microcap company unlikely to be noticed by potential bidders and the merger agreement permitted only a "window shop" (the right of the Board to consider unsolicited proposals) as contrasted with the active "go-shop" in *Lear*.

678 *In re Lear Corporation Shareholder Litigation*, Cons. C.A. No. 2728-VCS, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008) ("*Lear II*").

> plead facts suggesting a fair inference that the directors breached their duty of loyalty by making a bad faith decision to approve the merger for reasons inimical to the interests of the corporation and its stockholders.[679]

In rejecting plaintiff's arguments that the directors exhibited bad faith in agreeing to give a $25 million no-vote termination fee in exchange for only a $1.25 per share increase in the merger agreement, the Vice Chancellor commented that "[t]hese prosciutto-thin margins are indicative of tough end-game posturing, not a huge value chasm," and explained:

> Thus, the plaintiffs are in reality down to the argument that the Lear board did not make a prudent judgment about the possibility of future success. That is, the plaintiffs are making precisely the kind of argument precluded by the business judgment rule. Precisely so as to ensure that directors are not unduly hampered in taking good faith risks, our law eschews the use of a simple negligence standard. Even where it is possible to hold directors responsible for a breach of the duty of care, Delaware law requires that directors have acted with gross negligence. Unless judges are mindful of the substantial difference between a simple negligence and gross negligence standard, the policy purpose served by Delaware's choice of a gross negligence standard risks being undermined. The definition of gross negligence used in our corporate law jurisprudence is extremely stringent.
>
> Here, it is critically important that another substantial dividing line be respected. After *Van Gorkom* met an unenthusiastic reception, the General Assembly adopted §102(b)(7), authorizing corporations to exculpate their directors from liability for violations of the duty of care. Lear's charter contains such an exculpatory charter provision.
>
> To respect this authorized policy choice made by Lear and its stockholders, this court must be vigilant in reviewing the complaint here to make sure that it pleads particularized facts pleading a non-exculpated breach of fiduciary duty. That requires the plaintiffs to plead particularized facts supporting an inference that the directors committed a breach of the fiduciary duty of loyalty. More specifically here, because the plaintiffs concede that eight of the eleven Lear directors were independent, the plaintiffs must plead facts supporting an inference that the Lear board, despite having no financial motive to injure Lear or its stockholders, acted in bad faith to approve the Revised Merger Agreement. Such a claim cannot rest on facts that simply support the notion that the directors made an unreasonable or even grossly unreasonable judgment. Rather, it must rest on facts that support a fair inference that the directors consciously acted in a manner contrary to the interests of Lear and its stockholders.

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679 *Lear II* slip opinion p. 2. Because Lear's certificate of incorporation contained a DGCL § 102(b)(7) exculpatory provision, plaintiff could not survive a motion to dismiss by pleading facts showing only gross negligence; plaintiff had to plead facts showing the Lear directors' breach of their duty of loyalty by acting in bad faith for reasons inimical to Lear.

The plaintiffs recognize this reality, and have attempted to sustain their complaint by charging the Lear board with having acted with "no care" and having approved in "bad faith" a Revised Merger Agreement that was almost certain not to be approved, while supposedly knowing that the $37.25 price was unfair. But they plead no particularized facts that support these inflammatory and conclusory charges of wrongdoing.

In fact, the very need of the plaintiffs to take legal doctrine that arose in the very different monitoring context and try to apply it to a discrete transaction that was subject to almost daily board attention suggests their desperation. The line of cases running from *Graham v. Allis-Chalmers* to *Caremark* to *Guttman* to *Stone v. Ritter* dealt in large measure with what is arguably the hardest question in corporation law: what is the standard of liability to apply to independent directors with no motive to injure the corporation when they are accused of indolence in monitoring the corporation's compliance with its legal responsibilities? The question is difficult for many reasons, including the reality that even the most diligent board cannot guarantee that an entire organization will always comply with the law. But it must be answered because one of the central justifications for the use of independent directors is that they are well positioned to oversee management, particularly by monitoring the processes used by the corporation to accurately account for its financial affairs and comply with applicable laws. When a fiduciary takes on a paying role, her duty of loyalty requires that she make a good faith effort to carry out those duties. Although everyone has off days, fidelity to one's duty is inconsistent with persistent shirking and conscious inattention to duty. For this reason, *Caremark* and its progeny have held that directors can be held culpable in the monitoring context if they breach their duty of loyalty by "a sustained or systematic failure . . . to exercise oversight," or "were conscious of the fact that they were not doing their jobs [as monitors]." More generally, our Supreme Court has held that to hold a disinterested director liable for a breach of the fiduciary duty of loyalty for acting in bad faith, a strong showing of misconduct must be made. Thus, in its *Disney* decision, the Court enumerated examples that all depended on purposeful wrongdoing, such as intentionally acting "with a purpose other than that of advancing the best interests of the corporation," acting "with the intent to violate applicable positive law," or "intentionally fail[ing] to act in the face of a known duty to act."

The plaintiffs' invocation of this body of law in this case does not aid them. The complaint makes clear that the Lear board held regular meetings and received advice from several relevant experts. The plaintiffs have therefore not come close to pleading facts suggesting that the Lear directors "consciously and intentionally disregarded their responsibilities" and thereby breached their duty of loyalty.

To this point, the plaintiffs' use of this body of law also makes clear the policy danger raised by transporting a doctrine rooted in the monitoring context and importing it into a context where a discrete transaction was approved by the board. When a discrete transaction is under consideration, a board will always face the question of how much process should be devoted to that transaction given its overall importance in light of the myriad of other decisions the board must make. Seizing specific opportunities is an important business skill, and that involves some measure of risk. Boards may have to choose between acting rapidly to seize a valuable opportunity without the luxury of months, or even weeks, of deliberation — such as a large premium offer — or losing it altogether. Likewise, a managerial commitment to timely decision making is likely to have systemic benefits but occasionally result in certain decisions being made that, with more time, might have come out differently. Courts should therefore be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith. In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties. Where, as here, the board employed a special committee that met frequently, hired reputable advisors, and met frequently itself, a *Caremark*-based liability theory is untenable.[680]

IX. M&A During the Credit Crunch.

A. General.

The credit crunch during the fall of 2008 led to acquisitions of three major financial institutions in quick succession: (i) The Bear Stearns Companies Inc. was acquired by JPMorgan Chase & Co. on May 30, 2008 pursuant to a merger agreement dated March 24, 2008, (ii) Merrill Lynch & Co. Inc. was acquired by Bank of America Corporation on January 1, 2009 pursuant to a merger agreement dated September 15, 2008, and (iii) Wachovia Corporation was acquired by Wells Fargo & Company on December 31, 2008 pursuant to a merger agreement dated October 3, 2008. Stockholders challenged each acquisition on the grounds that target directors breached

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680 *Lear II* slip opinion pp. 21-27. In what may have been a reference to *Ryan v. Lyondell* (*see supra* notes 426-435 and related text), the Court wrote in a footnote to the foregoing:

> Another risk warrants mention, which arises if courts fail to recognize that not all situations governed by *Revlon* have the strong sniff of disloyalty that was present in the original case. *Revlon* was a case rooted in entrenchment and bias concerns, with incumbent managers preferring one bidder strongly over another when a sale became inevitable. Many of the early *Revlon* and *Unocal*, 493 A.2d 946 (Del.1985), cases involved this flavor. When, has become more common, a *Revlon* case simply involves the question of whether a board took enough time to market test a third-party, premium-generating deal, and there is no allegation of a self-interested bias against other bidders, a plaintiff seeking damages after the deal has closed cannot, in the presence of a §102(b)(7) clause, rest on quibbles about due care. And, in that sort of scenario, the absence of an illicit directorial motive and the presence of a strong rationale for the decision taken (to secure the premium for stockholders) makes it difficult for a plaintiff to state a loyalty claim.
>
> As this court has previously noted:
>
>> The fact that a corporate board has decided to engage in a change of control transaction invoking so-called *Revlon* duties does not change the showing of culpability a plaintiff must make in order to hold the directors liable for monetary damages. For example, if a board unintentionally fails, as a result of gross negligence and not of bad faith or self-interest, to follow up on a materially higher bid and an exculpatory charter provision is in place, then the plaintiff will be barred from recovery, regardless of whether the board was in *Revlon*-land.
>
> *Intercargo*, 768 A.2d at 502.

their fiduciary duties of care by hastily agreeing to the transaction and entering into onerous deal protection provisions. The decisions in these cases from courts in different states (but largely based on Delaware law) showed that the courts were sensitive to the national impact of the credit crunch and the pressures on directors for quick action in extreme circumstances, but that they analyzed the directors' actions in approving merger agreements under established principles governing directors' duties.[681] These decisions do not show "the rule of law becoming a rule of awe" or purport to be based on "a 'national interest" doctrine, absolving companies of governance actions that are potentially harmful, but are important to an economic or defense emergency" as has been suggested.[682]

B. Pre-Crunch Sensitivity to Target Financial Stress.

Delaware courts have previously confronted the challenges facing directors of troubled companies faced with difficult decisions, and have applied traditional principles when evaluating the directors' conduct.[683] A decision from earlier in 2008 rejecting a merger challenge suggested that the Delaware judiciary was sensitive to marketplace disruptions and reluctant to interfere with the completion of mergers where there were no other viable bidders.[684]

C. Bear Stearns.

On December 4, 2008, a New York state court issued a decision in *In re Bear Stearns Litigation*,[685] applying Delaware law as both Bear Stearns and JPMorgan Chase were Delaware corporations, and dismissing all claims against Bear Stearns directors and JPMorgan arising from the federally assisted merger of Bear Stearns with JPMorgan. The *Bear Stearns* decision was issued at the summary judgment stage after significant document and deposition discovery. After plaintiffs withdrew their motion to enjoin the shareholder vote, the merger was approved by Bear Stearns' shareholders, the merger was consummated, and the case proceeded on a claim for damages.

The Court discussed the extraordinary and rapidly deteriorating circumstances facing the Bear Stearns Board. Bear Stearns, through subsidiaries, was a leading investment banking, securities and derivatives trading, clearance and brokerage firm. Its demise quickly followed the downgrade on Monday, March 10, 2008, by Moody's Investors Services of the rating of

681 *In re Bear Stearns Litigation*, ____ N.Y.S.2d ____, 2008 WL 5220514, 2008 N.Y. Slip Op. 28500 (N.Y.Sup., Dec 04, 2008) (NO. 600780/08); *County of York Employees Retirement Plan v. Merrill Lynch & Co., Inc.*, 2008 WL 4824053 (Del.Ch., Oct 28, 2008) (NO. CIV.A. 4066-VCN); *Ehrenhaus v. Baker*, 2008 WL 5124899, 2008 NCBC 20 (N.C.Super., Dec 05, 2008) (NO. CIV.A. 08 CVS 22632).

682 Wall Street Journal (January 20, 2009) at p. C-3.

683 *See*, for example, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914 (Del. 2003), *supra* notes 595-598; *In re Loral Space and Communications Inc. Consolidated Litigation*, C.A. No. 2808-VCS, 2008 WL 4293781 (Del. Ch. September 19, 2008), *supra* notes 436-439; *Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT), *supra* notes 601-603.

684 *See Wayne County Employees' Retirement System v. Corti, et al.*, 954 A.2d 319 (Del.Ch., July 1, 2008) (denying plaintiff's motion for preliminary injunction because "where, as here, no other bidder has emerged despite relatively mild deal protection devices, the plaintiff's showing of a reasonable likelihood of success must be particularly strong. The risk that enjoining the shareholder vote will disrupt the deal and prevent the shareholders from exercising a potentially value-maximizing opportunity is not lost on this Court.").

685 *In re Bear Stearns Litigation*, ____ N.Y.S.2d ____, 2008 WL 5220514, 2008 N.Y. Slip Op. 28500 (N.Y.Sup., Dec 04, 2008) (NO. 600780/08).

mortgage-backed debt issued by an affiliate of Bear Stearns, which started questions regarding Bear Stearns' solvency to circulate in the market. Despite a press release denying the market rumors, by late Wednesday, March 12, an increased number of customers had expressed a desire to withdraw funds from Bear Stearns and counterparties had expressed concern over maintaining their ordinary course exposure to Bear Stearns.

On Thursday, March 13, 2008, the *Wall Street Journal* reported that, due to the market perception of Bear Stearns' liquidity problems, trading counterparties were becoming cautious about their dealings with, and exposure to, the company. Over the course of the day, an unusual number of customers withdrew funds from Bear Steams. In addition, a significant number of counterparties appeared unwilling to provide the short-term, fully secured funding customary in the investment banking business and necessary for the company's operations. Concerned that its liquidity had deteriorated sharply to the point that it would not have enough cash to meet its needs, Bear Stearns' senior management met with the New York Federal Reserve Bank ("*NY Fed*"), the SEC and representatives of the U.S. Treasury Department to inform them of Bear Stearns' condition. Bear Stearns' CEO contacted JPMorgan's CEO to seek funding assistance or some other solution to Bear Stearns' liquidity problem, including a possible business combination. At 10:30 p.m. that evening, Bear Stearns' Board held a special meeting at which its senior management and legal and financial advisors discussed the liquidity problem, and the possibility that the company would not be able to meet its operational needs the next day, absent the identification of sufficient funding sources. Following that meeting, representatives of JPMorgan and government officials held discussions and ultimately agreed to a temporary NY Fed-backed loan facility.

At a reconvened meeting at 8:00 a.m. the next morning, Friday, March 14, 2008, the Bear Stearns' Board approved the loan facility negotiated the previous evening. Despite Bear Stearns' announcement of the loan facility and discussions with JPMorgan, customers and counterparties continued to abandon the company, its common stock price declined precipitously and major rating agencies downgraded Bear Stearns' credit ratings. On the evening of March 14, the NY Fed informed Bear Stearns that the loan facility would no longer be available as of the upcoming Monday morning, March 17, 2008. Treasury Secretary Henry Paulson also advised Bear Stearns' CEO that the company needed to complete a stabilizing transaction by the end of the weekend. The Federal Reserve intervention was premised on a concern that a sudden and disorderly failure of Bear Stearns would have "unpredictable but likely severe consequences for market functioning and the broader economy" and would also likely pose "the risk of systemic damage to the financial system."

Accordingly, on Saturday, March 15, 2008, representatives of Bear Stearns and JPMorgan met to discuss a potential deal. Bear Stearns' financial adviser also contacted various potential buyers and parties capable of providing alternative funding, ultimately reporting to the Board that only JPMorgan and a private equity firm had expressed meaningful interest. A separate Bear Stearns team considered and prepared a bankruptcy filing.

Late Sunday morning, March 16, JPMorgan advised Bear Stearns' financial adviser that due to the risks of a merger it could not proceed without some level of financial and other support from the NY Fed. Late on the afternoon of Sunday, March 16, JPMorgan indicated that it was interested in a stock-for-stock merger with Bear Stearns at an implied value of $4 per share for Bear Stearns stock, a figure shortly thereafter reduced to $2 per share. Bear Stearns objected to the price and suggested a term requiring JPMorgan to pay additional consideration if certain Bear Stearns assets were sold for more than JPMorgan valued them. JPMorgan declined to increase the price as a consequence of the Treasury's insistence.

The Bear Stearns' Board was informed that without a deal, the company would have to file for bankruptcy immediately, in which case its stockholders would likely receive nothing and the holders of Bear Stearns' unsecured $70 billion debt might suffer significant loss. Bear Stearns' financial adviser issued an opinion that the "Exchange Ratio is fair, from a financial point of view, to the holders of' the Company Common Stock." Bear Stearns' Board approved an initial merger agreement on Sunday, March 16, 2008, which provided for a share-for-share merger at an implied price of $2 per share. JPMorgan provided an immediate guaranty of various Bear Stearns' obligations, with the NY Fed providing supplemental funding.

Under the initial merger agreement, JPMorgan received options to purchase 19.9% of Bear Stearns' stock at $2 per share, and to purchase Bear Stearns' headquarters building in New York for $1.1 billion. The agreement also contained a "no solicitation" clause which prohibited Bear Stearns from actively soliciting alternative proposals with a typical fiduciary out to respond to a "superior proposal."

Despite announcement of the merger, Bear Stearns' customers continued to withdraw funds and counterparties remained unwilling to provide secured financing on customary terms. JPMorgan advised Bear Steams that it was skeptical of its ability to continue to extend credit or guarantee the loans in the face of market fears over Bear Stearns' viability and the perceived risk that the merger might not be completed. JPMorgan proposed that Bear Stearns issue a sufficient number of additional shares to give JPMorgan a two-thirds common stock interest, thereby increasing the certainty that the merger would close. Bear Stearns rejected this proposal and indicated that it would require a significant increase in the merger consideration for any revision of the initial merger agreement.

Negotiations over revisions to the merger agreement continued throughout the weekend, with the participation of the NY Fed. The parties reached an agreement on early Monday morning, March 24, on an amended merger agreement which increased the merger consideration to an implied value of approximately $10 per share, required JPMorgan to guarantee Bear Stearns' current and future borrowings from the NY Fed, and provided for JPMorgan to purchase a 39.5% interest in Bear Stearns' common stock for the merger price of $10 per share. As part of the renegotiation, JPMorgan and the NY Fed separately agreed to modify the special funding facility.

On May 29, 2008, a majority of Bear Stearns' stockholders voted to approve the merger transaction. With abstentions and unvoted shares counting against the merger, the transaction passed with 71% of the vote. If the 39.5% block of shares issued to JPMorgan had been excluded, the merger would still have passed with 52% of the vote. However, if all of JPMorgan's shares had been excluded, including the 10% of the outstanding shares purchased on the open market, the measure would have failed with a 42.7% vote. The merger closed on May 30, 2008.

Prior to the shareholder vote on the merger, plaintiffs filed a class action complaint asserting causes of action for breach of fiduciary duty against Bear Stearns and for aiding and abetting a breach of fiduciary duty against JPMorgan. Plaintiffs' "due care" claims were predicated principally on the haste with which the merger was negotiated, although the Bear Stearns merger was renegotiated and amended after an initial agreement was reached. Plaintiffs also challenged three deal protection devices: (i) an agreement pursuant to which JPMorgan Chase would purchase 39.5% of Bear Stearns' outstanding common stock (to increase the likelihood of shareholder approval), (ii) a "no solicitation" provision preventing Bear Stearns from soliciting additional bidders but permitting the acceptance of a superior proposal if the directors' fiduciary duties so required, and (iii) an option permitting JPMorgan Chase to buy the Bear Stearns headquarters building for $1.1 billion.

In rejecting these claims, the court found no evidence that the Bear Stearns' Board (comprised of a majority of non-management, non-employee directors and assisted by teams of financial and legal advisers) acted out of self-interest or in bad faith, that the Board members had no financial or other interest distinct from that of the Bear Stearns stockholders at large or any affiliation with JPMorgan, and were not acting to preserve their power in response to overtures by an unwanted suitor or other uninvited bids (any claim regarding an entrenchment motive was negated by the provision in the merger agreement requiring the directors to resign). The court explained its decision as follows:

> In response to a sudden and rapidly-escalating liquidity crisis, Bear Stearns' directors acted expeditiously to consider the company's limited options. They attempted to salvage some $1.5 billion in shareholder value and averted a bankruptcy that may have returned nothing to the Bear Stearns' shareholders, while wreaking havoc on the financial markets. The Court should not, and will not, second guess their decision.
>
> However, even if enhanced scrutiny was applied to the board's decisions, plaintiffs' claim against the Director Defendants would still fail.
>
> lf the transaction is viewed as "defensive," under *Unocal*, there is still no showing negating that the directors reasonably perceived and assessed a threat to the corporation. The liquidity crisis genuinely threatened Bear Stearns with extinction, and on three separate occasions within an eleven-day period the company was on the verge of filing for bankruptcy. The threat was so severe that the Federal Reserve intervened to avoid a broader destabilization of the markets. The Bear Stearns board promptly retained competent, independent financial and legal advisers to explore its options. Further, the directors' response was proportionate to the threat. Bear Stearns' very survival and the benefit to shareholders therefrom, depended on consummating a transaction with a financially sound partner. Bear Stearns' agreement to the Share Exchange Agreement, the no solicitation clause and other provisions was essential to ensure JPMorgan's willingness to undertake what it perceived as significant risks involved in guaranteeing Bear Stearns' obligations, and to assure customers and counterparties that the deal would go through. Having contacted over a dozen other potential corporate parties without obtaining a viable alternative bid, its

> accommodation of JPMorgan's contractual demands to insure increased deal certainty, and to placate the demonstrably unsettled market concerns, was neither "draconian" nor outside the "range of reasonableness" (*Unitrin*, 651 A2d at 1388).
>
> These same considerations satisfy any burden the Director Defendants might have had under *Blasius*, pursuant to which a compelling justification may be found where the "directors act for the purpose of preserving what the directors believe in good faith to be a value-maximizing offer" (*Mercier*, 929 A2d at 819). Despite the exigent circumstances, the directors were able to reject or moderate some of JPMorgan's proposed terms.
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> * * *
>
> Additionally, even if the Director Defendants had duties under *Revlon* to pursue maximum shareholder value, such a duty has been met. A satisfactory showing under *Revlon* has been made where, as here, the directors: were sophisticated and knowledgeable about the industry and strategic alternatives available to the company; were involved in the negotiation process and bargained hard; relied on expert advice; and received a fairness opinion from a financial advisor (*see*, *e.g.*, *In re Toys "R" Us*; *In re Pennaco Energy, Inc. S'holder Litig.*, 787 A2d 691 705-06 [Del Ch. 2001]; *McMillan*, 768 A2d 492, 505 [Del Ch. 2000]). Moreover, *Revlon* duties may be fulfilled where, as here, the corporation is operating under extreme time pressure and can locate only one bona fide bidder despite its best efforts to find competing offers. The "*board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith*" (*Barkan*, 567 AD2d at 1286-87) (emphasis added). A "*court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision . . . [i]f a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination*" (*QVC*, 637 A2d at 45) (emphasis added).

Plaintiffs contended that the Bear Stearns directors did not adequately explore alternatives to the merger with JPMorgan Chase, including a spin-off, a partial bankruptcy or a sale of assets, any of which could have achieved a better result. After considering reports from experts for plaintiffs and defendants, the court concluded that "[t]he dispute between the experts is clearly one involving business judgment, which was within the board's discretion to resolve."

The court found that the directors faced a "very real emergency" and "real time pressure" because "[t]he company could simply not continue to carry on its major operations . . . unless it had put some major financing, or a major transaction which would carry with it major financing, into place. No options appeared to be available other than the merger transaction with JPMorgan." The court found that (i) there were no other actual or potential bidders even though more than a dozen other parties had been contacted and Bear Stearns' financial distress was "extraordinarily well-publicized," (ii) the directors were able to reject or moderate some of

JPMorgan Chase's demands and (iii) JPMorgan Chase increased the implied per share consideration from $2 in the initial merger agreement to $10 in the amended agreement.

The court also rejected the specific challenges to the deal protection devices, finding, among other things, that the building purchase option was at fair value and the "no solicitation" clause that prohibited Bear Stearns from actively soliciting alternative proposals had not prevented the board from entertaining additional offers, and found that the deal protections were "essential to ensure JPMorgan's willingness to undertake what it perceived as significant risks involved in guaranteeing Bear Stearns' obligations, and to assure customers and counterparties that the deal would go through." In rejecting challenges to the deal protection provisions in the merger agreement, the Court wrote:

> The *Revlon* standard, concerned with the sale or transfer of control, is also not applicable here. Bear Stearns' issuance to JPMorgan of a 39.5% block of its shares was not a transfer of a controlling interest. Even after JPMorgan purchased an additional 10% on the open market, it did not become a majority shareholder. Rather, the public shareholders retained ultimate control. Plaintiffs' conclusory averments that the merger constituted a sale of transfer of control, or made the break-up of Bear Stearns inevitable, do not alter the essential nature of the merger transaction.
>
> Heightened scrutiny of the merger protection provisions is simply not warranted in the instant case.
>
> Inasmuch as, none of the enhanced standards apply, the deal protection measures are reviewable only under the business judgment rule. Plaintiffs have not made the requisite showing of self-dealing or disloyalty. Rather, the board was apparently concerned with preserving Bear Stearns' existence by ensuring a merger with the only bidder possessing the credibility and financial strength to help facilitate a government-assisted rescue.
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> * * *
>
> Most importantly, under any standard, it is clear that the no solicitation clause did not prevent Bear Stearns from entertaining additional offers or sharing the necessary information with prospective partners. Bear Stearns' financial distress was extraordinarily well publicized and Lazard had already solicited the most likely merger candidates. *It simply cannot be said that the clause precluded any additional offers. In fact, it is quite apparent that there were no other potential or actual purchasers of Bear Stearns, in the circumstances which the company found itself. No other bidders were found despite Lazard's efforts.* Thus. the no solicitation clause did not limit competition for Bear Stearns shares.
>
> The financial catastrophe confronting Bear Stearns, and the economy generally, justified the inclusion of the various merger protection provisions intended to increase the certainty of the consummation of the transaction with JPMorgan.

The court also observed that when a corporation is insolvent, its directors also owe duties to its creditors. Thus, the court stated that the consideration being paid to stockholders was "primarily an incentive to secure approval of the merger" and that "[i]n seeking to maximize shareholder recovery, the directors were thus entitled to consider that the greatest amount that they could demand might reasonably coincide with the lowest price sufficient to induce approval of the merger."

D. Merrill Lynch.

In *County of York Employees Retirement Plan v. Merrill Lynch & Co., Inc.*,[686] stockholders alleged in Delaware Chancery Court that Merrill Lynch's directors "hastily negotiated and agreed to the Merger over a single weekend without 'adequately informing themselves' as to the true value of the Company or the feasibility of securing an alternative transaction." According to plaintiff, the "directors failed to conduct the proper due diligence for the transaction as a result of the speed with which it was put together and did not conduct a pre-agreement market check."

In an October 28, 2008 letter opinion, Vice Chancellor Noble granted plaintiff's motion to expedite discovery, finding through "an almost superficial factual assessment" that certain of plaintiff's due care and disclosure claims against the Merrill Lynch directors were colorable. The court evaluated the claims under the business judgment rule, commenting that a stock-for-stock merger is not subject to heightened scrutiny under Delaware law absent a showing that the Board acted without due care or loyalty. The court acknowledged the directors' contentions that "severe time-constraints and an impending crisis absent an immediate transaction" justified their approval of the merger, but reasoned that "[t]he interests of justice are served when such essential and critical facts are properly developed in a manner recognized and accepted for establishing a factual basis for judicial action." Although the court took judicial notice of "well-known market conditions" generally, it would not do so with respect to Merrill Lynch's financial condition an other internal affairs.

Plaintiff also challenged three deal protection provisions: (i) an equity termination fee capped at 4% of the transaction's total value, commenting that it was "an amount testing the high-end of the termination fees generally approved"; (ii) a "force the vote" provision requiring a shareholder vote even if the directors withdraw their support for the merger (e.g., in the event of a superior proposal); and (iii) a no shop provision that precluded the Board from soliciting other offers after the agreement was signed. After acknowledging that such provisions had been approved in other Delaware cases and commenting that "deal protection devices must be viewed in the overall context; checking them off in isolation is not the proper methodology," the court ruled that "[i]n light of Merrill's choice to eschew a pre-agreement market check, and to conduct a truncated valuation of the Company, these provisions are suspect to an extent, and as such allow the Plaintiff to present colorable claims."

The court denied defendants motions to dismiss or stay the proceedings and ordered limited expedited discovery. On November 21, 2008, the defendants entered into a

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686 *County of York Employees Retirement Plan v. Merrill Lynch & Co., Inc.*, 2008 WL 4824053 (Del.Ch., Oct 28, 2008) (NO. CIV.A. 4066-VCN).

memorandum of understanding with the plaintiffs in this action regarding a settlement of the case which resulted in Merrill Lynch making additional disclosures in its proxy statement relating to its merger with Bank of America and plaintiffs being entitled to apply for an award of attorneys fees, all subject to court approval.[687] The merger was subsequently approved by the Merrill Lynch stockholders and was consummated on January 1, 2009.

E. Wachovia.

In *Ehrenhaus v. Baker*,[688] a North Carolina state court declined to preliminarily enjoin a vote on the stock-for-stock merger transaction between Wachovia (a North Carolina corporation) and Wells Fargo (a Delaware corporation). The challenge was that the Wachovia directors abdicated their fiduciary responsibilities to stockholders by entering into an inferior transaction rather than waiting for government assistance and by agreeing to deal protection devices that were preclusive and coercive.

The *Wachovia* decision turned on its facts. In September 2008, Wachovia was the fourth largest bank holding company in the U.S. and Wells Fargo was the fifth largest bank holding company in the U.S. A financial crisis was engulfing Wachovia and the world when the Wachovia Board met in the evening of October 2, 2008 to consider a merger with Wells Fargo.

For several months prior to that meeting, the Wachovia Board was monitoring the troubled capital markets and considering strategic alternatives. On September 20, 2008, U.S. government officials had expressed concern to the company's management about Wachovia's liquidity posture and encouraged the company to consider acquisition proposals from an unidentified third-party suitor. Wachovia's management initiated that process the next day, but those talks broke off without an agreement.

On September 25, 2008, the combination of the seizure of Washington Mutual by federal regulators and Congress' rejection of the U.S. Treasury's bailout plan exacerbated Wachovia's liquidity crisis and caused a precipitous decline in the company's share price. At a telephone Board meeting, on September 26, management informed the Board that if a combination with another partner could not be arranged by Monday, September 29, the FDIC would place Wachovia's bank subsidiaries in receivership.

Over the weekend of September 27–28, 2008, Wachovia engaged in parallel negotiations with Citigroup, Inc. and Wells Fargo over terms of a potential merger. Neither suitor was willing to move forward without government assistance in the form of a loss-sharing arrangement. Citigroup, moreover, was only willing to consider the acquisition of the Company's bank subsidiaries.

On September 28, 2008, the FDIC notified the Company that, because the potential failure of Wachovia posed a "systemic risk" to the banking system, it intended to exercise its authority under federal law to force the sale of Wachovia to another financial institution in an

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[687] *See* Merrill Lynch & Co., Inc. Form 8-K Report dated November 21, 2008, which also describes three other purported class actions filed on behalf of Merrill Lynch stockholders in the Supreme Court of the State of New York, County of New York in respect of the merger that were also settled.

[688] *Ehrenhaus v. Baker*, 2008 WL 5124899, 2008 NCBC 20 (N.C.Super., Dec 05, 2008) (NO. CIV.A. 08 CVS 22632).

"open bank assisted transaction." Following another Board meeting, Wachovia's management proposed an alternative transaction to the FDIC in a bid to allow Wachovia to remain independent. The FDIC, however, rejected that proposal and declared instead "that Citigroup would acquire Wachovia's bank subsidiaries" with assistance from the FDIC.

On September 29, 2008, Citigroup and Wachovia signed an agreement-in-principle by which Citigroup would acquire Wachovia's bank subsidiaries for $2.16 billion in cash and/or stock at Citigroup's election and assume approximately $53.2 billion of Wachovia's debt. The Citigroup merger would have left Wachovia as a stand-alone entity, but with its principal businesses limited to its retail brokerage and mutual fund operations. The Citigroup merger would have required the FDIC to provide Citigroup with loss protection on a $312 billion Wachovia loan portfolio.

On October 2, 2008, Wells Fargo tendered a merger proposal to acquire all of Wachovia's assets without government assistance in a stock-for-stock transaction that was worth more than $15 billion to Wachovia's shareholders. The Wells Fargo merger agreement also provided that Wells Fargo would purchase Wachovia Preferred Stock representing 39.9% of the Company's aggregate voting rights, including the right to vote on the approval of the Merger Agreement. The merger agreement prohibited Wachovia from soliciting alternative acquisition proposals. If the Wachovia Board received what it considered to be a proposal superior to the terms of the merger agreement, it could negotiate with the third-party bidder but would have to submit the Wells Fargo merger agreement to the Wachovia shareholders, although the Board could decline to recommend the Wells Fargo merger and communicate the basis for its lack of recommendation to the shareholders.

In response to the Board's inquiry whether further negotiations with Wells Fargo would be likely to yield more favorable terms, Wachovia's advisors counseled against such negotiations under the circumstances, and indicated that they expected to be able to render an opinion that the exchange ratio contained in the merger agreement was fair, from a financial point of view, to Wachovia shareholders. In considering the merits of the merger agreement, the Board took into account the current and recent stresses on Wachovia's liquidity, and determined that the Wells Fargo merger would provide a strategic fit with a company with a strong balance sheet that had managed to avoid the negative impact of the crisis in the capital markets. The Board understood that the merger agreement was a "change in control" transaction that would result in (i) eleven of Wachovia's executive officers and the Board Chairman receiving vested stock option benefits totaling approximately $2.5 million, as a group, and (ii) ten executive officers being entitled to receive an aggregate amount of up to $98.1 million in severance payments should they be terminated from their employment following approval of the merger.

The Board also was aware that the FDIC had rebuffed an earlier attempt by Wachovia's management to obtain government assistance to allow Wachovia to remain a stand-alone entity and that the FDIC was again threatening to place Wachovia into receivership if a merger did not materialize with either Citigroup or Wells Fargo by the end of the day on October 3, 2008, which in turn would likely result in Wachovia shareholders receiving little or no value for their equity. After discussing the options available to them, the Board concluded that the Wells Fargo merger agreement provided an opportunity for enhanced financial performance and shareholder value and was otherwise fair to, and in the best interest of, Wachovia shareholders. Accordingly, the Board voted unanimously to approve it.

On October 12, 2008, the Federal Reserve Board approved the Wells Fargo merger noting that "the unusual and exigent circumstances affecting the financial markets [and] the weakened financial condition of Wachovia . . . justified expeditious action."

Plaintiff contended that the Wells Fargo merger agreement provided for inadequate consideration to Wachovia's shareholders and substantially deprives the shareholders of their ability to "determine the appropriateness and fairness of the transaction." According to plaintiff, the valuation of Wachovia's stock at the time of execution of the Wells Fargo merger agreement was substantially below the stock's market price a week earlier and was inconsistent with pronouncements made to the media by Wachovia's President and CEO two weeks earlier purportedly touting Wachovia's viability as an independent entity. Plaintiff's principal complaints, however, related to the defensive measures embedded in the merger agreement by which the Board "handed to Wells Fargo almost 40% of Wachovia's voting rights whether the merger was ultimately approved or not."

In refusing to enjoin a shareholder vote on the proposed merger, the court applied North Carolina law because Wachovia was a North Carolina corporation, but explained that North Carolina courts look to Delaware when interpreting North Carolina corporate law: "Although the corporate law of North Carolina and Delaware are not in complete lockstep, the North Carolina courts frequently look to Delaware for guidance on questions of corporate governance because of the special expertise and body of case law developed in the Delaware Chancery Court and the Delaware Supreme Court."[689]

In North Carolina, corporate directors' fiduciary duties are codified. North Carolina General Statutes § 55-8-30 requires directors to discharge their duties "(1) In good faith; (2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) In a manner [they] reasonably believe[] to be in the best interests of the corporation."

North Carolina law recognizes a business judgment rule comparable to Delaware's. Regarding deal protection, the North Carolina court quoted from then Delaware Chancery Court Vice-Chancellor (now Delaware Supreme Court Chief Justice) Myron T. Steele that the relevant question is whether the deal protection measures are actionably coercive on the shareholders and whether "the vote will be a valid and independent exercise of the shareholders' franchise, without any specific preordained result which precludes them from rationally determining the fate of the proposed merger."[690]

Plaintiff's principal argument focused on the duty of care and contended that the Wachovia Board was neither "attentive" nor "informed" as to the substantive deal protection devices embedded in the merger agreement. In determining whether the Board was attentive and

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[689] Id. at *9 n.19 (quoting *First Union Corp. v. SunTrust Banks, Inc.*, 2001 NCBC 9A ¶ 32 (N.C. Super. Ct. Aug. 10, 2001), http://www.ncbusinesscourt.net/opinions/2001%20NCBC%2009A.pdf).

[690] *In re IXC Commc'ns, Inc. S'holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210, at *3 (Del. Ch. Oct. 27, 1999).

informed when it approved the merger agreement, the court examined the extraordinary circumstances surrounding the decisions made by the directors:

- The Board (all of whom save one are outside directors) faced a financial crisis of historic proportions;
- In the second quarter of 2008, Wachovia had reported a loss of $ 9.1 billion;
- The Board had previously fired the Company's CEO;
- Over the mere span of weeks, the Board had seen the demise of other venerable financial institutions via bankruptcy or liquidation;
- The U.S. House of Representatives had rejected the U.S. Treasury's original bailout bill aimed at providing relief to the capital markets;
- The Company's stock price had plummeted nearly 90% in ten days;
- Wachovia was facing an extreme liquidity crisis that had gotten the attention of federal regulators, who had effectively demanded that the Company merge with another financial institution to avoid a forced liquidation;
- Although the Board had little time to digest the merger agreement, it was not acting in an information vacuum as to the precarious financial stability of the Company, having met nine times in the preceding two weeks; and been informed that other merger options had been explored as well as attempts to raise capital and sell assets and made an unsuccessful overture to federal regulators for assistance in allowing the Company to remain independent;
- The Board understood and appreciated the substantive terms of the merger agreement, including the deal protection devices embedded therein, and it had the benefit of counsel from legal and financial advisors;
- In deciding whether to accept the less palatable terms of the merger agreement, the Board weighed the certain value of the transaction against the risks of further negotiations with its two suitors and the very real probability that failure to consummate a merger (whether with Wells Fargo or Citigroup) would exacerbate Wachovia's liquidity crisis and result in a seizure of the Company's banking assets by federal regulators and the elimination of all shareholder equity;
- Following the Board's approval of the merger agreement, Wachovia posted a loss of more than $20 billion for the third quarter of 2008;
- No other entity had made a bid to purchase Wachovia; and

- There was no evidence that the U.S. government would assist Wachovia in remaining a stand-alone entity should the Wells Fargo merger not be consummated.

After considering these circumstances, the court concluded that:

> [T]he Board's decision-making process, although necessarily compressed given the extraordinary circumstances confronting it, was reasonable and fell within the standard of care demanded by law.
>
> What makes this case unique is the presence of the 800-pound gorilla in the Wachovia board room, in the form of the U.S. government's pervasive regulatory oversight over bank holding companies.
>
> Indeed, there is little doubt that the threat of government intervention (in the form of a forced liquidation of the Company's banking assets) weighed heavily on the Board as it considered the Merger Agreement.
>
> In that regard, this case does not fit neatly into conventional business judgment rule jurisprudence, which assumes the presence of a free and competitive market to assess the value and merits of a transaction.[691]
>
> But other than insisting that he would have stood firm in the eye of what can only be described as a cataclysmic financial storm, Plaintiff offers nothing to suggest that the Board's response to the Hobson's choice before it was unreasonable.
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> * * *
>
> Instead, what was clear to the Board as it met late in the evening on 2 October 2008 was that if it failed to consummate a merger with either Citigroup or Wells Fargo by the end of the day on 3 October 2008, it faced the very real prospect of a government-directed liquidation of the Company's banking assets and, with it, the loss of most, if not all, of the shareholder equity.

The merger agreement contained the following deal protection provisions: (i) an agreement under which Wells Fargo was issued new preferred stock constituting 39.9% of Wachovia's aggregate voting power, which stock could, in certain circumstances, not be redeemed by Wachovia for 18 months even if Wachovia's stockholders disapproved the transaction, (ii) a "no solicitation" provision that precluded Wachovia from soliciting other bids, and (iii) a "force the vote" provision that required the merger to be put to stockholder vote even if the directors did not recommend approval (for example, if Wachovia were to receive a superior proposal from another bidder). Applying North Carolina's business judgment rule, the court found that these deal protection devices – with one modification – did not constitute a breach of fiduciary duty. Although the 39.9% stock issuance to Wells Fargo created a "substantial hurdle" to defeating the transaction, it neither "precluded other bidders from coming forward" nor

[691] *See First Union Corp.*, *supra* note 689.

"forced management's preferred alternative upon the stockholders." It did not preclude other bidders because an absolute majority of shares required for approval of the merger was not "locked up," given that 60% of the shares could vote against the transaction. Nor was it "coercive" because there was no other offer except a proposal from Citigroup that the court characterized as "markedly inferior." The court also held that the "force the vote" provision was not problematic because the Wachovia board retained the ability to explain its rationale for withdrawing its recommendation, even if a shareholder vote took place in the face of a "superior proposal." The court did strike down the 18-month tail period for redemption of the preferred stock issued to Wells Fargo, reasoning that if the Wachovia stockholders voted down the merger, "the Board's duty to seek out other merger partners should not be impeded by a suitor with substantial voting power whose overtures have already been rejected."

F. Observations from Merrill Lynch, Bear Stearns and Wachovia.

The decisions in *Merrill Lynch*, *Bear Stearns* and *Wachovia* show that courts will scrutinize quickly made decisions under traditional principles before giving target directors the benefit of the business judgment rule. Extraordinary circumstances, however, may result in a different result than was reached by the Delaware Chancery Court in *Ryan v. Lyondell Chemical Company* in 2008[692] in stigmatizing Board action in a compressed period when there was no 800-pound gorilla at the door.

The unique circumstances facing the financial sector undoubtedly impacted the courts' views of the substantive deal protection devices. Issuing nearly 40% of the target's voting power to the acquiror – as in *Bear Stearns* and *Wachovia* – to ensure that the transactions secured stockholder approval was reflective of the unique economic environment and a lack of negotiating leverage by the target board. But, in each transaction, the court found that there were no superior proposals, and there existed an urgent need to ensure deal certainty with an interested suitor in order to secure any value for the shareholders. The lack of alternative proposals was a function not of the deal protection devices, but of the absence of any credible third-party interest. The 800-pound gorilla at the door was a fact legitimately considered by the directors. Nevertheless, the *Merrill Lynch* court refused to accede to the target's request that it simply take "judicial notice" of the financial condition of Merrill Lynch and approve the deal protection devices that were generally customary under Delaware law.

While courts will give substantial deference to target boards operating in financially stressful situations, such deference is not without limit. Although the *Wachovia* court understood that Wells Fargo had demanded the issuance of the preferred stock as a *sine qua non* of any transaction, the court effectively second-guessed the Board's decision to approve one aspect of the preferred stock (the 18-month tail provision). In this instance the *Wachovia* court's modification had no practical consequence as Wachovia's stockholders approved the merger, but courts in other situations may strike down provisions that potentially restrict stockholder ability to consider superior offers and that give the impression of overreaching in negotiations where one side has little leverage.[693]

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692 See *supra* notes 426-435.

693 *See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914 (Del. 2003), *supra* notes 595-598.

X. Other Director Considerations.

A. Enforceability of Contracts Violative of Fiduciary Duties

Otherwise valid contracts may be rendered unenforceable if the directors of the party against which the contract is to be enforced breached their fiduciary duties in approving the contract. In *Ace Ltd. v. Capital Re Corp.*,[694] a case in which the Chancery Court suggested that a "no-talk" provision (i.e., a provision without an effective carve-out permitting it to talk with unsolicited bidders) in a merger was not likely to be upheld and wrote:

> [T]here are many circumstances in which the high priority our society places on the enforcement of contracts between private parties gives way to even more important concerns.
>
> One such circumstance is when the trustee or agent of certain parties enters into a contract containing provisions that exceed the trustee's or agent's authority. In such a circumstance, the law looks to a number of factors to determine whether the other party to the contract can enforce its contractual rights. These factors include: whether the other party had reason to know that the trustee or agent was making promises beyond her legal authority; whether the contract is executory or consummated; whether the trustee's or agent's *ultra vires* promise implicates public policy concerns of great importance; and the extent to which the other party has properly relied upon the contract. Generally, where the other party had reason to know that the trustee or agent was on thin ice, where the trustee's or agent's breach has seriously negative consequences for her ward, and where the contract is as yet still unperformed, the law will not enforce the contract but may award reliance damages to the other party if that party is sufficiently non-culpable for the trustee's or agent's breach.
>
> Indeed, Restatement (Second) of Contracts § 193 explicitly provides that a "promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on public policy grounds." The comments to that section indicate that "[d]irectors and other officials of a corporation act in a fiduciary capacity and are subject to the rule in this Section." It is therefore perhaps unsurprising that the Delaware law of mergers and acquisitions has given primacy to the interests of stockholders in being free to maximize value from their ownership of stock without improper compulsion from executory contracts entered into by boards--that is, from contracts that essentially disable the board and the stockholders from doing anything other than accepting the contract even if another much more valuable opportunity comes along.
>
> But our case law does not do much to articulate an explicit rationale for this emphasis on the rights of the target stockholders over the contract rights of the suitor. The Delaware Supreme Court's opinion in *Paramount v. QVC* comes closest in that respect. That case emphasizes that a suitor seeking to "lock up" a

[694] 747 A.2d 95 (Del. Ch. 1999).

change-of-control transaction with another corporation is deemed to know the legal environment in which it is operating. Such a suitor cannot importune a target board into entering into a deal that effectively prevents the emergence of a more valuable transaction or that disables the target board from exercising its fiduciary responsibilities. If it does, it obtains nothing.

For example, in response to Viacom's argument that it had vested contract rights in the no-shop provision in the Viacom-Paramount Merger Agreement, the Supreme Court stated:

The No-Shop Provision could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act or not to act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations. Since the No-Shop Provision was invalid, Viacom never had any vested contract rights in the provision.

As to another invalid feature of the contract, the Court explained why this result was, in its view, an equitable one:

Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the Stock Option Agreement. It cannot be now heard to argue that it obtain vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties.... Likewise, we reject Viacom's arguments and hold that its fate must rise or fall, and in this instance fall, with the determination that the actions of the Paramount Board were invalid.

B. Director Consideration of Long-Term Interests.

It has been implicit under Texas law that a director may consider the long-term interests of the corporation. However, because short-term market valuations of a corporation may not always reflect the benefits of long-term decisions and inherent long-term values, article 13.06 was added to the TBCA in 1997 (carried over in TBOC § 21.401) to expressly allow directors to consider the long-term interests of a corporation and its shareholders when considering actions that affect the interest of the corporations.[695] Although this provision was viewed as a mere codification of existing law, it was intended to eliminate any ambiguity that might exist as to the right of a board of directors to consider long-term interests when evaluating a takeover proposal. There is no similar provision in the DGCL.

[695] TBOC § 21.401; TBCA art. 13.06.

C. Liability for Unlawful Distributions.

Both Texas and Delaware impose personal liability on directors who authorize the payment of distributions to shareholders (including share purchases) in violation of the statutory requirements.[696]

Under Delaware law, liability for an unlawful distribution extends for a period of six years to all directors other than those who expressly dissent, with the standard of liability being negligence.[697] DGCL § 172, however, provides that a director will be fully protected in relying in good faith on the records of the corporation and such other information, opinions, reports, and statements presented to the corporation by the corporation's officers, employees and other persons. This applies to matters that the director reasonably believes are within that person's professional or expert competence and have been selected with reasonable care as to the various components of surplus and other funds from which distributions may be paid or made.[698] Directors are also entitled to receive contribution from other directors who may be liable for the distribution and are subrogated to the corporation against shareholders who received the distribution with knowledge that the distribution was unlawful.[699] Under the Texas Corporate Statues, liability for an unlawful distribution extends for two years instead of six years and applies to all directors who voted for or assented to the distribution (assent being presumed if a director is present and does not dissent).[700] A director will not be liable for an unlawful distribution if at any time after the distribution, it would have been lawful.[701] A similar provision does not exist in Delaware. A director will also not be liable under the Texas Corporate Statues for an unlawful distribution if the director:

(i) relied in good faith and with ordinary care on information relating to the calculation of surplus available for the distribution under the Texas Corporate Statues;

(ii) relied in good faith and with ordinary care on financial and other information prepared by officers or employees of the corporation, a committee of the board of directors of which he is not a member or legal counsel, investment bankers, accountants and other persons as to matters the director reasonably believes are within that person's professional or expert competence;

(iii) in good faith and with ordinary care, considered the assets of the corporation to have a value equal to at least their book value; or

(iv) when considering whether liabilities have been adequately provided for, relied in good faith and with ordinary care upon financial statements of, or

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696 TBOC § 21.316; TBCA art. 2.41.A(1); DGCL § 174(a).

697 DGCL § 174.

698 DGCL § 172.

699 DGCL § 174(b), (c).

700 TBOC §§ 21.316, 21.317; TBCA art. 2.41.A.

701 TBOC § 21.316(b); TBCA art. 2.41.A.

> other information concerning, any other person that is contractually obligated to pay, satisfy, or discharge those liabilities.[702]

As in Delaware, a director held liable for an unlawful distribution under the Texas Corporate Statues will be entitled to contribution from the other directors who may be similarly liable. The director can also receive contribution from shareholders who received and accepted the distribution knowing it was not permitted in proportion to the amounts received by them.[703] The Texas Corporate Statues also expressly provide that the liability of a director for an unlawful distribution provided for under the Texas Corporate Statues[704] is the only liability of the director for the distribution to the corporation or its creditors, thereby negating any other theory of liability of the director for the distribution such as a separate fiduciary duty to creditors or a tortious violation of the Uniform Fraudulent Transfer Act.[705] No similar provision is found in the DGCL.

D. Reliance on Reports and Opinions.

Both Texas and Delaware provide that a director in the discharge of his duties and powers may rely on information, opinions and reports prepared by officers and employees of the corporation and on other persons as to matters that the director reasonably believes are within that person's professional or expert competence.[706] In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.[707] In Texas, reliance must be made both in good faith and with ordinary care.[708]

E. Inspection of Records.

Both Texas and Delaware have codified the common law right of directors to examine the books and records of a corporation for a purpose reasonably related to the director's service as a director.[709]

F. Bylaws.

The Texas Corporate Statutes and the DGCL each provide that the business and affairs of a corporation are to be managed under the direction of its Board.[710] Each also provides that both the Board and the shareholders have the power to adopt, amend or repeal the corporation's bylaws.[711]

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702 TBOC § 21.316; TBCA arts. 2.41.C and 2.41.D.

703 TBOC § 21.318(a); TBCA arts. 2.41.E and 2.41.F.

704 TBOC § 21.316 or TBCA art. 2.41.

705 *See* TBOC § 21.316(d); TBCA art. 2.41.G.

706 *See* TBOC §§ 21.316(c), 3.102; TBCA art. 2.41.D; DGCL § 141(e).

707 DGCL § 141(e); *see also Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

708 TBOC § 21.316(c)(1); TBCA art. 2.41.D.

709 TBOC § 3.152; TBCA art. 2.44.B; DGCL § 220(d).

710 TBOC § 21.401; TBCA art. 2.31; and DGCL § 141(a). *See supra* notes 9 and 10 and related text.

711 DGCL § 109 provides as follows:

> **§ 109. Bylaws.**

In *CA, Inc. v. AFSCME Employees Pension Plan*,[712] the Delaware Supreme Court addressed the dual power of the Board and the stockholders to amend bylaws in answering two questions that had been certified to it by the SEC. The two questions arose from a proposal that AFSCME Employees Pension Plan had submitted for inclusion in the proxy materials of CA, Inc., a Delaware corporation, for its annual meeting of stockholders, and that CA proposed to exclude on the basis that the proposed bylaw was not a proper subject for stockholder action and that, if implemented, would violate the DGCL. The proposal sought stockholder approval of an amendment to CA's bylaws that would require the CA Board to reimburse the reasonable expenses (not to exceed the amount expended by CA in connection with such election) incurred by a stockholder or group of stockholders running a short slate of director nominees for election if at least one nominee on the short slate is elected to the Board.

The questions of law certified by the SEC to the Supreme Court were: (i) whether the proposed bylaw is a proper subject for action by stockholders as a matter of Delaware law and (ii) whether the proposed bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject. The Court answered both questions in the affirmative -- the proposed bylaw (1) was a proper subject for action by stockholders, but (2) would cause CA to violate Delaware law.

Justice Jacobs explained that the DGCL empowers both directors (so long as the certificate of incorporation so provides, as CA's did) and stockholders of a Delaware corporation with the ability to adopt, amend or repeal the corporation's bylaws. Because the "stockholders of a corporation subject to DGCL may not directly manage the business and affairs of the

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> (a) The original or other bylaws of a corporation may be adopted, amended or repealed by the incorporators, by the initial directors if they were named in the certificate of incorporation, or, before a corporation has received any payment for any of its stock, by its board of directors. After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote, or, in the case of a nonstock corporation, in its members entitled to vote; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors or, in the case of a nonstock corporation, upon its governing body by whatever name designated. The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.
>
> (b) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees. (8 Del. C. 1953, § 109; 56 Del. Laws, c. 50; 59 Del. Laws, c. 437, § 1.)

TBOC §§ 21.057 and 21.058 provide as follows:

> § 21.057. BYLAWS. (a) The board of directors of a corporation shall adopt initial bylaws.
>
> (b) The bylaws may contain provisions for the regulation and management of the affairs of the corporation that are consistent with law and the corporation's certificate of formation.
>
> (c) A corporation's board of directors may amend or repeal bylaws or adopt new bylaws unless:
>
> (1) the corporation's certificate of formation or this code wholly or partly reserves the power exclusively to the corporation's shareholders; or
>
> (2) in amending, repealing, or adopting a bylaw, the shareholders expressly provide that the board of directors may not amend, repeal, or readopt that bylaw.
>
> § 21.058. DUAL AUTHORITY. Unless the certificate of formation or a bylaw adopted by the shareholders provides otherwise as to all or a part of a corporation's bylaws, a corporation's shareholders may amend, repeal, or adopt the corporation's bylaws regardless of whether the bylaws may also be amended, repealed, or adopted by the corporation's board of directors.

[712] 953 A.2d 227 (Del. 2008).

corporation, at least without specific authorization in either the statute or the certificate of incorporation … the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)."[713] While it declined to "articulate with doctrinal exactitude a bright line" that would divide those bylaws that stockholders may permissibly adopt from those that would go too far in infringing upon the Board's right to manage the corporation, the Court commented:

> It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.
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> * * *
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> Examples of the procedural, process-oriented nature of bylaws are found in both the DGCL and the case law. For example, 8 *Del. C.* § 141(b) authorizes bylaws that fix the number of directors on the board, the number of directors required for a quorum (with certain limitations), and the vote requirements for board action. 8 *Del. C.* § 141(f) authorizes bylaws that preclude board action without a meeting. And, almost three decades ago this Court upheld a shareholder-enacted bylaw requiring unanimous board attendance and board approval for any board action, and unanimous ratification of any committee action. Such purely procedural bylaws do not improperly encroach upon the board's managerial authority under Section 141(a).[714]

The Court held that the proposed bylaw concerned the process for electing directors, which is a subject in which shareholders of Delaware corporations have a proper interest. Therefore, the proposed bylaw was a proper subject for stockholder action.[715]

The Court, however, also found that the proposed bylaw could require the Board to reimburse dissident stockholders in circumstances where a proper application of fiduciary principles would preclude the Board from doing so (such as when a proxy contest was undertaken for "personal or petty concerns, or to promote interests that do not further, or are

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713 953 A.2d at 232.

714 953 A.2d at 235.

715 In the words of the Court:

> The context of the Bylaw at issue here is the process for electing directors—a subject in which shareholders of Delaware corporations have a legitimate and protected interest. The purpose of the Bylaw is to promote the integrity of that electoral process by facilitating the nomination of director candidates by stockholders or groups of stockholders. Generally, and under the current framework for electing directors in contested elections, only board-sponsored nominees for election are reimbursed for their election expenses. Dissident candidates are not, unless they succeed in replacing at least a majority of the entire board. The Bylaw would encourage the nomination of non-management board candidates by promising reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected. In that the shareholders also have a legitimate interest, because the Bylaw would facilitate the exercise of their right to participate in selecting the contestants.

953 A.2d at 237.

adverse to, those of the corporation").[716] Accordingly, the Court held that the proposed bylaw, as written, would violate Delaware law if enacted by stockholders.

G. Right to Resign.

Directors of corporations in trouble may be tempted to resign, especially when they sense that legal action may be imminent which would be time consuming and possibly result in personal liability. The general rule is that a director may resign at any time, for any reason.[717]

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716 The Court explained:

> Therefore, in response to the second question, we must necessarily consider any possible circumstance under which a board of directors might be required to act. Under at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw. Accordingly, we conclude that the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders.
>
> This Court has previously invalidated contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties.
>
> * * *
>
> [T]he Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude. That such circumstances could arise is not far fetched. Under Delaware law, a board may expend corporate funds to reimburse proxy expenses "[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management." But in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether. It is in this respect that the proposed Bylaw, as written, would violate Delaware law if enacted by CA's shareholders. As presently drafted, the Bylaw would afford CA's directors full discretion to determine what amount of reimbursement is appropriate, because the directors would be obligated to grant only the "reasonable" expenses of a successful short slate. Unfortunately, that does not go far enough, because the Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all.

953 A.2d at 240.

717 DGCL § 141(b) provides "[a]ny director may resign at any time upon notice given in writing or by electronic transmission to the corporation"; *see In re Telesport Inc.*, 22 B.R. 527, 532-3 n.8 (Bankr. E.D. Ark. 1982) ("Corporate officers [are] entitled to resign . . . for a good reason, a bad reason or no reason at all, and are entitled to pursue their chosen field of endeavor in direct competition with [the corporation] so long as there is no breach of a confidential relationship with [it]."); *Frantz Manufacturing Co. et al. v. EAC Industries*, 501 A.2d 401, 408 (Del. 1985); ("Directors are also free to resign."); *see also 2 Fletcher Cyclopedia on Corporations* § 345 (1998) ("A director or other officer of a corporation may resign at any time and thereby cease to be an officer, subject to any express charter or statutory provisions to which he or she has expressly or impliedly assented in accepting office, and subject to any express contract made with the corporation"); Medford, *Preparing for Bankruptcy; Director Liability in the Zone of Insolvency*, 20-APR AM. BANKR. INST. J. 30 (2001) ("A Delaware corporate director typically has the right to resign without incurring any liability or breaching any fiduciary duty").

TBOC § 21.4091 was amended (and TBCA art. 2.32 was similarly amended) in 2007 by H.B. 1737 to provide that although the general rule is that a director's resignation takes effect when received by the corporation, a resignation can provide that it takes effect upon the occurrence of a future event (including, e.g., the director's failure to receive a specified vote for reelection as a director):

> Sec. 21.4091. RESIGNATION OF DIRECTORS. (a) Except as otherwise provided by the certificate of formation or bylaws, a director of a corporation may resign at any time by providing written notice to the corporation.
>
> (b) The director's resignation takes effect on the date the notice is received by the corporation, unless the notice prescribes a later effective date or states that the resignation takes effect on the occurrence of a future event, such as the director's failure to receive a specified vote for reelection as a director.

There is, however, an exception in circumstances where that resignation would cause immediate harm to the corporation, allow such harm to occur, or leave the company's assets vulnerable to directors known to be untrustworthy.[718] While the judicial expressions of this exception appear broad, an analysis of the cases suggests that liability results only when the harm to the company is rather severe and foreseeable. Further and regardless of the timing of the resignation, a director is still liable for breaches of the fiduciary duty made during his tenure.[719] Resignation does not free a director from the duty not to misuse information received while a director.[720] Finally, a director may have an interest in staying on the board of directors to help the corporation work through its difficulties in the hope that by helping the corporation survive he is reducing the chances that he will be sued in connection with the corporation's troubles.

XI. Asset Transactions.

A. Shareholder Approval.

A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners depending on the nature of the transaction, the entity's organization documents and applicable state law.[721] In most states, shareholder approval of an asset sale has historically been required if the corporation is selling all or substantially all of its assets.[722]

(c) If the director's resignation is to take effect on a later date or on the occurrence of a future event, the resignation takes effect on the later date or when the event occurs.

(d) The director's resignation is irrevocable when it takes effect. The director's resignation is revocable before it takes effect unless the notice of resignation expressly states it is irrevocable.

718 *See Gerdes v. Reynolds*, 28 N.Y.S. 2d 622, 651 (N.Y. S.Ct. 1941) (In the context of a business combination, the court wrote that it "gravely doubt[s]" whether the directors could avoid liability if they sell their shares for a premium, resign and allow a transfer of control of a corporation to a purchaser before the full purchase price is paid and the transferee owns enough shares to elect its own slate of directors, suggesting that "officers and directors . . . cannot terminate their agency or accept the resignation of others if the immediate consequence would be to leave the interests of the company without proper care and protection"); *Xerox Corp. v. Genmoora Corp.*, 888 F.2d 345, 355 (5th Cir.1989), in a situation where a Texas corporation sold most of its assets and set up a liquidating trust to distribute the proceeds to shareholders and then four of the five directors resigned as liquidating trustees, leaving the liquidating trust in control of the fifth director known to be incompetent and dishonest, Judge Brown referred to the defense that the directors had resigned before the corporate abuse took place as the "Geronimo theory" and wrote "[u]nder this theory, by analogy, if a commercial airline pilot were to negligently aim his airplane full of passengers at a mountain, and then bail out before impact, he would not be liable because he was not at the controls when the crash occurred"; citing *Gerdes*, Judge Brown postulated that "[a] director can breach his duty of care – hence his fiduciary duty – by knowing a transaction that will be dangerous to the corporation is about to occur but taking no steps to prevent it or make his objection known;" *DePinto v. Landoe*, 411 F.2d 297 (9th Cir. 1969) (director found liable for resigning instead of opposing a raid on his corporation's assets); *Benson v. Braun*, 155 N.Y.S.2d 622, 624-6 ("officers and directors may not resign their offices and elect as their successors persons who they knew intended to loot the corporation's treasury").

719 *FDIC v. Wheat*, 970 F. 2d 124, 128 (5th Cir. 1992); *District 65 UAW v. Harper & Roe Publishers*, 576 F. Supp. 1468, 1484 (S.D.N.Y 1983).

720 *Quark Inc. v. Harley*, 1998 U.S. App. LEXIS 3864 at *23 (10th Cir. March 4, 1998); *T.A. Pelsue Co. v. Grand Enterprises Inc.*, 782 F. Supp. 1476, 1485-86 (D. Colo. 1991).

721 *See* TBCA arts. 5.09 and 5.10; TBOC § 10.251. *See also* Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001); Byron F. Egan and Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Sec. on Corp., Bank. & Bus. L. 1, 11-12 (No. 1, Sept. 1987).

722 *See Story v. Kennecott Copper Corporation*, 394 N.Y.S. 2d 353, Sup. Ct. (1977) in which New York court held that under New York law the sale by Kennecott of its subsidiary Peabody Coal Company, which accounted for approximately 55% of Kennecott's consolidated assets, was not a sale of "substantially all" Kennecott's assets

1. DGCL.

The Delaware courts have used both "qualitative" and "quantitative" tests in interpreting the phrase "substantially all," as it is used in DGCL § 271, which requires stockholder approval for a corporation to "sell, lease or exchange all or substantially all of its property and assets."[723]

In *Hollinger Inc. v. Hollinger International, Inc.*,[724] the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271. Without reaching a conclusion, the Chancery Court commented in dicta that "[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent's board can, without any appreciable stretch, be viewed as selling assets of the parent itself." The Chancery Court acknowledged that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of "its" assets, but found that analyzing dispositions by subsidiaries on the basis of whether there was fraud or a showing that the subsidiary was a mere alter ego of the parent[725] was too rigid. Examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that "substantially all" of the assets should be literally read, commenting that "[a] fair and succinct equivalent to the term 'substantially all' would be 'essentially everything,' notwithstanding past decisions that have looked at sales of assets around the 50% level," (2) that the principal inquiry was whether the assets sold were "quantitatively vital to the operations of" seller (the business sold represented 57.4% of parent's consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: "if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271"[726]), and (4) that the "qualitative" test focuses on "factors such as the cash-flow generating value of assets" rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen.[727]

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requiring shareholder approval even though Peabody was the only profitable operation of Kennecott for the past two years.

723 *See Gimbel v. The Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be "substantially all"); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be "substantially all"; court noted that seller would be left with only one operating subsidiary, which was marginally profitable).

724 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004); *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus Law. 843, 855-58 (2005).

725 *Leslie v. Telephonics Office Technologies, Inc.*, 1993 WL 547188 (Del. Ch., Dec. 30, 1993).

726 Quoting BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 at 10-7 (3rd ed. Supp. 2004).

727 *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 (3rd ed. Supp. 2004).

To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c), which provides as follows:

> (c) For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, "subsidiary" means any entity wholly-owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts. Notwithstanding subsection (a) of this section, except to the extent the certificate of incorporation otherwise provides, no resolution by stockholders or members shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.

This amendment answered questions raised by *Hollinger*, but raised or left unanswered other questions (e.g., (i) whether subsection (c) applies in the case of a merger of a subsidiary with a third party even though literally read DGCL § 271 does not apply to mergers), (ii) what happens if the subsidiary is less than 100% owned, and (iii) what additional is meant by the requirement that the subsidiary be wholly "controlled" as well as "wholly owned".[728]

In *Esopus Creek Value LP v. Hauf*,[729] the Delaware Chancery Court prohibited a solvent public corporation, whose shares were quoted in the over-the-counter "pink sheets" but which had been unable to generate the financial statements required to file proxy materials with the SEC, from selling substantially all of its assets without first obtaining approval of the corporation's stockholders pursuant to DGCL § 271.[730] The corporation had emerged from financial difficulties, but its independent auditors would not sign off on the financial statements required by the SEC in connection with a meeting of stockholders. Even though it was solvent, the corporation tried to solve its SEC reporting problem by an agreement to sell substantially all of its assets under Section 363 of Chapter 11 of the Bankruptcy Code which would not require

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728 *See* Mark A. Morton and Michael K. Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005), which can be found at http://www.potteranderson.com/news-publications-40-35.html; c*f. Weinstein Enterprises, Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) for a discussion of "control" in the context of a DGCL § 220 action seeking inspection of certain documents in the possession of a publicly held New York corporation of which the defendant Delaware corporation defendant was a 45.16% stockholder.

729 No. 2487-N (Del. Ch. Nov. 29, 2006).

730 In so holding the Chancery Court relied on *Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.*, 887 A.2d 975 (Del. Ch. 2005), aff'd 906 A.2d 807 (Del. 2005) (Chancery Court ordered corporation not to delay further in holding meeting of stockholders even through the auditors failure to sign off on financial statements made it impossible to comply with SEC rules for information required to be furnished to stockholders in connection with stockholder meetings; the Chancery Court suggested that the corporation should seek an exemptive order from the SEC); *cf Steel Partners II, L.P. v. Point Blank Solutions, Inc.*, 2008 WL 3522431 (Aug. 12, 2008) (the initial complaint was filed to force the holding of a shareholders meeting (which had not taken place for three years) pursuant to DGCL § 211; after a stipulation was entered into for a date to hold the meeting, the company moved for leave of court to postpone the date of the meeting by 90 days based on allegations that the plaintiff and its CEO together own about 40% of the stock and would attempt to install their own directors and then seek to buy the company at the lowest possible price for its own investors; the Chancery Court denied the request reasoning that the best way to deal with the issues presented was to communicate them to the shareholders and let them decide, based on those facts, who they wanted as directors instead of further delaying the exercise of the shareholder franchise.

approval of the corporation's common stockholders. The Section 363 agreement required approval of the corporation's preferred shareholders who extracted concessions favorable to them (and disadvantageous to the common stockholders) in return for their support of the transaction. The Chancery Court, however, concluded that the transaction resulted in an inequitable reallocation of control over the corporate enterprise and prohibited its consummation without approval of the common stockholders as required by DGCL § 271. The Chancery Court suggested that the corporation should seek an exemptive order from the SEC rather than trying to structure a transaction to avoid approval of the common stockholders pursuant to DGCL § 271.

2. Texas Corporate Statutes.

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA arts. 5.09 and 5.10 provide, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets.[731] Under TBCA art. 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who vote against the sale can perfect appraisal rights). TBCA art. 5.09A provides an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation. . . .", and a 1987 amendment added section B to art. 5.09 providing that a sale is

> in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.

TBOC §§ 21.451 and 21.455 carry forward TBCA arts. 5.09 and 5.10.

In *Rudisill v. Arnold White & Durkee, P.C.*[732] the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination of Arnold White & Durke, P.C. ("*AWD*") with another law firm, Howrey & Simon ("*HS*"). The combination agreement provided that all of AWD's assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP ("*HSAW*"). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

For business reasons, the AWD/HS combination was submitted to a vote of AWD's shareholders. Three AWD shareholders submitted written objections to the combination, voted against it, declined to sign the HSAW partnership agreement, and then filed an action seeking a declaration of their entitlement to dissenters' rights or alternate relief. The court accepted AWD's position that these shareholders were not entitled to dissenters' rights because the sale was in the "usual and regular course of business" as AWD continued "to engage in one or more

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731 *See* Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-290 (Winter 2001).

732 148 S.W.3d 556 (Tex. App. 2004).

businesses" within the meaning of TBCA art. 5.09B, writing that "AWD remained in the legal services business, at least indirectly, in that (1) its shareholders and employees continued to practice law under the auspices of HSAW, and (2) it held an ownership interest in HSAW, which unquestionably continues directly in that business." The court further held that AWD's obtaining shareholder approval when it was not required by TBCA art. 5.09 did not create appraisal rights, pointing out that appraisal rights are available under the statute only "*if special authorization of the shareholders is **required***."[733]

3. Model Business Corporation Act.

A 1999 revision to the Model Business Corporation Act ("*MBCA*") excludes from the requirement of a shareholder vote any disposition of assets that would not "leave the corporation without a significant continuing business activity." MBCA § 12.02(a). The revision includes a safe harbor definition of significant continuing business activity: at least 25 percent of the total assets and 25 percent of either income (before income taxes) or revenues from pre-transaction operations.

B. De Facto Merger.

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities.[734] Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume.[735] The extent to which an agreement between buyer and seller as to which seller liabilities will be assumed by buyer in an asset transaction has been circumscribed by (i) federal and state statutes which impose strict or successor liability on an asset buyer for environmental, labor and employment, product liability and tax liabilities incurred by the seller and (ii) common law theories developed by courts in various states requiring asset buyers to be responsible for seller liabilities in particular circumstances.[736] In certain jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a common law "*de facto merger*," which would result in the buyer becoming responsible as a matter of law for seller liabilities which buyer did not contractually assume.[737]

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733 *See* Subcommittee on Recent Judicial Developments, *ABA Negotiated Acquisitions Committee, Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 BUS. LAW. 843, 855-60 (2005).

734 David I. Albin, Byron F. Egan, Joel I. Greenberg, Mark A. Morton and Scott T. Whittaker, *Special Issues in Asset Acquisitions*, ABA 12th Annual National Institute on Negotiating Business Acquisitions, New Orleans, LA, November 1, 2007, at pages 11-20, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=841.

735 *Id.*

736 *See* Appendix A to David I. Albin, Byron F. Egan, Joel I. Greenberg, Mark A. Morton and Scott T. Whittaker, *Special Issues in Asset Acquisitions*, ABA 12th Annual National Institute on Negotiating Business Acquisitions, New Orleans, LA, November 1, 2007, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=841.

737 *See Knapp v. North American Rockwell Corp.*, 506 F.2d 361 (3rd Cir. 1974), *cert. den.* 421 U.S. 965 (1975); *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3rd Cir. 1985); *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3rd Cir. 1996); *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41 (2d Cir. 2003).

Texas has legislatively repealed the *de facto* merger doctrine in TBCA art. 5.10B, which provides that in relevant part that "[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume."[738] TBOC § 10.254 carries forward TBCA art. 5.10B and makes it applicable to all domestic entities. Although Delaware courts may follow the *de facto* merger doctrine in tort cases,[739] the DGCL does not have an analogue to TBCA art. 5.10(B) or TBOC § 10.254.

XII. Dissent and Appraisal Rights.

The corporation statutes of each state contain provisions permitting shareholders to dissent from certain corporate actions and to seek a court directed appraisal of their shares under certain circumstances by following specified procedures.[740] The principal purpose of these provisions is to protect the rights of minority shareholders who object to a fundamental corporate action which the majority approves.[741] The fundamental corporate actions covered vary from state to state, but generally include mergers and in some states conversions, statutory share exchanges and sales of all or substantially all of the assets of the corporation.[742] Set forth below is a summary of the dissent and appraisal provisions of the DGCL, the Texas Corporate Statutes and the MBCA.

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738 In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.—Houston [1st Dist.] 2004), a Texas Court of Civil Appeals, quoting Tex. Bus. Corp. Act Ann. art. 5.10(B)(2) and citing two other Texas cases, wrote: "This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation's liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency's sales and marketing agreements with the Tensor parties purported to bind their 'successors and assigns,' therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties' agreements with the Agency." See Egan and Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

739 In *Sheppard v. A.C.&S Co., Inc.*, 484 A.2d 521 (Del. Super. 1984), defendant argued that, as a matter of law and public policy, a successor corporation cannot be required to respond to a claim for punitive damages arising out of the acts of its predecessor which it did not expressly ratify or adopt. In denying the motion for summary judgment, the Court stated, "The question of successor liability for torts has not been directly considered in Delaware." The Court acknowledged that some of the elements of a *de facto* merger claim, should one exist in Delaware, were present, although the facts before the Court did not show a broad and continuous corporate connection in terms of officers, directors or stockholders. The Court stopped short of explicitly accepting the *de facto merger* doctrine, instead refusing to grant summary judgment until more facts were presented.

740 *See* Christian J. Henrick, *Game Theory and Gonsalves: A Recommendation for Reforming Stockholder Appraisal Actions*, 56 Bus. Law. 697 (2001).

741 *Id.*

742 *See* Stephen H. Schulman and Alan Schenk, *Shareholders' Voting and Appraisal Rights in Corporate Acquisition Transactions*, 38 Bus. Law. 1529 (1983).

A. Delaware Law.

1. When DGCL Appraisal Rights Are Triggered.

Delaware courts have considered a variety of remedies available to stockholders who oppose merger transactions. The statutory remedy in Delaware for dissenting stockholders in is appraisal pursuant to DGCL § 262.[743] Under DGCL § 262(b), appraisal rights are only available in mergers and consolidations effected pursuant to enumerated sections of the DGCL.[744] Delaware law does not extend appraisal rights to other fundamental changes that trigger appraisal rights under the laws of other states, including sales of all or substantially all of the assets of the corporation or amendments to the corporation's articles of incorporation.[745] Delaware also does not follow the *de facto* merger doctrine, under which a transaction structured to achieve the same result as a merger will have the same effect, including the triggering of appraisal rights.[746] Delaware instead follows the doctrine of independent legal significance, by which "a given result may be accomplished by proceeding under one section [of the DGCL] which is not possible, or is even forbidden under another."[747] The Delaware appraisal statute permits a corporation to include a provision in its certificate of incorporation granting appraisal rights under other circumstances.

DGCL § 262(b)(1) carves out certain exceptions when appraisal rights are not available even in mergers and consolidations that otherwise would qualify for appraisal rights. The principal exception is the so-called market-out exception, pursuant to which appraisal rights are not available to any class or series of stock listed on a national securities exchange or held of record by more than two thousand holders.[748]

In an exception to the market-out exception, DGCL 262(b)(2) restores appraisal rights to shares otherwise covered by the market-out if the holders of shares are required to accept anything other than: (a) shares of stock of the corporation surviving or resulting from the merger, regardless of whether they are publicly traded or widely held; (b) shares of stock of another corporation that are publicly traded or widely held; (c) cash in lieu of fractional shares; or (d) any

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743 *See generally* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS §§ 9.42 et. seq. (3rd ed 2005).

744 DGCL § 262(b). The enumerated sections are DGCL §§ 251, 252, 254, 257, 258, 263 and 264.

745 Compare DGCL § 262 *with* MBCA § 13.02(a) (providing for appraisal rights in these situations).

746 *See Hariton v. Arco Elecs., Inc.,* 182 A.2d 22, 25 (Del. Ch. 1962) (refusing to extend appraisal rights under *de facto* merger doctrine to sale of assets pursuant to DGCL § 271; finding that "the subject is one which . . . is within the legislative domain"); *cf. Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 758-59 (Del. 1959) (declining to invoke *de facto* merger doctrine to grant appraisal rights to purchasing corporation in sale of assets).

747 *Hariton v. Arco Elecs., Inc.,* 182 A.2d 22, 25 (Del. Ch. 1962); *see Fed. United Corp. v. Havender*, 11 A.2d 331, 342 (Del. 1940) (holding that preferred stock with accrued dividends that could not be eliminated by charter amendment could be converted into a new security under the merger provision of the Delaware code); *Field v. Allyn*, 457 A.2d 1089, 1098 (Del. Ch.) finding it "well established . . . that different sections of the DGCL have independent significance and that it is not a valid basis for challenging an act taken under one section to contend that another method of achieving the same economic end is precluded by another section"), *aff'd*, 467 A.2d 1274 (Del. 1983). *See* C. Stephen Bigler and Blake Rohrbacher, *Form or Substance? The Past, Present, and Future of the Doctrine of Independent Legal Significance*, 63 Bus. Law. 1 (Nov. 2007).

748 DGCL § 262(b)(1) specifies that depository receipts associated with shares are governed by the same principles as shares for purposes of appraisal rights.

combination of shares or fractional shares meeting the requirements of (a), (b) and (c).[749] DGCL § 262(b)(1) also provides that no appraisal rights shall be available for any shares of stock of the constituent corporation surviving the merger if the holders of those shares were not required to vote to approve the merger.[750] The exceptions set forth in DGCL §§ 262(b)(1) and (b)(2) apply

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749 DGCL § 262(b)(2).

750 DGCL § 262(b)(2). In a merger in which target company shares are converted into both stock of the surviving corporation and cash beyond that required for fractional shares, appraisal rights would be available. In *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 2007 WL 582510 (Del. Ch. Feb. 23, 2007) and *Express Scripts, Inc. v. Crawford*, 2007 WL 707550 (Del. Ch. Feb. 23, 2007), the Court of Chancery treated a special dividend declared prior to a stock for stock merger, but payable only after the effective time of the merger, as an integral part of the merger lacking independent legal significance, and concluded that the Caremark Rx, Inc. stockholders were entitled to appraisal rights. The Court postponed a vote of the stockholders of Caremark Rx, Inc. on its proposed merger with CVS Corporation for at least 20 days after corrective disclosures that the stockholders have appraisal rights. In reaching the decision that the special dividend was effectively cash consideration to be paid to the Caremark Rx stockholders as part of the proposed merger with CVS, the Court was persuaded by the fact that the payment of the special dividend was specifically conditioned on stockholder approval of the merger agreement and only became due after the effective time of the merger. The Court concluded that those "facts belie the claim that the special dividend has legal significance independent of the merger" and thus "the label 'special dividend' is simply cash consideration dressed up in a none-too-convincing disguise."

The Court stated that the Caremark stockholders "should not be denied their appraisal rights simply because their directors are willing to collude with a favored bidder to 'launder' a cash payment." The Court, however, postponed (but did not indefinitely enjoin) the vote, finding that there was neither irreparable harm nor extraordinary inequity because the stockholders would have the opportunity to vote in a fully-informed manner on the CVS/Caremark merger, supported by the protection of the appraisal remedy.

The Court also held that a postponement of the stockholder vote was necessary to provide the Caremark stockholders with additional disclosure that the major part of the financial advisors' fee was contingent upon the consummation of a Caremark Rx transaction with CVS or a third party. The proxy statement disclosure was misleading because it did not clearly state that the financial advisors were entitled to the fee only if the initial CVS/Caremark merger was approved. The Court concluded that disclosure of these financial incentives to the financial advisors was material to the stockholder deliberations on the CVS/Caremark Rx merger.

See C. Stephen Bigler and Blake Rohrbacher, *Form or Substance? The Past, Present, and Future of the Doctrine of Independent Legal Significance*, 63 Bus. Law. 1, 23-24 (Nov. 2007) (explaining that this CVS decision (which the authors referred to as "*LAMPERS*") seemed to some commentators as inconsistent with the doctrine of independent legal significance ("*ILS*"), noting that a Chancery Court's equitable powers may trump literal compliance with a statute where fiduciary duties are implicated, and explaining their view of the reaches of ILS as follows:

> The boundaries of ILS as applied by the courts are much narrower than those sometimes assumed by practitioners. Recent cases suggest that the Delaware courts view ILS as applying only where a transaction is effected in accordance with a statutory regime that reaches a result identical to the result either permitted or forbade by another statute. The implications of the distinction between legal review (ILS) and equitable review (the substance-over-form and step-transaction doctrines) for planners of corporate transactions are these: if planners have a choice of structuring a transaction under one or more statutory sections, and what planners propose is legal under one statutory section (and the transaction is structured to comply with that section), because of ILS the validity of the transaction will not be tested under an alternative statute. But if the issue is whether a vote or other stockholder rights exist under a specifi c statute or contract where there is no alternative statute with which the planners could have complied, the chosen structure may not be dispositive of the outcome, because a court may look beyond the form to the substance of the transaction to resolve the issue.
>
> Accordingly, a merger that amends the certificate of incorporation can be accomplished by compliance with the voting provisions of the merger statutes, and without regard to the class voting requirements of [DGCL] section 242, so long as it is done in accordance with [DGCL] section 251. If a transaction is structured in accordance with the statutory provisions applicable to a sale of assets or a dissolution, it will not be analyzed or subjected to the statutory requirements that would have been applicable if it were a merger. That is, ILS assures that a transaction structured in compliance with one provision of the DGCL will not be tested under the legal standards applicable to a different provision of the DGCL under which the same result would be achieved. But ILS will not preclude a court's invocation of its equitable powers.

equally to stockholders of the surviving corporation and the acquired corporation and to both voting and non-voting shares.

Thus, stated generally, DGCL § 262(b) provides appraisal rights in any merger where the holders of shares receive cash or securities other than stock of a widely held corporation, stock of the surviving corporation, or a mix of the two. Delaware law also provides specifically for appraisal rights in a short-form merger.[751]

2. Who Is Entitled to DGCL Appraisal Rights.

DGCL § 262(a) extends the right to pursue an appraisal to "any stockholder of a corporation in this state" who owns shares of stock on the date the stockholder demands an appraisal from the corporation and continues to hold the shares through the effective date of the merger or consolidation, and neither votes in favor of the merger or consolidation nor executes a written consent in favor of the transaction.[752] Only a stockholder of record has standing to pursue an appraisal.[753]

To qualify for appraisal rights, a stockholder must (a) remain a stockholder continuously through the period commencing on the date the stockholder makes a demand for appraisal through the effective date of the merger or consolidation[754] and (b) not vote in favor of or consent to the merger or consolidation.[755]

3. Procedural Aspects of DGCL Appraisal.

A stockholder's right to appraisal arises only upon compliance with specific statutory criteria.[756] The stockholder bears the burden of demonstrating compliance with the statutory requirements.[757] The statute also imposes specific requirements on the surviving corporation.

> Though ILS may be raised in many cases in which the parties dispute the character, substance, or validity of a transaction, the Delaware courts may be disinclined to accept the doctrine unless the defender of a challenged transaction demonstrates its affirmative choice to effect the transaction by complying with an alternative statutory regime. ILS does not apply at all in cases … where the primary issue is equitable. If the question is whether a process was unfair or whether fiduciary duties were breached, ILS cannot save the transaction. Moreover, in cases like *Hollinger* and *LAMPERS*, where the validity of a transaction does not rest on compliance with an alternative statutory regime, ILS may not be dispositive. These cases simply involve the question of compliance with a single statute (and may involve equitable review), so ILS does not provide an alternative means of demonstrating the transaction's validity.

See supra note 19 and notes 723-728.

751 *See* DGCL §§ 253(d), 262(b)(2).

752 DGCL § 262(a).

753 DGCL § 262(a).

754 DGCL § 262(a).

755 DGCL § 262(d)(1).

756 *Stephenson v. Commonwealth & S. Corp.*, 156 A.215, 216 (Del. Ch. 1931) ("a stockholder is required to comply with certain prescribed conditions precedent before his right to an appraisal and payout can arise"), *aff'd on other grounds*, 168 A. 211 (Del. 1933).

757 *Carl M. Loeb, Rhoades & Co. v. Hilton Hotels Corp.*, 222 A.2d 789, 793 (Del. 1966) ("[t]he claimants [have] the burden of proving compliance with each of the statutory perquisites . . .").

Corporations are held to the same strict standard as stockholders in fulfilling their obligations under the appraisal statute.[758]

DGCL § 262(d) requires that a corporation notify each of its stockholders entitled to appraisal rights not less than twenty days prior to the meeting at which the merger or consolidation giving rise to appraisal rights will be considered.[759] The corporation and its directors also have a fiduciary obligation to inform all stockholders of the proper procedures for obtaining an approval.[760] The pre-merger notice must explain in detail the process by which a stockholder may perfect the right to appraisal[761] and include a copy of the statute.[762]

Each stockholder who elects to demand an appraisal must submit a written demand for appraisal to the corporation before the vote on the merger or consolidation giving rise to appraisal rights.[763] There is no specific form for the written demand under the DGCL. The Delaware appraisal statute only requires that the demand "reasonably inform the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal of [its] shares."[764]

Within ten days after the effective date of the merger, the surviving corporation must notify each stockholder who has submitted a written demand and who did not vote in favor of or consent to the merger of the date that the merger became effective.[765]

Within 120 days after the effective date of the merger, either the corporation or any stockholder who qualifies for appraisal rights and who has submitted a written demand and not voted in favor of the merger, "and who is otherwise entitled to appraisal rights," may file a petition for appraisal in the Delaware Court of Chancery demanding a determination of the value of the stock of all stockholders entitled to any appraisal.[766] The petition for appraisal must be filed in the name of the record holder.[767]

Within twenty days after filing of the petition initiating the appraisal process, the corporation must file with the Register in Chancery a verified list containing the names and

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758 *Jackson v. Turnbull*, C.A. No. 13042 (Del. Ch. Feb. 8, 1994), slip op. at 12-13 (requiring corporation to "strictly comply" with statutory notice requirement).

759 DGCL § 262(d); DGCL § 262(d)(2) provides that if the merger was approved by written consent pursuant to DGCL § 228 or by the parent company in a merger with a 90% owned subsidiary pursuant to DGCL § 253, the notice shall be given by the corporation not less than ten days after the effective date of such action.

760 *See Raab v. Villager Indus., Inc.*, 355 A.2d 888, 894 (Del. 1976) (announcing that "[a] Delaware corporation, engaged in § 262 proceedings, henceforth shall have an obligation to issue specific instructions to its stockholders as to the correct manner of executing and filing a valid objection or demand for payment . . ."), *cert. denied sub nom. Mitchell v. Villager Indus., Inc.*, 429 U.S. 853 (1976).

761 *Raab v. Villager Indus., Inc.*, 355 A.2d 888, 894 (Del. 1976) (holding that notice must advise stockholders as to "(1) the general rule that all such papers should be executed by or for the stockholder of record, fully and correctly, as named in the notice to the stockholder, and (2) the manner in which one may purport to act for a stockholder of record, such as a joint owner, a partnership, a corporation, a trustee, or a guardian").

762 DGCL § 262(d)(1).

763 DGCL § 262(d)(1).

764 DGCL § 262(d)(1).

765 DGCL § 262(d)(1).

766 DGCL § 262(e).

767 DGCL § 262(e).

addresses of all stockholders who have demanded payment for their shares and with whom an agreement or settlement has not been reached.[768] The filing of the verified list does not prevent the corporation from contesting any stockholder's eligibility to an appraisal.[769] At the hearing, the court determines which stockholders have validly perfected their appraisal rights and become entitled to an appraisal.[770]

4. Valuation under DGCL.

The DGCL establishes the Delaware Court of Chancery's mandate to determine the value of the shares that qualify for appraisal:

> [T]he Court shall appraise the shares, determining their fair value, exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.[771]

The statute thus places the obligation to determine the value of the shares squarely on the court.

The Court may perform this duty by hearing the parties' valuation contentions, selecting the most representative analysis, and then making appropriate adjustments.[772] The Court also may "adopt any one expert's model, methodology, and mathematical calculations, *in toto*, if that valuation is supported by credible evidence and withstands a critical judicial analysis on the record."[773] "When . . . none of the parties establishes a value that is persuasive, the Court must make a determination based upon its own analysis."[774] The appraised value may well be less than the value provided in the transaction giving rise to appraisal rights.[775]

B. Texas Corporate Statutes.

1. When Texas Statutory Appraisal Rights Are Triggered.

Under the Texas Corporate Statutes and subject to certain limitations, a shareholder of a Texas corporation has the right to dissent from any of the following corporate actions: a merger, a statutory share exchange or the sale of all or substantially all of the corporation's assets other

768 DGCL § 262(f).

769 *Raynor v. LTV Aerospace Corp.*, 317 A.2d 43, 46 (Del. Ch. 1974) (noting that filing of verified list "does not . . . constitute an admission by the corporation" as to whether the stockholders listed have met the statutory requirements for appraisal).

770 DGCL § 262(g).

771 DGCL § 262(h).

772 *See Onti, Inc. v. Integra Bank*, 751 A.2d 904, 907 (Del. Ch. 1999) ("I can base my appraisal of the companies on the Hempstead Valuation, modifying it where appropriate.")

773 *M.G. Bancorporation Inc. v. LeBeau*, 737 A.2d 513, 526 (Del. 1999).

774 *Cooper v. Pabst Brewing Co.*, C.A. No. 7244 (Del. Ch. June 8, 1993), slip op. at 20.

775 *See Selfe v. Joseph*, 501 A.2d 409, 411 (Del. 1985) ("By opting for the appraisal remedy, dissenting [stockholders] cannot receive the cash-out price; and what they will eventually receive for their shares will depend upon the Court's determination of the appraised value of their shares under [DGCL § 262]."); *In re Appraisal of Shell Oil Co.*, C.A. No. 8080 (Del. Ch. Oct. 30, 1992), slip op. at 11 ("[a]n appraisal action will sometimes result in a [stockholder] receiving less after trial than he would have received had he accepted the merger consideration").

than in the usual and regular course of business;[776] provided that shareholder approval of the corporate action is required and the shareholder holds shares of a class or series entitled to vote on the corporate action.[777] The purpose of the dissenters' rights provisions of the Texas Corporate Statutes is to provide shareholders with the opportunity to choose whether to sell their shares at a fair price (as determined by a court) or to be bound by the terms of the corporate action.[778]

2. *Who Is Entitled to Texas Statutory Appraisal Rights.*

The Texas Corporate Statutes provide that a shareholder does not have the right to dissent from a plan of merger or exchange in which there is a single surviving or new domestic or foreign corporation, if:[779]

(i) The shares held by the shareholder are part of a class or series, shares of which are on the record date fixed to determine the shareholders entitled to vote on the plan of merger or exchange (a) listed on a national securities exchange; (b) listed on the NASDAQ Stock Market (or successor quotation system) or designated as a national market security on an interdealer quotation system by the National Association of Securities Dealers, Inc., or successor entity; or (c) held of record by not less than 2,000 holders;

(ii) The shareholder is not required by the terms of the plan of merger or exchange to accept for the shareholder's shares any consideration that is different than the consideration (other than cash in lieu of fractional shares that the shareholder would otherwise be entitled to receive) to be provided to any other holder of shares of the same class or series of shares held by the shareholder; and

(iii) The shareholder is not required by the terms of the plan of merger or exchange to accept for the shareholder's shares any consideration other than (a) shares of a corporation that, immediately after the effective time of the merger or exchange, will be part of a class or series, shares of which are listed, or authorized for listing upon official notice of issuance, on a national securities exchange, approved for quotation as a national market security on an interdealer quotation system, or held of record by not less than 2,000 holders; (b) cash in lieu of fractional shares otherwise entitled to be received; or (c) any combination of securities and cash in lieu of fractional shares. One reason for denying dissenters' rights under these circumstances is that the shareholders are able to liquidate their investment for fair value in the public market.[780]

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776 The Texas Corporate Statutes provide that an asset transaction is in the "usual and regular course of business" of the corporation if thereafter the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction in the conduct of a business in which it engages following the transaction. TBOC § 10.354; TBCA art. 5.09.B.

777 TBOC § 10.354; TBCA art. 5.11.A.

778 *Massey v. Farnsworth*, 353 S.W.2d 262, 267-268 (Civ. App.—Houston 1961), *rev'd on other grounds*, 365 S.W.2d 1 (Tex. 1963).

779 TBOC § 10.354(b); TBCA art. 5.11.B.

780 *See* Gray, et. al., *Annual Survey of Texas Law—Corporations*, 44. Sw. L.J. 225, 232 (1990).

3. *Procedural Aspects of Texas Statutory Appraisal.*

A shareholder wishing to object to a merger or exchange may do so only by complying with the statutory procedures.[781] Unless there is fraud in the transaction, no other remedies are available to recover the value of shares or damages with respect to the objectionable action.[782] A shareholder who fails to comply with the statutory dissent procedure is deemed to have approved the terms of the merger.[783]

A Texas corporation whose shareholders would have dissenters' rights for a proposed corporate action must send a notice to each affected shareholder advising of the shareholder's dissenters' rights under the Texas Corporate Statutes, which includes the applicable provisions of the Texas Corporate Statutes and the location of the responsible organization's principal executive offices to which notice of dissent may be sent.[784] The procedure for shareholder dissent depends on whether the shareholders are asked to act on the plan of merger or exchange by voting in person or by proxy at a meeting of shareholders or by executing a written consent.

> <u>Matters Submitted to a Vote of the Shareholders at a Meeting</u>. To perfect the dissenting shareholder's rights of dissent and appraisal, the shareholder must give to the corporation prior to the meeting of shareholders a notice objecting to the proposed corporate action, setting out that the shareholder's right to dissent will be exercised if the action is approved, demanding payment of the fair value of the stock, providing to the corporation an address to which a notice relating to the dissent and appraisal procedures may be sent, and stating the number and class of the shares owned by the shareholder and the fair value of the stock as estimated by the shareholder.[785] The shareholder must vote against the proposed corporate action.[786] Not later than the tenth day after the date the corporate action submitted to a vote of the shareholders takes effect, the corporation must give notice that the action has been effected to each shareholder who voted against the action and sent notice to the corporation of such shareholder's dissent.[787]
>
> <u>Matters Approved by Written Consent</u>. If approval of the corporate action is obtained by written consent of the shareholders, the notice regarding dissenters' rights must be provided (i) to each shareholder who consents in writing to the action before the shareholder delivers the written consent and (ii) to each shareholder who is entitled to vote on the action and does not consent in writing

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781 TBOC § 10.356; TBCA art. 5.12.

782 TBOC § 10.368; TBCA art. 5.12.G.

783 TBOC §§ 10.356, 10.368; TBCA arts. 5.12.A and 5.12.G; *Hochberg v. Schick Investment Company*, 469 S.W.2d 474, 476 (Civ. App.—Fort Worth 1971, no writ); *see Farnsworth v. Massey*, 365 S.W.2d 1 (Tex. 1963).

784 TBOC §§ 10.355(a) and 10.355(c). Under the TBCA, this requirement expressly only exists with respect to actions approved without a meeting by written consent (see TBCA art. 5.12.A(1)(b)), but proxy statements for meetings at which shareholders are asked to vote on corporate actions in respect of which the shareholders would typically contain this information because of SEC proxy rules (if applicable) or director fiduciary duties of disclosure.

785 TBOC § 10.356(b); TBCA art. 5.12.A contains similar requirements.

786 TBOC § 10.356(b)(1)(A); TBCA art. 5.12.A(1)(a).

787 TBOC § 10.355(e); TBCA art. 5.12.A.

to the action before the eleventh day after the date the action takes effect.[788] To perfect the dissenting shareholder's rights of dissent and appraisal, the shareholder must not execute a consent to the corporate action and must give to the corporation a notice dissenting to the action that demands payment of the fair value of the stock, states the number and class of the shares of the domestic corporation owned by the shareholder and the fair value of the stock as estimated by the shareholder, and is delivered to the corporation not later than the twentieth day after the date the corporation sends to the shareholder a notice regarding the action.[789]

Not later than the twentieth day after the date a shareholder makes a demand as a dissenter, the shareholder must submit to the corporation any certificates representing the shares to which the demand relates for purposes of making a notation on the certificates that a demand for the payment of the fair value of the shares has been made.[790] A shareholder's failure to submit the certificates within the required period has the effect of terminating, at the option of the corporation, the shareholder's rights to dissent and appraisal unless a court, for good cause shown, directs otherwise.[791]

Not later than the twentieth day after the date a corporation receives a demand for payment made by a dissenting shareholder that complies with the statute, the corporation shall respond to the dissenting shareholder in writing by:

(1) accepting the amount claimed in the demand as the fair value of the shares specified in the notice; or

(2) rejecting the demand and including in the response an estimate by the corporation of the fair value of the shares and an offer to pay the amount of the estimate.[792]

If the corporation accepts the amount claimed in the demand, the corporation shall pay the amount not later than the ninetieth day after the date the action that is the subject of the demand was effected if the shareholder delivers to the corporation endorsed certificates representing the shares if the shares are certificated or signed assignments of the shares if the shares are uncertificated.[793]

If a dissenting shareholder accepts an offer made by a corporation or if a dissenting shareholder and a corporation reach an agreement on the fair value of the shares, the corporation shall pay the agreed amount not later than the sixtieth day after the date the offer is accepted or the agreement is reached, as appropriate, if the dissenting shareholder delivers to the corporation

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788 TBOC § 10.355(d); TBCA art. 5.12.A(1)(b).

789 TBOC § 10.356(b); TBCA art. 5.12.A contains similar requirements.

790 TBOC § 10.356(d); TBCA art. 5.13.B.

791 TBOC § 10.356(d); TBCA art. 5.13.B; *Parkview Gen. Hosp. v. Waco Constr., Inc.*, 531 S.W.2d 224, 228 (Civ. App.—Corpus Christi 1975, no writ).

792 TBOC §§ 10.358(a), (c), and (d); TBCA art. 5.12.A.

793 TBOC § 10.358(b); TBCA art. 5.12.A.

endorsed certificates representing the shares if the shares are certificated or signed assignments of the shares if the shares are uncertificated.[794]

If a corporation rejects the amount demanded by a dissenting shareholder and the dissenting shareholder and corporation are unable to reach an agreement relating to the fair value of the shares within the sixty day period described above, the dissenting shareholder or corporation may file a petition requesting a finding and determination of the fair value of the dissenting shareholder's shares by a court.[795] Such a petition must be filed not later than the sixtieth day after the expiration of the sixty day statutory period.[796]

4. Valuation under Texas Corporate Statutes.

The fair value of shares of a domestic corporation subject to dissenters' rights is generally the value of the shares on the date preceding the date of the action that is the subject of the appraisal proceedings.[797] Any appreciation or depreciation in the value of the shares occurring in anticipation of the proposed action or as a result of the action, and control premiums and discounts for minority ownership and lack of marketability, must be specifically excluded from the computation of the fair value of the shares; however, where the corporation has more than one class or series of shares outstanding, the relative rights and preferences of the respective classes or series (other than relative voting rights) must be taken into account.[798] In computing the fair value of the shares in an appraisal proceeding, the Texas Corporate Statutes provide that consideration must be given to the value of the corporation as a going concern without including in the computation of value any payment for a control premium or minority discount other than a discount attributable to the type of share held by the dissenting shareholder and any limitation placed on the rights and preference of those shares.

C. Model Business Corporation Act.

MBCA § 13.02(a)(3) confers upon certain shareholders not consenting to the sale or other disposition the right to dissent from the transaction and to obtain appraisal and payment of the fair value of their shares. The right is generally limited to shareholders who are entitled to vote on the sale. Some states, such as Delaware, do not give appraisal rights in connection with sales of assets. The MBCA sets forth procedural requirements for the exercise of appraisal rights that must be strictly complied with. A brief summary follows:

1. If the sale or other disposition of the assets of a corporation is to be submitted to a meeting of the shareholders, the meeting notice must state that shareholders are or may be entitled to assert appraisal rights under the MBCA. The notice must include a copy of the section of the statute conferring those rights. MBCA § 13.20(a). A shareholder desiring to exercise those rights must deliver to the corporation <u>before</u> the vote is taken a notice of his or her

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[794] TBOC § 10.358(e); TBCA art. 5.12.A.

[795] TBOC § 10.361(a); TBCA art. 5.12.B.

[796] TBOC § 10.361(b); TBCA art. 5.12.B.

[797] TBOC § 10.362(a); TBCA art. 5.12.A.

[798] TBOC § 10.362(a); TBCA art. 5.12.A.

intention to exercise dissenters' rights and must not vote in favor of the proposal. MBCA § 13.21(a).

2. Following the approval of the sale or other disposition, a specific notice must be sent by the corporation to the dissenting shareholders who have given the required notice, enclosing a form to be completed by those shareholders and specifying the date by which the form must be returned to the corporation and the date the shareholders' stock certificates must be returned for deposit with the corporation. The notice must also state the corporation's estimate of the fair value of the shares and the date by which any withdrawal must be received by the corporation. MBCA § 13.22.

3. Following the receipt by the corporation of the completed form from a dissenting shareholder and the return and deposit of his or her stock certificates, the corporation must pay to each shareholder who has complied with the appraisal requirements and who has not withdrawn his or her demand for payment, the amount of the corporation estimates to be the "fair value" of his or her shares, plus interest, and must accompany this payment with copies of certain financial information concerning the corporation. MBCA § 13.24. Some jurisdictions only require an offer of payment by the corporation, with final payment to await acceptance by the shareholder of the offer.

4. A dissenting shareholder who is not satisfied with the payment by the corporation must timely object to the determination of fair value and present his or her own valuation and demand payment. MBCA § 13.26.

5. If the dissenting shareholder's demand remains unresolved for sixty days after the payment demand is made, the corporation must either commence a judicial proceeding to determine the fair value of the shares or pay the amount demanded by the dissenting shareholder. The proceeding is held in a jurisdiction where the principal place of business of the corporation is located or at the location of its registered office. The court is required to determine the fair value of the shares plus interest. MBCA § 13.30. Under the prior MBCA, it was the shareholder's obligation to commence proceedings to value the shares. Currently forty-six jurisdictions require the corporation to initiate the litigation, while six put this burden on the dissenting shareholder.

Many jurisdictions follow the MBCA by providing that the statutory rights of dissenters represent an exclusive remedy and that shareholders may not otherwise challenge the validity or appropriateness of the sale of assets except for reasons of fraud or illegality. In other jurisdictions, challenges based on breach of fiduciary duty and other theories are still permitted.

XIII. Alternative Entity Fiduciary Duties.

A. General Partnership

1. General. Under the Texas Revised Partnership Act (the "*TRPA*")[799] and the TBOC (the "*Tex. GP Stats.*"), a partner owes duties of loyalty and care to the partnership, the other partners, and the heirs, legatees or personal representatives of a deceased partner to the

799 TEX. REV. CIV. STAT. ANN. art. 6132b (repealed 1999) (hereinafter "*TRPA*").

extent of their respective partnership interests.[800] These duties are fiduciary in nature although not so labeled.[801]

2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.[802] It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.[803]

3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.[804] A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.[805]

4. Candor. In addition to the duties of loyalty and care, a partner owes his co-partners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.[806]

5. Liability. A partner is liable to the partnership and the other partners for violation of a statutory duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.[807] Tex. GP Stats. provide that a partner, in that capacity, is not a

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800 TRPA § 4.04; TBOC § 152.204.

801 *See Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199–200 (Tex. 2002) (asserting that since the court historically has held that partners owe certain fiduciary duties to other partners, it did not have to consider the impact of the TRPA on such duties); Erin Larkin, *What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act*, 59 Baylor L. Rev. 895 (2007).

802 *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928), in which Justice Cardozo wrote:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

803 *See* TRPA § 4.04(b); TBOC § 152.205; Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003), at § 6.07.

804 TRPA § 4.04(c); TBOC § 152.206(a).

805 TRPA §§ 4.04(c), (d); TBOC §§ 152.204(b), 152.206(c).

806 Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003), at §§ 6.05(c) and 6.06.

807 TRPA § 4.05; TBOC § 152.210.

trustee and is not held to the same standards as a trustee,[808] which represents a change from cases under TUPA.[809] A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.[810]

6. Effect of Partnership Agreement. A partnership agreement governs the relations of the partners, but may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types or categories of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, or (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured.[811]

B. Limited Partnership

Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership cases.[812] Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[813] Those in control of the general partner have been held to the same high standards.[814]

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

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808 TRPA § 4.04(f); TBOC § 152.204(d).

809 *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) (holding that a managing partner owes his co-partners the highest fiduciary duty recognized in the law).

810 *See, e.g.*, *Hughes v. St. David's Support Corp.,* 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.); *Huffington*, 532 S.W.2d at 579; *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993) (noting that a fiduciary relationship exists between general partners, as well as between general and limited partners); *Crenshaw*, 611 S.W.2d at 890.

811 TRPA § 1.03(b); TBOC § 152.002.

812 *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied) (holding that "in a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied) (holding that "in a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.); *Watson v. Limited Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref'd n.r.e.); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (stating that "[g]eneral partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners."); *see also Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

813 In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership "owe[s] the limited partners an even greater duty than is normally imposed [upon general partners]."

814 *See In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty).

the Texas Revised Limited Partnership Act (the "*TRLPA*"),[815] TRPA section 4.04 and TBOC section 152.204, which basically codify those duties without giving them the "fiduciary" appellation.[816] Since TRPA and the limited partnership provisions of the TBOC (the "*Tex. LP Stats.*") provide that a general partner's conduct is not to be measured by trustee standards, it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards.[817] Courts, however, continue to refer to the trustee standard.[818]

A partner owes the duties of care and loyalty to the partnership and the other partners.[819] Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.[820] An error in judgment does not by itself constitute a breach of the duty of care.[821] Further, a partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.[822] These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a partner will not be held liable for mere negligent mismanagement.[823]

In Texas, the duty of loyalty is defined as including[824]:

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;

2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and

3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

These provisions mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).[825] To temper some

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815 TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2008) (hereinafter "TRLPA").

816 TRLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152.

817 TRPA § 4.04(f); TBOC § 152.204(d).

818 *See Hughes v. St. David's Support Corp.,* 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

819 TRPA § 4.04(a); TBOC § 152.204(a).

820 TRPA § 4.04(c); TBOC § 152.206(a).

821 TRPA § 4.04(c); TBOC § 152.206(a).

822 TRPA § 4.04(c)-(d); TBOC §§ 152.204(b), 152.206.

823 *See Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

824 TRPA § 4.04(b); TBOC § 152.205.

825 Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496 (Tex. App.—Austin 1988, writ denied); s*ee also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.[826] It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.[827]

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.[828] Directors of a corporate general partner who dominate and control the underlying limited partnership can be liable for the corporate general partner's breach of fiduciary duty to the limited partners.[829] Similarly, the parent and grandparent entities of the managing owner of a Delaware statutory business trust may be liable, directly or indirectly, for exercising control over or aiding and abetting the managing owner's actions to serve its own self-interest in violation of its fiduciary duties to the Delaware statutory business trust, which suffered significant losses as a result of a transfer of certain of its assets to a third party shortly before the transferee's collapse.[830]

The TBOC makes it clear that *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.[831] Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA section 13.03. That literal interpretation of the statutes, however, was contrary to the general concept that limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.[832] An exception is made to this general rule in the case where a limited partner actually has or exercises control in management matters (e.g., because of control of the general partner, contractual veto powers over partnership actions or service as an agent of the partnership). In such situations, the limited partner's conduct may be judged by fiduciary principles.[833]

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826 TRPA § 4.04(e)-(f); TBOC § 152.204(c)-(d).

827 TRPA § 4.04(d); TBOC § 152.204(b).

828 *James River-Pennington, Inc. v. CRSS Capital, Inc.*, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995) (also recognizing also that the general partner's fiduciary duties might be modified by the limited partnership agreement); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, 2001 WL 1641239, at *1-2, 8-9 (Del. Ch. Dec. 4, 2001) (in holding that various "upstream" entities controlling general partners could owe fiduciary duties to either the partnership or the limited partners, the court explained: "While mere ownership—either direct or indirect—of the general partner does not result in the establishment of a fiduciary relationship, those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.").

829 *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991).

830 *Cargill, Inc. v. JWH Special Circumstance LLC*, CA No. 3234-VCP (Del. Ch., Nov. 7, 2008).

831 TBOC § 153.003(b), (c).

832 *See, e.g.*, *In re Villa West Assocs.*, 146 F.3d 798, 806 (10th Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

833 *See RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at *10 (Del. Ch. July 16, 1999) (unpublished mem. op.) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683,

The Tex. LP Stats. state 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."[834] This language indicates that the partnership agreement may modify the internal liabilities of a general partner, but it is not clear 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.[835]

Delaware expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement.[836] Although limitations on fiduciary duty in a partnership agreement may

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1993 WL 285900, at *4 (Del. Ch. July 27, 1993) (unpublished mem. op.). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. *See* American Law Institute, *Restatement of the Law of Agency 2nd* (1958) §§ 13 ("An agent is a fiduciary with respect to matters within the scope of his agency"), 387 ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency"), 393 ("Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency"), 394 ("Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed"), and 395 ("Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge"); *see also Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177 (Tex. App.—Houston [1st Dist.] 2005, no pet. hist).

834 TRLPA § 4.03(b); TBOC § 153.152(a). Note, this language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. The registered limited liability partnership ("***LLP***") provisions in TRPA and the TBOC permit a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified filing with the Secretary of State. TRPA § 3.08; TBOC Title 1 and §§ 152.801-152.805.

835 *See* TRPA § 1.03(b); TBOC § 152.002(b). One additional point applies to limited partnerships that continue to be governed by the TRLPA. When originally drafted, it was the intent of the Partnership Law Committee of the Business Law Section of the State Bar of Texas that the TRLPA be subject to variation by agreement *only* if expressly permitted by the TRLPA; otherwise, the parties were *not* free to agree to provisions in the partnership agreement that differ from those contained in the TRLPA. TRLPA § 4.03 bar committee's cmt. Given the subsequent adoption of the TRPA, with its more flexible approach to contractual modifications of the statutory provisions, and the linkage provision contained in section 13.03 of the TRLPA, there is some question as to whether the more restrictive approach of the TRLPA to contractual modifications continues to have any application. *Cf.* TRLPA § 1.03 bar committee's cmt. Thus, a prudent course for limited partnerships formed before January 1, 2006 was to draft the partnership agreement as if the flexibility afforded by the TRPA applied, but to be aware that any provisions of the partnership agreement that varied the requirements of the TRLPA without express statutory authority were subject to challenge.

"Partnership agreement" is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* TRLPA § 1.02(10); TBOC § 151.001(5) (emphasis added).

Some TRLPA provisions permit modification by either a written or oral partnership agreement, while others require the modification to be in the form of a written partnership agreement. *Compare* TRLPA § 4.03(a) and TBOC § 153.152 concerning restrictions on a general partner *with* TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

836 Section 17-1101(b)-(f) of the Delaware Revised Limited Partnership Act ("***DRLPA***"), DEL. CODE ANN. tit. 6, section 17 1101(b)-(f) (Supp. 2007), provide as follows:

> (b) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
>
> (c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.
>
> (d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to

be respected by courts when they are expressly set forth in the four corners of the partnership agreement, "a topic as important as this should not be addressed coyly."[837]

> or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.
>
> (f) A partnership agreement may provide for the limitation of elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DEL. CODE ANN. tit. 6, § 17-1101(b)-(f) (Supp. 2007).

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

> The courts' approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

See infra note 850 regarding Chief Justice Steele's views in respect of fiduciary duties in the LLC context.

837 *Miller v. American Real Estate Partners, L.P.*, No. CIV.A.16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in section 6.13(d) of the partnership agreement, which read as follows:

> Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its "sole discretion" or "discretion", with "absolute discretion" or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its "good faith" or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

In finding that the foregoing provision was not adequate to eliminate the general partner's fiduciary duty of loyalty, Vice Chancellor Strine wrote:

> This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real

Unlike DRLPA, under Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.[838] For example, the partnership agreement may not eliminate the

Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.

* * *

Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court's decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners' freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.

This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.

* * *

This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.

But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

[838] TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b); TBOC §§ 152.002(b); 153.003(a).

duty of care but may determine the standards by which the performance of the obligation is to be measured, if the standards are not "manifestly unreasonable."[839] In one case decided prior to the passage of the TRPA and the TBOC, the court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.[840]

With respect to a partner's duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not "manifestly unreasonable."[841] The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not "manifestly unreasonable."[842] Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.[843] This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner's broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.[844]

C. Limited Liability Company

The Texas Limited Liability Company Act (the "*LLC Act*")[845] and the limited liability company ("*LLC*") provisions of the TBOC ("*Tex. LLC Stats.*") do not address specifically whether Manager or Member fiduciary duties exist or attempt to define them,[846] but implicitly recognize that they may exist in statutory provisions which permit them to be expanded or restricted in the Company Agreement.[847] The duty of Managers in a Manager-managed LLC and

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839 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b); TBOC § 152.002(b)(3).

840 *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

841 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(2); TBOC §§ 152.002(b)(2), 153.003(a).

842 TRLPA §§ 4.03(b), 13.03(a); TRPA § 1.03(b)(4); TBOC §§ 152.002(b)(4), 153.003(a).

843 TRLPA § 1.07; TBOC §§ 153.551, 153.552.

844 *See* TRPA § 4.03; TBOC §§ 153.551, 153.552.

845 TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2008) (hereinafter "LLC Act").

846 *See* Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

847 LLC Act article 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors. By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule. Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.[848]

The Tex. LLC Stats. allow LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.[849] This provision of Texas law was designed, in the same vein as the Delaware Limited Liability Company Act (the "DGLLCA") from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.[850] Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include

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> To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations.

Similarly, TBOC section 101.401 provides:

> 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.

848 *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1780236, at *6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication). In *Suntech*, a minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets. *Id.* at *5. The court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law. *Id.* at *1.

849 *See* LLC Act art. 2.20B; TBOC § 101.401. Prior to the effectiveness of S.B. 555 on September 1, 1997, LLC Act section 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in the Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act section 2.20B.

850 DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2007). The Delaware Limited Liability Company Act aggressively adopts a "contracterian approach" (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement as follows:

> **18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.**
>
> (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
>
> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
>
> (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.

> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable 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 for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person 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; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.
>
> (f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

DLLCA sections 18-1101(a)-(f) are counterparts of, and virtually identical to, sections 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. *See* DEL. CODE ANN. tit. 6, § 17-1101 (2007). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases, and that:

> Delaware's Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position "to the extent, at law or in equity" limited liability companies have "duties (including fiduciary duties)." These duties, in turn, "may be expanded or restricted or eliminated" in the agreement, provided that the "agreement may not eliminate the implied contractual covenant of good faith and fair dealing."
>
> The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties' status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

See supra note 836 and related text regarding Chief Justice Steele's views in respect of fiduciary duties in the limited partnership context.

In *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. 2008), Delaware Chancellor William Chandler wrote that LLCs are creatures of contract and that a prerequisite to any breach of contract analysis is to determine if there is a *duty* in the document that has been breached. The Chancellor quoted in footnote 34 Chief Justice Steele's article entitled *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007) ("Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties…"), and found no provision in the LLC Agreement at issue that: "create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability." The Chancellor wrote:

> There is no basis in the language of the LLC Agreement for Segal's contention that all members were bound by a code of conduct, but, even if there were, this Court could not enforce such a code because there is no limit whatsoever to its applicability".

provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate liability for breach of fiduciary duties, the legislative history and scope of LLC Act section 2.20B, the precursor to TBOC section 101.401, indicate that there may be more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to corporations. Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as coyness can lead to unenforceability.[851] A provision which purports to limit fiduciary duties in

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In addressing the breach of fiduciary duty claims asserted by plaintiff, the Chancellor focused on Delaware LLC Act § 18-1101(c) which allows for the complete elimination of all fiduciary duties in an LLC agreement. The Court then read the subject LLC Agreement to eliminate fiduciary duties because it flatly stated that:

> No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question….

Because the foregoing LLC Agreement exception for gross negligence, fraud or intentional misconduct did not create a fiduciary duty and the LLC Agreement did not otherwise expressly articulate fiduciary obligations, the foregoing LLC Agreement provision was held to be sufficient to eliminate defendant's fiduciary duties.

The Chancellor considered and disposed of plaintiff's "implied covenant of good faith and fair dealing" claim as follows:

> Every contract contains an implied covenant of good faith and fair dealing that "requires a 'party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that "a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter." Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was *actually bargained and negotiated for* in the contract. Moreover, because the implied covenant is, by definition, *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.
>
> Here, Segal argues that Fisk, Rose and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is "another in a long line of cases in which a plaintiff has tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation." Moreover, the LLC Agreement *does* address the subject of financing, and its specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal's proposals. As this Court has previously noted, "[t]he mere exercise of one's contractual rights, without more, cannot constitute … a breach [of the implied covenant of good faith and fair dealing]." Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

851 *Solar Cells, Inc. v. True N. Partners, LLC,* No. CIV.A.19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware "entire fairness" doctrine notwithstanding an operating agreement section providing in relevant part as follows:

> Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the True North Mangers. Both [First Solar] and Solar Cells hereby

the LLC context "to the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time" probably is not adequate.

While courts may be tempted to find contractual limitations on fiduciary duties ambiguous in particular situations where it appears that the provision is allowing a fiduciary to get away with something egregious, they should generally recognize the ability of LLCs to contractually limit fiduciary duties. In *McConnell v. Hunt Sports Enterprises*,[852] the court stated that Members (of what was apparently a Member-managed LLC) are generally in a fiduciary relationship and would ordinarily be prohibited from competing with the LLC. The court, however, recognized the validity of a provision in the Ohio LLC's operating agreement (the equivalent of a Texas LLC's Company Agreement) providing:

> <u>Members may Compete</u>. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.

The Ohio court in *McConnell* found that this provision clearly and unambiguously permitted a Member to compete against the LLC to obtain a hockey franchise sought by the LLC.[853] The court noted the trial court's finding that the competing Members had not engaged in willful misconduct, misrepresentation or concealment.[854]

> waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

Chancellor Chandler noted that the above clause purports to limit liability stemming from any conflict of interest, but that Solar Cells had not requested that the Court impose liability on the individual defendants; rather it was only seeking to enjoin the proposed merger. Therefore, exculpation for personal liability would have no bearing on whether the proposed merger was inequitable and should be enjoined. Further, Chancellor Chandler wrote that "even if waiver of liability for engaging in conflicting interest transactions is contracted for, that does not mean that there is a waiver of all fiduciary duties [for the above quoted provision] expressly states that the True North Managers must act in 'good faith.'"

Noting that the LLC was in financial distress and that the owners had been negotiating unsuccessfully to develop a mutually acceptable recapitalization, the Chancellor found that the managers appointed by the controlling owners appeared not to have acted in good faith when they had adopted the challenged plan of merger by written consent without notice to the minority managers. Chancellor Chandler commented:

> The fact that the Operating Agreement permits action by written consent of a majority of the Managers and permits interested transactions free from personal liability does not give a fiduciary free reign to approve any transaction he sees fit regardless of the impact on those to whom he owes a fiduciary duty.

852 725 N.E.2d 1193 (Ohio App. 1999).

853 *Id*. at 1215.

854 *Id*. at 1214. *But see Dragt v. Dragt/DeTray, LLC*, 161 P.3d 473 (Wash. App. 2007) (holding that non-managing members of a Washington LLC do not owe fiduciary duties to other members unless fiduciary duties are imposed under the operating agreement).

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.[855] A legal claim exists in some jurisdictions for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.[856]

The Tex. LLC Stats., which are based on TBCA article 2.35-1, provide that, unless the articles of organization, certificate of formation, Regulations or Company Agreement provide otherwise, a transaction between an LLC and one or more of its Managers or officers, or between an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers which authorizes the transaction or the Manager's votes are counted for such purpose, if any of the following is satisfied:

(i) The material facts as to the transaction and interest are disclosed or known to the governing authority, and the governing authority in good faith authorizes the transaction by the affirmative vote of a majority of the disinterested Managers or Members (as appropriate) even though the disinterested Managers or Members are less than a quorum; or

(ii) The material facts as to the transaction and interest are disclosed or known to the Members entitled to vote thereon, and the transaction is approved in good faith by a vote of the Members; or

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.[857]

In a joint venture, the duty of a Manager to all Members could be an issue since the Managers would often have been selected to represent the interests of particular Members. The issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.[858]

XIV. Conclusion.

SEC disclosure requirements and SOX significantly influence the governance of the internal affairs of public companies, including executive compensation processes, and are increasingly influencing best practices for private companies and nonprofit organizations. While SOX and related SEC and SRO requirements have changed many things, state corporation law remains the principal governor of the internal affairs of corporations. State statutes are still

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855 *See In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

856 *Fitzgerald v. Cantor*, No. CIV.A.16297-NC, 1999 WL 182573, at *1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary.

857 LLC Act art. 2.17; TBOC § 101.255.

858 *Id.*; *see* TRPA § 4.04; *see also* TBOC § 152.204.

supplemented to a large degree by evolving adjudications of the fiduciary duties of directors and officers.

Appendix A

SUMMARY OF THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (*"SOX"*)[1] intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. This is the "tough new corporate fraud bill" trumpeted by the politicians and in the media. Among other things, SOX amends the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*).

Although SOX does have some specific provisions, and generally establishes some important public policy changes, it is implemented in large part through rules adopted by the Securities and Exchange Commission (*"SEC"*). Set forth below is a summary of SOX and related SEC rulemaking.

To What Companies Does SOX Apply. SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act (*"reporting companies"*) or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, *"public companies"* or *"issuers"*). Some of the SOX provisions apply only to companies listed on a national securities exchange[2] (*"listed companies"*), such as the New York Stock Exchange (*"NYSE"*), the American Stock Exchange (*"AMEX"*) or the NASDAQ Stock Market (*"NASDAQ"*)[3] (the national securities exchanges and NASDAQ are referred to collectively as *"SROs"*), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets.[4] Small business issuers[5] that file reports on

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1 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in several sections of 15 U.S.C.A.) (*"SOX"*); see Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 TEXAS JOURNAL OF BUSINESS LAW 305 (Winter 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=505; Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 TEXAS JOURNAL OF BUSINESS LAW 131 (Fall 2005); Byron F. Egan, *Communications with Accountants After the Sarbanes-Oxley Act (including Attorney Letters to Auditors re Loss Contingencies, Attorney Duties under SOX §§ 303 and 307, and Options Backdating)* (Oct. 24, 2006), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=624; and Byron F. Egan, *Responsibilities of Attorneys and Other M&A Professionals After the Sarbanes-Oxley Act* (Nov. 7, 2008), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1035.

2 A "national securities exchange" is an exchange registered as such under 1934 Act §6. There are currently nine national securities exchanges registered under 1934 Act §6(a): American Stock Exchange (AMEX), Boston Stock Exchange, Chicago Board Options Exchange (CBOE), Chicago Stock Exchange, Cincinnati Stock Exchange, International Stock Exchange, New York Stock Exchange (NYSE), Philadelphia Stock Exchange and Pacific Stock Exchange.

3 A "national securities association" is an association of brokers and dealers registered as such under 1934 Act §15A. The National Association of Securities Dealers (*"NASD"*) is the only national securities association registered with the SEC under 1934 Act §15A(a). The NASD partially owns and operates The NASDAQ Stock Market (*"NASDAQ"*), which has filed an application with the SEC to register as a national securities exchange.

4 The OTC Bulletin Board, the Pink Sheets and the Yellow Sheets are quotation systems that do not provide issuers with the ability to list their securities. Each is a quotation medium that collects and distributes market maker quotes to subscribers. These interdealer quotations systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the issuers whose securities are quoted

Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB).

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the *"1940 Act"*) and (ii) public companies domiciled outside of the U.S. (*"foreign companies"*).[6]

Companies that file periodic reports with the SEC solely to comply with covenants under debt instruments, to facilitate sales of securities under Rule 144 or for other corporate purposes (*"voluntary filers"*), rather than pursuant to statutory or regulatory requirements to make such filings, are not issuers and generally are not required to comply with most of the corporate governance provisions of SOX.[7] The SEC's rules and forms implementing SOX that require disclosure in periodic reports filed with the SEC apply to voluntary filers by virtue of the fact that voluntary filers are contractually required to file periodic reports in the form prescribed by the rules and regulations of the SEC.[8] The SEC appears to be making a distinction in its rules between governance requirements under SOX (which tend to apply only to statutory "issuers") and disclosure requirements (which tend to apply to all companies filing reports under the 1934 Act).

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX §§ 802 and 1102 make it a crime for any person to alter, destroy, mutilate or

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through them. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the interdealer quotation system, the issuers whose securities are quoted on the systems do not have any filing or reporting requirements to the system. *See* SEC Release No. 33-8820 (April 9, 2003).

5 *"Small business issuer"* is defined in 1934 Act Rule 0-10(a) as an issuer (other than an investment company) that had total assets of $5 million or less on the last day of its most recent fiscal year, except that for the purposes of determining eligibility to use Forms 10-KSB and 10-QSB that term is defined in 1934 Act Rule as a United States (*"U.S."*) or Canadian issuer with neither annual revenues nor *"public float"* (aggregate market value of its outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more. Some of the rules adopted under SOX apply more quickly to larger companies that are defined as *"accelerated filers"* under 1934 Act Rule 12b-2 (generally issuers with a public common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter that have been reporting companies for at least 12 months).

6 Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the *"foreign private issuer,"* which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as:

- More than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer's assets are not located in the U.S.; and;
- The issuer's business is not administered principally in the U.S.

7 *Question 1*, SEC's Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions, posted November 8, 2002 (revised November 14, 2002) at www.sec.gov/divisions/corpfin/faqs/soxact2002.htm.

8 *Id.*

conceal a record or document so as to (x) impede, obstruct or influence an influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding; (ii) SOX § 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense; and (iii) SOX § 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 (*"ERISA"*). These three provisions are applicable to private and nonprofit entities as well as public companies.[9]

Further, the principles of SOX are being applied by the marketplace to privately held companies and nonprofit entities. Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct their affairs as if they were subject to SOX.[10]

Accounting Firm Regulation. SOX creates a five-member board appointed by the SEC and called the Public Company Accounting Oversight Board (the *"PCAOB"*) to oversee the accounting firms that serve public companies and to establish accounting standards and rules. SOX does not address the accounting for stock options, but the PCAOB would have the power to do so.[11] The PCAOB is a private non-profit corporation to be funded by assessing public companies based on their market capitalization. It has the authority to subpoena documents from public companies. The PCAOB is required to notify the SEC of any pending PCAOB investigations involving potential violations of the securities laws. Additionally, SOX provides that the PCAOB should coordinate its efforts with the SEC's enforcement division as necessary to protect ongoing SEC investigations.

Restrictions on Providing Non-Audit Services to Audit Clients. SOX and the SEC rules thereunder restrict the services accounting firms may offer to clients. Among the services that audit firms may not provide for their audit clients are (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services; and (9) expert services unrelated to the audit.

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9 Byron F. Egan, *Responsibilities of M&A Professionals After the Sarbanes-Oxley Act* (Oct. 4, 2007), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=838.

10 *See* Joseph Kubarek, *Sarbanes-Oxley Raises the Bar for Private Companies*, NACD-Directors Monthly (June 2004 at 19-20); Peter H. Ehrenberg and Anthony O. Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, Wall Street Lawyer (December 2002 at 12-13).

11 SOX § 101. On August 22, 2008, in Free Enterprise Fund v. Public Company Accounting Oversight Board, No. 07-5127, 2008 WL 3876143 (D.C. Cir. Aug. 22, 2008), the U.S. Court of Appeals for the District of Columbia upheld SOX and the creation of the PCAOB as constitutional holding that the PCAOB does not encroach upon the appointments clause, separation of powers principles or the non-delegation doctrines of the U.S. Constitution.

Accounting firms may generally provide tax services to their audit clients, but may not represent them in tax litigation or in respect of certain aggressive tax transactions.[12]

Enhanced Audit Committee Requirements/Responsibilities. SOX provides, and the SEC has adopted rules such that, audit committees of listed companies (i) must have direct responsibility for the appointment, compensation and oversight (including the resolution of disagreements between management and the auditors regarding financial reporting) of the auditors,[13] (ii) must be composed solely of independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees (x) accept any consulting, advisory or other compensation from the issuer, directly or indirectly, or (y) be an officer or other affiliate of the issuer,[14] and (iii) are responsible for establishing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer (*"whistleblowers"*) of concerns regarding any questionable accounting or auditing matters.[15] Whistleblowers are protected against discharge or discrimination by an issuer.[16]

Issuers are required to disclose (i) the members of the audit committee and (ii) whether the audit committee has an *"audit committee financial expert"* and, if so, his or her name.[17]

SOX requires that auditors report to audit committees regarding (a) all critical accounting policies and practices to be used and (b) all alternative treatments of financial information within

12 SOX § 201; Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, 68 Fed. Reg. 6006 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm, as amended by Strengthening the Commission's Requirements Regarding Auditor Independence; Correction, Release No. 33-8183A (March 31, 2003), *available at* http://www.sec.gov/rules/final/33-8183a.htm [hereinafter the *"Title II Release"*]; Public Company Accounting Oversight Board; Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules, Exchange Act Release No. 34-53677 (April 19, 2006), *available at* http://www.sec.gov/rules/pcaob/2006/34-53677.pdf; PCAOB Release No. 2005-014 (July 26, 2005), *available at* http://www.pcaobus.org/rules/docket_017/2005-07-26_release_2005-014.pdf, amended by http://www.pcaobus.org/rules/docket_017/2005-11-22_release_2005-020.pdf.

13 SOX § 202; Title II Release.

14 SOX § 301; Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, 68 Fed. Reg. 18,788 (April 16, 2003), *available at* www.sec.gov/rules/final/33-8220.htm.

15 *Id.*

16 SOX § 806.

17 SOX § 407; Disclosure Required by Sections 406 and 407 of the Sarbanes Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 23, 2003) (*codified at* 17 C.F.R. 229.406(a) (2004)), *available at* http://www.sec.gov/rules/final/33-8177.htm, as amended by Disclosure Required by Sections 406 and 407 of the Sarbanes Oxley Act of 2002; Correction, Release No. 33-8177A (March 31, 2003) *available at* http://www.sec.gov/rules/final/33-8177a.htm.

generally accepted accounting principles for financial reporting in the U.S. (*"__GAAP__"*) that have been discussed with management.[18]

SOX requires audit committee preapproval of all auditing services and non-audit services provided by an issuer's auditor.[19] The audit committee may delegate the preapproval responsibility to a subcommittee of one or more independent directors.[20]

__CEO/CFO Certifications__. SOX contains *two* different provisions that require the chief executive officer (*"__CEO__"*) and chief financial officer (*"__CFO__"*) of each reporting company to sign and certify company SEC periodic reports, with possible criminal and civil penalties for false statements. The result is that CEOs and CFOs must each sign two separate certifications in their companies' periodic reports, one certificate being required by rules adopted by the SEC under an amendment to the 1934 Act (the *"__SOX §302 Certification__"*) and the other being required by an amendment to the Federal criminal code (the *"__SOX §906 Certification__"*).[21] Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

__Improperly Influencing Auditors__. Pursuant to SOX, the SEC has amended its rules to specifically prohibit officers and directors and "persons acting under [their] direction" (which would include attorneys), from coercing, manipulating, misleading or fraudulently influencing an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading.[22]

__Enhanced Attorney Responsibilities__. The SEC has adopted under SOX rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of any U.S. law or fiduciary duty to the chief legal officer (*"__CLO__"*) or the CEO of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to an appropriate committee of independent directors or to the board of directors.[23]

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18 SOX § 204; Title II Release.

19 SOX § 202; Title II Release.

20 Title II Release.

21 SOX §§ 302 and 906; Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm.

22 SOX § 303; Improper Influence on Conduct of Audits, Exchange Act Release No. 47,890, 68 Fed. Reg. 31,820 (May 28, 2003) (*codified at* 17 C.F.R. 240 (2004)), *available at* http://www.sec.gov/rules/final/34-47890.htm.

23 SOX § 307; Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, 68 Fed. Reg. 6296 (Feb. 6, 2003) (*codified at* 17 C.F.R. § 205 (2004)), *available at* http://www.sec.gov/rules/final/33-8185.htm.

<u>CEO/CFO Reimbursement to Issuer</u>. SOX provides that, if an issuer is required to restate its financial statements owing to noncompliance with securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or incentive or equity based compensation received in the 12 months prior to the restatement and (2) any profits realized from the sale of issuer securities within the preceding 12 months.[24]

<u>Insider Trading Freeze During Plan Blackout</u>. Company executives and directors are restricted from trading stock during periods when employees cannot trade retirement fund-held company stock (*"<u>blackout periods</u>"*).[25] These insiders are prohibited from engaging in transactions in any equity security of the issuer during any blackout period when at least half of the issuer's individual account plan participants are not permitted to purchase, sell or otherwise transfer their interests in that security.[26]

<u>Insider Loans</u>. SOX prohibits issuers from making loans to their directors or executive officers.[27] There are exceptions for existing loans, for credit card companies to extend credit on credit cards issued by them, for securities firms to maintain margin account balances and for certain regulated loans by banks.[28]

<u>Disclosure Enhancements</u>. Public companies are generally required to publicly disclose in "plain English" additional information concerning material changes in their financial condition or operations on an increasingly "real time" basis.[29] As instructed by SOX, the SEC has adopted rules changes designed to address reporting companies' use of "non-GAAP financial measures" in various situations, including (i) Regulation G which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure and (ii) amendments to Item 10 of Regulation S-K to include a statement concerning the use of non-GAAP financial measures in filings with the SEC.[30] Form 8-K was amended to require disclosure for all public companies of additional items and accelerated disclosure of others.[31]

SOX amends §16(a) of the 1934 Act to require officers, directors and 10% shareholders to file with the SEC Forms 4 reporting (i) a change in ownership of equity securities or (ii) the purchase or sale of a security based swap agreement involving an equity security "*before the end*

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24 SOX § 304.

25 SOX § 306; Insider Trades During Pension Fund Blackout Periods, Exchange Act Release No. 47,225, 68 Fed. Reg. 4338 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/34-47225.htm.

26 *Id.*

27 SOX § 402.

28 *Id.*

29 SOX § 409.

30 Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8176, Exchange Act Release No. 47,226, 68 Fed. Reg. 4820 (Jan. 30, 2003), available at http://www.sec.gov/rules/final/33-8176.htm.

31 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, (March 16, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm, as amended by Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, Release No. 33-8400A, (Aug. 4, 2004), *available at* http://www.sec.gov/rules/final/33-8400a.htm.

of the second business day following the business day on which the subject transaction has been executed…"[32] and the SEC has amended Regulation S-T to require insiders to file Forms 3, 4 and 5 (§16(a) reports) with the SEC on EDGAR.[33] The rules also require an issuer that maintains a corporate website to post on its website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing.[34]

SOX also requires the SEC to regularly and systematically review corporate filings, with each issuer to be reviewed at least every three years.[35] Material restatements, the level of market capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.

Internal Controls. SOX § 404 directs the SEC to prescribe rules mandating inclusion in Form 10-K annual reports of (i) a report by management on the issuer's internal control over financial reporting ("*ICFR*") and (ii) a PCAOB registered accounting firm's attestation report on the effectiveness of the issuer's ICFR.[36] The rules implementing SOX § 404 define ICFR as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

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32 SOX § 403.

33 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 46,421, 67 Fed. Reg. 56,462 (Sept. 3, 2002), *available at* http://www.sec.gov/rules/final/34-46421.htm.

34 *Id.*

35 SOX § 408.

36 SOX § 404, 15 U.S.C.A. § 7262 (West Supp. 2007) [hereinafter *"SOX § 404"*]. SOX § 404 requires the SEC to adopt rules requiring a company's management to present an internal control report in the company's annual report containing: (1) a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. SOX § 404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment. The SOX § 404 requirements did not become applicable until the SEC's implementing rules became effective. The SEC's implementing rules, as amended, only require a single audit opinion directly on the effectiveness of the issuer's ICFR and the SEC believes this to be consistent with SOX § 404 and SOX § 103. See *infra* note 305.

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.[37]

The SEC rules implementing SOX § 404[38] require each reporting company to include in its Form 10-K an ICFR report of management that includes:

- A statement that it is management's responsibility to establish and maintain adequate ICFR for the issuer;[39]
- A statement identifying the framework[40] used by management to conduct the required evaluation of the effectiveness of the issuer's ICFR; and
- Management's assessment of the effectiveness of the issuer's ICFR as of the end of the issuer's most recent fiscal year, including a statement as to whether or not the issuer's ICFR is effective. The assessment must include disclosure of any "material weaknesses" in the issuer's ICFR identified by management. Management is not permitted to conclude that the issuer's ICFR is effective if there are one or more material weaknesses in the issuer's ICFR.

In addition to management's assessment on ICFR, the Form 10-K Report must include an attestation report of the issuer's auditor as to the effectiveness of the issuer's ICFR.[41] SOX § 404(b) requires the auditor to "attest to, and report on, the assessment made by the

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37 17 C.F.R. § 240.13a-15 (2006) (with regard to Regulation 13A); 17 C.F.R. § 240.15d-15 (2006) (with regard to Regulation 15D).

38 SEC Release No. 33-8238, titled "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," which can be found at http://www.sec.gov/rules/final/33-8238.htm (the "*Internal Control Release*").

39 Controls over financial reporting may be preventive controls or detective controls. Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring (*e.g.*, segregation of duties; two check signers). Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements (*e.g.*, regular reconciliation of accounts payable and accounts receivable). Effective ICFR often includes a combination of preventive and detective controls. PCAOB Accounting Standards PCAOB Release 2007-005A (June 12, 2007) at A-8.

40 The framework on which management's evaluation is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The SEC staff has indicated that the evaluative framework set forth in the 1992 Treadway Commission report on internal controls (also known as the "*COSO Report*"), which is available at http://www.coso.org, will be a suitable framework, and that foreign private issuers will be permitted to use the framework in effect in their home countries. In the COSO Report, the term "*control environment*" encompasses the attitudes and values of executives and directors and the degree to which they recognize the importance of method, transparency, and care in the creation and execution of their company's policies and procedures. A proper control environment is one factor an external auditor considers when called upon to evaluate internal control over financial reporting pursuant to SOX § 404. Stephen Wagner and Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, BEST PRACTICE, HARVARD BUSINESS REVIEW 133, 134 (April 2006).

41 17 C.F.R. § 210.2.02 (2007); Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928 (June 20, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8809.pdf.

management of the issuer," and SOX § 103(a)(2)(A)(iii) requires that each audit report describe the scope of the auditor's testing of the issuers ICFR structure and procedures and present, among other information: (1) the findings of the auditor from such testing; (2) an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP; and (3) a description of any material weaknesses in such ICFR. The SEC believes that a single audit opinion directly on the effectiveness of the issuer's ICFR is consistent with both SOX § 404 and SOX § 103, and its rules now so require.[42]

Under these SOX § 404 rules, management must disclose any material weakness and will be unable to conclude that the issuer's ICFR is effective if there are one or more material weaknesses in such control.[43] The term "material weakness" is now defined in 1934 Act Rule 12b-2 as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."[44] The SOX § 404 rules require reporting companies to perform quarterly evaluations of changes that have materially affected, or are reasonably likely to materially affect, the issuer's ICFR.[45]

Compliance with the SOX § 404 rules proved difficult and expensive for issuers. In response, on May 23, 2007 the SEC issued interpretive guidance to help public companies strengthen their ICFR while reducing unnecessary costs, particularly at smaller companies, by focusing company management on the internal controls that best protect against the risk of a material financial misstatement and enabling issuers to scale and tailor their evaluation

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42 Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928 (June 20, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8809.pdf; SOX § 103(a)(2)(A)(iii) states that "each registered public accounting firm shall --

> describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) --
>
> (I.) the findings of the auditor from such testing;
>
> (II.) an evaluation of whether such internal control structure and procedures –
>
> > (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
> >
> > (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
>
> (III.) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing."

43 *Id*.

44 Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928 (June 20, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8809.pdf.

45 *Id*. §§ 13a-15(a), 15d-15(f).

procedures according to the facts and circumstances.[46] This guidance was principles based to afford flexibility to issuers and, notwithstanding requests from some commentators for more specific guidance, does not contain detailed rules, which the SEC feared some issuers might learn how to game. An issuer that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by 1934 Act Rules 13a-15 and 15d-15.

Then on May 24, 2007, the PCAOB adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements ("*AS 5*"),[47] that was approved by the SEC on July 25, 2007[48] and that superseded PCAOB Auditing Standard No. 2 ("*AS 2*"), which was adopted by the PCAOB in March 2004 and approved by the SEC in June 2004. This AS 5 standard will apply to audits of all companies required by SEC rules to obtain an audit of ICFR. In adopting AS 5, the PCAOB commented that AS 5 results from the PCAOB's monitoring of auditors' implementation of AS 2 through, among other things, inspections of internal control audits and public roundtable discussions held in April 2005 and May 2006 and that while the PCAOB observed significant benefits produced by the ICFR audit under AS 2, including higher quality financial reporting, it also noted that, at times, the related effort has appeared greater than necessary to conduct an effective audit.[49] Based on these observations, and in light of the approaching date for smaller companies to comply with the SOX § 404 reporting requirements, the PCAOB adopted AS 5 to achieve four objectives:

1. Focus the Internal Control Audit on the Most Important Matters – AS 5 focuses auditors on those areas that present the greatest risk that an issuer's ICFR will fail to prevent or detect a material misstatement in the financial statements. It does so by incorporating certain best practices designed to focus the scope of the audit on identifying material weaknesses in internal control, before they result in material misstatements of financial statements, such as using a top-down approach to planning the audit. It also emphasizes the importance of auditing higher risk areas, such as the financial statement close process and controls designed to prevent fraud by management. At the same time, it provides auditors a range of alternatives for addressing lower risk areas, such as by more clearly demonstrating how to calibrate the nature, timing and extent of testing based on risk, as well as how to incorporate knowledge accumulated in previous years'

46 Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-55929 (June 20, 2007), *available at* http://www.sec.gov/rules/interp/2007/33-8810.pdf.

47 PCAOB Auditing Standard No. 5 may be found at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx.

48 Public Company Accounting Oversight Board: Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, Exchange Act Release No. 34-56152 (July 27, 2007), *available at* http://www.sec.gov/rules/pcaob.shtml.

49 Press Release, Public Company Accounting Oversight Board, Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule (May 24, 2007), *available at* http://www.pcaobus.org/News_and_Events/News/2007/05-24.aspx.

audits into the auditors' assessment of risk and use the work performed by companies' own personnel, when appropriate.

2. <u>Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits</u> – After examining the ICFR audit processes to determine whether the previous standard encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit, the PCAOB decided not to include in detailed requirements to evaluate management's own evaluation process and to clarify that an internal control audit does not require an opinion on the adequacy of management's process. As another example, AS 5 refocuses the multi-location direction on risk rather than coverage by removing the requirement that auditors test a "large portion" of the company's operations or financial position.

3. <u>Make the Audit Clearly Scalable to Fit the Size and the Complexity of Any Company</u> – In coordination with PCAOB's ongoing project to develop guidance for auditors of smaller, less complex companies, AS 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited. AS 5 does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies.

4. <u>Simplify the Text of the Standard</u> – AS 5 eliminates the previous standard's discussion of materiality, thus clarifying that the auditor's evaluation of materiality for purposes of an ICFR audit is based on the same long-standing principles applicable to financial statement audits. AS 5 conforms certain terms to the SEC's rules and guidance, such as the definition of "material weakness" and use of the term "entity-level controls"[50] instead of "company-level controls."

Compliance with the rules regarding management's report on ICFR is required as follows: accelerated filers are required to comply with the management report on ICFR requirements for fiscal years ending on or after November 15, 2004, and all other domestic issuers (including small business issuers) will be required to comply with the SOX § 404(a) requirement of including management's report on ICFR for fiscal years ending on or after December 15, 2007 and with the SOX § 404(b) requirement of including the auditor's attestation report for fiscal years ending on or after December 15, 2009.[51]

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50 Entity level controls include tone at the top and corporate governance, including the effectiveness of the audit committee.

51 Securities Act Release No. 8238, *supra* note 21, at 36,650. *"Accelerated filer"* is defined in the rules of the Securities Exchange Act of 1934 generally as an issuer which had a public common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter and has been a reporting company for at least 12 months (other than foreign private issuers). 17 C.F.R. 240.12b-2 (2006). The dates were further extended to the dates set forth in the text by (i) Management's Report on Internal Controls over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release 33-8392, 34-49312 (Feb. 24, 2004) *available at* http://www.sec.gov/rules/final/33-8392.htm; (ii) Management's Report on Internal Control over Financial

<u>Codes of Ethics</u>. As instructed by SOX, the SEC has adopted rules that require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a code of ethics that applies to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and

- If the issuer has not adopted such a code of ethics, the reasons it has not done so.[52]

<u>Record Retention</u>. SOX and SEC rules thereunder prohibit (1) destroying, altering, concealing or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy and (2) auditor failure to maintain for a seven-year period all audit or review work papers pertaining to an issuer.[53]

Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release 33-8545, 34-51293 (March 2, 2005), which can be found at http://sec.gov/rules/final/33-8545.htm; and (iii) Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release 33-8618, 34-52492 (Sept. 22, 2005), which can be found at http://sec.gov/rules/final/33-8618.pdf. *See also* Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, SEC Release 50754 (November 30, 2004), which can be found at http://www.sec.gov/rules/exorders/34-50754.htm, in which the SEC gave certain smaller accelerated filers an additional 45 days after their Form 10-K is due to file their management's assessment of the internal controls and the related auditor's report thereon, and Division of Corporation Finance FAQ on Exemptive Order on Management's Report on Internal Control over Financial Reporting and Related Auditor Report Frequently Asked Questions, (January 21, 2005), which can be found at http://www.sec.gov/divisions/corpfin/faq012105.htm, in which that Order was interpreted. In Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928 (June 20, 2007), available at http://www.sec.gov/rules/final.shtml, the SEC indicated that there would be no further extensions for non-accelerated filers which are scheduled to begin including a management report on ICFR in their annual reports filed for a fiscal year ending on or after December 15, 2007 and an auditor's report on ICFR for a fiscal year ending on or after December 31, 2008. Nevertheless, with the intention of providing the SEC and the PCAOB more time to complete initiatives intended to improve cost-effectiveness and efficiency of SOX § 404 compliance for smaller reporting companies, the SEC approved its proposal to delay the requirements that non-accelerated filers, including smaller reporting companies, include in their annual reports, pursuant to the rules implementing SOX § 404(b), an attestation report of their independent auditor on the issuer ICFR for one years to fiscal years ending on or after December 15, 2009. For annual reports for fiscal years ending before December 15, 2009, a non-accelerated filer must state in its management report that the company's annual report does not include the auditor attestation report. Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, SEC Release 33-8934 (June 26, 2008), which can be found at http://www.sec.gov/rules/final/2008/33-8934.pdf.

[52] SOX § 407; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 23, 2003) (*codified at* 17 C.F.R. 229.406(a) (2004)), *available at* http://www.sec.gov/rules/final/33-8177.htm, as amended by Disclosure Required by Sections 406 and 407 of the Sarbanes Oxley Act of 2002; Correction, Release No. 33-8177A (March 31, 2003) *available at* http://www.sec.gov/rules/final/33-8177a.htm.

[53] SOX Title VIII; Retention of Records Relevant to Audits and Reviews, Securities Act Release No. 8180, Exchange Act Release No. 47,241, 68 Fed. Reg. 4862 (January 30, 2003) (*codified in* 17 C.F.R. § 210 (2004)), *available at* http://www.sec.gov/rules/final/33-8180.htm.

Criminal and Civil Sanctions. SOX mandates maximum sentences of 20 years for such crimes as mail and wire fraud, and maximum sentences of up to 25 years for securities fraud. Civil penalties are also increased.[54] SOX restricts the discharge of such obligations in bankruptcy.[55]

SOX, as a response to the abuses which led to its enactment, will also influence courts in dealing with common law fiduciary duty claims.[56]

Further Information. For further information regarding SOX, see Byron F. Egan, *Responsibilities of M&A Professionals After the Sarbanes-Oxley Act* (Oct. 4, 2007), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=838; see Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 TEXAS JOURNAL OF BUSINESS LAW 305 (Winter 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=505; Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 TEXAS JOURNAL OF BUSINESS LAW 131 (Fall 2005); and Byron F. Egan, *Responsibilities of Attorneys and Other M&A Professionals After the Sarbanes-Oxley Act* (Nov. 7, 2008), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=1035.

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54 SOX Titles IX and XI.

55 SOX § 803.

56 *See* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Impacts of the Enron Debacle*, 57 BUS. LAWYER 1371 (Aug. 2002).

OPTIONS BACKDATING ISSUES

PCAOB Issues Audit Practice Alert Regarding Timing and Accounting for Stock Option Grants. On July 28, 2006, the PCAOB issued its staff Practice Alert No. 1, entitled "Matters Relating to Timing and Accounting for Options Grants"[1] (the *"Alert"*) that was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including the "backdating" of such grants, which indicate that some issuers' actual practices in granting options might have been inconsistent with the manner in which these transactions were initially recorded and disclosed.[2] The Alert noted that some issuers have announced restatements of previously issued financial statements as a result of these practices and that some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

As of September 4, 2007, more than 140 companies were undergoing some form of investigation involving their stock option grants, and more are likely to come under scrutiny.[3] Further, among nearly 150 late filers of quarterly results in the second quarter, roughly 50 companies disclosed delays resulting from stock option grant reviews.[4]

The Alert advises auditors that these stock option grant practices may have implications for audits of financial statements or of internal control over financial reporting and discusses factors that may be relevant in assessing the risks related to these matters. As a result of this Alert, together with SEC investigations, media, analyst and shareholder activist inquiries, and litigation surrounding option grant practices of other issuers, auditors are making more detailed and far reaching requests for documentation and representations from their clients about stock option grants than in prior years. Further, the significantly expanded executive compensation and related person disclosures that will be required for all proxy and information statements filed on or after December 15, 2006 by the amendments to SEC Regulation S-K items 402 and 404 adopted by the SEC on July 26, 2006 (the *"2006 Executive Compensation Rules"*)[5] will require specific information regarding option granting practices.

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1 http://www.pcaobus.org/News_and_Events/News/2006/07-28.aspx

2 *See* David I. Walker, "Some Observations on the Stock Options Backdating Scandal of 2006," Boston University School of Law Working Paper Series, Law and Economics Working Paper No. 06-31, available at http://www.bu.edu/law/faculty/scholarship/workingpapers/2006.html, in which the author suggests that the options backdating phenomena in the companies he surveyed is less about accounting fraud and executive greed than about a broad based effort to compensate rank-and-file employees as well as officers.

3 *See* Options Scorecard, Wall Street Journal Online (September 4, 2007), available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

4 *See* "Is Your Target an Option Timer?", Securities Mosaic (September 25, 2006).

5 1933 Act Release No. 33-8732A (August 29, 2006) "Executive Compensation and Related Person Disclosure," *available at* http://www.sec.gov/rules/final/2006/33-8732a.pdf (the *"2006 Executive Compensation Release"*); *see* **Appendix C**, Summary of SEC Executive Compensation Disclosure Rules, *infra*.

Vocabulary.

"*At-the-money*" options are stock options granted with an exercise price equal to the fair market value (usually the closing price) of the issuer's stock on the grant date.

"*Backdating*" involves setting the grant date of an employee stock option that precedes the actual date of the corporate action required to effect the grant in order to provide a lower exercise price, and hence a higher value, to the recipient.

"*Bullet-dodging*" is the converse of spring loading and involves granting of stock options after the issuer's release of negative information that can reasonably be expected to have a negative impact on the market value of the stock.

"*Discounted*" or "*In-the-Money*" options are stock options granted with an exercise price less than the fair market value of the stock at the time of grant (usually the closing price of the issuer's stock on the grant date).

"*Grant date*" or "*measurement date*" under APB 25 is the first date on which both of the following are known: (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Under APB 25, even if documents related to an award of options are dated "as of" an earlier date, the measurement date does not occur until the date the terms of the award and its recipient are actually determined.

"*Spring-loading*" or "*spring-dating*" involves granting stock options in advance of the issuer's release of material information that can reasonably be expected to have a positive effect on the market price of the stock.

GAAP Accounting for Options. The Alert notes that under generally accepted accounting principles for financial reporting in the U.S. (*"GAAP"*), the recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Where discounted options were granted, the issuer would ordinarily record initially the amount of the discount as compensation cost in the period of grant. If proper recording of the compensation cost was not made, the errors may cause the issuer's financial statements, including related disclosures, to be materially misstated. Periods subsequent to the grant of an option may also be affected by improper accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

The specific accounting treatment for an option will be determined by whichever of the following is applicable:

APB 25. Under Accounting Principles Board (*"APB"*) Opinion No. 25, *Accounting for Stock Issued to Employees* (*"APB 25"* or *"Opinion 25"*), which defined the method many companies used to account for stock options until recently, there was no compensation expense recorded if the option was issued with an exercise price not less than the fair market price (usually the closing price) of the stock on the date of grant (the *"measurement date"*) entitling the employee to purchase a fixed number of shares for a fixed price for a fixed period of time and vesting based on continued service over a specified period of time. If on the measurement date the fair market value of the stock exceeded the option exercise price, then the issuer would have to record the amount of the discount as compensation expense in the period of grant.[6]

FAS 123(R). An option granted today is accounted for under Financial Accounting Statement No. 123(R), titled "Accounting for Stock Based Compensation" (*"FAS 123(R)"*),[7] which requires a charge to earnings of the fair value of the option (often determined under the Black-Scholes method) over the vesting period. An option exercise price which is lower than the fair market value on the date of grant will increase the value of the option and hence the charge to earnings.

Background. In 2005 Dr. Erik Lie of the University of Iowa published a paper[8] that showed that before 2003 a number of public companies had an uncanny ability to choose grant dates coinciding with the lowest stock prices around the time of the grant.[9] Media analyses suggested that "the odds of this happening by chance were extraordinarily remote – around one in 300 billion."[10] Suspecting that such patterns were not the result of chance but of some manipulation, the SEC and other federal and state law enforcement groups began to investigate. The scandal had mushroomed to the point that on September 6, 2006 the SEC was investigating over 100 companies concerning possible fraudulent reporting of stock option grants involving a variety of companies ranging from Fortune 500 companies to smaller cap issuers and spanning multiple industry sectors, with a large number from the technology sector.[11] More companies have announced internal investigations into their option granting practices, often with

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6 In a letter dated September 19, 2006 from the SEC Chief Accountant to the Chairman of Center for Public Company Audit Firms, American Institute of Certified Public Accountants (the *"SEC Options Guidance"*), the importance of the measurement date was emphasized:

> The accounting under Opinion 25 relies heavily on the determination of the *measurement date*, which is defined as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." Under Opinion 25, the final amount of compensation cost of an option is measured as the difference between the exercise price and the market price of the underlying stock at the measurement date. As such, for the purpose of determining compensation cost pursuant to Opinion 25, it is important to determine whether a company's stock option granting practices resulted in the award of stock options with an exercise price that was lower than the market price of the underlying stock at the date on which the terms and recipients of those stock options were determined with finality.

7 Financial Accounting Standards Board (*"FASB"*) Statement of Financial Accounting Standards (*"SFAS"*) No. 123 R (revised 2004), *Share-Based Payment*, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers).

8 Erik Lie, *On the timing of CEO stock option awards*, 51 MGMT. SCI. 801,802 (2005).

9 "Testimony Concerning Options Backdating" by Christopher Cox, Chairman, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs on September 6, 2006, which can be found at http://www.sec.gov/news/testimony/2006/ts090606cc.htm.

10 Charles Forelle and James Bandler, *The Perfect Payday – Some CEO's reap millions by landing stock options when they are most valuable. Luck – or something else?*, Wall St. J., March 18, 2006, at A1.

11 "Testimony Concerning Executive Compensation and Options Backdating Practices" by Linda Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Finance on September 6, 2006, which can be found at http://www.sec.gov/news/testimony/2006/ts090606lt.htm.

announcements that the filing of SEC reports is being delayed pending completion of the investigation.[12]

The incidence of backdating may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by SOX § 403, which resulted in the SEC requiring the reporting of an option grant on Form 4 within two days of the date of grant.[13]

Backdating.

When Was Option Granted. An option is "granted" under an employee stock option plan, and a "measurement date" under APB 25 occurs, when the person authorized by the plan to make the grant (typically the compensation or stock options committee of the board of directors) takes the requisite corporate action to effect the grant in accordance with the terms of the plan. A committee can act either at a meeting at which a quorum is present or by unanimous written consent. A written consent is effective on the later of the date specified in the consent or the date on which all directors have signed the consent to the action and filed with the minutes of the Board or committee, as the case may be.[14] The "unanimous" requirement may make the written consent problematic when one of the persons who must sign the consent has a disabling self interest that would prohibit voting because he or she is to receive an option.[15]

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12 *See* Options Scorecard, Wall Street Journal Online (September 4, 2007), available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

13 *See* Byron F. Egan, *Responsibilities of M&A Professionals After the Sarbanes-Oxley Act* (Oct. 4, 2007) - Accelerated §16(a) Reporting, at 63-68, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=838.

14 DGCL § 141(f) and TBCA art. 9.10A both authorize boards of directors and committees thereof to act by unanimous written consent. *See* C. Stephen Bigler & Pamela H. Sudell, *Delaware Law Developments: Stock Option Backdating and Spring-Loading*, 40 Rev. Sec. & Comm. Reg. 115, 116-117 (May 16, 2007) ("Section 141(f) generally provides that an action may be taken 'if all members of the board of directors or committee, as the case may be, consent thereto in writing, or by electronic transmission and the writing or writings are filed with the minutes of proceedings of the board of directors, or committee.' Thus, for purposes of Delaware law, an action taken by written consent is not taken until the written consent has been executed by all of the members of the board or committee and has been filed with the minutes. * * * Ultimately, the date on which the written consent was signed by all the directors or committee and filed with the minutes is a factual question that must be determined from the company's records, the recollections of the relevant directors or committee members, and the officers responsible for preparing, disseminating, retrieving and filing the signed written consents. * * * Acting at an in-person or a telephonic meeting would help avoid potential issues resulting from the uncertainty surrounding when actions are legally effective when the directors act by written consent.")

15 In *Solstice Capital II, Ltd. P'ship v. Ritz*, 2004 WL 765939 (not reported in A.2d) (Del. Ch. April 6, 2004), Delaware Chancellor Chandler held that a written consent to the removal of an officer was invalid because it was not signed by all of the directors even though it was signed by all of the disinterested directors, and explained:

> Action by written consent requires unanimity of the entire board, not just the unanimity of the disinterested directors. There is no exception to this rule, even if a director has an interest in the transaction at issue. This comports with the notion that directors should participate actively and engage in discussion before voting at meetings. The policy underlying board action by written consent is that "meetings should be required except where the decision is so clear that the vote is unanimous and in writing." Unless there is

The SEC Chief Accountant recognized that corporate formalities do not always keep up with what the issuer's governing authority intended and thought it was accomplishing. In a letter dated September 19, 2006 from the SEC Chief Accountant to the Chairman of Center for Public Company Audit Firms, American Institute of Certified Public Accountants (the *"SEC Options Guidance"*), the SEC Chief Accountant recognized:

> [T]here may also be situations where an at-the-money grant was actually decided with finality, but there were unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting actions. In those situations, if compensation cost would not have otherwise been recorded pursuant to Opinion 25, short delays in completing the administrative procedures to finalize the grant would not result in an accounting consequence.[16]

> unanimous written consent, the only way to remove Puchek as the CEO is at a special meeting of the board.

Action on a compensation issue was found not to be in good faith where it was taken by unanimous written consent without any deliberation or advice from any expert in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, No. CIV.A.20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

[16] In the SEC Options Guidance, the SEC Chief Accountant elaborated as follows:

> Typically, a company's corporate governance provisions, stock option plans, and applicable laws specify the actions required in order to effect the grant of a stock option (collectively referred to as "required granting actions"). Absent provisions of the option or company practices that indicate the terms of the award could change at a later date, the date when these actions are completed in full has generally been regarded as the measurement date.
>
> However, we understand that some companies have accounted for their option grants using a measurement date that is other than the date at which all required granting actions have been completed. Two such examples that we have become aware of are as follows.
>
> > a) Companies may have been awarding stock options by obtaining oral authorization from the board of directors (or compensation committee thereof) and subsequently completing the documents evidencing the award at a later date, or
> >
> > b) Companies may have delegated the authority to award options to a member or committee of management. That member or committee of management determined option awards to be made to subordinates within specific parameters previously communicated by the board of directors (or compensation committee thereof) and obtained any appropriate approvals at a later date.
>
> The delay in completion of all required granting actions suggests that options terms may not have been final until the completion of those actions. Nonetheless, some companies that utilized the practices described above have asserted that the measurement date occurred before the required granting actions were completed because all option terms and recipients were final and known at an earlier date, and the completion of required granting actions represented only an administrative delay, rather than a period during which any of the terms of the award remained under consideration or subject to change.
>
> The staff believes that a conclusion that a measurement date occurred before the completion of required granting actions must be considered carefully, as the fact that the applicable corporate governance provisions, terms of the stock option plans, or applicable

Consequences. Backdating of options can be a valid corporate action that does not violate any fiduciary duties if the action is taken by an informed board or committee,[17] but it may

> laws require certain procedures to be completed in order to effect a stock option grant suggests that option terms may not have been final (or "known") until those procedures were completed. * * *
>
> In many cases, when options were awarded before (or in the absence of) completion of required granting actions, the terms cannot be considered to have been determined with finality until (and unless) such actions were completed. Indeed, as evidenced by some of the option granting practices and patterns of conduct that the staff has become aware of, awarding options in a manner that did not comply with the required granting actions does suggest that the terms and recipients of the options may have been subject to change. For example, in the event that the company's stock price declined prior to finalizing the required granting actions, the company may have retracted awards (e.g., failed to follow through with the initially determined awards) or lowered the exercise price of options. This type of practice indicates that, for all awards (including those awards for which the terms were not changed), the terms and recipients were not determined with finality (and therefore were not "known") prior to the completion of all required granting actions. Similarly, any evidence indicating that the preparation of documentation was done in a manner calculated to disguise the true nature of the option granting actions would preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions. **If a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by retracting awards or changing their terms), the staff believes the company should conclude that the measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.**
>
> On the other hand, in certain instances where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions. This would only be the case, however, when a company's facts, circumstances, and pattern of conduct make clear that the company considered the terms and recipients of the awards to be *fixed and unchangeable* at the earlier date. The practices described in the preceding paragraph would, of course, preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions.
>
> In evaluating whether a company's facts and circumstances do support a conclusion that the terms of stock option awards were fixed ("known") prior to the completion of all required granting actions, it is important that all information be considered. * * *
>
> Any analysis will be heavily dependent upon the particular facts and circumstances of each company, and evidence of fraudulent or manipulative conduct would affect the analysis. * * *

17 On July 6, 2006, SEC Commissioner Paul S. Atkins in his "Remarks Before the International Corporate Governance Network 11th Annual Conference," *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm, commented, "Backdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated. Purposefully backdated options that are properly accounted for and do not run afoul of the company's public disclosure are legal. Similarly, there is no securities law issue if backdating results from an administrative, paperwork delay. A board, for example, might approve an options grant over the telephone, but the board members' signatures may take a few days to trickle in. One could argue that the grant date is the date on which the last director signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people

still not comply with the requirements of the option plan which was approved by the shareholders if it results in the granting of in-the-money options.[18] Most option plans specify

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to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent."

Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

[18] In the SEC Options Guidance, the SEC Chief Accountant addressed the accounting consequences where an issuer's consistent practice may not have complied with the terms of the applicable plan and suggested that more flexibility may be appropriate with respect to grants to rank and file employees:

> We understand that, in certain circumstances, the validity of past option grants has been called into question, even though both the company and the affected employees have and continue to comply with the terms of such options. For example, an option plan may preclude grants that are in-the-money at the grant date, or may contain a cap on the number of options that may be issued. Notwithstanding these restrictions, options that may not have complied with the terms of the plan were awarded to employees. This could arise due to some of the practices described in this letter.
>
> Questions have arisen as to whether an option can be accounted for as a fixed option with a measurement date on the date that the terms and recipient of the award were determined if uncertainty exists as to the validity of the grant. Specifically, the following questions have arisen:
>
> > a) If, for example, a shareholder-approved option plan only permits at-the-money grants, some have questioned whether the compensation committee may have lacked the authority under the entity's corporate governance procedures to authorize an in-the-money grant. If that were the case, under the plan, only the shareholders had the ability to approve such a grant and shareholder approval was not obtained. * * *
> >
> > b) Some have questioned whether the non-compliance of options with the company's option plan may create uncertainty as to whether the company will ultimately have the ability to settle the award in stock or instead may be required to settle the award in cash. Absent an ability to settle the award in stock, it is possible that the option would be accounted for as a cash-settled stock appreciation right pursuant to FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."
>
> We understand that, in many of these cases, (a) the company has, as applicable, been honoring the awards and settling in stock, (b) the company intends to honor outstanding unexercised awards and has a reasonable basis to conclude that the most likely outcome is that the awards will be honored, and (c) the company intends to settle the outstanding unexercised awards in stock and has a reasonable basis to conclude that it will be able to do so (even if such settlement is not entirely within the company's control). In those circumstances, the staff believes that the substantive arrangement that is mutually understood by both the company and its employees represents the underlying economic substance of the past option grants, and should serve as the basis for the company's accounting. Accordingly, assuming all other conditions for the establishment of a measurement date have been satisfied, the staff believes it would be appropriate to account for the awards as fixed options with a measurement date on the date that the terms and recipients were determined with finality. While legal opinions regarding the validity of the option grant and the company's ability to honor the award would be helpful, the staff does not believe that a company would necessarily be required to obtain a legal opinion in order to reach these accounting conclusions.
>
> When a company either does not intend to or does not have a reasonable basis to conclude that it will be able to honor the award or settle it in stock, further analysis of the facts and circumstances would be necessary to determine the appropriate accounting for

> the options. The staff understands that significant uncertainty as to a company's ability to honor options arises more often for grants that were made to senior officers of the company (particularly officers who were involved in the option granting process), and less often for grants made to rank-and-file employees. Accordingly, the staff believes that the need for a legal analysis may be greater when questions exist as to the validity of grants made to senior officers who participated in the option granting process.

Similar flexibility was expressed in the SEC Options Guidance where there was uncertainty as to individual award recipients:

> We understand that some companies may have approved option awards before the number of options to be granted to each individual employee was finalized. For example, the compensation committee may have approved an award by authorizing an aggregate number of options to be granted prior to the preparation of a final list of individual employee recipients. In these cases, the allocation of options to individual employees was completed by management after the award approval date, or the unallocated options were reserved for grants to future employees. Pursuant to paragraph 10(b) of Opinion 25, no measurement date can occur until "the number of shares that an individual employee is entitled to receive" is known.
>
> In certain circumstances, the approved award may contain sufficient specificity to determine the number of options to be allocated to individual employees, notwithstanding the absence of a detailed employee list. If management's role was limited to ensuring that an allocation was made in accordance with definitive instructions (e.g., the approved award specified the number of options to be granted based on an individual's level within the organization), the measurement date could appropriately be the date the award was approved. However, if management was provided with discretion in determining the number of options to be allocated to each individual employee, a measurement date could not occur for such options prior to the date on which the allocation to the individual employees was finalized. If the allocation of a portion of the award is specified at the award approval date with the allocation of the remainder left to the discretion of management, the measurement date could appropriately be the date the award was approved only for those options whose allocation was specified.
>
> The staff also has become aware that some companies may have changed the list of recipients or the number of options allocated to each recipient subsequent to the preparation of the initial list at the award approval date. When changes to a list are made subsequent to the preparation of the list that was prepared on the award approval date, based on an evaluation of the facts and circumstances, the staff believes companies should conclude that either (a) the list that was prepared on the award approval date did not constitute a grant, in which case the measurement date for the entire award would be delayed until a final list has been determined or (b) the list that was prepared on the award approval date constituted a grant, in which case any subsequent changes to the list would be evaluated to determine whether a modification (such as a repricing) or cancellation has occurred. When a company determines that a repricing occurred, variable accounting should be applied to the option from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

The SEC Options Guidance provided some flexibility where (i) the legal documents evidencing past grants may not exist in the issuer's records, (ii) contemporaneous documentation of the date on which a telephonic or in-person meeting of the compensation committee was held may not have been prepared, (iii) written documentation includes only "as of" dates, and not the dates the documentation was actually prepared and approved, or (iv) the issuer may have reason to believe that the documentation in its records is not accurate:

> The appropriate accounting in circumstances where records cannot be located or may be inaccurate will depend on the particular facts and circumstances. We understand that, in some cases, the lack of documentation or existence of contradictory documentation may lead a company to conclude either that the terms of options cannot reasonably be

how the option exercise price is to be determined (typically at the closing price of the stock on the date of grant). Failure to comply with the plan or GAAP can result in a number of collateral consequences, including the following:

- Financial Statement Impact. A backdating that results in options being issued at a discount could result in the understatement of compensation expenses with the attendant consequences described in the Alert and could require the issuer to restate[19] its financial statements.[20]

> considered fixed, resulting in the application of variable accounting, or that awards do not substantively exist until the board of directors affirms which awards will be honored. However, the staff does not believe that the lack of complete documentation being available several years after the activities occurred should necessarily result in a "default" to variable accounting or to treating the awards as if they had never been granted. Rather, a company must use *all available relevant information* to form a reasonable conclusion as to the most likely option granting actions that occurred and the dates on which such actions occurred in determining what to account for. The existence of a pattern of past option grants with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms of those grants were determined with hindsight. Further, in some cases, the absence of documentation, in combination with other relevant factors, may provide evidence of fraudulent conduct.

19 *See* David Reilly, *No More 'Stealth Restating' – SEC Forces Companies to Highlight Earnings Changes, Not Just Tack Them on to Their Newest Filings*, WALL ST. J., Sept. 21, 2006 at C1:

> At issue is guidance from the regulator that companies shouldn't try to sweep under the carpet errors in their financial results. In recent years, scores of companies have changed previously reported figures via what critics call "stealth restatements," commonly including the new, different figures in subsequent securities filings. The SEC's stand: Such changes constitute information that is material to investors and thus needs to be formally disclosed in a restatement filing clearly labeled as such. As a result, some companies are announcing restatements to earnings reports they made months ago.
>
> In 2004, as part of changes brought about by the Sarbanes-Oxley corporate-overhaul legislation, the SEC said companies should file a special form announcing a restatement with the agency. But some companies mistakenly believed that they wouldn't have to do so if they were submitting a new earnings filing in the days after concluding that a restatement of old results was necessary. Instead, they would just include the restated results in the new filing.
>
> John White, director of the corporate-finance division, added that his staff has "focused" on restatement-related disclosures to make clear that companies can't avoid such announcements by simply including a restatement in a filing of current results. The loophole some companies may have tried to exploit didn't actually exist, he explained.
>
> Restatements are admissions by companies that a prior financial filing can't be relied upon, which explains why many executives prefer not to draw attention to them. "It's embarrassing," said Eric Keller, chief executive of Movaris Inc., a company that develops financial-reporting systems. "It's akin to a product recall."

See also Peter Grant, James Bandler and Charles Forelle, *Cablevision Gave Backdated Grant To Dead Official*, WALL ST. J., Sept. 22, 2006 at A1:

> Cablevision Systems Corp. awarded options to a vice chairman after his 1999 death but backdated them, making it appear the grant was awarded when he still was alive, according to a company filing and people familiar with the matter. The country's fifth-

- Misleading SEC Filings. The resulting financial statement misreporting could result in the issuer's periodic reports being in violation of the 1934 Act and any 1933 Act registration statement which incorporates them by reference being in violation of the 1933 Act and could require amendment of any SEC filings containing materially misstated financial statements.[21] Further, the compensation disclosures in proxy statements filed with the SEC could likewise be incorrect.

- SOX §§ 302 and 906 Certifications. The CEO and CFO of a public company are required to certify in each periodic report filed with the SEC that, to the best of their knowledge: (1) the financial statements and other information in the report fairly present, in all material respects, the financial condition and results of operation of the issuer, (2) the disclosure controls and procedures are designed to provide reasonable assurance regarding the reliability of the financial statements in accordance with GAAP, and (3) they have disclosed to the company's auditors and audit committee any internal control deficiencies.[22] Options backdating and other manipulations, if committed with the

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> largest cable operator in terms of subscribers also improperly awarded a compensation consultant options but accounted for them as if he were an employee, according to a Securities and Exchange Commission filing, citing the results of a six-week investigation by an outside law firm. The findings of the probe were released yesterday as the . . . company restated its financial results and said two of its directors had stepped down from posts on the board's audit and compensation committees as part of an escalating investigation into its improper granting of stock options.
>
> * * *
>
> John Coffee, a professor of law at Columbia University, noted that options are intended to create an incentive for executives to boost their company's stock price. "Trying to incentivize a corpse suggests they were not complying with the spirit of shareholder-approved stock-option plans," he said.

20 The SEC Options Guidance suggests that an issuer may have to restate its financial statements where options backdating has occurred in prior periods:

> Companies that determine their prior accounting to be in error and that those errors are material should restate their financial statements to reflect the correction of those errors. Evaluation of materiality requires a consideration of all relevant facts and circumstances. Qualitative factors (for example, if the error is intentional) may cause misstatements of quantitatively small amounts to be material. When disclosures of these issues are made, it is important that the registrant discuss not only the accounting restatements, but also the circumstances that gave rise to the errors.

21 The SEC Options Guidance suggests that an issuer may have to amend its prior SEC filings that contained financial statements that had to be restated due to options backdating:

> Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. The staff understands that errors related to the issues addressed in this letter may affect several years of filings, and that companies may believe that amending all of the affected filings is unnecessary. Companies that propose to correct material errors without amending all previously filed reports should contact the staff of the Division of Corporation Finance. No amendment of previously filed reports is necessary to correct prior financial statements for immaterial errors. Such corrections, if necessary, may be made the next time the registrant files the prior financial statements.

22 *See* Byron F. Egan, *Responsibilities of M&A Professionals After the Sarbanes-Oxley Act* (Oct. 4, 2007) - CEO/CFO Certifications, at 36-40, *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=838.

knowledge of the certifying officer, could subject the officer to SEC enforcement action or criminal prosecution for false certification.

- Federal Income Tax Consequences. Under the Internal Revenue Code of 1986, as amended (the *"IRC"*), a finding that an option was backdated can cause the tax treatment of the option grant and exercise to be different for both the issuer and the employee, with the result that the issuer may be subject to tax liabilities and liabilities to the option grantee under federal securities laws and a variety of common law causes of action.

    - IRC § 162(m). In-the-money options may not be treated as "performance based" compensation within the meaning of IRC § 162(m). Thus, for the issuer, any deduction of compensation related to the backdated option would be subject to the $1 million IRC § 162(m) limitation and would be disallowed if paid to the chief executive officer or one of the four other highest paid executive officers.[23]

    - Incentive Stock Options. If an Incentive Stock Option (*"ISO"*) is backdated so that it was in-the-money on the real date of grant, the option would no longer qualify for preferential ISO treatment and would be reclassified as a nonqualified stock option.[24] The difference between the exercise price and the sales price would be additional wages to the executive and should be included on the employee's Form W-2 in the year of exercise. The executive would lose the deferral and rate benefits associates with ISO qualification, but the corporation may be eligible for an additional wage deduction if IRC § 162(m) limitations are not triggered.[25]

    - IRC § 409A. Under IRC § 409A, the grantee of a backdated option may now be responsible for the payment of tax on income previously deferred until the exercise of the options.[26] In addition, there can be substantial additional taxes under IRC § 409A. This provision applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004. During a transition period with the rules relating to IRC

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23 "Testimony on Backdating of Stock Options and Other Executive Compensation Issues" by Mark Everson, Commissioner of Internal Revenue, before the U.S. Senate Committee on Finance on September 6, 2006.

24 Under IRC § 421 an optionee does not recognize income upon the receipt or exercise of an ISO and, upon sale of stock acquired upon the exercise thereof, the entire spread between the exercise price and the sale price is taxed as a capital gain. This favorable tax treatment is available only if the option exercise price is at or above the fair market value of the underlying stock on the date of grant and the option and the plan under which it was granted meet the other requirements of IRC § 421 on the date of grant, including issuer shareholder approval of the plan pursuant to which the ISO was granted. If the option does not qualify as an ISO, under IRC § 83 the optionee would recognize income on the date of grant if it then has a readily ascertainable fair market value and, if not, ordinarily would recognize ordinary income when the option is exercised equal to the spread between the exercise price and the fair market value of the stock on the date of exercise.

25 "Testimony on Backdating of Stock Options and Other Executive Compensation Issues" by Mark Everson, Commissioner of Internal Revenue, before the U.S. Senate Committee on Finance on September 6, 2006.

26 *Id.*

§ 409A, options that were in the money on the grant date could be amended to avoid violating IRC § 409A either by (1) increasing the exercise price to equal the fair market value on the original grant date and eliminate any other deferral feature, or (2) amending the options to provide for a fixed exercise date after which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised.[27]

- Internal Investigations. An early step in an issuer's investigating and determining how to deal with suggestions that it may have backdated stock option grants is an internal investigation conducted by the issuer's audit committee, or another committee of independent directors appointed by the issuer's board of directors, often with the assistance of independent counsel and forensic accountants.

- Stock Exchange Delisting. Issuer listing agreements with the stock exchanges generally require that listed companies (1) timely file their SEC periodic reports and (2) obtain shareholder approval of new or amended plans under which issuer stock may be issued. The delays in filing SEC reports because of backdated option related internal investigations or restatements would result in listing agreement violations. Likewise, the grant of backdated options could be deemed a defacto amendment of the option plan without shareholder approval in violation of listing agreement covenants.

- Lenders. Loan agreements with banks and other institutional lenders require the timely filing of SEC reports. The failure to make such filings can result in covenant defaults which can justify accelerating the debt, which in turn would require the issuer to classify the debt as a current liability in its financial statements. Lenders are increasingly extracting payments or other consideration in exchange for waivers of covenant defaults.[28]

- Civil and Criminal Actions by SEC, Department of Justice and Others. Some SEC and criminal actions[29] have been initiated to date and, with over 140

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27 *Id.*

28 *See* Peter Lattman and Karen Richardson, *Hedge Funds Play Hardball With Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1.

29 *See, e.g.,* SEC v. Symbol Technologies, Inc., et al, Accounting and Auditing Release No. 2029 (June 3, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18734.htm (SEC complaint alleged defendants fraudulently used a variety of non-GAAP revenue recognition principles to create false impression that Symbol had met or exceeded its financial projections; Symbol's former general counsel and senior vice president, Leo Goldner consented to a final judgment referenced at Accounting and Auditing Release No. 2391 (March 2, 2006), *available at* http://www.sec.gov/litigation/litreleases/lr19585.htm, permanently enjoining him from violating the 1933 Act, the 1934 Act and rules thereunder, and civil forfeiture of $2 million in connection with his guilty plea in a parallel criminal case, based on allegations that Goldner chose "a more advantageous exercise date" from a 30-day look back period to calculate the cost of exercising the executive option plans instead of the stated terms of Symbol's option plans and without the approval of the board or public disclosure, and also used improper "look-back" practices to benefit himself and directly instructed his staff to backdate SEC forms, including Forms 4, registration

investigations pending as of March 23, 2007, more such actions are to be expected.[30] Anyone in the chain of action in granting a backdated option is subject to scrutiny,[31] including outside directors on compensation committees[32] and general counsel.[33] Plaintiffs' lawyers have filed numerous derivative and class action lawsuits.[34]

- Business Combinations. Most agreements for the sale of a business via merger, stock sale or asset sale require the seller to make representations regarding the financial statements[35] of the business, the absence of any material adverse change in the business or condition (financial or other) of the issuer (*"MAC"*),[36] and its compliance with applicable laws,[37] and

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statements and proxy statements); SEC v. Gregory L. Reyes, et al, Litigation Release No. 19768 (July 20, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19768.htm (SEC and DOJ civil and criminal complaints alleged former chief executive officer, chief financial officer and vice president of human resources of Brocade Communications Systems, Inc. caused Brocade to issue in the money backdated stock options to both new and current employees between 2002 and 2004, thus concealing millions of compensation expenses from investors); SEC v. Jacob "Kobi" Alexander, et al, Accounting and Auditing Release No. 2472 (August 9, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19796.htm, in which the former chief executive officer, chief financial officer and general counsel of Comverse Technology, Inc. were charged in civil and criminal actions with a decade long fraudulent scheme to grant options backdated to coincide with historically low closing prices of Comverse common stock and to use a slush fund of backdated options to be granted first to fictitious employees and later to new key hires.

30 *See* Options Scorecard, Wall Street Journal Online (March 23, 2007), available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

31 Eric Dash, *Who Signed Off on Those Options?*, N.Y. Times, August 27, 2006.

32 SEC Commissioner Roel C. Campos, How to be an Effective Board Member, speech at the HACR Program on Corporate Responsibility, Boston, MA (Aug. 15, 2006), *available at* http://www.sec.gov/news/speech/2006/spch081506rcc.htm, in which he said, "[I]f the facts permit – and I want to emphasize that all our Enforcement cases are very fact-specific – it wouldn't surprise me to see charges brought against outside directors."

33 Alan R. Bromberg and Lewis D. Lowenfels, *Backdating Stock Options—Effects Upon In-House Corporate Counsel*, 39 BNA Sec. Reg. & Law Rept. No. 11 at 436 (March 19, 2007); Petra Pasternak, In-House Counsel Vulnerable to Options Backdating Inquiries, The Recorder (August 14, 2006), 2006 Texas Lawyer Online, *available at* http://www.texaslawyer.com. *See* SEC Seen Likely to Look at Role Of Lawyers in Stock Option Investigations, 38 BNA Sec. Reg. & Law Rept. No. 26 at 1118 (June 26, 2006) ("SEC has greatly stepped up the number of enforcement actions its brings against lawyers, accountants, and other 'gatekeepers' since the implosion of Enron. * * * [T]he SEC expects attorneys to understand wrongdoing is when a company has used a side letter to conceal a specific term of a deal from its auditors . . . [I]n ongoing investigations regarding the backdating of stock options, . . . the SEC will be interested in knowing 'what lawyers knew and said about the fact that some companies were dating the options as of a date different from the grant date'").

34 Julie Creswell, *One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal*, The N.Y. Times, September 5, 2006 (author counts 57 derivative actions and 15 class actions to September 5, 2006 based on options backdating).

35 ABA Model Asset Purchase Agreement with Commentary (2001) § 3.4. *See*, Byron F. Egan and H. Lawrence Tafe, III, *Private Company Acquisitions* (October 16, 2007) – Financial Statements, at 81-86, available at http://www.jw.com/site/jsp/publicationinfo.jsp?id=839.

36 *Id*. at § 3.15.

37 *Id*. at § 3.17.

condition the closing of the transaction on the correctness of the representations[38] and the absence of any MAC. The negotiation and documentation of such a transaction will require seller to make disclosures regarding its option backdating exposure,[39] which in turn might result in the

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38 *Id*. at § 7.1.

39 On July 25, 2006, Hewlett-Packard Company (*"HP"*) filed a Form 8-K Report with the SEC announcing that it had entered into an Agreement and Plan of Merger dated August 25, 2006 with Mercury Interactive Corporation (*"Mercury"*). Mercury had made various public statements regarding ongoing investigations into its option granting practices. To make exception for these investigations and a related restatement of its financial statements, the HP/Mercury merger agreement definition of the term "Company Material Adverse Effect" in § 1.1 contained a broad carve-out for Mercury's option situation, including accounting and tax aspects, which read as follows:

> "(ix) (A) actions, claims, audits, arbitrations, mediations, investigations, proceedings or other Legal Proceedings (in each case whether threatened, pending or otherwise), (B) penalties, sanctions, fines, injunctive relief, remediation or any other civil or criminal sanction (in each case whether threatened, pending, deferred or otherwise, and whether financial or otherwise), or (C) facts, circumstances, changes, effects, outcomes, results, occurrences and eventualities (whether or not known, contemplated or foreseeable, and whether financial or otherwise), in each case with respect to (A) through (C), resulting from, relating to or arising out of: (1) the Company's restatement of its historical consolidated financial statements for the fiscal years ended December 31, 2002, 2003 and 2004 (the *"Restatement"*), the matters referred to in Item 9A, Note 3 or Note 19, or the Company's pending restatement of the unaudited financial statements contained in its quarterly report on Form 10-Q for the quarter ended March 31, 2005; (2) the Company's failure to file in a timely manner its Annual Report on Form 10-K for the fiscal year ended December 31, 2005, the Quarter Reports on Form 10-Q for the quarters ended March 31, June 30, and September 30, 2006; or (3) the Company's historical stock-based compensation practices, including with respect to the grant of stock options and the purchase of Company stock by employees; the recording of, accounting for and disclosure relating to the stock option grants and the purchase of Company stock purchases by employees, remedies determined by the Company's Special Committee or Special Litigation Committee of the Company Board or the Company Board relating to the Company's investigation of such stock-based compensation or in connection with the Restatement, and the Company's tax practices with respect to such compensation practices, including the grant of stock options and the purchase of Company stock by employees."

The HP/Mercury merger agreement representations and warranties were typical and did not make any other special provision. Mercury's disclosure schedule, which is not publicly available, likely listed exceptions to Mercury's representations and warranties to deal with its options issues.

On July 31, 2006, Sandisk Corp. (*"SDC"*) filed a Form 8-K Report with the SEC announcing that it had entered into an Agreement and Plan of Merger dated as of July 31, 2006 pursuant to which it would acquire msystems Ltd. (*"msystems"*). On July 13, 2006, msystems had announced that its board of directors had determined that the actual measurement dates of certain past stock option grants differed from the previously recorded measurement dates. The SDC/msystems merger agreement included in the definition of "Material Adverse Change" in § 8.7 the following reference to an options issue: "with respect to the Company, the matters described in Section 8.7(f) of the Company Disclosure Letter (the 'Options Matters')." The representations and warranties of msystems were typical and were all qualified by reference to matters disclosed in the Company Disclosure Letter, which would have contained any qualifications relating to the "Options Matters."

waiver of any attorney-client privilege that might otherwise protect the confidentiality of the information.[40]

- D&O Insurance. Options backdating investigations and litigation are causing affected issuers, officers and directors to hire counsel (often separate counsel because of differing exposures and defenses), and to focus on indemnification and advancement of expenses of defense from the issuer pursuant to applicable indemnification contracts and provisions in the issuer certificate of incorporation and bylaws and applicable state laws.[41] They will also be reviewing the issuer's director and officer insurance policies (*"D&O Policies"*).[42] D&O Policies are typically written on a "claims made" basis which requires prompt notice within the policy period of any claim which the insurer will be asked to pay or defend. The applicable definitions of covered "claims," "wrongful acts"[43] and "losses" will vary. D&O Policies typically contain representations regarding the correctness of the issuer's financial statements and SEC filings, which could be breached by the very options backdating that results in the claim for which insurance protection is sought.[44] Many D&O Policies also contain a personal-profit exclusion which precludes coverage when "an insured has in fact gained any personal profit, remuneration or advantage to which the insured was not legally entitled," and which could be applicable to claims related to options backdating.[45] Some more recent D&O Policies are including specific exclusions for claims arising out of the issuance or use of stock options, which would preclude

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40 § 12.6 of the ABA Model Asset Purchase Agreement with Commentary (2001) is a provision for an asset purchase agreement to the effect the parties do not intend to waive any attorney-client or work product privilege and the related Comment discusses the effect of such a provision in different circumstances. *See*, Byron F. Egan and H. Lawrence Tafe, III, *Private Company Acquisitions* (October 16, 2007) – Attorney-Client Privilege, at 199-203, available at http://www.jw.com/site/jsp/publicationinfo.jsp?id=839.

41 *See*, e.g. Texas Business Corporation Act art. 2.02-1, Texas Business Organizations Code §§ 8.001 et seq., and Delaware General Corporation Law § 145.

42 Liam Pleven, *Options Timing Raises Concerns Among Insurers – Probes Could Shake Up Coverage For Company Officials' Liability; Bracing for a Slew of Claims*, WALL ST. J., June 20, 2006, at C1.

43 Latham & Watkins Litigation Department Client Alert, No. 519 (June 27, 2006), *available at* http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=1592:

> [T]he term "Wrongful Act" is frequently defined to include any actual or alleged error, misstatement or action or failure to act in connection with the company's regular activities.
>
> In recent years, however, some insurers have been changing their policy definition of "Wrongful Act" to include only *negligent* acts or omissions. If the policy is so limited, the carrier may deny coverage on the ground that the option dating was an intentional act and therefore any claim against the director or officer based on it falls outside the policy's coverage. *See, e.g., Oak Park Calabasas Condominium Assn. v. State Farm Fire and Cas. Co.*, 137 Cal. App. 4th 557 (Cal. App. 2 Dist. 2006) (holding that language of D&O liability insurance coverage grant applied only to negligent acts and omissions).

44 Daniel K. Winters, *Obtaining Insurance Coverage for Stock-Option Backdating Investigations and Suits*, 22 No. 5 Andrews Corp. Off. & Directors Liab. Litig. Rep. 3 (September 7, 2006).

45 *Id*.

claims related to options backdating.[46] Whether any of the possible D&O Policy coverage defenses or exclusions would be applicable is a very policy provision and fact specific analysis whose result will vary from issuer to issuer.

Spring-Loading. Some issuers have granted options immediately before the release of information that the issuer believed would be favorable to its share price, which may create legal or reputational risks and raise concerns about the issuer's control environment. There is a debate about the propriety of spring-loading,[47] with SEC Commissioner Paul S. Atkins arguing that a board of directors can exercise informed business judgment to grant options ahead of what is expected to be favorably received and noting that a board is almost always in possession of some material non-public information.[48] Former SEC Chief Accountant Lynn E. Turner has argued that spring-loading inevitably results in financial statements not conforming to GAAP because the options were issued at less than fair market value because the market price at grant did not reflect the undisclosed information, which would make the issuer's representations to its auditors false and its SEC disclosures misleading.[49] The SEC staff, however, suggested that neither bullet-dodging nor spring-loading would require any adjustment in the "market price of a share of the same class that trades freely in an established market" for the purposes of measuring compensation costs.[50]

Matters for Auditor Consideration Under the Alert. The Alert cautioned that auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its internal controls. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow the auditor to assess the nature and potential magnitude of these risks, and use professional judgment in making these assessments and in determining whether to apply additional procedures in response. In making these judgments, the PCAOB Alert said that auditors should be mindful of the following:

Applicable Financial Accounting Standards. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the Alert states that the auditor should determine the GAAP in effect in those periods and to consider the specific risks associated with these principles.

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46 Latham & Watkins Litigation Department Client Alert, No. 519 (June 27, 2006), *available at* http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=1592.

47 Kara Scannell, Charles Forelle and James Bandler, *Can Companies Issue Options, Then Good News? – SEC Is Divided on Practice Known as 'Spring Loading;' Critics See 'Insider Trading'*, Wall St. J., July 8-9, 2006, at A1.

48 SEC Commissioner Paul S. Atkins, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm, at 5-7.

49 Prepared Statement of Lynn E. Turner, then SEC Chief Accountant, before U.S. Senate Committee on Banking, Housing, and Urban Afairs Hearing on: Stock Options Backdating on September 6, 2002.

50 SEC Options Guidance at p. 9.

- *Accounting for Discounted Options*. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method under FAS No. 123 R, the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.

- *Accounting for Variable Plans*. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date, may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost under FAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.

- *Accounting for Contingencies*. If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, *Accounting for Contingencies*, may require that the issuer record additional cost or make additional disclosures in financial statements.

- *Accounting for Tax Effects*. The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of Materiality. In evaluating materiality, the Alert cautioned auditors to remember that both quantitative and qualitative considerations must be assessed.[51] The Alert cautioned that quantitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability and that, in all cases, auditors should evaluate the adequacy of related issuer disclosures.

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[51] See paragraph .11 of AU § 312, *Audit Risk and Materiality in Conducting an Audit*, and SEC Staff Accounting Bulletin: No. 99 – *Materiality*.

Possible Illegal Acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable auditing requirements[52] and § 10A of the 1934 Act, which requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred…."[53] If it is likely that an illegal act has occurred, the registered public accounting firm must "determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages." The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed "unless the illegal act is clearly inconsequential." The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

Effects of Options-related Matters on Planned or Ongoing Audits. In planning and performing an audit of financial statements and internal controls, the Alert cautioned the auditor to assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives --

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in internal controls related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
    - The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
    - The results of direct inquiries of members of the issuer's management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
    - Public information related to the timing of options grants by the issuer.
    - The terms and conditions of plans or policies under which options are granted; in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to management. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.

52 *See* AU § 317, *Illegal Acts*.

53 *See* "I. Pressure on Auditors to Detect Corporate Fraud – Accountant Duties Under 1934 Act Section 10A" in Byron F. Egan, "*Communications with Accountants After the Sarbanes-Oxley Act (including Attorney Letters to Auditors re Loss Contingencies, Attorney Duties under SOX §§ 303 and 307, and Options Backdating)*," at 7, available at http://www.jw.com/site/jsp/publicationinfo.jsp?id=624.

        - Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high in relation to shares outstanding, situations in which option-based compensation is a large component of executive compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, or high levels of stock-price volatility.

    - In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:

        - In addition to the general planning considerations for financial statement audits, the auditor was advised to consider:

            - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud; the potential for illegal acts; or the assessment of an issuer's internal controls.

            - The scope of procedures applied to assess the potential for fraud and illegal acts.

        - The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options, including:

            - The need for specific management representations related to these matters[54] and **the nature of matters included in inquiries of lawyers**.[55]

            - Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.

            - The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits[56] the Alert advised the auditor to consider the implications of identified or potential accounting and legal risks related to options in planning, performing and reporting on audits of internal controls. In addition, the results of the audit of internal controls should be considered in connection with the related financial statement audit.

Auditor Involvement in Registration Statements. In cases where an auditor is requested to consent to the inclusion of a report (including a report on internal controls) in a

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[54] *See* AU § 333, *Management Representations*.

[55] *See* AU § 337, *Inquiry of a Client's Lawyer*.

[56] See PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (*"AS No. 2"*).

registration statement under the 1933 Act, the Alert reminds the auditor to perform certain procedures prior to issuing such a consent with respect to events subsequent to the date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances), including inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading with particular consideration to inquiries and representations specifically related to the granting and recording of option grants.[57] In the case of a predecessor auditor that has been requested to consent to the inclusion of a report on prior-period financial statements in a registration statement, the predecessor auditor should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor was instructed to follow specified procedures.[58] If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor is admonished to refer to existing guidance.[59]

Effects of Option-related Matters on Previously Issued Opinions. If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, the auditor may be required to take specified actions.[60]

New Executive Compensation Rules. The 2006 Executive Compensation Rules require that proxy statements filed with the SEC after December 15, 2006 contain a new narrative disclosure section called "Compensation, Discussion and Analysis" (*"CD&A"*), which is intended to address a number of key compensation question, including information about the time and pricing of option grants. The 2006 Executive Compensation Rules require disclosure of company programs, plans and practices relating to the granting of options, including in particular the timing of option grants in coordination with the release of material non-public information and the selection of exercise prices that differ from the underlying stock's price on the grant date, including:

- Tabular presentations of option grants including:

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57 *See* AU § 711, *Filings Under Federal Securities Statutes*.

58 *See* ¶s .21 and .22 of AU § 315.

59 *See* AU § 711.

60 *See* AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

    - The grant date fair value;
    - The FAS 123R grant date;
    - The closing market price on the grant date if it is greater than the exercise price of the award; and
    - The date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.

    Further, if the exercise price of an option grant is not the grant date closing market price per share, the rules will require a description of the methodology for determining the exercise price.

- The CD&A must contain narrative disclosure about option grants to executives. Companies are required to analyze and discuss, as appropriate, material information such as the reasons a company selects particular grant dates for awards or the methods a company uses to select the terms of awards, such as the exercise prices of stock options.
- With regard to the timing of stock options in particular, companies are called upon to answer questions such as:
    - Does a company have any program, plan or practice to time option grants to its executives in coordination with the release of material non-public information?
    - How does any program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice, if any, with regard to option grants to employees more generally?
    - What was the role of the compensation committee in approving and administering such a program, plan or practice? How did the board or compensation committee take such information into account when determining whether and in what amount to make those grants? Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
    - What was the role of executive officers in the company's program, plan or practice of option timing?
    - Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?
    - Does a company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Disclosure is also be required where a company has not previously disclosed a program, plan or practice of timing option grants to executives, but has adopted such a program, plan or practice or has made one or more decisions since the beginning of the past fiscal year to time option grants.

- Similar disclosure standards apply if a company has a program, plan or practice of awarding options and setting the exercise price based on the stock's price on a date other than the actual grant date or if the company determines the exercise price of option grants by using formulas based on average prices (or lowest prices) of the company's stock in a period preceding, surrounding or following the grant date.

Appendix C

Summary of SEC Executive Compensation Disclosure Rules

Summary

On July 26, 2006, the SEC adopted sweeping changes to its rules for disclosing compensation of executive officers and directors of public companies, information about related person transactions, director independence and other corporate governance matters (the "*compensation disclosure rules*" or the "*rules*").[1] The SEC also adopted changes to its Form 8-K disclosure requirements relating to management contracts and compensatory plans, contracts and arrangements.

These new SEC compensation disclosure rules are divided into five primary areas:

- Compensation Discussion and Analysis ("*CD&A*") and a new form of Compensation Committee Report.
- Compensation of named executive officers ("*NEOs*") for the last fiscal year (and the two preceding fiscal years).
- Grants of equity-related (and incentive plan) interests to NEOs, holdings of outstanding equity-related interests and realization on equity-related interests.
- Retirement plans, deferred compensation and other post-employment payments and benefits for NEOs.
- Director compensation.

The rules continue to rely heavily on tabular disclosure of executive compensation, and now the tables are supplemented with extensive narrative disclosure. New narrative disclosures include CD&A. In addition, supplemental footnotes to the tables and discussions are designed to give context to the quantitative tabular disclosures.

With the rules, the SEC is seeking to ensure that all elements of compensation are disclosed in plain English,[2] and that they are disclosed in a manner that facilitates

[1] SEC Release No. 33-8732 was made available on August 11, 2006 and can be found at www.sec.gov/rules/final/2006/33-8732.pdf, which was modified by SEC Release No. 33-8765 effective December 22, 2006 and can be found at http://www.sec.gov/rules/final/2006/33-8765.pdf.

[2] SEC Chairman Christopher Cox in his Closing Remarks to the Second Annual Corporate Governance Summit at USC Marshall School of Business, Los Angeles, California on March 23, 2007, which can be found at http://www.sec.gov/news/speech/2007/spch032307cc.htm, criticized the "Legalese" found in CD&A disclosures reviewed by the SEC staff to date and commented:

meaningful comparisons from company to company and from year to year. It is also seeking to make executive compensation information easier to understand in order to provide investors with a clearer and more complete picture of the compensation paid to executives and directors.

Effective Dates

Amendments to Form 8-K—effective for triggering events occurring on or after November 7, 2006.

Other Changes—apply to years ending on or after December 15, 2006:

- Proxy statements filed on or after December 15, 2006 that are required to include executive compensation and related person disclosure for fiscal years ending on or after December 15, 2006.

- Form 10-Ks for fiscal years ending on or after December 15, 2006.

- Registration statements (including pre- and post-effective amendments) filed on or after Dec. 15, 2006 that are required to include executive compensation and related person disclosure for fiscal years ending on or after December 15, 2006.

For starters, the executive pay disclosures in the study were verbose. We had it in mind that they'd be just a few pages long, but the median length for the CD&As was 5,472 words – over 1,000 words more than the U.S. Constitution.

* * * * *

You will not be surprised to hear that prospectuses and proxy statements used to be shorter, and less cumbersome. The accretion of detail that comprises today's much longer investor disclosures took time. Whereas in 1934 securities lawyers were writing on an essentially blank slate when it came to compliance, today we have the benefit of seven decades of judicial common law, regulatory interpretations, congressional enactments, and industry standards. Increasingly in recent years, the omnipresent threat of litigation, which can instill a healthy fear into managers of other people's money when conscience is insufficient, has had a decidedly unhealthy influence on the writing style in disclosure documents. That's because slowly but surely, the main purpose of the drafting exercise has shifted from informing investors to insuring the issuer and the underwriter against potential claims. In the process, the jargon of lawyers has taken over.

The lawyer's understandable concern, of course, extends not only to the full disclosure of all material facts – in that the SEC wholly concurs – but equally if not more strongly, to the recital of magic words from court opinions, rules, and regulations that have definitively addressed some topic or other. I think we've all observed that there is a near-religious scrupulousness in this adherence to "legally correct" language. If a competitor in the same industry has faced a disclosure issue that has survived a court test, by all means someone in the company's legal department will want to mimic the very phrases. Choosing words to describe the company's business that no other company has used in exactly the same way is thought to be indefensibly risky.

And so the overarching purpose seems no longer to be informing the investor, but above all else erecting a sturdy defense against potential claims that something was left out or improperly expressed. Rather obviously, the result of all this is not plain English.

Three-year phase-in—no requirement to restate Item 402 or 404 disclosure for prior years:

- For 2006, present only 2006 information;
- For 2007, present 2 years of information; and
- For 2008 and thereafter, present 3 years.

Compensation Discussion and Analysis

The CD&A must address all compensation awarded to, earned by or paid to NEOs.

CD&A to provide context to accompanying tabular disclosures. It is filed with, not furnished to, the SEC, which means it is covered by SOX §§302 and 906 CEO and CFO certifications.

The CD&A discussion must explain all material elements of a company's compensation decisions, policies and programs and must address the following six principal topics:

- Objectives of the compensation programs;
- What the programs are designed to reward;
- Elements of compensation;
- Reason for each element;
- How company determines the amount (and, where applicable, the formula) of each element; and
- Relationship of each element to others and to overall compensation objectives.

Examples of matters to address in CD&A:

- Policies for allocating among the following;
    - long-term and current compensation;
    - cash and non-cash compensation and among different forms of non-cash compensation;
    - for long-term compensation, each different form of award;
- How the determination is made as to when awards are granted;

- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;

- How specific elements of compensation are structured and implemented to reflect the company's performance and the executive's individual performance;

- Address not only whether discretion can be exercised (e.g., to award compensation despite not reaching performance goal, reduce or increase size of award in payout, etc.), but also whether discretion has been exercised;

- The factors considered in decisions to increase or decrease compensation materially;

- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation;

- The impact of accounting and tax treatments of a particular form of compensation;

- The company's equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership;

- Whether the company benchmarks compensation, identifying the benchmark and, if applicable, its components (including component companies);

- The role of executive officers in the compensation process;

- Policies and procedures regarding adjustment or recovery of awards/payments if company performance measures are adjusted or restated; and

- Basis for selecting particular events as triggering payment under post-termination agreements.

Analysis, not Process:

- Focus on <u>analysis</u> of compensation elements and numbers in a way that gives shareholders a window into directors' thinking when they make compensation decisions.

- Process and procedures of compensation committee disclosed in a different location:

- Compensation committee calendar (when and how meetings are held, when salary and incentive targets were established, and when payouts were determined); and

- Information-input process that led to decisions made at each meeting.

Separate Discussion of each NEO—must identify differences in compensation policy and decisions for each NEO, not just CEO.

Time Period—must cover last fiscal year (but may need to discuss pre and post actions to provide context and fair disclosure).

Performance Targets–-need not include specific target levels if competitively harmful (but then must disclose difficulty or likelihood of achieving target).

Elements: Analyze each of the elements of NEO compensation in relation to the whole and how they operate together to meet program's objectives.

Policies: No longer sufficient to just set forth policies. For example, company policy about Section 162(m) compliance or providing tax gross-ups should include disclosure regarding the following in the CD&A:

- Actual material outcomes with respect to the NEOs (i.e., who will receive what amounts, and the additional costs from lost tax deductions); and

- Describe how these amounts affected the compensation committee's decisions (i.e., (a) whether these additional amounts factored into the calculation of the executive's total compensation at the time it was approved, and (b) the justification for the additional compensation and costs).

Analytical Tools: address the tools that the compensation committee utilized, such as tally sheets, wealth accumulation analyses, and internal pay equity studies and describe findings and resulting actions taken.

Benchmarking:

- Disclose not only whether a certain percentile is targeted, but also whether the total compensation paid actually differed from the stated policy.

- Where surveys are referenced, the disclosure will have to take much more care in analyzing the data, not just with peer groups, but with the total compensation delivered to, and accumulated by, a given executive.

- To counter over-reliance on external survey data disclosure whether the company undertook its own internal pay studies and how it factored-in the findings.

Compensation Discussion and Analysis Option Granting Practices

SEC expressly stated that the CD&A must discuss the process for awarding stock options including the timing and pricing of awards.

Matters companies should address:

- Does company time grants in coordination with release of material non-public information?
- How does timing of grants to executives fit in context of grants to employees generally?
- What is compensation committee's role in approving such grants? Did the committee delegate any aspects of the administration of such grants to any other person?
- What is executive officers' role in option timing?
- Are option grant dates for new executive officers coordinated with release of material information?
- Does company set exercise price based on stock price on a date other than actual grant date?

Compensation Committee Report

Streamlined report:

- Whether committee has reviewed and discussed CD&A with management.
- Whether, based upon this discussions, the committee recommends inclusion of CD&A in the Form 10-K and proxy statement.
- Name of each committee member below report.
- Furnished not filed.

Named Executive Officers

Named Executive Officers include the following:

- Principal executive officer (anyone serving during fiscal year);
- Principal financial officer (anyone serving during fiscal year);
- 3 other most highly paid executive officers who were employed at year end whose compensation exceeded $100,000; and

- Up to 2 additional persons for whom disclosure would have been required but for the fact no longer serving as executive officer at end of year.

Determination of NEO Status—Based on total compensation for last year, excluding increase in pension values and above market or preferential earnings on nonqualified deferred compensation (column (h) of new Summary Compensation Table).

Summary Compensation Table

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
NEOs									

Salary – cash & non-cash earned during year

Bonus – cash & non-cash earned during year (includes discretionary bonuses and bonuses paid on satisfaction of performance goals if performance target is not pre-established and communicated, or the outcome is not substantially uncertain).

Stock and Option Awards – dollar value of stock and option awards granted to NEO. Value is cost allocated to fiscal year under SFAS 123R (i.e., over requisite service period):

- For service-based vesting, assume requisite service requirements will be met. If NEO fails to meet requirements, compensation cost previously disclosed will be deducted in year in which forfeiture occurs; and

- For performance-based vesting, disclose compensation cost if it is probable that performance condition will be achieved.

Non-equity Incentive Plan Compensation – all earnings for services performed during the year pursuant to awards under non-equity incentive plans (incentive plan with awards that do not fall within the scope of SFAS 123R) and all earnings on outstanding awards (include bonuses paid on satisfaction of performance goals if outcome is substantially uncertain and performance target is communicated to executive); disclose in year in which performance criteria are achieved and compensation is earned.

Change in Pension Value and Nonqualified Deferred Comp. Earnings – annual increase (if any) in actuarial value of defined benefit and actuarial pension plans and above market or preferential earnings on nonqualified deferred compensation; disclose in footnote identification and quantification of amount of each element.

Summary Compensation Table: All Other Compensation Column

All Other Compensation includes but not limited to:

- Perquisites and other personal benefits, unless aggregate amount is less than $10,000;
- Tax gross-ups and reimbursements;
- Company securities purchased at discount unless discount is generally available to shareholders or employees;
- Amount paid or accrued pursuant to termination or change in control arrangements;
- Company contributions to defined contribution plans;
- Life insurance premiums paid by company;
- Dividends or other earnings paid on stock or option awards if not factored in value of awards; and
- Each item in All Other Comp Column (other than perks and personal benefits) must be identified and quantified in footnote if item exceeds $10,000.

Separate tabular disclosure recommended but not required:

Name	Perquisites ($)	Tax Reimburse-ments ($)	Insurance Premiums ($)	Company Contributions to DC Plans ($)	Severance Payments/ Accruals ($)	Change in Control Payments/ Accruals ($)
NEOs						

Summary Compensation Table: All Other Compensation Column—Perquisites

Perquisites and personal benefits:

- Each item must be identified in a footnote, unless aggregate value of perquisites is less than $10,000.
- Must be quantified in footnote if value is greater of $25,000 or 10% of total perquisites for NEO.
- An item is <u>not</u> a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties (needs item to do the job).

- Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the registrant, unless it is generally available on a nondiscriminatory basis to all employees.

- Value at incremental cost to the company.

- Footnote disclosure of method used to calculate incremental cost.

Interpretive guidance

- No disclosure of items integrally and directly related to performance of NEO's duties:

  - Narrow concept;

  - Office space at a company business location;

  - Reserved parking space closer to business facilities but not otherwise preferential;

  - Additional secretarial services devoted to company matters;

  - Travel to and from business meetings;

  - Business entertainment;

  - Security during business travel; and

  - Itemized expense accounts limited to business purposes.

Must disclose any item that confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for convenience of the company (unless generally available on a non-discriminatory basis to all employees):

- Club memberships not used exclusively for business purposes;

- Personal financial or tax advice;

- Personal travel using vehicles or other property owned or leased by the company;

- Housing and other living expenses (including relocation assistance);

- Personal security services;

- Commuting expenses;
- Discounts on company products not generally available to employees on a non-discriminatory basis; and
- Additional secretary services devoted to personal matters.

Tables Relating to Plan-Based Awards   Grants of Plan-Based Awards Table

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/Sh)	Grant Date Fair Value of Stock and Option Awards
		Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)				
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)

- Grants made to NEOs during last fiscal year.
- Must disclose each grant by separate line item.
- If grant date (as determined under SFAS 123R) differs from date compensation committee or board takes action, add separate column between columns (b) and (c) for such date.
- If option exercise price is not closing market price on date of grant, must explain in a footnote how exercise price was determined and add a column after column (k) showing market price on date of grant.
- Grant Date Fair Value is determined per SFAS 123R.

Tables Relating to Plan-Based Awards   Additional Narrative Disclosure

Narrative Disclosure. Provide a narrative disclosure following the Summary Compensation Table and the Grants of Plan-Based Awards Table of any material factors necessary to an understanding of the information disclosed in the tables, such as:

- Material terms of NEO’s employment agreements;
- Option repricings or material modifications; and

- Material terms of awards, including formula for determining amounts payable, dividend rates on stock (if any), vesting schedule, material conditions.

Tables Relating to Plan-Based Awards Outstanding Equity Awards at Fiscal Year-end

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)

- Separate column disclosure for exercisable options, unexercisable options, unexercisable unearned options, RSU's and similar instruments.

- Separate line-item disclosure of each award, except where expiration date and exercise price identical.

- For equity incentive plan awards, must show number of shares (columns (d) and (i)) and value (column (j)) based on achieving threshold performance goals.

- "Unearned" awards refer to performance-based awards where performance threshold has not been achieved.

- Vesting dates disclosed by footnote.

Tables Relating to Plan-Based Awards Option Exercises and Stock Vested Table

	Option Awards		Stock Awards	
Name	Number of Shares Acquired On Exercise (#)	Value Realized On Exercise ($)	Number of Shares Acquired On Vesting (#)	Value realized On Vesting ($)
NEOs	(b)	(c)	(d)	(e)

- Amounts received upon exercise of options or vesting of stock or similar instruments during last fiscal year.

- Value realized on exercise of option is market price less exercise price, multiplied by number of securities acquired.
- Value realized on vesting of restricted stock is market value times number of securities vested.
- Value realized for any related payment provided by company should be included in All Other Compensation and not in this table.
- Deferrals disclosed by footnote.

Tables Related to Post-Employment Payments and Benefits Pension Benefits Table

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit ($)	Payments During Last Fiscal Year ($)
(a)	(b)	(c)	(d)	(e)

- Replaces current pension plan table.
- Includes tax qualified defined benefit and actuarial benefit plans.
- Does not include nonqualified defined contribution plans and nonqualified deferred compensation plans (reported in Nonqualified Deferred Compensation table).
- Number of years credited and actuarial present value of accumulated benefits under each plan providing post-retirement benefits (computed using same assumptions as for audited financials).
- Separate line item for each plan.
- Narrative description of material terms and factors necessary to understand each plan, as well as valuation method and material assumptions used in determining present value (can refer to discussion of such in financial statements).
- Footnote disclosure if number of years of credited service is different from number of actual years of service.

Tables Related to Post-Employment Payments and Benefits Nonqualified Deferred Compensation

Name	Executive Contributions in Last FY ($)	Registrant Contributions in Last FY ($)	Aggregate Earnings in Last FY ($)	Aggregate Withdrawals/ Distributions ($)	Aggregate Balance at Last FYE ($)
(a)	(b)	(c)	(d)	(e)	(f)

- Contributions, earnings, withdrawals, distributions and balances under nonqualified defined contribution and other nonqualified deferred compensation plans.

- Do not include tax-qualified retirement plans (e.g. 401(k) plan benefits).

- Footnote disclosure of extent to which amounts reported are included in Summary Compensation Table in last year and in prior years.

- Narrative description of material factors necessary to understand plan disclosures, including types of compensation deferred, limits on deferrals, measures for calculating interest and plan earnings and other material terms.

Tables Related to Post-Employment Payments and Benefits Termination/Change-in-Control Payments

- Narrative disclosure of arrangements (written or unwritten) providing for payments to NEOs in connection with a termination (including resignation, severance, retirement), a change in control or a “change in responsibilities” of the NEO, including:

  - The specific circumstances that trigger payment of benefits;

  - The estimated payments payable upon the occurrence of <u>each triggering event</u>, including the form, duration and the source of such payments;

  - How the benefit levels under the various triggers are determined;

  - Any material conditions to receipt of the benefits, including but not limited to non-compete, nonsolicitation, non-disparagement or confidentiality agreements, including the duration of such agreements; and

  - Tax gross-ups, including golden parachute excise tax payments.

- Quantify payment amounts assuming triggering events occurred on last day of company’s fiscal year and price per company share is closing market price as of that day.

- If amounts uncertain, use estimates based on assumptions and disclose assumptions.

- Although not required, tabular disclosure could be used.

Director Compensation Table

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)

- Tabular disclosure similar to Summary Compensation Table.

- All Other Compensation includes consulting fees and director legacy and charitable award programs, along with all other compensation items for Summary Compensation Table.

- Can group directors together if all elements and amounts of compensation identical.

- Disclose only last fiscal year, not 3 years.

- Need not disclose compensation paid to NEO who is also director if disclosed in Summary Compensation Table with footnote regarding amounts that reflect director compensation.

- Footnote disclosure of aggregate numbers of equity awards outstanding at fiscal year-end and other material factors necessary to an understanding of compensation.

Related Party Transactions Disclosure

<u>Revisions</u>:

- Threshold increased from $60,000 to $120,000.

- “Participant” rather than “party.”

- Covers all related party transactions during the year, even if person is not a “related person” at year-end.

- Disclosure of compensation to an executive officer will not be required if:

  (i) the compensation is reported as previously described; or

  (ii) the executive officer is not an immediate family member and such compensation would have been reported as previously described if the executive officer was a named executive officer, and such compensation has been approved, or recommended to the Board for approval, by the compensation committee.

Policies and Procedures – disclose material features of policies and procedures for review or approval of reportable related party transactions. For example:

Types of related party transactions covered by such policies.

Standards to be applied pursuant to such policies.

Board members or committee responsible for applying such policies and procedures.

Whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

Non-Review or Non-Compliance

- Identify/disclose reportable transactions where policies and procedures do not require review or approval.
- Disclose where such policies and procedures have not been followed.

Performance Graph and Beneficial Ownership Table

- Performance Graph

  Moved from proxy statement to annual report to shareholders.

  Continues to be furnished rather than filed.

- Beneficial Ownership Table Disclosure

  Footnote disclosure to Beneficial Ownership Table of number of shares pledged as security by NEO's, directors and director nominees and directors and executive officers as a group. Pledged shares can include margin accounts.

Corporate Governance Disclosure

- Consolidates corporate governance disclosure requirements and director independence determinations.
- Director independence – must disclose:
  - Directors and director nominees identified as independent (and committee members who are not independent) using applicable stock exchange definition;

    - By specific category or type, any transactions not required to be disclosed that were considered by board in determining whether independence standard was met (specific details not required, but nature of relationship must be readily apparent on a director-by-director basis) (no dollar threshold); and

    - Disclosure required for anyone who was director during the year, even if no longer serving as director or standing for re-election

- Must describe the compensation committee's <u>processes</u> and <u>procedures</u> for the consideration and determination of executive and director compensation.

    - Scope of authority of compensation committee.

    - Extent to which compensation committee may delegate authority.

    - Role of executive officers in determining or recommending amount or form of executive and director compensation.

    - Role of compensation consultants in determining or recommending amount or form of executive and director compensation:

      (i) identify consultant;

      (ii) identify who engaged consultant;

      (iii) describe nature and scope of assignment; and

      (iv) material elements of instructions given to consultant.

    - State whether Compensation Committee has a charter:

        - If so, must state if on website; or

        - If not, must include with proxy statement every three years (or if materially amended during the year, then with next proxy statement).

New/Revised Form 8-K Disclosure

Executive compensation arrangements moved from Item 1.01 to Item 5.02. As a result, materiality no longer determined under S-K Item 601(b)(10)(iii) standard.

<u>Item 5.02(b)</u>: information regarding retirement, resignation or termination expanded to include named executive officers.

<u>Item 5.02(c) & (d)</u>: if covered officer or director is appointed, must describe any material plan, contract or arrangement (written or unwritten) entered into or

materially amended in connection with appointment and any related grant or award.

Item 5.02(e): for principal executive officer, principal financial officer and named executive officers (not directors):

> Description of any material new plan, contract, arrangement, award or grant; and
>
> Any material amendment thereto (can exclude grants, awards and amendments thereto if materially consistent with previous disclosure).

Item 5.02(f): must disclose salary, bonus and total compensation of NEO for last year if information wasn't available for proxy statement.