DIRECTOR AND OFFICER RESPONSIBILITIES REVISITED

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26TH ANNUAL CONFERENCE ON SECURITIES REGULATION AND BUSINESS LAW PROBLEMS

DALLAS, TEXAS • FEBRUARY 19, 2004

CO-SPONSORED BY: THE UNIVERSITY OF TEXAS SCHOOL OF LAW,
THE FORT WORTH DISTRICT OFFICE OF THE U.S. SECURITIES AND EXCHANGE COMMISSION,
THE TEXAS STATE SECURITIES BOARD, AND
THE BUSINESS LAW SECTION OF THE STATE BAR OF TEXAS

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Appendix A – Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., William C. Powers Chair, dated February 1, 2002

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

DIRECTOR AND OFFICER RESPONSIBILITIES REVISITED

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I. Introduction.

These are troubled times in parts of corporate America. The collapse of many dot.com companies was followed by the tragedy of September 11, 2001 and its after-shocks which hurt many businesses. Then came some high profile bankruptcies and related startling developments.

The conduct of directors and officers has long been scrutinized when the corporation was confronted with the prospect of a business combination, whether friendly or hostile, or when the corporation was charged with illegal conduct. These recent events have further focused attention on how directors and officers discharge their duties, particularly during times of corporate turmoil, and have caused much reexamination of how corporations are governed and how they relate to their shareholders.

The individuals who play leadership roles in corporations are fiduciaries in relation to the corporation and its owners. These troubling times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including the duties of care, loyalty and oversight. Those duties are generally owed to the corporation and its shareholders, but when the corporation is on the penumbra of bankruptcy and the shareholders have no equity remaining in the company, those duties may begin to shift to the new *de facto* owners of the business – the creditors.

The failure of Enron Corp.[1] and other corporate debacles resulted in renewed focus on how corporations should be governed and led to the Sarbanes-Oxley Act of 2002 (the "*SOB*")[2], which

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1 *See Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, William C. Powers Chair, dated February 1, 2002 (the "*Powers Report*") is attached at **Appendix A**.

2 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in several sections of 15 U.S.C.A.) ("*SOB*"); see Byron F. Egan, *The Sarbanes Oxley Act and Its Extraterritorial Reach* (October 3, 2003), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=247.

President Bush signed on July 30, 2002 and which was intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.[3]

While SOB 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.[4] Our focus will be in the context of companies organized under the Texas Business Corporation Act (as amended to date, the "*TBCA*") and the Delaware General Corporation Law (as amended to date, the "*DGCL*").

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

Both the TBCA and the DGCL provide that the business and affairs of a corporation are to be managed under the direction of its board of directors.[5] While the TBCA 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. In Texas, the fiduciary duty of a director has been characterized as including duties of loyalty, care, good faith and obedience.[6] In Delaware, the fiduciary duties include those of loyalty, care and good faith.[7] 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. The term "duty of disclosure," however, is somewhat of a misnomer because no separate duty of disclosure actually exists. Rather, as indicated, the fiduciary

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3 The SOB 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 SOB does have some specific provisions, and generally establishes some important public policy changes, it is being implemented in large part through rules adopted and to be adopted by the SEC. See Summary of the Sarbanes-Oxley Act of 2002 attached as **Appendix B**. Among other things, the SOB amends the Securities Exchange Act of 1934 (the "*1934 Act*") and the Securities Act of 1933 (the "*1933 Act*").

4 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.

5 TBCA art. 2.31 and DGCL § 141(a).

6 *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).

7 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("*Technicolor I*"); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

obligations of directors in the disclosure context involve a contextually-specific application of the duties of care, good faith, and loyalty.[8]

B. Applicable Law.

Under the internal affairs doctrine, courts in Texas apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.[9] Delaware also subscribes to the internal affairs doctrine. However, Delaware has a choice of law statute under which the parties can agree that internal matters ordinarily governed by the law of another state of incorporation will be resolved under the laws of Delaware in Delaware courts.[10]

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.[11] 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 which amplify *Gearhart* as they apply it in particular situations, such as lawsuits by the Federal Deposit Insurance Corporation ("*FDIC*") and the Resolution Trust Company ("*RTC*") arising out of failed financial institutions.[12]

1. Loyalty.

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.[13] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[14]

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8 *Malone v. Brincat*, 722 A.2d 5, 10 (Del 1998).

9 TBCA art. 8.02 and Texas Miscellaneous Corporations Act ("*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); *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Civ. App. - Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. dismissed*, 485 U.S. 944 (1988).

10 Del. Code Ann. Tit. 6, §2708; *see* Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 Del. J. Corp. L. 999 (1994).

11 *Gearhart*, 741 F.2d at 712-720; *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

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

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

14 *International Bankers Life Insurance Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1967).

Whether there exists a personal interest by the director will be a question of fact.[15] 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.[16]

The court in *Gearhart* summarized Texas law with respect to the question of whether a director is "interested":

> 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.[17]

2. ***Care (including business judgment rule).***

The duty of care in Texas requires the director to handle his duties with such care as an ordinary 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.[18]

In general, the duty of care will be satisfied if the directors' 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 *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.[19]

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15 *Id.* at 578.

16 *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).

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

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

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

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*,[20] 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.[21]

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."[22]

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."[23]

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 right or welfare of the person or persons to be affected by it."[24] In *Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[25]

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20 11 S.W. 846 (1889),

21 *Id.* at 849.

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

23 *FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *see also 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).

24 *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)).

25 844 F. Supp. at 306 n.7.

The business judgment rule 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.[26]

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."[27]

3. ***Good Faith.***

While *Gearhart* categorized good faith as an essentiality requirement for satisfying the duty of loyalty rather than a separate fiduciary duty, it remains an important component of a director's fiduciary obligations under Texas law. In *International Bankers Life Insurance Co. v. Holloway*,[28] the court indicated that good faith conduct requires a showing that the directors had "an intent to confer a benefit to the corporation." In the most recent case of *FDIC v. Harrington*,[29] 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." Due to the sparsity of Texas precedent on the good faith issue, Texas courts may draw from Delaware and other case law in defining the meaning of "good faith" conduct by directors.[30]

4. ***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.[31] 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*[32] 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 procedures, and by ratifying

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

27 TBCA art. 2.41D.

28 368 S.W. 2d 567 (Tex. 1967).

29 844 F. Supp. 300 (N.D. Tex. 1994).

30 *See* Section II.D.3 infra.

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

32 830 F. Supp. 351 (S.D. Tex. 1993).

loans that did not comply with state and federal regulations and Commonwealth's Bylaws."[33] 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.
>
> . . . .
>
> 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 . . . .[34]

D. Fiduciary Duties in Delaware Cases.

1. Loyalty.

In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."[35] 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.[36] 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.[37]

Importantly, conflicts of interest do not per se result in a breach of the duty of loyalty. Rather, it is the manner in which interested directors handle a conflict and the processes they invoke to insure fairness to the corporation and its stockholders that will determine the propriety of the

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

34 *Id.*

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

36 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("*Technicolor I*").

37 *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.

directors' conduct and the validity of the particular transaction.[38] 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 which benefited the majority stockholder to the detriment of the minority shareholders.[39]

2. ***Care.***

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.[40] Directors are not required, however, "to read in haec verba every contract or legal document,"[41] or to "know all particulars of the legal documents [they] authorize[ ] for execution."[42] Although a director must act diligently and with the level of due care appropriate to the particular situation, the Delaware courts have held that action (or inaction) will constitute a breach of a director's fiduciary duty of care only if the director's conduct rises to the level of gross negligence.[43]

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,

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38 Committee on Corporate Laws, Section of Business Law, American Bar Association, *Corporate Director's Guidebook Third Edition*, 56 The Business Lawyer 1571, 1584 (2001) (*"Director's Guidebook Third Edition"*).

39 *Crescent/Mach I Partners, L.P. v. Twiner*, 2000 Del. Ch. LEXIS 145 (2000) at note 50; *Strassburger v. Earley*, 752 A.2d 577, 581 (Del. Ch. 2000).

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

41 *Van Gorkom*, 488 A.2d at 883 n.25.

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

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

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.

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. In the seminal decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,[44] the Delaware Court of Chancery approved the settlement of a derivative action that involved claims that members of Caremark's board of directors breached their fiduciary duty of care to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes. In so doing, the court discussed the scope of a board of directors' 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.[45]

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

First, 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."[47] 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.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"[48] 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.

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44 698 A.2d 959 (Del. Ch. 1996).

45 *Id.* at 970.

46 *Id.*

47 *Id.* at 971.

48 *Id.* at 970.

Third, *Caremark* considered it obvious that "no rationally designed information system . . . will remove the possibility" that losses could occur.[49] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[50] 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.[51]

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.[52]

Significantly, DGCL § 141(e) provides protection to directors only if they have satisfied their fiduciary duty of good faith, which is discussed below.

The second statutory protection is DGCL § 102(b)(7) which allows a Delaware corporation to provide for limitations on (or partial elimination of) director liability in relation to the duty of care, and reads as follows:

> **102 CONTENTS OF CERTIFICATE OF INCORPORATION.**
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> * * *
>
> (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:
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> * * *

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49 *Id.*

50 *Id.* at 970 n. 27.

51 *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).

52 DGCL § 141(e).

> (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 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.[53]

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.[54] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, failures 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.[55] 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.[56]

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53 The Texas analogue to DGCL § 102(b)(7) is TMCLA art. 1302-7.06, which provides in relevant part:

> B. The articles of incorporation of a corporation may provide that a director of the corporation shall not be liable, or shall be liable only to the extent provided in the articles of incorporation, to the corporation or its shareholders or members for monetary damages for an act or omission in the director's capacity as a director, except that this article does not authorize the elimination or limitation of the liability of a director to the extent the director is found liable for:
>
> (1) a breach of the director's duty of loyalty to the corporation or its shareholders or members;
>
> (2) an act or omission not in good faith that constitutes a breach of duty of the director to the corporation or an act or omission that involves intentional misconduct or a knowing violation of the law;
>
> (3) a transaction from which the director received an improper benefit, whether or not the benefit resulted from an action taken within the scope of the director's office; or
>
> (4) an act or omission for which the liability of a director is expressly provided by an applicable statute.

54 DGCL § 102(b)(7).

55 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).

56 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

Caremark was followed by the Seventh Circuit applying Illinois law in *In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002), which involved a shareholders derivative suit against the health care corporation's directors, alleging breach of fiduciary duty and asserting that directors were liable under state law for harms resulting from a consent decree between 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 company 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 board of directors would be futile, the Seventh Circuit held that the complaints raised reasonable doubt as to whether directors' actions were product of valid exercise of business judgment, thus excusing demand requirement, and were sufficient to overcome directors' exemption from liability contained in articles of incorporation. 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 gross negligence 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:

> We find that the facts alleged are sufficient to show that although corporate governance practices were in place, the directors were grossly negligent in failing to inform themselves of all reasonably available material information.

Delaware law also states that director liability may arise for the breach of the duty to exercise appropriate attention to potentially illegal corporate activities from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."[57] The court held that "a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to [director] liability." *Id.* at 971. Although the present case does not deal with a claim of fraud like that in *In re Caremark*, with the extensive paper trail concerning the violations and the implied awareness of the problems in the SEC filings, it is clear that the directors either knew or should have known 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 the substantial losses incurred by the consent decree.[58]

The Seventh Circuit further held that the provision in the corporation's articles of incorporation limiting director liability[59] would not be applicable to facts alleged as the "plaintiffs'

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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 shareholder 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.

57 *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

58 393 F.3d at 389-390.

59 Abbott's Articles of Incorporation included the following provision limiting director liability:

complaint sufficiently alleges 'omissions not in good faith' and 'intentional misconduct' concerning 'violations of law,' which conduct falls outside of the exemption."[60]

3. 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."[61] 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.[62]

The duty of good faith was recognized as a distinct directorial duty in *Cede & Co. v. Technicolor, Inc.*[63] The duty of good faith requires that directors act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. While the Court's review requires it to examine the board's subjective motivation, the Court will utilize objective facts to infer such motivation. 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, including the recent *Disney* decision, suggest 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."

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 due care.[64] However, DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in

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> "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 . . . ."

393 F.3d at 390-391.

60 393 F.3d at 391.

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

62 *See In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003); 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).

63 634 A.2d at 361.

64 8 *Del. C.* §102(b)(7).

good faith or breaches of the duty of loyalty.[65] 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."[66] 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.[67] 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.[68]

Given the recent emphasis on director oversight, and in light of the recent wave of corporate scandals, the Delaware courts may be more willing to consider seriously claims of bad faith by otherwise disinterested directors who are alleged to have abdicated their responsibilities or acted in a manner contrary to their professed rational. As Chancellor Chandler's opinion in *Disney* confirms, however, Delaware courts continue to be extremely reluctant to impose liability on disinterested directors who make even modest attempts to fulfill their duty to make informed decisions regarding matters of importance to the corporation.

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

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65 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 . . .

66 8 *Del. C.* §§145(a) and (b).

67 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).

68 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.

may be."[69] To be held liable for a breach of fiduciary duty, "it will have to be concluded for each of the alleged breaches that [an officer] had the discretionary authority in a relevant functional area and the ability to cause or prevent a complained-of-action."[70] Derivative claims against officers for failure to exercise due care in carrying out their responsibilities as assigned by the board of directors 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 this regard, the Chancery Court's opinion in *In re The Walt Disney Co. Derivative Litigation*,[71] which resulted from the failed marriage between Disney and its former President Michael Ovitz, is instructive as to the duties of an officer.[72] 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, and was negotiated with Ovtiz's long time personal friend CEO Michael Eisner and without an active independent compensation committee process or the active involvement of a compensation consultant. His tenure as an officer was mutually unsatisfying, and a year later he was discussing with Eisner the terms of a no fault separation. In holding that a stockholder derivative complaint alleged facts sufficient to withstand a motion to dismiss, the Chancery Court wrote:

> Defendant Ovitz contends that the action against him should be dismissed because he owed no fiduciary duty not to seek the best possible employment agreement for himself. Ovitz did have the right to seek the best employment agreement possible for himself. Nevertheless, once Ovitz became a fiduciary of Disney on October 1, 1995, according to the new complaint, he also had a duty to negotiate honestly and in good faith so as not to advantage himself at the expense of the Disney shareholders. He arguably failed to fulfill that duty, according to the facts alleged in the new complaint.
>
> Ovitz and Eisner had been close friends for over twenty-five years. Ovitz knew when he became president of Disney on October 1, 1995, that his unexecuted contract was still under negotiation. Instead of negotiating with an impartial entity, such as the compensation committee, Ovitz and his attorneys negotiated directly with Eisner, his close personal friend. Perhaps not surprisingly, the final version of the employment agreement differed significantly from the draft version summarized to the board and to the compensation committee on September 26, 1995. Had those

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69 *See 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).

70 *Pereira v. Cogan*, 294 B.R. 449, 511 (SDNY 2003); 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.").

71 825 A.2d 275 (Del. Ch. 2003).

72 See the discussion of the *Disney* case in Section II.F.4.c below in respect of director duties when approving executive officer compensation.

changes been the result of arms-length bargaining, Ovitz's motion to dismiss might have merit. At this stage, however, the alleged facts (which I must accept as true) suggest that Ovitz and Eisner had almost absolute control over the terms of Ovitz's contract.

The new complaint arguably charges that Ovitz engaged in a carefully orchestrated, self-serving process controlled directly by his close friend Eisner, all designed to provide Ovitz with enormous financial benefits. The case law cited by Ovitz in support of his position suggests that 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*. The facts, as alleged in the new complaint, belie an adversarial, arms-length negotiation process between Ovitz and the Walt Disney Company. Instead, the alleged facts, if true, would support an inference that Ovitz may have breached his fiduciary duties by engaging in a self-interested transaction in negotiating his employment agreement directly with his personal friend Eisner.

The same is true regarding the non-fault termination. In that instance, Ovitz was also serving as a member of the Disney board of directors. The Supreme Court recently held in *Telxon Corp. v. Meyerson* that "directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation." According to the facts alleged in the new complaint, Ovitz did not advise the Disney board of his decision to seek a departure that would be fair and equitable to all parties. Instead, he went to his close friend, Eisner, and, working together, they developed a secret strategy that would enable Ovitz to extract the maximum benefit from his contract, all without board approval.

Although the strategy was economically injurious and a public relations disaster for Disney, the Ovitz/Eisner exit strategy allegedly was designed principally to protect their personal reputations, while assuring Ovitz a huge personal payoff after barely a year of mediocre to poor job performance. These allegations, if ultimately found to be true, would suggest a faithless fiduciary who obtained extraordinary personal financial benefits at the expense of the constituency for whom he was obliged to act honestly and in good faith. Because Ovitz was a fiduciary during both the negotiation of his employment agreement and the non-fault termination, he had an obligation to ensure the process of his contract negotiation and termination was both impartial and fair. The facts, as plead, give rise to a reasonable inference that, assisted by Eisner, he ignored that obligation.

A corporate officer is an agent of the corporation.[73] If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions.[74] The corporation may also be liable under *respondant superior*.

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

1. Overview.

Responding to problems in corporate governance, SOB and related changes to SEC rules and stock exchange listing requirements[75] have implemented a series of reforms that require all public companies[76] to implement or refrain from specified actions,[77] some of which are expressly

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73 *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).

74 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).

75 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.nasdaq.com/about/SECApproval%20Order_34-48745.pdf, pursuant to which the SEC approved the rule changes proposed by the NYSE and NASD to comply with SOB. These rule changes, which are discussed at greater length below, are generally effective for NYSE and NASDAQ listed companies, respectively, upon the earlier of their first annual meeting after January 15, 2004, or October 31, 2004. The effective date of the SRO rules discussed herein is July 31, 2005 for foreign private issuer's under both the NYSE Rules and the NASD Rules, as well as for small business issuers as defined in 1934 Act Rule 12b-2 under the NASD Rules. 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, and do not refer to such rules as they existed prior to their adoption by the SEC.

76 The SOB 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 SOB provisions apply only to companies listed on a national securities exchange (*"listed companies"*), such as the New York Stock Exchange (*"NYSE"*) 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 SOB generally in the same ways as larger companies although some specifics vary. SOB 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 SOB's directives provide limited relief from some SOB 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 <u>not</u> directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are <u>not</u> U.S. citizens or residents;
- More than 50% of the issuer's assets are <u>not</u> located in the U.S.; and;
- The issuer's business is <u>not</u> administered principally in the U.S.

77 *See* **Appendix B** and Byron F. Egan, *The Sarbanes Oxley Act and Its Extraterritorial Reach* (October 3, 2003), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=247.

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

2. Shareholder Causes of Action.

SOB 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.[78] 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 SOB constitute violations of fiduciary duties of obedience or supervision.[79]

3. Director Independence.

a. **Power to Independent Directors.**

(1) *General*. The SEC rules under SOB 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.[80]
- An audit committee[81] composed entirely of independent directors.[82]

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78 "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.

79 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.

80 *See* NYSE Rules 303A(1) and 303A(2); NASD Rules 4350(c) and 4200(a)(15).

81 1934 Act § 3(a)(5)added by SOB § 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.

82 On April 9, 2003, the SEC issued Release No. 33-8220 (the "*SOB §301 Release*") adopting, effective April 25, 2003, 1934 Act Rule 10A-3, titled "Listing Standards Relating to Audit Committees" (the "*SOB §301 Rule*"), which can be found at http://www.sec.gov/rules/final/33-8220.htm, to implement SOB §301. Under the SOB §301

- A nominating/corporate governance committee composed entirely of independent directors.[83]

- A compensation committee composed entirely of independent directors.[84]

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 SOB §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 SOB and the SOB §301 Rule. The NYSE and NASD have adopted such rules, which are discussed below. *See* NYSE Rules 303A(6) and (7) and NASD Rule 4350(d).

Effective Dates. Listed issuers must be in compliance with the new listing rules' audit committee standards by the earlier of (i) their first annual shareholders meeting after January 15, 2004 or (ii) October 31, 2004. Foreign private issuers and small business issuers are given until July 31, 2005 to comply with the new audit committee requirements.

83 *See* NYSE Rule 303A(4); NASD Rule 4350(c).

84 *See* NYSE Rule 303A(5); NASD Rule 4350(c). 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:

(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

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.[85] 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.[86] 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.[87] 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.[88] Alternative members may also be appointed to committees under both states' laws.[89]

(2) *NYSE*. NYSE Rule 303(A)(1) 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(2), no director qualifies as "independent" unless the board affirmatively determines that the director has no 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.

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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).

85 BCA 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.

86 TBCA art. 2.36; DGCL § 141(c).

87 TBCA art. 2.36(B).

88 TBCA art. 2.36(C); DGCL § 141(c)(1).

89 TBCA art. 2.36(A); DGCL § 141(c)(1).

(b) NYSE Per Se Independence Disqualifications. In addition to the general requirement discussed above, NYSE Rule 303A(2) considers a number of relationships to be an absolute bar on a director being independent as follows:

> First, 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.
>
> Second, a director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the NYSE listed company, except for certain payments, would not be independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.
>
> Third, a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company can not be considered independent until three years after the end of the affiliation or the employment or auditing relationship.
>
> Fourth, 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 serve on that company's compensation committee can not be considered independent until three years after the end of such service or the employment relationship.
>
> Fifth, a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the NYSE listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, can not be considered independent until three years after falling below such threshold. 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 Commission, 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) *NASD*. 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.[90]

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[90] 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.

(a) NASDAQ Base Line Test. Each NASDAQ listed company must 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.[91]

(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 company or by any parent or subsidiary of the company, is not deemed to be independent (the "*NASDAQ Employee Provision*").
>
> Second, a director who accepts or has a "*Family Member*" as defined in NASD Rule 4200(a)(14) who accepts any payments from the company, or any parent or subsidiary of the company, in excess of $60,000 during the current fiscal year or any of the past three fiscal years, other than certain permitted payments, is not deemed to be independent (the "*NASDAQ Payments Provision*"). NASDAQ states in the interpretive material to the NASD Rules (the "*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, is not independent (the "*NASDAQ Family of Executive Officer Provision*").
>
> 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, is not independent (the "*NASDAQ Business Relationship Provision*"). The 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 Interpretive Material states that it may be appropriate to apply

91 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, the new NASD Rules require 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.

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 Interpretive Material further notes that the NASDAQ Business Relationship Provision is more broad than the rules for audit committee member independence set forth in 1934 Act Rule 10A-3(e)(8).

The 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 the greater of 5% of the charity's revenues or $200,000. The 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 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 of the NASDAQ listed company who is, or has a Family Member who is, employed as an executive officer of another entity at any time during the past three years where any of the executive officers of the NASDAQ listed company serves on the compensation committee of such other entity, is not independent ("*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, is not independent ("*NASDAQ Auditor Relationship Provision*").

Seventh, in the case of an investment company, a director is not independent if the director 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. This provision replaces the tests for independence specified in the old rule.

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 Interpretive Material states that these three year look-back periods commence on the date the relationship ceases. As an example, the Interpretive Material states that a director employed by the company would not be independent until three years after such employment terminates. NASDAQ also proposes to add Interpretive Material stating 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 Commission (but not if the issuer reflects such entity solely as an investment in its financial statements). The Interpretive Material also states that the reference to "executive officer" has the same meaning as the definition in Rule 16a-1(f) under the Exchange Act.

b. **Audit Committee Member Independence.**

(1) *SOB*. To be "independent" and thus eligible to serve on an issuer's audit committee under the SOB §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)[92] 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).[93]

Since it is difficult to determine whether someone controls the issuer, the SOB §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 circumstances. Because companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the SOB §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

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92 The SOB §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.

93 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 SOB §301 Release, the SEC clarified that a director, executive officer, partner, member, principal or designee of an affiliate would be not deemed to be an affiliate. 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).

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, SOB §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(6) and 303A(7) 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(2) and SEC [1934 Act] Rule 10A-3. The Commentary to NYSE Rule 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 Exchange will provide companies with the opportunity to cure defects provided in SEC Rule 10A-3(a)(3)."

The Commentary to NYSE Rule 303A(7)(a) 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 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(e) 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, 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(7)(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 annually obtain and review a report by the independent auditor; discuss the company's annual audited financial statement and quarterly financial statements with management and the independent auditor; 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.

(3) *NASD*.

(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)); and (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, in addition to satisfying the requirement that the member 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 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 in addition requires the charter to specify the committee's purpose of overseeing the accounting and financial reporting processes and the audits of the financial statements of the issuer. The written charter is also required to include specific audit committee responsibilities and authority. NASDAQ states in 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(4) 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) *NASD*. NASD Rule 4350(c) now 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) 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, the NASD Rules now require each issuer 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(5) 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(5) 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) *NASD*. NASD Rule 4350(c) 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*"). 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 SOB 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.[94]

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. TBCA art. 5.14.F provides that a court shall dismiss a derivative action if the determination to dismiss is made by directors who are both disinterested and independent. For this purpose, a director is considered "disinterested"[95] in the sense of lacking any disqualifying financial interest in

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

95 TBCA art. 1.02A(12) defines "disinterested" director as follows:

the matter, and is considered "independent"[96] 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.

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(12) "Disinterested," when used to indicate a director or other person is disinterested in a contract, transaction, or other matter for purposes of approval of a contract or transaction under Article 2.35-1 of this Act and for purposes of considering the disposition of a claim or challenge with respect to a particular contract or transaction or to particular conduct means the director or other person, or an associate of the director (other than the corporation and its associates) or other person, is not a party to the contract or transaction or is not materially involved in the conduct that is subject to the claim or challenge and does not otherwise have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge. A director or other person is not to be considered to be materially involved in conduct that is subject to a claim or challenge or to otherwise have a material financial interest in the outcome of a contract or transaction or the disposition of the claim or challenge solely by reason of the existence of one or more of the following circumstances:

(a) the person was nominated or elected as a director by persons who are interested in the contract or transaction or who are alleged to have engaged in the conduct that is subject to the claim or challenge;

(b) the person receives normal director's fees or similar customary compensation, expense reimbursement, and benefits as a director of the corporation;

(c) the person has a direct or indirect equity interest in the corporation;

(d) the corporation or its subsidiaries has an interest in the contract or transaction or was affected by the alleged conduct;

(e) the person or an associate or affiliate of the person receives ordinary and reasonable compensation for services rendered to review, make recommendations, or decide on the disposition of the claim or challenge; or

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

(i) the person is named as a defendant in the derivative proceeding with respect to such matter or as a person who engaged in the alleged conduct; or

(ii) the person approved of, voted for, or acquiesced in, as a director, the act being challenged if the act resulted in no material personal or financial benefit to the person and the challenging party fails to allege with particularity facts that, if true, raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders by reason of that conduct.

96 TBCA art. 1.02A(15) defines "independent" as follows:

(15) "Independent," when used to indicate a director or other person is independent for purposes of considering the disposition of a claim or challenge with respect to a particular contract or transaction or to particular conduct or alleged conduct means:

(a) the director or other person is disinterested;

(b) the director or other person is not an associate (other than by reason of being a director of the corporation or one more of its subsidiaries or associates) or member of the immediate family of a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in the conduct that is subject to the claim or challenge;

(c) the director or other person, or an associate or member of the immediate family of the director or other person, does not have a business, financial, or familial relationship with a party to the contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to the claim or challenge, which, in each case, could reasonably be expected to

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.[97] 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.[98]

The Delaware focus includes both financial and other disabling interests. 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

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materially and adversely affect the director's or other person's judgment with respect to the consideration of the disposition of the matter subject to the claim or challenge in the interests of the corporation; and

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

A director or other person is not considered to have a relationship that could be expected to materially and adversely affect the director's or other person's judgment with respect to the consideration of the disposition of a matter subject to a claim or challenge or to otherwise be under the controlling influence of a party to a contract or transaction that is the subject of the claim or challenge or that is alleged to have engaged in conduct that is subject to a claim or challenge solely by reason of the existence of one or more of the following circumstances:

(a) the person has been nominated or elected as a director by persons who are interested in the contract or transaction or who are alleged to have engaged in the conduct that is subject to the claim or challenge;

(b) the person receives normal director's fees or similar customary compensation, expense reimbursement, and benefits as a director of the corporation;

(c) the person has a direct or indirect equity interest in the corporation;

(d) the corporation or its subsidiaries have an interest in the contract or transaction or were affected by the alleged conduct;

(e) the person or an associate or affiliate of such person receives ordinary and reasonable compensation for services rendered to review, make recommendations, or decide on the disposition of the claim or challenge; or

(f) the person or an associate (other than the corporation and its associates), immediate family, member or affiliate of the person has an ongoing business relationship with the corporation that is not material to that person, associate, family member, or affiliate.

97 *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984); *Odyssey Partners v. Fleming Companies*, 735 A.2d 386 (Del. Ch. 1999).

98 *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).

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.[99]

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99 *In Re Oracle Corp. Derivative Litigation*, 2003 WL 21396449 (Del. Ch. June 17, 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 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."

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.[100] 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."[101] Employment or consulting relationships can impair independence.[102] Family relationships can also impair independence.[103] Other business relationships may also prevent independence.[104]

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

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

102 *See In re Ply Gem Indus., Inc. S'holders Litig.*, C.A. No. 15779-NC, 2001 Del. Ch. LEXIS 84 (Del. Ch. June 26, 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 Entm't, Inc.*, C.A. No. 15765, 1999 Del. Ch. LEXIS 5 (Del. Ch. Jan. 22, 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.*, C.A. No. 17148, 2002 Del. Ch. LEXIS 28 (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 contributions to certain sports programs).

103 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).

104 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); 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).

A controlled director is not an independent director.[105] Control over individual directors is established by facts demonstrating that "through personal or other relationships the directors are beholden to the controlling person."[106]

4. ***Compensation.***

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

SOB §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.[107] Four categories of personal loans by an issuer to its directors and officers are expressly exempt from SOB §402's prohibition:[108]

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

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105 *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").

106 *Aronson*, *supra*, 473 A.2d at 815; *compare In re The Limited, Inc. S'holders Litig.*, 2002 WL 537692, *6-*7 (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).

107 SOB §402(a) provides: "It shall be unlawful for any issuer (as defined in [SOB §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."

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

- 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) "any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."[109]

The SEC to date has not provided guidance as to the interpretation of SOB §402, although a number of interpretative issues have surfaced. The prohibitions of SOB §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.[110]

SOB §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 SOB §402.[111] The real question is whether a broker-administered same-day sale involves "an

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[109] 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 SOB §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.

[110] 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."

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

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.[112]

Some practitioners have questioned whether SOB §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 companies could deny participant loans to directors and officers without violating the Labor Department rules.

b. **Exchange Requirements.**

The stock exchanges require shareholder approval of many equity compensation plans.[113] 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, the directors must act in accordance with their fiduciary duties. In respect of directors' fiduciary duties in approving executive compensation, Delaware Chancery Court's opinion dated May 28, 2003, in *In re The Walt Disney Co. Derivative Litigation*,[114] which resulted from the failed marriage between Disney and its former President Michael Ovitz, is instructive.

The 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

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112 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 SOB §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 SOB §402 assuming the issuer is not involved in arranging the credit.

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

114 825 A.2d 275 (Del. Ch. 2003).

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." The allegations of fact in the complaint were based on information received by plaintiffs from a request for books and records (the court suggested that plaintiffs should, as a matter of course, make such a request before filing a complaint).

The court focused on the following factors:

(1) Neither the board nor the compensation committee reviewed a draft of the employment agreement or received any report or analysis from a compensation consultant, nor did they review or receive any information about the cost of the potential payout to Ovitz throughout the contract or upon its termination or how the terms of the contract compared to others in the industry or even the analytical information in Disney's possession, nor were any of the foregoing requested;

(2) The compensation committee approved the terms of the compensation initially based on a summary of the terms, but there were significant changes before the definitive agreement was executed;

(3) The options were priced based on a market value at a point of early approval and were significantly in the money by the time the definitive agreement was executed due to an 8% run-up in the value of Disney stock;

(4) The terms of the employment agreement were negotiated between Ovitz and his long-time friend CEO Eisner, who made the decision to hire Ovitz as President without prior approval or discussion by the board;

(5) When Eisner concluded that Ovitz was not working out, Eisner agreed to a lucrative no fault separation without prior committee or board approval;

(6) Ovitz' employment agreement did not have a covenant not to compete; and

(7) The minutes of board and compensation committee meetings contained scant discussions of the processes directors went through in approving Ovitz' employment agreement and the terms of his separation.

The court found that the alleged conduct, if proved, would establish a lack of "good faith" which would deprive the defendant directors of the limitation of director liability for duty of care breaches under DGCL Section 102(b)(7). Because Ovitz was an officer and director of Disney at the time of his no-fault separation from the company, he owed a fiduciary duty to negotiate honestly and in good faith so as not to advantage himself at the expense of Disney and its shareholders.

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.[115]

(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.

b. **Interested Director Transactions — Article 2.35-1 of the TBCA and § 144 of the DGCL.**

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.[116] 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

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

116 *Id.* § 144(a).

and liability imposed on a director if the transaction is not fair to the corporation).[117]. 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.[118]

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted article 2.35-1 of the TBCA.[119] In general, TBCA art. 2.35-1 provides 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.[120] Because TBCA art. 2.35-1 was essentially identical to § 144 of the DGCL, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler*'s interpretation of § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in 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.[121] Under the statute, 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.[122] Article 2.35-1 relies heavily on the statutory definition of "disinterested" contained in TBCA art. 1.02.[123] Under the definition, 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.[124]

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.[125] Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are

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

118 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979.

119 TBCA art. 2.35-1.

120 *Id.*

121 Id. art. 2.35-1.

122 *Id.* art. 2.35-1(A).

123 *Id.* art. 1.02(A)(12).

124 *Id.*

125 *Compare* TBCA art. 2.35-1(A) *with* TBCA art. 2.35-1(A).

structured. However, article 2.35-1 does not eliminate a director's or officer's fiduciary duty to the corporation.

III. Standards of Review.

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.[126] 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."[127]

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 corporation.[128] 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."[129] "[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation."[130]

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.[131]

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

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

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

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

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

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

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."[132]

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.[133] 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 director action.[134] 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 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. . . .[135]

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 the corporate lawyers negotiating the transaction 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:

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

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

134 *Id*. at 1291-93.

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

(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[136] 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.

The *business judgment rule* provides a presumption in favor of directors, and places the burden on those challenging director action, where the directors have acted with care, loyalty and independence. Before the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.*,[137] it was generally believed that in the takeover context director action would be accorded the protection of the business judgment rule in the absence of a traditional conflict of interest. As applied in the takeover context in *Smith v. Van Gorkom*,[138] this protection of the business judgment rule was premised upon directors adequately informing themselves of all material information reasonably available to provide bases for their decisions.

Beginning with *Unocal*, however, the conduct of directors was subjected to "*enhanced scrutiny*" in circumstances where a traditional conflict of interest was absent. The enhanced scrutiny standard places a burden on directors not only to be adequately informed but also to have "acted reasonably."[139] The range of reasonableness addressed by enhanced scrutiny may be a middle ground between the "any rational purpose" to which the business judgment rule defers and the "entire fairness" sought for transactions in which directors or other affiliates have an interest.[140]

Enhanced scrutiny was initially the product of court review of defensive techniques used to respond to an unwanted suitor.[141] The burden of enhanced scrutiny was extended to director responses to competing bids when a decision is made to sell a company.[142] In *QVC*, the Delaware Supreme Court confirmed that the application of enhanced scrutiny is to sales of control generally.[143]

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136 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.

137 493 A.2d 946 (Del. 1985).

138 488 A.2d 858 (Del. 1985).

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

140 *See QVC*, 637 A.2d at 42, 45.

141 *See Unocal*, 493 A.2d 946; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

142 *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

143 *QVC*, 637 A.2d at 46.

Whether the burden of proof is ultimately found to be with the directors or their challengers, in all cases, directors and their counsel are well advised to establish a record supporting the reasonableness of their actions from the very beginning of the decision-making process.

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."[144] "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'."[145]

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.'"[146] 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.[147]

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:

(i) 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

(ii) 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.[148]

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144 *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).

145 *Unocal*, 493 A.2d at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

146 *Van Gorkom*, 488 A.2d at 872 (citation omitted).

147 *Id*. at 874.

148 *QVC*, 637 A.2d at 45; *see also Quickturn*, 721 A.2d at 1290.

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.[149]

a. **Defensive Measures.**

When directors authorize 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."[150] Courts review such actions with enhanced scrutiny even though a traditional conflict of interest is 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)[151] 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).[152]

b. **Sale of Control.**

In *QVC*, 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. Although the decision can be viewed as a variation on *Unocal and Revlon*, the Delaware Supreme Court's language is sweeping as to 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.[153]

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

150 *Unocal*, 493 A.2d at 954.

151 *Id*. at 954-55.

152 *Unitrin, Inc. v. Am. Gen. Corp*., 651 A.2d 1361, 1387-88 (Del. 1995).

153 *QVC*, 637 A.2d at 43 (footnote omitted).

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.*,[154] 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."[155]

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 Bancorp and Bank of Boston in which Bancorp stock was exchanged for Bank of Boston stock.[156] 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.[157] 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.[158] 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.'"[159] As continuing shareholders in Bank of Boston, the former Bancorp shareholders retained the opportunity to receive a control premium.[160] 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.[161]

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.[162] In reviewing board

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[154] 634 A.2d 345 (Del. 1993).

[155] *Id.* at 361.

[156] 650 A.2d at 1273.

[157] *Id.* at 1289.

[158] *Id.* at 1289-90.

[159] *Id.* at 1290.

[160] *Id.*

[161] *Id.*; *see also Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

[162] If a stockholder plaintiff successfully rebuts the presumption of valid business judgment, the burden of proof is shifted to the directors to prove the entire fairness of the transaction to the corporation and its stockholders. *Aronson v. Lewis*, 473 A.2d at 811-12.

action in transactions involving management, board members or a principal shareholder, the Delaware Supreme Court has imposed an "entire fairness" standard.[163] 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.[164]

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,[165] or (ii) the transaction is negotiated by a special committee of independent directors that is truly independent, not coerced and has real bargaining power.[166]

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.*:[167] "[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.

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163 *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).

164 *Weinberger*, 457 A.2d at 711.

165 *Id* at 703.

166 *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

167 567 A.2d 1279, 1286 (Del. 1989).

IV. Shifting Duties When Company on Penumbra of Insolvency.

A. Insolvency Changes Relationships.

Directors owe fiduciary duties to the owners of the corporation.[168] When the corporation is solvent, the directors owe fiduciary duties to the corporation and the shareholders of the corporation. 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. When the corporation is insolvent and there is no value left for the shareholders, the corporation's creditors become its owners and the directors owe fiduciary duties to the creditors as the owners of the business.[169]

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). 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."[170] Owing

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168 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.

169 *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).

170 *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 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 [based on] the array of probable outcomes of the appeal [25% chance of affirmance, 70% chance of modification and 5% chance of reversal] the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million

fiduciary duties to the "whole enterprise" puts the directors in the uncomfortable position of owing duties to multiple constituencies having conflicting interests.[171]

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

It is the fact of insolvency, rather than the commencement of statutory bankruptcy or other insolvency proceedings, that causes the shift in director duties.[172] 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."[173]

Under the "balance sheet" test used for bankruptcy law purposes, insolvency is defined as when an entity's debts exceed entity's property at fair valuation,[174] and the value at which the assets carried for financial accounting or tax purposes is irrelevant.

Fair value of assets is the amount that would be realized from the sale of assets within a reasonable period of time.[175] Fair valuation is not liquidation or book value, but is the value of the

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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 the 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.

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

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

173 *Id.*

174 11 U.S.C. § 101(32) (2001). A "balance sheet" test is also used under the fraudulent transfer statutes of Delaware and Texas. *See* 6 Del. Code § 1302 and Tex. Bus. & Com. Code § 24.003. For general corporate purposes, TBCA art. 1.02(16) (2001) defines insolvency as the "inability of a corporation to pay its debts as they become due in the usual course of its business." 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 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.

assets considering the age and liquidity of the assets, as well as the conditions of the trade.[176] 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, begin the shift even before the moment of insolvency. Where the corporation may not yet be technically insolvent but "is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bears, but owes its duty to the corporate enterprise".[177] 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.[178]

C. Director Liabilities to Creditors.

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.[179] Where directors are interested, the conduct of directors will likewise be judged by the standards that would have otherwise have been applicable. A director's stock ownership, however, may call into question a director's independence where the fiduciary duties are owed to the creditors, for the stock ownership would tend to ally to director with the interests of the shareholders rather than the creditors, but relatively insubstantial amounts of stock ownership should not impugn a directors independence.[180]

In *Pereira v. Cogan*[181], a Chapter 7 trustee bought an adversary proceeding against the former chief executive officer ("*CEO*") of a closely held Delaware corporation of which he was the majority stockholder and the corporation's other officers and directors for their alleged self-dealing or breach of fiduciary duty.[182] The court held *inter alia*, that (1) ratification by board of directors

175 *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

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

177 *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150 Mem. Op., Del. Ch. LEXIS 215 (Del. Ch. 1991).

178 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).

179 *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

180 *Cf. Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

181 294 B.R. 449 (SDNY 2003).

182 "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 that was not independent[183] of compensation that the *CEO* had previously set for himself, without 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;[184] (6) term "redeem," as used in DGCL § 160, providing

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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.

183 "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 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.

184 "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 the 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 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, other entity used money to purchase shares, and corporation then accepted shares as collateral for loan; and (7) officers and directors could not assert individual-based offsets as defenses to breach of fiduciary duty claims.

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.[185]

D. Conflicts of Interest.

Conflicts of interest are usually present in closely held corporations where the shareholders are also directors and officers. While the TBCA allows transactions with interested parties after disclosure and disinterested director or shareholder approval,[186] when the insolvency arises, the conflict of interest rules change.

After insolvency, Texas directors begin to owe a fiduciary duty to the creditors and cannot rely on the business judgment rule or disclosure to the disinterested directors as a defense.[187] Instead, the disclosure must include the creditors.[188]

After insolvency, Delaware law dictates a similar result.[189] The Delaware duty of fairness on transactions with interested parties runs to the creditors when the corporation is insolvent.[190]

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.

E. Fraudulent Transfers.

Both state and federal law prohibit fraudulent transfers.[191] All require insolvency at the time of the transaction. Texas and Delaware are identical to the Uniform Fraudulent Transfer Act, except Delaware adds the following provision: "Unless displaced by the provisions of this chapter, the

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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.

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

186 *See* discussion of TBCA art. 2.35-1 under Part VI.C *supra*.

187 *Weaver v. Kellog*, 216 B.R. 563 (S.D. Tex. 1997).

188 *Id.*

189 *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1984).

190 *Id.*

191 Tex. Bus. & Com. Code Chap. 24; 6 Del. C. § 1301 et seq., 11 U.S.C. § 548.

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."

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.

V. Friendly M&A Transactions.

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.[192] 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.[193] As with other transactions, article 2.28 of the TBCA permits a corporation's articles of incorporation to reduce the required vote to an affirmative vote of the holders of a majority of the outstanding shares.[194]

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.[195]

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 rather it need only adopt a resolution directing the submission of the plan of merger to the corporation's shareholders.[196] 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.[197] The TBCA's 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.[198] Delaware law has no similar provision and requires that the

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[192] *See* 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).

[193] TBCA art. 5.03(E); DGCL § 251(c).

[194] TBCA art. 2.28.

[195] TBCA art. 5.03(G); DGCL § 251(f).

[196] TBCA art. 5.03(B)(1).

[197] *Id*.

[198] Egan and Huff, *supra* note 8, at 282.

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.[199] 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.[200]

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.*,[201] 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.*,[202] 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."[203] 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.[204]

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."[205] 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

199 *See* DGCL § 251(c); TBCA art. 5.01(C)(3) (1998).

200 *Id*.

201 569 A.2d 53 (Del. 1989).

202 729 A.2d 280 (Del. Ch. 1998).

203 *Id*. at 292.

204 *Id*.

205 *Unocal*, 493 A.2d at 954.

proposals may present more of an opportunity for shareholders, they ought to require more consideration by the board.[206]

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.[207]

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.[208] 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."[209] 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:

> 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

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206 *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).

207 *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."

208 *See Technicolor*, 634 A.2d at 368.

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

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.[210]

2. Being Adequately Informed.

Although there is no one blueprint for being adequately informed,[211] 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.**

The fact that the board of directors relies on expert advice to reach a decision provides strong support that the board acted reasonably.[212]

Addressing the value of a corporation generally entails obtaining investment banking advice.[213] The analysis of value requires the "techniques or methods which are generally considered acceptable in the financial community. . . ."[214] 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.[215] Although the Delaware Supreme Court noted that "fairness opinions by independent investment bankers are [not] required as a matter of law,"[216] in practice, investment banking advice is obtained for any decision to sell and for many decisions 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.

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210 *Macmillan*, 559 A.2d at 1282 n.29 (citations omitted).

211 *See Goodwin v. Live Entertainment, Inc.*, 1999 WL 64265, at *21 (Del. Ch. 1999) (citing *Barkan*, 567 A.2d at 1286).

212 *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).

213 *See, e.g.*, *In re Talley Indus., Inc. Shareholders Litig.*, 1998 WL 191939, at *11-12 (Del. Ch. 1998).

214 *Weinberger*, 457 A.2d at 713.

215 *Van Gorkom*, 488 A.2d at 878.

216 *Id*. at 876.

The advice of investment bankers is not, however, a substitute for the judgment of the directors.[217] As the court pointed out in *Citron*, "in change of control situations, sole reliance on hired experts and management can 'taint[] the design and execution of the transaction'."[218] 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*,[219] the Delaware Supreme Court held that the board's approval of an interested merger transaction did not meet the test of fairness.[220] 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.[221]

(2) In *Macmillan*,[222] 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.[223]

(3) In *Technicolor*,[224] the court faulted the valuation package prepared by the investment bankers because they were given limited access to senior officers and directors of Technicolor.

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217 *See In re IXC Communications, Inc. Shareholders Litigation,* 1999 Del. Ch. Lexis 210 (De. Ch. 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 from Morgan Stanley or Merrill Lynch for the business judgment of the board charged with ultimate responsibility for deciding the best interests of shareholders."

218 *Citron*, 569 A.2d at 66 (citation omitted).

219 *Weinberger*, 457 A.2d 701.

220 *Id*. at 715.

221 *Id*. at 712.

222 *Macmillan*, 559 A.2d 1261.

223 *Id*. at 1271.

224 *Technicolor*, 634 A.2d 345.

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. In responding to a suitor, a corporation that has significant independent directors may have an advantage over companies without such independent directors.[225] 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."[226] 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]."[227]

(1) *Characteristics of an Independent Director*. An independent director has been defined as a non-employee and non-management director.[228] In addition, a court may consider the sophistication of the individual board members in evaluating their independence and their ability to make informed judgments. In *Van Gorkom*, the fact that no directors were investment bankers or financial analysts contributed to the evidence indicating that the board was uninformed.[229] Moreover, to be effective, outside directors cannot be dominated by financially interested members of management.[230] 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.[231]

(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*,[232] 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,

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225 *See, e.g.*, *Kahn v. MSB Bancorp, Inc.*, 1998 WL 409355, at *3 (Del. Ch. 1998), a*ff'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.")

226 *QVC*, 637 A.2d at 44; *see also Macmillan*, 599 A.2d 1261.

227 *Unocal*, 493 A.2d at 955.

228 *Unitrin*, 651 A.2d at 1375.

229 *Van Gorkom*, 488 A.2d at 877-78.

230 *See Macmillan*, 559 A.2d at 1266.

231 *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).

232 571 A.2d 1140 (Del. 1989).

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.[233]

(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 only the appearance of a conflict, as the mere appearance of a conflict may be sufficient to invoke application of the entire fairness standard of review.[234] 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.[235] If a majority of the board is disinterested and independent with respect to the proposed transaction, 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

233 *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 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.

234 *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").

235 *See In re Digex, Inc. Shareholders Litig.*, C.A. No. 18336, 2000 WL 1847679 (Del. Ch. Dec. 13, 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*, Del. Ch., 770 A.2d 536 (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).

may act on behalf of the company and the interested directors should abstain from deliberating and voting on the proposed transaction.[236]

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.[237]

(i) Formation of the Committee

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.[238] Where a majority of the directors have some real or perceived conflict, however, formation of a special committee may still be useful. 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. 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. Rather, the disinterested directors should select the committee members and the committee members should elect their chairperson. To the extent possible, however, the interested party(ies) should not be permitted to influence the selection of the members of the special committee or its chairperson.[239]

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236 *See* 8 *Del. C.* §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).

237 *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"); *Jedweb 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").

238 *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).

239 *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*, 1988 Del. Ch. LEXIS 110, at *36 (Del. Ch. Aug. 8, 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.").

(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.[240] 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.[241] To be independent, the member's decisions must be "based on the corporate merits of the subject before the [committee] rather than extraneous considerations or influences."[242] 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."[243] 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."[244]

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.[245]

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240 *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").

241 *Pogostin v. Rice*, 480 A.2d 619, 624, 627 (Del. 1984).

242 A*ronson*, 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)). *See also Grimes v. Donald*, 673 A.2d at 1219 n.25 (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").

243 *MAXXAM*, 659 A.2d at 773 (*quoting Rales*, 634 A.2d at 936).

244 *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (Del. 1997) (citing *Aronson*, 473 A.2d at 816).

245 *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).

(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.[246] The selection of advisors, however, may influence a court's determinations of the independence of the committee and the effectiveness of the process.[247]

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 affiliation with the company or interested parties.[248] 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.[249] 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."[250]

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246 *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").

247 *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*, 1988 Del. Ch. LEXIS 110, at *36 (Del. Ch. Aug. 8, 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").

248 *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 Del. Ch. LEXIS 110, at *36 (Del. Ch. Aug. 8, 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).

249 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).

250 *See Clements v. Rogers*, C.A. No. 15711, 2001 WL 946411 at **4 (Del. Ch. Aug. 14, 2001)(court brushing aside criticism of choice of local banker where there was valid business reasons for the selection).

(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.[251] 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.[252] 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.[253]

The requisite power of a special committee was addressed initially in *Rabkin v. Olin Corp.*[254] 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.[255]

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[251] *See, e.g., In re Digex, Inc. Shareholders Litig.*, C.A. No. 18336, 2000 WL 1847679 (Del. Ch. Dec. 13, 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).

[252] *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).

[253] *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).

[254] 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*").

[255] *Rabkin*, 1990 Del. Ch. LEXIS 50, at *18-19 (citations omitted); *see also Lynch II*, 669 A.2d at 82-83 (noting the Supreme Court's approval of the *Rabkin* two-part test).

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.[256] 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.[257]

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."[258]

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.[259]

(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.[260] The concepts of

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256 *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").

257 *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)).

258 *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.*, C.A. No. 18336, 2000 WL 1847679 (Del. Ch. Dec. 13, 2000) (inability of special committee to exercise real bargaining power concerning Section 203 issues is fatal to the process).

259 *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).

260 *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*, 2001 WL 946411 (Del. Ch. Aug. 14, 2001)(court criticizing a special committee for failing to fully understand the scope of the committee's assignment).

being active and being informed are interrelated. An informed committee will almost necessarily be active and vice versa.[261]

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]."[262]

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."[263]

Similarly, in *Mills Acquisition Co. v. MacMillan*, Inc.,[264] 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 independent directors, the legal complications which a challenged transaction faces under [enhanced judicial scrutiny] are unnecessarily intensified.[265]

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

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261 *Kahn v. Tremont Corp.*, 694 A.2d at 430.

262 *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).

263 1988 Del. Ch. LEXIS 139, at *12, *22 (Del. Ch. Oct. 21, 1988) *reprinted in* 14 Del. J. Corp. L. 870 (1989).

264 559 A.2d at 1281.

265 *Id.* at 1282.

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.[266]

(1) In *Van Gorkom*,[267] 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*,[268] 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*,[269] where the board met often to discuss the adequacy of Paramount's offer and the outside directors met frequently without management, officers or directors.[270]

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266 *See, e.g.*, *Moore Corp. Ltd. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995) for an in depth description of a decision-making process that withstood review under enhanced scrutiny.

267 488 A.2d 858.

268 634 A.2d 345.

269 571 A.2d 1140.

270 *See also Moran*, 500 A.2d 1346, 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

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.[271] Defensive measures are subject to enhanced 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 Section 203 can be viewed as defensive.[272] 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 the 1998 amendment to DGCL Section 251(c), 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.

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process for the board's deliberations, *see* Frankle, *Counseling the Board of Directors in Exploring Alternatives*, 1101 PLI/Corp. 261 (1998).

271 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 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 theory, at least, 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.

272 *See e.g., Moore*, 907 F. Supp. at 1556 (failure to redeem poison pill defensive).

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*,[273] 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'."[274] 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.[275] "Time's board was under no obligation to negotiate with Paramount."[276] 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."[277]

b. In *Unitrin*,[278] 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 measures to protect against a hostile bid until American General issued a press release announcing the offer.[279] 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."[280] In response, the board adopted a poison pill and an advance notice bylaw provision for shareholder proposals.[281] The directors then adopted a repurchase program for Unitrin's stock.[282] The directors owned 23% of the stock and did not participate in the repurchase program.[283] This increased their percentage ownership and made approval of a business combination with a

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[273] 571 A.2d 1140.

[274] *Id*. at 1149.

[275] *Id*. at 1154.

[276] *Id*.

[277] *Id*. at 1152 (citing *Macmillan*, 552 A.2d at 1285 n.35; *Van Gorkom*, 448 A.2d at 881; and *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

[278] 651 A.2d 1361.

[279] *Id*. at 1370.

[280] *Id*.

[281] *Id*.

[282] *Id*. at 1370-71.

[283] *Id*. at 1370.

shareholder without director participation more difficult.[284] 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 court determined that the Court of Chancery used an incorrect legal standard and substituted its own business judgment for that of the board.[285] The 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."[286]

c. In *Revlon*,[287] 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.[288] 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.[289]

d. In *Desert Partners*,[290] 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.[291] "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."[292]

e. In *MSB Bancorp*,[293] 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.[294] In reaching its conclusion, the court applied the business judgment rule because it determined that there

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284 *Id*. at 1371-72.

285 *Id*. at 1389.

286 *Id*. at 1390.

287 506 A.2d 173.

288 *Id*. at 180-81.

289 *Id*. at 182.

290 686 F. Supp. 1289 (applying Delaware law).

291 *Id*. at 1300.

292 *Id*. at 1300.

293 1998 WL 409355.

294 *Id*. at *4.

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.[295]

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.[296] 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.[297]

In *Moran*,[298] 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."[299] The court upheld the pre-planned poison pill but noted that the approval was not absolute.[300] 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."[301]

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

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295 *Id*. at *3.

296 *See, e.g., Quickturn*, 721 A.2d at 1290.

297 *Unitrin*, 651 A.2d at 1387 (citations omitted).

298 500 A.2d 1346.

299 *Id*. at 1349.

300 *Id*. at 1354.

301 *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.

the best value reasonably available to the stockholders."[302] 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."[303]

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.[304] 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.[305]
>
> [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.[306]

The principles of *Revlon* are applicable to corporations which are not public companies.[307] 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.[308]

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

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302 *QVC*, 637 A.2d at 48; *see also Matador*, 729 A.2d at 290.

303 *Technicolor*, 634 A.2d at 361.

304 *See Revlon*, 506 A.2d 173.

305 *QVC*, 637 A.2d at 47 (citation omitted).

306 *Id*. at 48.

307 *See Cirrus Holding v. Cirrus Ind.*, 794 A.2d 1191 (Del Ch. 2001).

308 *Cirrus Holding v. Cirrus Ind.*, 794 A.2d 1191 (Del Ch. 2001); *McMillan v. Intercago Corp*., 768 A.2d 492, 502 (De. 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).

board's fiduciary duties (the so-called "Revlon duties").[309] 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.[310]

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.[311] 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."[312]

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*,[313] the corporation had been put "in play" by the actions of an earlier bidder.[314] Instead of taking an earlier offer, the corporation instituted a management buyout (the "*MBO*") through an employee stock ownership program.[315] 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.[316] In holding that an active market check was not necessary, however, the court sounded a note of caution:

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309 *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).

310 *Barkan*, 567 A.2d at 1286.

311 *In re Fort Howard Corp. Shareholders Litig.*, 1988 WL 83147 (Del. Ch. 1988).

312 *Barkan*, 567 A.2d at 1287.

313 567 A.2d 1279 (Del. 1989).

314 *Id*. at 1287.

315 *Id*. at 1282-83.

316 *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.*[317]

b. In *In re Vitalink*,[318] Vitalink entered a merger agreement with Network Systems Corporation.[319] 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.[320] 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.[321]

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.[322]

3. 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 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 and, if any shares of any of the constituent corporations are not to be converted solely into shares or other securities of the surviving or resulting corporation, the cash, property, rights or securities of any

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317 *Id*. at 1288 (emphasis added).

318 1991 WL 238816.

319 *Id*. at *3-4.

320 *Id*. at *7.

321 *Id*. at *11-12.

322 *See Barkan*, 567 A.2d at 1287 (there is no single method that a board must employ to become informed).

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." Similarly, TBCA Art. 5.01.B provides that a "plan of merger shall set forth: (3) the manner and basis of converting any of the shares or other evidences of ownership of each domestic or foreign corporation and other entity that is a party to the merger into shares, obligations, evidences of ownership, rights to purchase securities or other securities of one or more of the surviving or new domestic or foreign corporations or other entities, into cash or other property, including shares, obligations, evidences of ownership, rights to purchase securities or other securities of any other person or entity, or into any combination of the foregoing, *and if any shares* or other evidences of ownership of any holder of a class or series of shares or other evidence of ownership is *to be converted in a manner or basis different than any other holder of shares of such class* or series or other evidence of ownership, *the manner and basis applicable to such holder*." [Emphasis added]

DGCL § 251(b)(5) and TBCA Art. 5.01.B.(3) 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.[323] Certain Delaware court decisions provide guidance. In *Jedwab v. MGM Grand Hotels, Inc.*,[324] 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.[325]

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323 *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).

324 509 A.2d 584 (Del. Ch. 1986).

325 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

In *Jackson v. Turnbull*,[326] 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 such an issue. The clear implication of the Court's decision in Jackson is that the equality of treatment of holders of shares of the same class of stock in a merger is not statutorily mandated by DGCL § 251, but rather is a matter of equity.

Even though a merger agreement providing for different treatment of stockholders within the same class appears to be authorized by both DGCL and the TBCA, 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*,[327] the Court approved a proposed settlement in connection with claims asserted in connection with 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 and, 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,"

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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).

326 C.A. No. 13042 (Del. Ch. Feb. 8, 1994), aff'd, No. 73, 1994 (Del. Dec. 7, 1994) *disposition reported at* 653 A.2d 306.

327 C.A. No. 13550 (Del. Ch. Nov. 30, 1994) (Bench Ruling).

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.*,[328]-- 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.
>
> 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.

4. 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.[329]

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[328] 493 A.2d 946 (Del. 1985).

[329] *Roberts v. General Instrument Corp.*, 1990 WL 118356, at *8 (Del. Ch. 1990).

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, or a break-up fee. 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 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.[330]

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.[331] A customary, and limited, no-shop clause

[330] *QVC*, 637 A.2d at 48.

[331] *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 Communications, Inc. Shareholders Litigation*, 1999 WL 1009174 (Del. Ch. 1999) (no talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty"). For a

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.[332] 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.[333] 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 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."[334]

See Ace Ltd. v. Capital Re Corp.[335] 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.[336]

See also *Cirrus Holding v. Cirrus Ind.*,[337] 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

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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).

332 *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).

333 *See Id.*

334 *Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, 1999 WL 1054255, (Del. Ch. 1999).

335 747 A.2d. 95 (Del. Ch. 1999).

336 *Id*. at 107-108.

337 794 A.2d 1191 (Del. Ch. 2001).

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.[338] As a 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.[339] Lock-ups

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338 *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):

> [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.

339 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

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."[340] 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.[341]

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 the lock-up resulted in an enhanced bid (in addition to the fact that the lock-up ended an active auction).[342] 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.[343]

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.[344] As the cases that follow indicate, however, break-up fees

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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.

340 *Revlon*, 506 A.2d at 176.

341 *Revlon*, 506 A.2d at 183.

342 *See Revlon*, 506 A.2d 173; *Macmillan*, 559 A.2d 1261.

343 *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).

344 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

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.[345] 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. However, the Delaware jurisprudence was not yet resolved whether the appropriate basis for calculating a termination fee is equity or enterprise value.[346] For this purpose, the value of any lock-up given by the corporation to the bidder should be included.

5. ***Specific Cases Where No-Shops, Lock-ups, and Break-Up Fees Have Been Invalidated.***

a. In *Revlon*,[347] 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.[348] The court noted that the no-shop is "impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder."[349] *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."[350]

b. In *Macmillan*,[351] the directors of the corporation granted one of the bidders a lock-up agreement for one of its "crown jewel" assets.[352] 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

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.

345 *See Goodwin*, 1999 WL 64265, at * 23; *Matador*, 729 A.2d at 291 n.15 (discussing authorities).

346 *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)."

347 *Revlon*, 506 A.2d 173.

348 *Id.* at 182.

349 *Id.* at 184.

350 *Id.* at 183.

351 *Macmillan*, 559 A.2d 1261.

352 *Id.* at 1286.

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."[353]

> 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.[354]

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."[355]

c. In *QVC*,[356] which like *Revlon* involved an active auction, the no-shop provision provided that Paramount would not:

> [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.[357]

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.[358] 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."[359] The court held that the

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353 *Id*.

354 *Id*. at 1286.

355 *Id*.

356 *QVC*, 637 A.2d 34.

357 *Id*. at 39 (citations omitted).

358 *Id*.

359 *Id*.

lock-up, no-shop and break-up fee were "impeding the realization of the best value reasonably available to the Paramount shareholders."[360]

d. In *Holly Farms*,[361] 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.[362] 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."[363] The court further stated that "the lock up was nothing but a 'show stopper' that effectively precluded the opening act."[364] 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."[365]

6. Specific Cases Where No-Shops, Lock-ups and Break-Up Fees Have Been Upheld.

a. In *Goodwin*,[366] the plaintiff shareholder argued that the board of Live Entertainment violated its fiduciary duties by entering into a merger agreement with Pioneer Electronics.[367] The merger agreement contained a 3.125% break-up fee.[368] 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."[369] Ultimately, the Chancery Court upheld the merger agreement.

b. In *Matador*,[370] 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.[371] Three BRC shareholders also entered into

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360 *Id*. at 50.

361 *In re Holly Farms Corp. Shareholders Litig.*, 564 A. 2d 342 (Del. Ch. 1989).

362 *Id*. at *2.

363 *Id*. at *6 (citations omitted).

364 *Id*.

365 *Id*.

366 *Goodwin*, 1999 WL 64265.

367 *Id*. at *21.

368 *Id*. at *23.

369 *Id*.

370 *Matador*, 729 A.2d 280.

371 *Id*. at 289.

lock-up agreements with ACS to tender their shares to ACS within five days of the tender offer of ACS.[372] 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."[373] 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.[374]

c. In *Rand*,[375] Western had been considering opportunities for fundamental changes in its business structure since late 1985.[376] In the spring of 1986, Western had discussions with both American and Delta, as well as other airlines.[377] 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]."[378] 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."[379]

d. In *Vitalink*,[380] the court held that the break-up fee, which represented approximately 1.9% of the transaction, did not prevent a canvass of the market.[381] 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.[382] 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

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372 *Id*.

373 *Id*. at 291.

374 *Id*. at 291 n.15.

375 *Rand*, 1994 WL 89006.

376 *Id*. at *1.

377 *Id*.

378 *Id*. at *2.

379 *Id*. at *7.

380 *In re Vitalink*, 1991 WL 238816.

381 *Id*. at *7.

382 *Id*. at *3.

highest price reasonably attainable for shareholders)."[383] The court also held that the lock-up at issue did not constitute a "real impediment to an offer by a third party."[384]

e. In *Roberts,*[385] General Instrument entered into a merger agreement with a subsidiary of Forstmann Little & Co.[386] 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."[387] 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.[388] 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.[389] 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.[390] 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.[391] 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.[392]

f. In *Fort Howard*,[393] 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.[394] None of the eight made a bid.[395] The agreement also contained a break-up fee of

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383 *Id*. at *7.

384 *Id*.

385 *Roberts*, 1990 WL 118356.

386 *Id*. at *6.

387 *Id*.

388 *Id*.

389 *Id*.

390 *Id*. at *9.

391 *Id*. at *6.

392 *Id*. at *9.

393 *In re Fort Howard*, 1988 WL 83147.

394 *Id*. at *8.

395 *Id*. at *8-9.

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.[396]

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."[397]

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.[398] 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.[399] Generally the same principles that guided consideration of an initial proposal (being adequately informed and undertaking an active and orderly deliberation) will also guide consideration of the competing proposal.[400]

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.[401] 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.

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396 *Id*. at *13.

397 *Id*.

398 *See e.g., Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 48306 (Del. Ch. 1996) (bidding and negotiations continued more than six months after merger agreement signed).

399 *See Phelps Dodge*, 1999 WL 1054255 and *Ace*, 747 A.2d at 107-108.

400 *See Macmillan*, 559 A.2d at 1282 n.29.

401 *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.

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.[402]

The Delaware Supreme Court's April 4, 2003 decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*[403] 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 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 and 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

[402] *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).

[403] _____ A. 2d _____ (Del. 2003).

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.*:[404]

> 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.*,[405] 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."

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404 493 A.2d 946 (Del. 1985).

405 637, A.2d 34, 51 (Del. 1993).

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 is likely to have several important ramifications with regard to the approval of deal protection measures in the merger context.

<u>First</u>, 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 and 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 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.

Third, 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.*[406] 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.

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.

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 defensive mechanisms to thwart an auction or to favor one bidder over another."[407] In *Macmillan*,

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406 506 A.2d 173, 182 (Del. 1986).

407 Barkan, 567 A.2d at 1286-87; *see also QVC*, 637 A.2d at 45.

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."[408] 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.[409]

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.[410]

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."[411]

3. ***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*,[412] Fairchild was the subject of a bidding contest between two competing bidders, Schlumberger and Gould.[413] 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.[414] 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.[415] 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

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408 *Macmillan*, 559 A.2d at 1286-87.

409 *Id*. at 1287 n.38.

410 *Revlon*, 506 A.2d at 184.

411 *QVC*, 637 A.2d at 45 (quoting *Macmillan*, 559 A.2d at 1288).

412 569 A.2d 53.

413 *Id*. at 54.

414 *Id*.

415 *Id*. at 68-69.

corporation and its stockholders," in deciding whether to accept or reject Gould's claim.[416] Nevertheless, the *Citron* court specifically found that Fairchild "studiously endeavored to avoid 'playing favorites'" between the two bidders.[417]

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.*,[418] 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 involved incremental stockholder value. The court placed great weight on the approval of the transaction by the stockholders after disclosure of the carve-up possibility.[419]

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.[420]

VI. Responses to Hostile Takeover Attempts.

A. Certain Defenses.

Shareholder rights plans and state anti-takeover laws developed in response to abusive takeover tactics and inadequate bids and 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

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416 *Id.* at 68.

417 *Id.*

418 757 A.2d 720 (Del. Ch. 1999).

419 *Lukens*, 757 A.2d at 738.

420 *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 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").

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 acquiror. 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 acquiror 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 Hotel Corp.*,[421] in which the Chancery Court, citing *Moran*,[422] 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.

Federal courts applying Texas law have upheld the concept of rights plans.[423]

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[424] or inadequate 100% cash offers[425] as well as to protect an auction or permit a target to explore alternatives.[426] On the other hand, some decisions

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421 C.A. No. 17803, 2000 WL 1528909 (Del. Ch. Oct. 10, 2000).

422 500 A.2d at 1346.

423 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).

424 *Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289 (N.D. Ill. 1988).

425 *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).

426 *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); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988); *In re Holly Farms Corp. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,181 (Del. Ch. 1988).

have held that the rights may not interfere with shareholder choice at the conclusion of an auction[427] or at the "end stage" of a target's attempt to develop alternatives.[428] Both *Pillsbury* and *Interco* 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.[429]

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 Section 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 TBCA art. 9.10A, unanimous consent is required for shareholder action by written consent unless the articles of incorporation otherwise provide). Under DGCL a raider can call a special meeting between annual meetings only if permitted under the target's bylaws, whereas under TBCA art. 2.24C any holder of at least 10% of the outstanding shares can call a special meeting unless the articles of incorporation specify a higher percentage (not to exceed 50%). 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.

A target 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.

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427 *Mills Acquisition Co. v. Macmillan, Inc.*, [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).

428 *City Capital Associates Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 798-800 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988).

429 *See TW Services v. SWT Acquisition Corp.*, C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at 24-25 (Mar. 2, 1989); *Paramount Communications Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch.) (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).

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.[430]

The Delaware Supreme Court held that the dead hand feature of the rights plan ran afoul of DGCL Section 141(a), which empowers the board of directors to manage the corporation. Relying on the requirement in Section 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.[431]

Not all states have come down against dead hand rights plans.[432] The rights plan upheld in *Copeland*, supra, involved dead hand features, although the opinion did not focus on the validity of the dead hand feature.

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.

Section 203 of the DGCL. Section 203 of the DGCL imposes restrictions on transactions between public corporations and certain stockholders defined as "interested stockholders" unless specific conditions have been met. In general, Section 203 provides that a publicly held Delaware corporation may not engage in a business combination with any interested stockholder for a period

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430 *See Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. Supr. 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.

431 *See also Carmody v. Toll Brothers, Inc.*, C.A. No. 15983, 1998 Del. Ch. LEXIS 131 (July 24, 1998).

432 *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); *AMP Incorporated v. AlliedSignal Inc.*, C.A. Nos. 98-4405, 98-4058, and 98-4109, 1998 U.S. Dist. LEXIS 15617 (E.D. Penn. 1998).

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 stockholders by an 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.[433]

An interested stockholder is generally defined under DGCL § 203(c)(3) 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. A business combination is defined under DGCL § 203 to include (i) mergers, (ii) consolidations, (iii) direct or indirect sales, leases, 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).[434] The provisions of DGCL § 203 also will not apply to certain stockholders who held their shares prior to the adoption of DGCL § 203 or to stockholders whose acquisition of shares is approved by the corporation prior to the stockholder becoming an interested stockholder. 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.

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.[435] Significantly, in transactions involving a controlling stockholder, the board's decision to

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433 *See* DGCL § 203(c)(8).

434 DGCL § 203(b).

435 *See Digex*, 2000 WL 1847679.

grant a DGCL § 203 waiver to a buyer may present conflict issues for a board dominated by representatives of the controlling stockholders.[436]

Part Thirteen of the TBCA. Part Thirteen of the TBCA, like DGCL § 203, imposes 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.[437]

In general, Part Thirteen prohibits 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 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. Part Thirteen does 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.

Part Thirteen applies 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, as amended, or similar or successor statute, or (iii) any class or series of its voting shares qualified for trading in a national market system.[438] For the purposes of this definition, a shareholder is a shareholder of record as shown by the share transfer records of the corporation.[439] Part Thirteen 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.

VII. Going Private Transactions

In re Pure Resources Shareholders Litigation[440] 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

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436 See Digest, 2000 WL 184769.

437 *See* TBCA arts. 13.01-13.08.

438 *Id.* at art. 13.02A(b).

439 *Id.*

440 808 A.2d 421 (Del. Ch. 2002).

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 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.* 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."[441]

In analyzing cases involving negotiated mergers, Vice Chancellor Strine focused on *Kahn v. Lynch Communications Systems, Inc.*, 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*], 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 being 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.

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441 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 doctrine alters the fundamental rule that inequitable actions in technical conformity with statutory law can be restrained by equity."

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 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.

VIII. Director Responsibilities and Liabilities.

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.*,[442] 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 enforcemnet 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.
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> 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.

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[442] 747 A.2d 95 (Del. Ch. 1999).

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 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 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.[443] 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.

[443] 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.[444]

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.[445] 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.[446] 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.[447] Under the TBCA, 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).[448] A director will not be liable for an unlawful distribution if *at any time* after the distribution, it would have been lawful.[449] A similar provision does not exist in Delaware. A director will also not be liable under the TBCA 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 TBCA art. 2.38-3;

(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 other information

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444 TBCA art. 2.41(A)(i); DGCL § 174(a).

445 DGCL § 174.

446 *Id.*

447 DGCL § 174(b).

448 TBCA art. 2.41(A).

449 *Id.*

> concerning, any other person that is contractually obligated to pay, satisfy, or discharge those liabilities.[450]

As in Delaware, a director held liable for an unlawful distribution under the TBCA 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.[451] The TBCA also expressly provides that the liability of a director for an unlawful distribution provided for under article 2.41 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.[452] 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.[453] In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.[454] In Texas, reliance must be made both in good faith and with ordinary care.[455]

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.[456]

F. 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.[457] There is,

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[450] TBCA art. 2.41(C), (D).

[451] *Id.* art. 2.41(E), (F).

[452] *Id.* art. 2.41(G).

[453] *See id.* art. 2.41(D); DGCL § 141(e).

[454] DGCL § 141(e); *see also Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

[455] TBCA art. 2.41(D).

[456] TBCA art. 2.44(B); DGCL § 220(d).

[457] 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, fn. 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

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.[458] 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.[459] Resignation does not free a director from the duty not to misuse information received while a director.[460] 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.

IX. Conclusion.

SOB marked a major incursion by the federal government into the governance of the internal affairs of public companies. While SOB 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 supplemented to a large degree by evolving adjudications of the fiduciary duties of directors and officers.

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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*, 1985 Del. LEXIS 598 at 22 (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*, 2001 Am. Bk. Inst. Jnl. LEXIS 73 at 30 ("A Delaware corporate director typically has the right to resign without incurring any liability or breaching any fiduciary duty").

458 *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.").

459 *FDIC v. Wheat*, 970 F. 2d 124, 128 (5th Cir. 1992); *District 65 UAW v. Harper & Roe Publishers*, 576 F. Supp. 1468 (S.D.N.Y 1983).

460 *Quark Inc. v. Harley*, 1998 U.S. App. LEXIS 3864 (10th Cir. 1998); *T.A. Pelsue Co. v. Grand Enterprises Inc.*, 782 F. Supp. 1476 (D. Colo. 1991).

REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE

OF THE

BOARD OF DIRECTORS OF ENRON CORP.

William C. Powers, Jr., Chair

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February 1, 2002

EXECUTIVE SUMMARY AND CONCLUSIONS

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors. In accordance with our mandate, the Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer, and by other Enron employees who worked with Fastow.

The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the most significant transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. We were not asked, and we have not attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications activities, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

There were some practical limitations on the information available to the Committee in preparing this Report. We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. We have had only limited access to certain workpapers of Arthur Andersen LLP ("Andersen"), Enron's outside auditors, and no access to materials in the possession of the Fastow partnerships or their limited partners. Information from these sources could affect our conclusions.

This Executive Summary and Conclusions highlights important parts of the Report and summarizes our conclusions. It is based on the complete set of facts, explanations and limitations described in the Report, and should be read with the Report itself. Standing alone, it does not, and cannot, provide a full understanding of the facts and analysis underlying our conclusions.

Background

On October 16, 2001, Enron announced that it was taking a $544 million after-tax charge against earnings related to transactions with LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. It also announced a reduction of shareholders' equity of $1.2 billion related to transactions with that same entity.

Less than one month later, Enron announced that it was restating its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. ("LJM1"), and an additional related-party entity, Chewco Investments, L.P. ("Chewco"). Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow.

The LJM1- and Chewco-related restatement, like the earlier charge against earnings and reduction of shareholders' equity, was very large. It reduced Enron's reported net income by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $893 million total), and by $99 million in 2000 (of $979 million total). The restatement reduced reported shareholders' equity by $258 million in 1997, by $391 million in 1998, by $710 million in 1999, and by $754 million in 2000. It increased reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000. Enron also revealed, for the first time, that it had learned that Fastow received more than $30 million from LJM1 and LJM2. These announcements destroyed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.

Summary of Findings

This Committee was established on October 28, 2001, to conduct an investigation of the related-party transactions. We have examined the specific transactions that led to the third-quarter 2001 earnings charge and the restatement. We also have attempted to examine all of the approximately two dozen other transactions between Enron and these related-party entities: what these transactions were, why they took place, what went wrong, and who was responsible.

Our investigation identified significant problems beyond those Enron has already disclosed. Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received—Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each, and still two more by amounts we believe were at least in the hundreds of thousands of dollars. We have seen no evidence that any of these employees, except Fastow, obtained the permission required by Enron's Code of Conduct of Business Affairs to own interests in the partnerships. Moreover, the extent of Fastow's ownership and financial windfall was inconsistent with his representations to Enron's Board of Directors.

This personal enrichment of Enron employees, however, was merely one aspect of a deeper and more serious problem. These partnerships—Chewco, LJM1, and LJM2—were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off of its balance sheet; but the transactions did not follow those rules.

Other transactions were implemented—improperly, we are informed by our accounting advisors—to offset losses. They allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported.

Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.

Many of the transactions involve an accounting structure known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Summary and in the Report). A company that does business with an SPE may treat that SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related. It was the technical failure of some of the structures with which Enron did business to satisfy these requirements that led to Enron's restatement.

<u>Summary of Transactions and Matters Reviewed</u>

The following are brief summaries of the principal transactions and matters in which we have identified substantial problems:

The Chewco Transaction

The first of the related-party transactions we examined involved Chewco Investments L.P., a limited partnership managed by Kopper. Because of this transaction, Enron filed inaccurate financial statements from 1997 through 2001, and provided an unauthorized and unjustifiable financial windfall to Kopper.

From 1993 through 1996, Enron and the California Public Employees' Retirement System ("CalPERS") were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Because Enron and CalPERS had joint control of the partnership, Enron did not consolidate JEDI into its consolidated financial statements. The financial statement impact of non-consolidation was significant: Enron would record its contractual share of gains and losses from JEDI on its income statement and would disclose the gain or loss separately in its financial statement footnotes, but would *not* show JEDI's debt on its balance sheet.

In November 1997, Enron wanted to redeem CalPERS' interest in JEDI so that CalPERS would invest in another, larger partnership. Enron needed to find a new partner, or else it would have to consolidate JEDI into its financial statements, which it did not want to do. Enron assisted Kopper (whom Fastow identified for the role) in forming Chewco to purchase CalPERS' interest. Kopper was the manager and owner of Chewco's general partner. Under the SPE rules summarized above, Enron could only avoid consolidating JEDI onto Enron's financial statements if Chewco had some independent ownership with a minimum of 3% of *equity* capital at risk. Enron and Kopper, however, were unable to locate any such outside investor, and instead financed Chewco's purchase of the JEDI interest almost entirely with debt, not equity. This was done hurriedly and in apparent disregard of the accounting requirements for nonconsolidation. Notwithstanding the shortfall in required equity capital, Enron did not consolidate Chewco (or JEDI) into its consolidated financial statements.

Kopper and others (including Andersen) declined to speak with us about why this transaction was structured in a way that did not comply with the non-consolidation rules. Enron, and any Enron employee acting in Enron's interest, had every incentive to ensure that Chewco complied with these rules. We do not know whether this mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or others putting their own interests ahead of their obligations to Enron.

The consequences, however, were enormous. When Enron and Andersen reviewed the transaction closely in 2001, they concluded that Chewco did not satisfy the SPE accounting rules and—because JEDI's non-consolidation depended on Chewco's status—neither did JEDI. In November 2001, Enron announced that it would consolidate Chewco and JEDI retroactive to 1997. As detailed in the Background section above, this retroactive consolidation resulted in a massive reduction in Enron's reported net income and a massive increase in its reported debt.

Beyond the financial statement consequences, the Chewco transaction raises substantial corporate governance and management oversight issues. Under Enron's Code of Conduct of Business Affairs, Kopper was prohibited from having a financial or managerial role in Chewco unless the Chairman and CEO determined that his participation "does not adversely affect the best interests of the Company." Notwithstanding this requirement, we have seen no evidence that his participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors.

While the consequences of the transaction were devastating to Enron, Kopper reaped a financial windfall from his role in Chewco. This was largely a result of arrangements that he appears to have negotiated with Fastow. From December 1997 through December 2000, Kopper received $2 million in "management" and other fees relating to Chewco. Our review failed to identify how these payments were determined, or what, if anything, Kopper did to justify the payments. More importantly, in March 2001 Enron repurchased Chewco's interest in JEDI on terms Kopper apparently negotiated with Fastow (during a time period in which Kopper had undisclosed interests with Fastow in both LJM1 and LJM2). Kopper had invested $125,000 in Chewco in 1997. The repurchase resulted in Kopper's (and a friend to whom he had transferred part of his interest) receiving more than $10 million from Enron.

The LJM Transactions

In 1999, with Board approval, Enron entered into business relationships with two partnerships in which Fastow was the manager and an investor. The transactions between Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense.

The two members of the Special Investigative Committee who have reviewed the Board's decision to permit Fastow to participate in LJM notwithstanding the conflict of interest have concluded that this arrangement was fundamentally flawed.[1] A relationship with the most senior financial officer of a public company—particularly one requiring as many controls and as much oversight by others as this one did—should not have been undertaken in the first place.

The Board approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. The Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were done on terms fair to Enron. In taking this step, the Board thought that the LJM partnerships would offer business benefits to Enron that would outweigh the potential costs. The principal reason advanced by Management in favor of the relationship, in the case of LJM1, was that it would permit Enron to accomplish a particular transaction it could not otherwise accomplish. In the case of LJM2, Management advocated that it would provide Enron with an additional potential buyer of assets that Enron wanted to sell, and that Fastow's familiarity with the Company and the assets to be sold would permit Enron to move more quickly and incur fewer transaction costs.

Over time, the Board required, and Management told the Board it was implementing, an ever-increasing set of procedures and controls over the related-party transactions. These included, most importantly, review and approval of all LJM transactions by Richard Causey, the Chief Accounting Officer; and Richard Buy, the Chief Risk Officer; and, later during the period, Jeffrey Skilling, the President and COO (and later CEO). The Board also directed its Audit and Compliance Committee to conduct annual reviews of all LJM transactions.

These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels. No one in Management accepted primary responsibility for oversight; the controls were not executed properly; and there were structural defects in those controls that became apparent over time. For instance, while neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored his responsibilities, they interpreted their roles very narrowly and did not give the transactions the degree of review the Board believed was occurring. Skilling appears to have been almost entirely uninvolved in the process, notwithstanding representations made to the Board that he had undertaken a significant role. No one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention.

As we discuss further below, the Board, having determined to allow the related-party transactions to proceed, did not give sufficient scrutiny to the information that was provided to it thereafter. While there was important information that appears to have been withheld from the Board, the annual reviews of LJM transactions by the Audit and Compliance Committee (and later also the Finance Committee) appear to have involved only brief presentations by Management (with Andersen present at the Audit Committee) and did not involve any meaningful examination of the

[1] One member of the Special Investigative Committee, Herbert S. Winokur, Jr., was a member of the Board of Directors and the Finance Committee during the relevant period. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of the other two members of the Committee, Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh.

nature or terms of the transactions. Moreover, even though Board Committee-mandated procedures required a review by the Compensation Committee of Fastow's compensation from the partnerships, neither the Board nor Senior Management asked Fastow for the amount of his LJM-related compensation until October 2001, after media reports focused on Fastow's role in LJM.

From June 1999 through June 2001, Enron entered into more than 20 distinct transactions with the LJM partnerships. These were of two general types: asset sales and purported "hedging" transactions. Each of these types of transactions was flawed, although the latter ultimately caused much more harm to Enron.

Asset Sales. Enron sold assets to LJM that it wanted to remove from its books. These transactions often occurred close to the end of financial reporting periods. While there is nothing improper about such transactions if they actually transfer the risks and rewards of ownership to the other party, there are substantial questions whether any such transfer occurred in some of the sales to LJM.

Near the end of the third and fourth quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. These transactions appeared consistent with the stated purpose of allowing Fastow to participate in the partnerships—the transactions were done quickly, and permitted Enron to remove the assets from its balance sheet and record a gain in some cases. However, events that occurred after the sales call into question the legitimacy of the sales. In particular: (1) Enron bought back five of the seven assets after the close of the financial reporting period, in some cases within a matter of months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999 (apparently including one hedging transaction). (The details of the transactions are discussed in Section VI of the Report.) Although we have not been able to confirm Fastow's calculation, Enron's reported earnings for that period were $570 million (pre-tax) and $549 million (after-tax).

We have identified some evidence that, in three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against loss. If this was in fact the case, it was likely inappropriate to treat the transactions as sales. There also are plausible, more innocent explanations for some of the repurchases, but a sufficient basis remains for further examination. With respect to those transactions in which risk apparently did not pass from Enron, the LJM partnerships functioned as a vehicle to accommodate Enron in the management of its reported financial results.

Hedging Transactions. The first "hedging" transaction between Enron and LJM occurred in June 1999, and was approved by the Board in conjunction with its approval of Fastow's participation in LJM1. The normal idea of a hedge is to contract with a creditworthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here. Instead, Enron transferred its own stock to an SPE in exchange for a note. The Fastow partnership, LJM1, was to provide the outside equity necessary for the SPE to qualify for non-consolidation. Through the use of options, the SPE purported to take on the risk that the price of the stock of Rhythms NetConnections Inc. ("Rhythms"), an interact service provider, would decline. The idea was to "hedge" Enron's profitable merchant investment in Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms stock declined. If the SPE were required to pay Enron on the Rhythms options, the transferred Enron stock would be the principal source of payment.

The other "hedging" transactions occurred in 2000 and 2001 and involved SPEs known as the "Raptor" vehicles. Expanding on the idea of the Rhythms transaction, these were extraordinarily complex structures. They were funded principally with Enron's own stock (or contracts for the delivery of Enron stock) that was intended to "hedge" against declines in the value of a large group of Enron's merchant investments. LJM2 provided the outside equity designed to avoid consolidation of the Raptor SPEs.

The asset sales and hedging transactions raised a variety of issues, including the following:

Accounting and Financial Reporting Issues. Although Andersen approved the transactions, in fact the "hedging" transactions did not involve substantive transfers of economic risk. The transactions may have looked superficially like economic hedges, but they actually functioned only as "accounting" hedges. They appear to have been designed to circumvent accounting rules by recording hedging gains to offset losses in the value of merchant investments on Enron's quarterly and annual income statements. The economic reality of these transactions was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron.

Enron used this strategy to avoid recognizing losses for a time. In 1999, Enron recognized after-tax income of $95 million from the Rhythms transaction, which offset losses on the Rhythms investment. In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with the Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of $532 million (including net interest income). Enron's reported pre-tax earnings for the last two quarters of 2000 totaled $650 million. "Earnings" from the Raptors accounted for more than 80% of that total.

The idea of hedging Enron's investments with the value of Enron's capital stock had a serious drawback as an economic matter. If the value of the investments fell at the same time as the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This is precisely what happened in late 2000 and early 2001. Two of the Raptor SPEs lacked sufficient credit capacity to pay Enron on the "hedges." As a result, in late March 2001, it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect the shortfall in credit capacity. Rather than take that loss, Enron "restructured" the Raptor vehicles by, among other things, transferring more than $800 million of contracts to receive its own stock to them just before quarter-end. This transaction apparently was not disclosed to or authorized by the Board, involved a transfer of very substantial value for insufficient consideration, and appears inconsistent with governing accounting rules. It continued the concealment of the substantial losses in Enron's merchant investments.

However, even these efforts could not avoid the inevitable results of hedges that were supported only by Enron stock in a declining market. As the value of Enron's merchant investments continued to fall in 2001, the credit problems in the Raptor entities became insoluble. Ultimately, the SPEs were terminated in September 2001. This resulted in the unexpected announcement on

October 16, 2001, of a $544 million after-tax charge against earnings. In addition, Enron was required to reduce shareholders' equity by $1.2 billion. While the equity reduction was primarily the result of accounting errors made in 2000 and early 2001, the charge against earnings was the result of Enron's "hedging" its investments—not with a creditworthy counter-party, but with itself.

Consolidation Issues. In addition to the accounting abuses involving use of Enron stock to avoid recognizing losses on merchant investments, the Rhythms transaction involved the same SPE equity problem that undermined Chewco and JEDI. As we stated above, in 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation. At the same time, Enron and Andersen also concluded that the LJM1 SPE in the Rhythms transaction failed the same threshold accounting requirement. In recent Congressional testimony, Andersen's CEO explained that the firm had simply been wrong in 1999 when it concluded (and presumably advised Enron) that the LJM1 SPE satisfied the non-consolidation requirements. As a result, in November 2001, Enron announced that it would restate prior period financials to consolidate the LJM1 SPE retroactively to 1999. This retroactive consolidation decreased Enron's reported net income by $95 million (of $893 million total) in 1999 and by $8 million (of $979 million total) in 2000.

Self-Dealing Issues. While these related-party transactions facilitated a variety of accounting and financial reporting abuses by Enron, they were extraordinarily lucrative for Fastow and others. In exchange for their passive and largely risk-free roles in these transactions, the LJM partnerships and their investors were richly rewarded. Fastow and other Enron employees received tens of millions of dollars they should not have received. These benefits came at Enron's expense.

When Enron and LJM1 (through Fastow) negotiated a termination of the Rhythms "hedge" in 2000, the terms of the transaction were extraordinarily generous to LJM1 and its investors. These investors walked away with tens of millions of dollars in value that, in an arm's-length context, Enron would never have given away. Moreover, based on the information available to us, it appears that Fastow had offered interests in the Rhythms termination to Kopper and four other Enron employees. These investments, in a partnership called "Southampton Place," provided spectacular returns. In exchange for a $25,000 investment, Fastow received (through a family foundation) *$4.5 million* in approximately two months. Two other employees, who each invested $5,800, each received *$1 million* in the same time period. We have seen no evidence that Fastow or any of these employees obtained clearance for those investments, as required by Enron's Code of Conduct. Kopper and the other Enron employees who received these vast returns were all involved in transactions between Enron and the LJM partnerships in 2000—some representing Enron.

Public Disclosure

Enron's publicly-filed reports disclosed the existence of the LJM partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influenced substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen.

The Participants

The actions and inactions of many participants led to the related-party abuses, and the financial reporting and disclosure failures, that we identify in our Report. These participants include not only the employees who enriched themselves at Enron's expense, but also Enron's Management, Board of Directors and outside advisors. The factual basis and analysis for these conclusions are set out in the Report. In summary, based on the evidence available to us, the Committee notes the following:

Andrew Fastow. Fastow was Enron's Chief Financial Officer and was involved on both sides of the related-party transactions. What he presented as an arrangement intended to benefit Enron became, over time, a means of both enriching himself personally and facilitating manipulation of Enron's financial statements. Both of these objectives were inconsistent with Fastow's fiduciary duties to Enron and anything the Board authorized. The evidence suggests that he (1) placed his own personal interests and those of the LJM partnerships ahead of Enron's interests; (2) used his position in Enron to influence (or attempt to influence) Enron employees who were engaging in transactions on Enron's behalf with the LJM partnerships; and (3) failed to disclose to Enron's Board of Directors important information it was entitled to receive. In particular, we have seen no evidence that he disclosed Kopper's role in Chewco or LJM2, or the level of profitability of the LJM partnerships (and his personal and family interests in those profits), which far exceeded what he had led the Board to expect. He apparently also violated and caused violations of Enron's Code of Conduct by purchasing, and offering to Enron employees, extraordinarily lucrative interests in the Southampton Place partnership. He did so at a time when at least one of those employees was actively working on Enron's behalf in transactions with LJM2.

Enron's Management. Individually, and collectively, Enron's Management failed to carry out its substantive responsibility for ensuring that the transactions were fair to Enron—which in many cases they were not—and its responsibility for implementing a system of oversight and controls over the transactions with the LJM partnerships. There were several direct consequences of this failure: transactions were executed on terms that were not fair to Enron and that enriched Fastow and others; Enron engaged in transactions that had little economic substance and misstated Enron's financial results; and the disclosures Enron made to its shareholders and the public did not fully or accurately communicate relevant information. We discuss here the involvement of Kenneth Lay, Jeffrey Skilling, Richard Causey, and Richard Buy.

For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.

Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship.

Skilling was Enron's President and Chief Operating Officer, and later its Chief Executive Officer, until his resignation in August 2001. The Board assumed, and properly so, that during the entire period of time covered by the events discussed in this Report, Skilling was sufficiently knowledgeable of and involved in the overall operations of Enron that he would see to it that matters of significance would be brought to the Board's attention. With respect to the LJM partnerships, Skilling personally supported the Board's decision to permit Fastow to proceed with LJM, notwithstanding Fastow's conflict of interest. Skilling had direct responsibility for ensuring that those reporting to him performed their oversight duties properly. He likewise had substantial responsibility to make sure that the internal controls that the Board put in place—particularly those involving related-party transactions with the Company's CFO—functioned properly. He has described the detail of his expressly-assigned oversight role as minimal. That answer, however, misses the point. As the magnitude and significance of the related-party transactions to Enron increased over time, it is difficult to understand why Skilling did not ensure that those controls were rigorously adhered to and enforced. Based upon his own description of events, Skilling does not appear to have given much attention to these duties. Skilling certainly knew or should have known of the magnitude and the risks associated with these transactions. Skilling, who prides himself on the controls he put in place in many areas at Enron, bears substantial responsibility for the failure of the system of internal controls to mitigate the risk inherent in the relationship between Enron and the LJM partnerships.

Skilling met in March 2000 with Jeffrey McMahon, Enron's Treasurer (who reported to Fastow). McMahon told us that he approached Skilling with serious concerns about Enron's dealings with the LJM partnerships. McMahon and Skilling disagree on some important elements of what was said. However, if McMahon's account (which is reflected in what he describes as contemporaneous talking points for the discussion) is correct, it appears that Skilling did not take action (nor did McMahon approach Lay or the Board) after being put on notice that Fastow was pressuring Enron employees who were negotiating with LJM—clear evidence that the controls were not effective. There also is conflicting evidence regarding Skilling's knowledge of the March 2001 Raptor restructuring transaction. Although Skilling denies it, if the account of other Enron employees is accurate, Skilling both approved a transaction that was designed to conceal substantial losses in Enron's merchant investments and withheld from the Board important information about that transaction.

Causey was and is Enron's Chief Accounting Officer. He presided over and participated in a series of accounting judgments that, based on the accounting advice we have received, went well beyond the aggressive. The fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact.

Causey was also charged by the Board of Directors with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between Enron and the LJM partnerships, and he was to review those transactions with the Audit and Compliance Committee annually. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions and did not give those transactions the level of scrutiny the Board had reason to believe he would. He did not provide the Audit and Compliance Committee with the full and complete information about the transactions, in particular the Raptor III and Raptor restructuring transactions, that it needed to fulfill its duties.

Buy was and is Enron's Senior Risk Officer. The Board of Directors also charged him with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between them. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions. Perhaps more importantly, he apparently saw his role as more narrow than the Board had reason to believe, and did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.

The Board of Directors. With respect to the issues that are the subject of this investigation, the Board of Directors failed, in our judgment, in its oversight duties. This had serious consequences for Enron, its employees, and its shareholders.

The Board of Directors approved the arrangements that allowed the Company's CFO to serve as general partner in partnerships that participated in significant financial transactions with Enron. As noted earlier, the two members of the Special Investigative Committee who have participated in this review of the Board's actions believe this decision was fundamentally flawed. The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." We do note, however, that the Committee was told that Andersen was "comfortable" with the transaction. As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of the LJM transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead, these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function. The Compensation Committee was given the role of reviewing Fastow's compensation from the LJM entities, and did not carry out this review. This remained the case even after the Committees were on notice that the LJM transactions were contributing very large percentages of Enron's earnings. In sum, the Board did not effectively meet its obligation with respect to the LJM transactions.

The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the Report lies with Management, the participating members of this Committee believe those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant.

Outside Professional Advisors. The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions. Andersen has admitted that it erred in concluding that the Rhythms transaction was structured properly under the SPE non-consolidation rules. Enron was required to restate its financial results for 1999 and 2000 as a result. Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective accounting judgment that should have prevented these transactions from going forward. According to Enron's internal accountants (though this apparently has been disputed by Andersen), Andersen also reviewed and approved the recording of additional equity in March 2001 in connection with this restructuring. In September 2001, Andersen required Enron to reverse this accounting treatment, leading to the $1.2 billion reduction of equity. Andersen apparently failed to note or take action with respect to the deficiencies in Enron's public disclosure documents.

According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen had concerns about Enron's disclosures of the related-party transactions. A week after that e-mail, however, Andersen's engagement partner told the Audit and Compliance Committee that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion. From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions. The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the Report. It also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings.[2] Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not within its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.

Enron Employees Who Invested in the LJM Partnerships. Michael Kopper, who worked for Fastow in the Finance area, enriched himself substantially at Enron's expense by virtue of his roles in Chewco, Southampton Place, and possibly LJM2. In a transaction he negotiated with Fastow, Kopper, and his co-investor in Chewco received more than $10 million from Enron for a $125,000 investment. This was inconsistent with his fiduciary duties to Enron and, as best we can determine, with anything the Board—which apparently was unaware of his Chewco activities—authorized. We do not know what financial returns he received from his undisclosed investments in LJM2 or Southampton Place. Kopper violated Enron's Code of Conduct not only by purchasing his personal interests in Chewco, LJM2, and Southampton, but also by secretly offering an interest in Southampton to another Enron employee.

Ben Glisan, an accountant and later McMahon's successor as Enron's Treasurer, was a principal hands-on Enron participant in two transactions that ultimately required restatements of earnings and equity: Chewco and the Raptor structures. Because Glisan declined to be interviewed by us on Chewco, we cannot speak with certainty about Glisan's knowledge of the facts that should have led to the conclusion that Chewco failed to comply with the non-consolidation requirement. There is, however, substantial evidence that he was aware of such facts. In the case of Raptor, Glisan shares responsibility for accounting judgments that, as we understand based on the accounting advice we have received, went well beyond the aggressive. As with Causey, the fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact. Moreover, Glisan violated Enron's Code of Conduct by accepting an interest in Southampton Place without prior disclosure to or consent from Enron's Chairman and Chief Executive Officer—and doing so at a time when he was working on Enron's behalf on transactions with LJM2, including Raptor.

Kristina Mordaunt (an in-house lawyer at Enron), Kathy Lynn (an employee in the Finance area), and Anne Yaeger Patel (also an employee in Finance) appear to have violated Enron's Code of Conduct by accepting interests in Southampton Place without obtaining the consent of Enron's Chairman and Chief Executive Officer.

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The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-

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2 Because of the relationship between Vinson & Elkins and the University of Texas School of Law, the portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates that many of those consequences could and should have been avoided.

SUMMARY OF THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (the *"SOB"*) 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, the SOB amends the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*).

Although the SOB does have some specific provisions, and generally establishes some important public policy changes, it is being implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (*"SEC"*). Set forth below is a summary of the SOB and related SEC rulemaking.

To What Companies Does SOB Apply. The SOB 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 SOB provisions apply only to companies listed on a national securities exchange[1] (*"listed companies"*), such as the New York Stock Exchange (*"NYSE"*) or the NASDAQ Stock Market (*"NASDAQ"*)[2] (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.[3] Small business issuers[4] that file reports on Form 10-QSB and Form 10-KSB are subject

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1 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.

2 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.

3 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 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).

4 "*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

to SOB 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).

SOB 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"*).[5]

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 SOB.

Accounting Firm Regulation. The SOB 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. The SOB does not address the accounting for stock options, but the PCAOB would have the power to do so. 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, the SOB 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. The SOB and 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. Accounting firms may generally provide tax services to their audit clients, but may not represent them in tax litigation.

$25,000,000 or more. Some of the rules adopted under SOB 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).

[5] Many of the SEC rules promulgated under SOB's directives provide limited relief from some SOB 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 <u>not</u> directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are <u>not</u> U.S. citizens or residents;
- More than 50% of the issuer's assets are <u>not</u> located in the U.S.; and;
- The issuer's business is <u>not</u> administered principally in the U.S.

Enhanced Audit Committee Requirements/Responsibilities. The SOB 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, (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, 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. Whistleblowers are protected against discharge or discrimination by an issuer.

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.

The SOB 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 generally accepted accounting principles for financial reporting in the U.S. (*"GAAP"*) that have been discussed with management.

The SOB requires audit committee preapproval of all auditing services and non-audit services provided by an issuer's auditor. The audit committee may delegate the preapproval responsibility to a subcommittee of one or more independent directors.

CEO/CFO Certifications. The SOB 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 *"SOB §302 Certification"*) and the other being required by an amendment to the Federal criminal code (the *"SOB §906 Certification"*). Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

Improperly Influencing Auditors. Pursuant to the SOB, the SEC has adopted a rule that specifically prohibits 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.

Enhanced Attorney Responsibilities. The SEC has adopted under SOB 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.

CEO/CFO Reimbursement to Issuer. The SOB 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.

Insider Trading Freeze During Plan Blackout. Company executives and directors are restricted from trading stock during periods when employees cannot trade retirement fund-held company stock (*"blackout periods"*). 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.

Insider Loans. The SOB prohibits issuers from making loans to their directors or executive officers. 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.

Disclosure Enhancements. Public companies will be required to publicly disclose in "plain English" additional information concerning material changes in their financial condition or operations on a "real time" basis. SEC rulemaking will define the specific requirements of the enhanced reporting.

The SOB instructs the SEC to require by rule: (1) Form 10-K and 10-Q disclosure of all material off-balance sheet transactions and relationships with unconsolidated entities that may have a material effect upon the financial status of an issuer; and (2) presentation of pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under GAAP. The SEC has adopted rules changes under SOB 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.

The SEC amendments to Form 8-K to add new Item 12, "Disclosure of Results of Operations and Financial Condition," which requires issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods.

SOB 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 of the second business day following the business day on which the subject transaction has been executed…*" 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. 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.

The SOB also requires the SEC to regularly and systematically review corporate filings. Each issuer must be reviewed at least every three years. Material restatements, the level of market capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.

Internal Controls. As directed by the SOB, the SEC has prescribed rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The SOB further requires the public accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls.

Codes of Ethics. 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.

Record Retention. SOB 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.

Criminal and Civil Sanctions. The SOB 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. The SOB restricts the discharge of such obligations in bankruptcy.

SOB Organization. The SOB is organized in eleven titles which are summarized below with emphasis on those parts most relevant to public companies. Rules adopted by the SEC to date under the SOB are generally discussed below in relation to the SOB provisions being implemented thereby.

Further Information. For further information regarding SOB, see "*The Sarbanes Oxley Act and Its Extraterritorial Reach*" by Byron F. Egan (October 3, 2003) which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=247.