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RECENT DEVELOPMENTS IN DELAWARE CORPORATE LAW

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Introduction

These materials summarize and explain the significance of various recent decisions of the Delaware Supreme Court and Court of Chancery, and the Federal District Court for the District of Delaware regarding Delaware corporate law. These materials also highlight amendments to the Delaware General Corporation Law which became effective on August 1, 2006.

I. RECENT DECISIONS OF DELAWARE COURTS.

A. Business Combinations.

1. Lock-Ups.

a. *Orman v. Cullman*, C.A. No. 18039 (Del. Ch. Oct. 20, 2004).

In *Orman v. Cullman*, C.A. No. 18039. (October 20, 2004), the plaintiff brought suit against the board of directors of General Cigar Holdings, Inc. ("General Cigar") for breach of their fiduciary duties in negotiating a minority squeeze-out merger transaction with Swedish Match AB ("Swedish Match") which included a lock-up voting agreement with General Cigar's controlling stockholders. The lock-up agreement required the controlling stockholders to vote against any alternative acquisition proposal for 18 months following a termination of the merger agreement. Applying *Omnicare v. NCS Healthcare, Inc.*, the Court of Chancery concluded that the lock-up agreement with General Cigar's controlling stockholders did not coerce the General Cigar stockholders to approve the merger and, therefore, granted defendants' motion for summary judgment.

General Cigar was founded in 1906 by the Cullman family. In 1997, General Cigar became a public company. The Cullman family, however, retained control over General Cigar by virtue of their exclusive control over the Class B common stock (which entitled the holders thereof to ten votes per share). In 1999, Swedish Match contacted General Cigar to discuss the possibility of acquiring a significant stake in General Cigar, with certain Cullman family members maintaining management responsibility. The board of directors of General Cigar formed a special committee to advise and make recommendations to the full board concerning the transaction with Swedish Match.

The negotiations between General Cigar and Swedish Match resulted in an agreement whereby General Cigar would merge with a subsidiary of Swedish Match, with the public stockholders of General Cigar receiving $15 per share (a significant premium over the market price). As a condition to entering into the merger agreement, Swedish Match required the Cullmans to enter into a voting agreement in which they agreed not to sell their shares and to vote their shares against any alternative acquisition proposal for a period of one year following the termination of the merger agreement. In exchange for an increase in the merger consideration to the public stockholders to $15.25 per share, Swedish Match required the Cullmans to increase the restricted period in the voting agreement to eighteen months. The merger agreement allowed the board of General Cigar to entertain unsolicited acquisition proposals if, upon recommendation of the special committee, the board concluded that such a proposal was *bona fide* and would be more favorable to the public stockholders than the merger with Swedish Match. The merger agreement also permitted the board to withdraw its recommendation of the merger agreement if the board concluded, upon consultation with outside counsel, that its fiduciary duties so required. The merger agreement required that the merger agreement be submitted to the General Cigar stockholders for a vote, but importantly provided that the merger could not proceed without the approval of a "majority of the minority" (*i.e.*, a majority of the public stockholders). The merger agreement did not contain a termination fee.

The plaintiff, relying on *Paramount Communications, Inc. v. QVC Network, Inc.* and *NCS*, argued that the members of the Cullman family on the board of directors of General Cigar breached their fiduciary duties by entering into the voting agreement. The Court found plaintiff's reliance on *Paramount* and *NCS* misplaced. While the Court agreed that a provision of a contract purporting to require a director to act in a manner as to limit the exercise of fiduciary duties would be unenforceable, the provisions of the voting agreement in the present case only limited the Cullmans' ability to act in their capacity as stockholders. Thus, the Cullmans could still have exercised their duties as directors to vote to withdraw their recommendation of the merger.

The Court of Chancery then turned to the remaining issue of whether the public stockholders of General Cigar were impermissibly coerced to vote for the merger because of the lock-up provision required by Swedish Match as part of the transaction. The Court noted that in NCS a bare majority of the Supreme Court held that deal protection devices, even when those devices protect a merger that does not result in a change of control, require the enhanced scrutiny set forth in Unocal Corp. v. Mesa Petroleum Co, 493 A.2d 946 (Del. 1985). The first step of the Unocal analysis requires a board to show that they have reasonable grounds for believing that a danger to corporate policy and effectiveness existed without the deal protection measures. The second step requires the board to show that the deal protection devices are not coercive or preclusive and are within the range of reasonable responses to the danger to corporate policy and effectiveness.

Applying the first step of Unocal, the Court found that if the board had not included the deal protection devices demanded by Swedish Match, General Cigar risked losing the transaction and being left with no comparable alternative transaction. Like NCS, this was reasonable grounds for believing that a danger to corporate policy and effectiveness existed.

With respect to the second step of the Unocal analysis, the Court held that the standard for determining if deal protection devices are coercive is whether they "have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." (quoting Williams v. Geier). The Court found that because the merger with Swedish Match would not have occurred without the deal protection devices, such devices were an "integral part of the merits of the transaction." Furthermore, unlike NCS, the deal protective devices in this case were not tantamount to "a fait accompli." The Court held:

> The public shareholders were free to reject the proposed deal, even though, permissibly, their vote may have been influenced by the existence of deal protection measures. Because General Cigar's public shareholders retained the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one -- it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal. That is to say, had the board determined that it needed to recommend that the General Cigar's shareholders reject the transaction, the shareholders were fully empowered to act upon that recommendation because the public shareholders (those not "locked-up" in the voting

> agreement) retained the power to reject the proposed merger. For these reasons, I conclude as a matter of law that the deal protection mechanisms present here were not impermissibly coercive.

The Court then turned to the last part of the *Unocal* analysis to determine whether the deal protection devices were within the range of reasonable responses to the danger to corporate policy and effectiveness. The Court found that without the deal protection devices there would have been no merger and the General Cigar stockholders could have lost the significant premium being offered by Swedish Match. The Court held that, because there was no competing bid for General Cigar, the board would be given broad latitude regarding its decision to recommend the Swedish Match merger. Thus, in light of the effective fiduciary out and the ability of the public stockholders to vote down the merger, the Court concluded that the "Cullman lock-up hardly seems unreasonable, given the absence of other deal protection devices in this particular transaction and given the buyer's understandable concern about transaction costs and market uncertainties."

b. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

In *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), the Delaware Supreme Court issued a sharply divided opinion refusing to enforce a fully locked-up agreement between a bidder and a target in the face of a greater offer by a third party in circumstances that caused the Court of Chancery to conclude that the lock-up was justifiable. The case concerns a challenge to a merger (the "Merger") between NCS Healthcare, Inc. ("NCS") and Genesis Health Ventures, Inc. ("Genesis"). NCS was at the time a publicly traded, insolvent corporation. After exploring strategic alternatives for over two years, NCS entered into an exclusivity agreement with Genesis which contemplated all of NCS's senior debt being paid and NCS's stockholders receiving shares of Genesis and which prohibited NCS from discussing potential business combination transactions with other third parties for a short period of time. Thereafter, Omnicare, Inc. ("Omnicare") sent NCS a letter outlining a proposed acquisition in which, subject to a number of contingencies, all of NCS's debt would be paid and the stockholders of NCS would receive more consideration than they would receive in the transaction with Genesis.

After considering, *inter alia*, the exclusivity agreement's prohibition against negotiating with other third parties, the increased offer price received from Genesis after informing Genesis of the Omnicare proposal, the risks attendant with allowing the exclusivity agreement to expire without reaching an agreement with Genesis, and the terms of an acquisition agreement demanded by Genesis, NCS entered into a merger agreement with Genesis pursuant to which NCS's creditors would be paid in full and NCS's stockholders would receive additional Genesis stock. The merger agreement included a provision requiring the board of directors of NCS (the "Board") to submit the merger agreement to the stockholders of NCS regardless of whether the Board continued to recommend the Merger. As a condition to the Merger, Genesis demanded that Mr. Outcalt and Mr. Shaw, directors of NCS who together owned a majority in voting power of the outstanding capital stock of NCS, enter into voting agreements to vote in favor of the Merger. After the announcement of the Merger, Omnicare submitted an unconditional proposal to NCS that would result in the NCS stockholders receiving more consideration than they would receive in the Merger. As a result of the Omnicare proposal, the Board withdrew its recommendation that the stockholders vote in favor of the merger agreement and NCS's financial advisors withdrew their fairness opinion.

The plaintiffs challenged the deal protection devices. The plaintiffs argued that the voting agreements signed by Outcalt and Shaw, when coupled with the requirement that the Board submit the merger agreement to the stockholders, regardless of the Board's recommendation, constituted "defensive reactions" under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), and that the defensive devices were impermissibly preclusive, coercive and unreasonable. While noting that this aspect of the merger agreement required special scrutiny, the Court of Chancery held that the plaintiffs failed to show that the Board acted unreasonably and upheld the protective measures. The Delaware Supreme Court, by a vote of three to two, disagreed and reversed the Court of Chancery's denial of a preliminary injunction. In so holding, the Supreme Court held that the Board's decision to adopt the defensive devices to completely lock-up the Merger required "special scrutiny" under Unocal, but also held that the record did not support the Court of Chancery's conclusion that the protective devices adopted by the Board were reasonable and proportionate to the threat the Board perceived from the potential loss of the Merger.

The Supreme Court first noted that a "board's decision to protect its decision to enter [into] a merger agreement with defensive devices against uninvited competing transactions that may emerge is analogous to a board's decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest." *Id*. at 932. Thus, a board does not have unfettered discretion to defeat any perceived threat to a merger by protecting it with any coercive or preclusive means available. The Supreme Court, therefore, concluded that the enhanced scrutiny of Unocal applied to the Board's decision to adopt the deal protection devices.

In applying the *Unocal* analysis, the Supreme Court held that the Board was required to show that their defensive response was "reasonable in relation to the threat posed." *Id*. at 935 (citations omitted). In order to do so, the Board first had to establish that the deal protection devices were not "coercive" *or* "preclusive" and then demonstrate that its response was within the "range of reasonable responses" to the threat perceived. *Id*. The Supreme Court held that "any stockholder vote would have been robbed of effectiveness by the impermissible coercion that predetermined the outcome of the [M]erger without regard to the merits of the [Merger] at the time the vote was scheduled to be taken." *Id*. at 936. The deal protective devices also precluded the consideration of any superior proposal. Thus, the protective provisions were both preclusive and coercive because they accomplished a *fait accompli*. Accordingly, the Supreme Court held the deal protection devices unenforceable.

The Supreme Court also held that the absence of an effective fiduciary out clause invalidated the deal protection devices because they limited the Board's ability to exercise their fiduciary duties. In so holding, the Supreme Court noted:

> The [Board] could not abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove the merger agreement because two stockholders had already combined

> to establish a majority of the voting power that made the outcome of the stockholder vote a foregone conclusion.
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> The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced. ... Instead of agreeing to the absolute defense of the [Merger] from a superior offer, however, the [Board] was required to negotiate a fiduciary out clause to protect the NCS stockholders if the [Merger] became an inferior offer. By acceding to Genesis' ultimatum for complete protection *in futuro*, the [Board] disabled itself from exercising its own fiduciary obligations at a time when the [Board's] own judgment is most important, i.e. receipt of a subsequent superior offer.

Id. at 937, 938.

In a rare dissenting opinion, now-retired Chief Justice Veasey, joined by now Chief, and then Justice, Steele, disagreed with the majority's decision that the deal protection devices were unenforceable. Chief Justice Veasey was troubled by what he perceived to be a new rule adopted by the majority, namely a *per se* prohibition on a board's ability to act in concert with a controlling stockholder to lock-up a merger no matter how compelling the circumstances. The Chief Justice argued that the majority reviewed the protective provisions out of context instead of reviewing the entire bidding process. In the case at hand, only Genesis was offering a value enhancing transaction, but only in exchange for certainty that the Merger would close. The Chief Justice noted that "lock-ups" permit a target board and bidder to "exchange certainties" which can be valuable to the parties and argued that "[s]ituations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward. Accordingly, any bright-line rule prohibiting lock-ups could, in circumstances such as these, chill otherwise permissible conduct." *Id.* at 942.

The Chief Justice questioned the applicability of *Unocal* to the case. Notably, Omnicare's "hostile" offer did not occur until after NCS conducted a market search and entered into the locked-up transaction with Genesis. Thus, there was no "specter of self-interest" since the Board was not reacting to any threat in an attempt to entrench itself in office. The Chief Justice further argued that the majority misapplied the concepts of "coercion" and "preclusion" to preempt the proper proportionality balancing of *Unocal*. *Id.* at 943. In this respect, the Chief Justice noted that the deal protection devices were not adopted to fend off an existing hostile action but rather were adopted because they were required by Genesis for Genesis to proceed with the Merger. The Chief Justice stated that the test for coercion should be whether the Board took actions that "have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." *Id.* at 944 (citation omitted). Here, the deal protection devices were integral to the merits of the transaction. Outcalt and Shaw were fully informed stockholders and they, in their capacity as stockholders, made the decision to commit themselves to enter into the voting agreements. Thus, Outcalt and Shaw were not coerced to vote in favor of the Merger. To the extent any minority stockholders felt coerced to vote in favor of the Merger, such coercion was meaningless because the outcome was already determined. Chief Justice Veasey also argued that even though the voting agreements may have precluded an overriding vote against the Merger, they were not preclusive within the meaning of *Unocal* because the minority vote was meaningless as a result of the non-coerced vote of the majority stockholders. Therefore, the majority should have applied the proportionality prong of *Unocal* and concluded that the deal protection devices were reasonable because they were the only way Genesis would agree to the Merger, which at the time was the only value-enhancing transaction available to NCS.

Chief Justice Veasey also rejected the majority's rule that it was a per se violation of fiduciary duty to fail to negotiate a fiduciary out in an otherwise locked-up transaction. In the instant case, Genesis, the only bidder at the time proposing a value-enhancing transaction, made it clear that a fiduciary out was unacceptable. Chief Justice Veasey rejected the majority's reliance on Paramount Communications v. QVC Network, Inc., 637 A.2d 34 (Del. 1993), distinguishing the facts in QVC where a board turned away from a superior proposal to lock-up a less valuable deal and the facts in the present case where the Board committed itself to the only value-enhancing transaction available. Furthermore, in the view of the Chief Justice, a board should not have a special duty to protect the minority stockholders from a controlling stockholder unless the controlling stockholder is on both sides of the transaction. The Chief Justice closed by expressing his hope that the majority's decision would be narrowly interpreted. In addition to joining the Chief Justice's dissent, Justice Steele wrote a separate dissent.

2. <u>Third-Party Mergers and Hostile Takeovers.</u>

a. ***In re CompuCom Systems, Inc. S'holders Litig.*, C.A. No. 499-N (Del. Ch. Sept. 29, 2005).**

In *In re CompuCom Systems, Inc. S'holders Litig.*, C.A. No. 499-N, Lamb, V.C. (Del. Ch. Sept. 29, 2005), the Delaware Court of Chancery granted a motion to dismiss for failure to state a claim upon which relief can be granted in favor of a Delaware corporation, its directors and its controlling stockholder in response to plaintiff's claim that the defendants breached their fiduciary duties in connection with the sale of the corporation to a third party. The factors that influenced the Court's decision included the use of a special committee process, which included an 18-month search for a buyer, as well as the use of outside legal and financial advisors, absence of strong lock-ups or other deal-protection devices in the merger agreement and the fact that no better offer ever emerged.

In August 2002, the board of directors (the "Board") of CompuCom Systems, Inc. ("CompuCom") created a special committee of the Board (the "Special Committee") comprised of purportedly independent directors to either find a buyer for the shares of stock of CompuCom held by its controlling stockholder, Safeguard Scientifics, Inc. ("Safeguard"), or in the alternative, put CompuCom up for sale. At the time of the disputed transaction, Safeguard was the owner of 48% of CompuCom's common stock and 100% of its preferred stock, and held 51% of the voting power with regard to an acquisition and 58% of the voting power with regard to the election of the Board. The Special Committee selected and retained its own financial and legal advisors and spent 18 months exploring various strategic options, but was unable to locate a suitable deal. In 2004, CompuCom received an offer from Platinum Equity Capital Partners, L.P. ("Platinum") to buy CompuCom. After several rounds of negotiations, CompuCom and Platinum entered into a merger agreement whereby the holders of all shares of common stock received $4.60 per share, and Safeguard received a total of $15 million plus accrued and unpaid dividends for the preferred stock. The total consideration for the transaction was $254 million, of which Safeguard received approximately $128 million. The financial advisors for both CompuCom and the Special Committee rendered fairness opinions, and the transaction was recommended by the Special Committee and approved by the full Board.

Plaintiffs, former minority stockholders of CompuCom, challenged the sale of CompuCom on the grounds that the Board was dominated and controlled by Safeguard and improperly agreed to sell CompuCom in order to satisfy Safeguard's pressing need for cash. The plaintiffs alleged that the defendants failed to comply with their fiduciary duties by structuring a sale that improperly favored Safeguard to the detriment of the minority stockholders, and that the defendants sought to discourage the assertion of appraisal rights by the minority stockholders by disseminating a materially false and misleading proxy statement.

The plaintiffs alleged that Safeguard's impetus for selling CompuCom was that it needed cash for itself and for its founder and former CEO, Warren V. Musser, and that it began liquidating investment assets in companies in which Musser also invested, including CompuCom, at fire sale prices. Included among the plaintiffs' assertions was the fact that the acquisition price of $4.60 per share of common stock of the Company represented a discount to the closing price of $4.84 on the day before the acquisition was announced.

In holding that the plaintiffs were unable to successfully rebut the presumption of the business judgment rule, the Court noted that the Special Committee spent 18 months searching for an appropriate transaction – a fact inconsistent with the plaintiffs' "fire sale" accusation. The Court also gave weight to the use by the Special Committee of independent legal and financial advisors and the fact that the merger agreement did not contain strong lock-ups or other deal-protection provisions that would have prevented the emergence of a competing bid. In addressing the fact that the acquisition price paid by Platinum represented a discount to the market price, the Court noted that the public trading price of the Company's shares fluctuated during the negotiating period across a wide range from as low as $4.16 to as high as $5.99.

The plaintiffs also questioned the independence of most of the members of the Special Committee due to their purported connections to Safeguard. The Court held that the plaintiffs did not show that the Special Committee was dominated and controlled by Safeguard. The Court noted the significance of the fact that at the time of the transaction, none of the members of the Special Committee were employed by CompuCom, Platinum or Safeguard and stated that the alleged conflicts of the Special Committee members did not appear to be material enough to preclude a finding of independence. The Court stated,"'[o]ur cases have determined that personal friendships, without more; outside business relationships, without more ... are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment.'"

The plaintiffs also claimed that CompuCom's proxy statement was misleading and omitted certain facts, and that these alleged defects dissuaded the Company's stockholders from pursuing their statutory appraisal rights. However, CompuCom issued a supplement to the proxy statement in order to avoid any argument that CompuCom should have included certain factual information on the issues identified by the plaintiffs in its proxy filings. CompuCom also postponed the stockholder meeting and vote in order to allow the stockholders sufficient time to evaluate the supplemental information. The Court held that the proxy supplement filed by CompuCom cured any alleged defects.

This opinion demonstrates the continued importance of the special committee process, including the use of independent legal and financial advisors, particularly in transactions involving a controlling stockholder.

b. *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005).

In *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005), the Delaware Court of Chancery held that where directors of a Delaware corporation have made a conscious effort to employ a thorough and independent process to explore strategic alternatives, they will be afforded broad discretion in structuring the exploration process in general and deal-protection devices in particular.

In January 2004, the board of directors of Toys "R" Us, Inc. (the "Company") began a lengthy, publicly announced search for strategic alternatives that ultimately led to the sale of the entire Company to a group led by Kohlberg Kravis Roberts & Co. (the "KKR Group"). The board, in consultation with expert advisors, considered a wide array of options, including (i) a sale of the entire Company and (ii) a sale of the Company's toy retailing business ("Global Toys") while retaining the baby products retailing business ("Babies"). Based on the Company's market canvass (and somewhat erroneous information from their financial advisors),[2] the board determined that no one was interested in buying the entire Company and that the best strategic option would be to sell Global Toys, while retaining Babies. As the sale of Global Toys was nearing completion, one of the bidders expressed an interest in buying the entire Company. In light of this expression of interest, the executive committee of the board solicited bids for the entire Company from the final bidders for Global Toys, after a short period of due diligence. The KKR Group submitted the ultimate winning bid, which was $1.50 per share higher than the next most favorable bid.

The plaintiffs alleged that the Company's board failed to fulfill its duty to act reasonably in pursuit of the highest attainable value for the Company's stockholders, and that the board's decision to conduct a brief auction for the entire Company from the final bidders rather than conducting a new, "full-blown" search for buyers was unreasonable. The plaintiffs also complained that the board unreasonably locked up the KKR Group's bid by agreeing to draconian deal termination measures that precluded any topping bid.

[2] Although the financial advisors had only received written offers for Global Toys, they had also received some oral interest from buyers willing to purchase the entire Company, which they had failed to pass on to the Company.

In denying plaintiffs' motion to enjoin the transaction preliminarily, the Court described in detail the efforts of the Company to conduct a fair, thorough and independent process, which included consultation with two outside financial advisors, separate legal counsel for the board and the Company, and an instruction from the board to key management employees not to discuss the possibility of working for any of the bidders until authorized to do so by the board. The Court also emphasized the fact that nine of the Company's ten directors were independent. The Court also noted the fact that the winning KKR Group bid was at or above the top of virtually all of the valuation ranges employed by the financial advisors. In response to the plaintiffs' duty of loyalty allegations against the CEO, the Court noted that a winning bid by the KKR Group might leave the CEO without a job and that the CEO's financial interests were aligned with the stockholders because his compensation package was largely comprised of stock and options.[3]

The Court did note, however, the few instances where the Company's process could have been improved. Specifically, the Court criticized the Company's financial advisor for neglecting to inform the Company of the informal interest it received regarding possible purchases of the entire Company, and was critical of the financial advisor's desire to provide financing to the buyer: "[It] is advisable that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by others." However, because the Company insisted that its financial advisor refrain from holding discussions with potential buyers until after the transaction was approved and a fairness opinion was rendered not only by the lead financial advisor but by another advisor as well, the Court stated that although this chain of events "tends to raise eyebrows," the Court could not conclude that the financial advisor's work prior to approval of the transaction was tainted in any way.

In response to the plaintiffs' claim that the Company should have conducted a more thorough bidding process upon its decision to switch from a sale of Global Toys to a sale of the entire Company, the Court gave great deference to the defendants' arguments that (i) there had been sufficient publicity regarding the Company's intention to explore strategic alternatives and that anyone who would be interested in making a bid would have likely already done so, and (ii) the Company did not want to give up the "bird in hand" (i.e., the bid for Global Toys) by conducting a long bidding process for the entire Company. Similarly, the Court recognized the Company's need to consent to some deal-protection measures in order to keep the most advantageous deal for its stockholders from falling apart. Furthermore, the Court viewed the fact that two of the groups that had previously been competing against each other in the bidding for Global Toys joined forces to bid for the entire Company as a positive, rather than a negative, development. Indeed, the Court said that this "emerging practice among financial buyers" benefits stockholders in that it permits buyers "to make bids that would be imprudent, if pursued in isolation."

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[3] The Court also noted that "to be an inside or non-independent director is not a crime, it is a status. And that fact cannot be forgotten by those who apply, or those who make, corporate law. To do otherwise is to risk boardrooms devoid of the very members with the best capacity to help management craft and implement a sound business plan."

While the Court declined to invalidate a 3.75% break-up fee coupled with a matching right, it should be noted that the Court expressly refused to give either a blanket endorsement of break-up fees below a certain percentage or a blanket disapproval of break-up fees above a certain percentage,[4] stating instead that it was approving the 3.75% break-up fee (and corresponding matching rights) in the context of the thorough process that was employed by the Company, implying that a similar (or even a lower) break-up fee coupled with a less pristine sale process might not receive the Court's approval. The Court also pointed out that the Company's negotiators were able to bargain the break-up fee down from 4% to 3.75% and were able to reduce the fee that would have to be paid in the event of a "naked no vote" from $50 million to $30 million. The final merger agreement also contained a no-shop clause that was relatively non-restrictive and permitted the consideration of unsolicited bids.

Finally, the plaintiffs alleged that the financial advisor was conflicted because its engagement letter stated that it would earn substantially greater fees for a sale of the entire Company versus a smaller transaction (i.e., an acquisition of just Global Toys). The Court found that this fee structure did not taint the firm's work.

This opinion provides judicial guidance on a number of practices and issues that have arisen in the current deal climate and have not been recently addressed by the Delaware courts. Practitioners who wish to use this opinion as a roadmap for structuring a deal should take care to note, however, the Court's emphasis on the length and public nature of the processes employed by the Company, the overwhelming independence of the board, the Court's refusal to provide a fixed percentage that is acceptable for a break-up fee, and the Court's general distaste for the practice of financial advisors of the seller providing buy-side financing.

c. ***In re MONY Group Inc., S'holders Litig.*, 853 A.2d 661 (Del. Ch. 2004).**

In February 2004, the Delaware Court of Chancery addressed a number of important issues for those negotiating the acquisition of public companies in its decision to grant a preliminary injunction of the proposed merger of the MONY Group, Inc. ("MONY"). *In re MONY Group, Inc., Shareholders Litigation*, 853 A.2d 661 (Del. Ch. 2004). Specifically, in the February decision, the MONY stockholders challenged the proposed stock-for-cash merger of MONY with and into a subsidiary of AXA Financial Inc. ("AXA"). The plaintiffs sought a preliminary injunction based on a variety of claims, including that the MONY board of directors breached its *Revlon* duties by failing to conduct an auction in a sale-of-control transaction. The Court determined to grant the preliminary injunction. A week after this first injunction was issued, the defendant directors postponed the stockholder meeting until May 18, 2004 and changed the record date to April 8, 2004. The plaintiffs then sought a second injunction requiring the defendants to make corrective disclosures and invalidating all of the proxies.

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[4] The Court cited a prior case where the Court condemned a 6.3% termination fee and stated that such a high termination fee would present a rather high barrier to a second bidder, implying that such a fee may not be valid even with a pristine sale process.

In November 2002, the board of directors of MONY authorized MONY's chairman and CEO, Michael I. Roth ("Roth"), to begin exploring strategic alternatives after consultation with MONY's financial advisor, Credit Suisse First Boston LLC ("CSFB"). In 2001 and 2002, MONY had posted significant losses, and in October 2003, MONY had its financial strength ratings downgraded by four major rating firms. The MONY board considered and rejected the idea of publicly auctioning MONY out of fear that a failed auction would reveal the company's weaknesses and provide competitors with information that they could use to steal its career agents.

In December 2002, AXA expressed an interest in acquiring MONY at a price of between $26 and $26.50 in cash per MONY share. AXA and MONY negotiated the transaction price over the course of the ensuing nine months, during which time the MONY board and Roth were able to extract several concessions from AXA. The parties ultimately agreed on a price of $31 in cash for each MONY share. During the course of these negotiations, the MONY board decided to re-evaluate certain change-in-control agreements between the company and its senior management (the "CICs") that would be triggered by a change-in-control transaction. The MONY board engaged a consulting firm to analyze the CICs. Based on the consultant's advice, the MONY board decided: (i) not to renew the CICs (which were worth 15.4% of the proposed transaction with AXA) when they expired in December 2003; (ii) to offer management CICs a lower payout that represented only five to seven percent (5-7%) of the transaction value; and (iii) to forbid Roth from engaging in further negotiations with AXA until new CICs were in place. In July 2003, MONY's management signed the new CICs. In September, negotiations with AXA resumed and Roth was able to gain additional concessions from AXA after informing AXA about the new CICs.

In September 2003, AXA and MONY signed a definitive merger agreement that contained a non-solicitation provision with a broad fiduciary out, as well as a termination fee that represented 3.3% of MONY's equity value and 2.4% of the transaction value in the event of termination of the merger agreement for a superior proposal. During the five-month period between the announcement of the AXA-MONY transaction and the initiation of this litigation, no third party made a competing proposal for MONY. The first injunction was granted because the Court found that the MONY board breached its duty of disclosure by failing to disclose how the payments to be made under the new CICs compared to payments made in similar transactions, as a percentage of the aggregate transaction value, and certain undisclosed analyses indicated that the payments under the CICs would exceed those paid in 75% of comparable transactions as a percentage of deal value.

In seeking their second injunction, the plaintiffs made several disclosure claims, as well as allegations that the directors had breached their fiduciary duties by using old proxies and changing the record and stockholder meeting dates.

On March 30, 2004, MONY filed revised proxy materials with the SEC which indicated that MONY intended to vote proxies received for the February 24, 2004 special stockholders' meeting at the May 18, 2004 special stockholders' meeting. The plaintiffs claimed that the use of the old proxies should not be allowed because such use would be inequitable. The Court noted that decisions made by boards of directors are usually upheld under the business judgment rule. However, in the conduct of the election of directors, "action designed principally to interfere with the effectiveness of a shareholder vote, even if that action is taken in good faith honestly and competently is not an action that may be left to the Board's business judgment." *Blasius Indus., Inc. v. Atlas Corp*, 564 A.2d at 654 (Del. Ch. 1988). When the matter to be voted on does not touch on issues of directorial control, courts will apply the exacting *Blasius* standard sparingly and only in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the stockholders. The Court also stated that once the board of directors deems a merger agreement favorable, it may employ various legal powers to achieve a favorable outcome on a shareholder to approve a merger agreement. A board cannot coerce the shareholder vote by agreeing to unduly high termination fees or other structural devices that force stockholders to vote in favor of a transaction for these reasons, not related to its merits. A board of directors also cannot mislead the stockholders or engage in other fraudulent or inequitable practices. The Court noted in this case that setting a new meeting and record date did not fall within the category of prohibited acts of boards of directors.

The Court concluded that the Board discharged its fiduciary duties in its decision to postpone the meeting and set a new record date, which were done in response to this Court's injunction and the amendments made to the merger agreement. The Board had to delay the meeting to allow for the preparation, filing and distribution of supplemental proxy material. The Board did not simply rubber stamp Roth's recommendations; in fact, the record indicated that the Board considered what would happen should the deal be voted down and openly discussed continuing MONY's business with new management. The Court concluded that the *Blasius* standard was not necessary in this non-election context and the judgment to set the new record and meeting dates appeared reasonable in the circumstances. The Court found that in this case the Board detected a threat of not being able to get enough stockholders to approve the merger. In response to this threat, the Board changed the record date, which was not preclusive of a full and fair vote but enfranchised stockholders who were equity owners of the corporation and who would not use the vote.

The *In re MONY* decisions are significant in several respects. First, the February decision confirms that *Revlon* does not require a board of directors of a Delaware corporation to conduct an auction in all change-of-control transactions or, in particular, in those transactions in which the target board has established a "floor" for the transaction and the parties have agreed to a non-solicitation agreement with a broad fiduciary out that allows for a post-agreement market check. Second, the April decision indicates that the exacting *Blasius* standard is not necessarily implicated by the moving of stockholder meeting and resetting of a record date.

3. <u>Material Adverse Change/Material Adverse Effect Clauses.</u>

***Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502 (Del. Ch. Apr. 29, 2005).**

In *Frontier Oil Corporation v. Holly Corporation*, CA No. 20502 (Del. Ch. Apr. 29, 2005), the Delaware Court of Chancery addressed claims of repudiation and breach of the covenant of good faith and fair dealing in the context of a merger agreement containing a fiduciary out clause and other customary termination provisions. The claims and counter-claims at issue arose in connection with the proposed merger of two independent petroleum refiners, Frontier Oil Corporation, a Wyoming corporation ("Frontier"), and Holly Corporation, a Delaware corporation ("Holly").

Prior to the execution of the merger agreement, Holly's counsel, in the course of due diligence, uncovered a news article describing plans by activist Erin Brockovich and related plaintiffs' law firms to bring a mass tort claim alleging that students attending Beverly Hills High School suffered from a disproportionate incidence of cancer attributable to the release of toxic chemicals from oil drilling activities adjacent to the high school. A predecessor of Frontier had operated the drilling facility in the past.

Confronted with this information, the Holly board did not initially approve the merger agreement, but instead directed management to pursue various options, including bolstering Frontier's representations and warranties and strengthening the definition of "material adverse effect" or an "MAE" in the merger agreement. As a result, several changes to the agreement were made. For example, the definition of an MAE in the merger agreement was modified to include "results of operations" and "prospects." Likewise, the Schedule to the agreement was modified to provide that the disclosure of the "threatened" litigation did not operate to remove this prospective litigation from Frontier's representation that there were no pending or threatened suits that could reasonably be expected to have an MAE.

The merger agreement, as executed, contained several customary termination provisions, including, *inter alia*, the right of each party to terminate the agreement if the other party's representations or warranties were or became inaccurate or if threatened litigation would be expected to have an MAE. The agreement also provided termination rights upon the exercise of a fiduciary out by the board of Holly or Frontier. Exercise of the fiduciary out required payment of a break-up fee of $15 million (plus reimbursement of expenses up to $1 million).

Following the execution of the merger agreement, tort litigation was actually filed, and the parties learned that Frontier had, through leases and related agreements, guaranteed certain obligations at the oil production site. During the same period, Lehman Brothers made a presentation to Holly suggesting that Holly's pipeline assets were so undervalued that Frontier could potentially recoup more than 100% of the merger price simply by securitizing Holly's pipeline assets in a so-called Master Limited Partnership ("MLP").

After Holly's board expressed concern about proceeding with the merger, the parties engaged in almost a month of further negotiations. Thereafter, the parties reached agreement on a restructured deal which provided that the Holly stockholders could choose between a transaction with a nominally higher value or one with nominally lower value but a greater cash component. Following conclusion of negotiations, Holly's CEO, C. Lamar Norsworthy III, who had agreed to recommend the reformulated deal to his board, determined not to recommend the revised transaction to his board, in part due to a concern that he and his associates would be sued if the Frontier stock issued in the transaction performed poorly, since the insider group clearly planned to take the high cash option. Predictably, the Holly board rejected the transaction.

Thereafter, the chief executives of the two companies spoke by telephone. Frontier's CEO presented a series of questions to Holly's CEO, including whether Holly was still prepared to recommend the merger agreement to its stockholders. Holly's CEO replied that Holly was not prepared to recommend the transaction and that Holly's board was no longer willing to support the merger agreement on its existing terms. The following day, Frontier filed an action in the Delaware Court of Chancery for repudiation of the merger agreement. Frontier asserted that Norsworthy's statements repudiated the merger agreement, which allowed Frontier to declare a breach of the merger agreement and to sue for damages. Frontier also asserted a claim for breach of the covenant of good faith and fair dealing with respect to Holly's conduct and sought damages totaling $160 million.

In response to Frontier's repudiation lawsuit, Holly issued a notice claiming that the Beverly Hills tort litigation constituted an MAE. In addition, Holly argued that the CEOs' phone call could not form the basis of a repudiation claim because there was no clear expression of a refusal to comply with the terms of the merger agreement, given that Holly still had avenues of exit under the merger agreement. Holly also argued that Frontier breached its representations and warranties in the merger agreement with respect to the tort litigation. Finally, Holly claimed that Frontier's repudiation constituted a breach of contract, which entitled Holly to recover damages.

In weighing Frontier's repudiation claim, the Court applied basic principles of contract interpretation and stated that repudiation involves an unequivocal statement by a promisor that he will not perform his promise. The Court noted, however, that the merger agreement was not an ordinary contract and stated that while the existence of a fiduciary out does not preclude a finding of repudiation, it does establish the context in which the parties' conduct is to be assessed. The Court found that Holly had not repudiated the merger agreement because it had not made an unequivocal statement that it would not perform its promise. The Court noted that Norsworthy had not stated that Holly intended to ignore the terms of the merger agreement and that his statement confirming that the Holly board would not recommend the merger agreement was contractually permitted. The Court also found that by declaring a repudiation following the call, Frontier deprived Holly of its right to exercise its fiduciary out or otherwise terminate the merger agreement.

The Court also found that Holly did not breach the covenant of good faith and fair dealing. Frontier argued that Holly's conduct stemmed in large part from its discovery that Holly had substantially undervalued its MLP assets in the merger, and that it sought to avoid paying the break-up fee by dragging on the negotiations past the "drop dead" date in the merger agreement. The Court found, however, that Holly did not mislead Frontier. While Holly's board had not formally opted to terminate the agreement and pay Frontier its break-up fee, the Court suggested that Frontier's suing for repudiation effectively cut off that opportunity.

The Court also denied Frontier's claim for the break-up fee under the agreement. The Court held that Holly's board never formally withdrew or modified its recommendation, even though the directors had clearly determined individually not to proceed. In addition, the Court found that Frontier's right to seek the break-up fee was conditioned upon its termination of the merger agreement and rejected the argument that Frontier's institution of its litigation constituted termination. Finally, the Court held that a consequence of Frontier's decision to sue for repudiation was that it could not maintain a claim for relief under the contract.

In a counterclaim, Holly sought damages from Frontier as a result of Frontier's alleged repudiation and breach of representations and warranties in the merger agreement. The Court found that Frontier's decision to file the anticipatory repudiation litigation and to abandon the merger agreement constituted a breach of the merger agreement.

In assessing Holly's claim for damages as a result of Frontier's breach, the Court found that Holly's proof of damages at trial was defective. The Court's decision not to grant Holly damages was based in part on the finding that Holly, prior to Frontier's repudiation, had determined that the merger agreement would not proceed on its terms and that, as a consequence, the harm about which Holly complained was not caused by Frontier's breach. The Court awarded Holly nominal damages of $1.00.

In reviewing Holly's MAE claim, the Court found that the burden of establishing an MAE with respect to Frontier fell on Holly. The Court noted that while the notion of an MAE is imprecise, the drafters of the merger agreement had the benefit of the analysis set forth in *In re IBP, Inc. Shareholders Litigation*, 787 A.2d 14 (Del. Ch. 2001) ("*IBP*"), which discussed whether an acquiring party in a merger could invoke an MAE to escape from the transaction. The Court noted that the court in *IBP*, applying New York law, found that a buyer would be required to make a strong showing to invoke an MAE exception, namely, a showing that the complained of event would have a material effect on the long-term earnings potential of the target company. While noting that *IBP* applied New York law, the Court found no reason why Delaware law should prescribe a different approach. The Court found that since, under *IBP* a defendant seeking to avoid performance of a contract due to its counterparty's breach of warranty must assert that breach as an affirmative defense, it followed that the same defendant pursuing an affirmative counter-claim would be charged with the burden as well.

Whether the Beverly Hills tort litigation was, or was reasonably likely to be, an MAE was, in the Court's view, an issue with quantitative and qualitative aspects. Since Holly presented no evidence, scientific or otherwise, relating to the substance of the California plaintiffs' claims, the Court found that Holly failed to meet its burden. With respect to Holly's claims that the defense costs alone of the litigation constituted an MAE, Holly variously had estimated the defense costs of the litigation as ranging from $200,000 per month to $25 million to $40 million and then from $40 million to $50 million. Frontier produced separate estimates suggesting that the defense costs would be in the range of $11 million to $13 million. The Court found that a reasonable estimate of the costs would be in the range of $15 million to $20 million and concluded that this range of costs alone did not constitute an MAE.

In addition, the Court found that Frontier did not breach its warranty as to the absence of material contracts (*i.e.*, its guarantees). The Court found that the documents relating to the guarantee would be material at the time of the merger agreement if the litigation risks related thereto were sufficiently foreseeable and large. In light of the Court's holding relating to the litigation, the Court found no breach of warranty.

The *Frontier* decision provides significant guidance to parties faced with decisions relating to a merger agreement that is no longer attractive to one of the parties to the agreement.

4. Going-Private Transactions by Controlling Stockholders.

a. *Gesoff v. IIC Industries Inc.*, C.A. No. 19600 (Del. Ch. May 18, 2006).

In *Gesoff v. IIC Industries Inc.*, C.A. 19600, Lamb, V.C. (Del. Ch. May 18, 2006), the Delaware Court of Chancery found that the process leading up to the going-private merger at issue was unfair and resulted in an unfair price to the minority stockholders. Accordingly, the Court awarded damages to the individual plaintiffs and to the stockholders seeking appraisal in an amount in excess of the consideration offered in the merger. The Court's conclusion was based primarily on its finding that the single-person special committee charged with negotiating the merger on behalf of the minority stockholders did not function properly. Nonetheless, the Court found that the special committee director was entitled to rely on the exculpatory provision adopted pursuant to Section 102(b)(7) of the General Corporation Law, which generally authorizes corporations to eliminate or limit the liability of directors for personal monetary damages arising out a breach of the duty of care, and was therefore not subject to liability for monetary damages.

The plaintiff in *Gesoff*, a stockholder of IIC Industries Inc. ("IIC"), brought suit to challenge the fairness of, and to seek an appraisal in connection with, the cash-out merger of IIC effected at the direction of CP Holdings ("CP"), which owned approximately 80% of the shares of IIC. The challenged merger arose out of the transactions beginning in December of 2000, when CP's finance director was asked to review and consider CP's corporate structure. After concluding the review, CP determined that it could obtain significant benefits, including a reduction of regulatory costs and potential tax liability, by removing IIC as an intermediate holding company of CP's other interests. Following this report, CP began investigating potential transactions designed to eliminate the minority stockholders of IIC. In May of 2001, CP's board of directors authorized a tender offer for IIC's shares at a price per share of $13, which would be followed by a short-form merger under Section 253 of the General Corporation Law. In connection with the proposed tender offer, IIC's board appointed a special committee consisting of Alfred L. Simon, the only director who was both independent of CP and capable of fulfilling the committee's responsibilities. Simon was vested with the power to present a recommendation to IIC's full board and the public stockholders as to IIC's position with respect to CP's tender offer. Simon was also given the authority to appoint outside auditors and counsel to assist him in making the recommendation. Despite this relatively broad grant, Simon's authority was in fact "closely circumscribed" in that he had no real authority to retain his own legal counsel or financial advisor but was instead essentially forced to use advisors selected by or at the direction of CP.

CP made an initial bid of $10 per share, a price that, though lower than the initial bid of $13 per share considered by CP's board, was deemed to be a starting bid from which further negotiations would proceed. The special committee's financial advisor conducted a valuation of IIC purportedly for the benefit of the special committee in considering this bid. Unbeknownst to Simon, however, CP was privy to the financial advisor's valuation numbers and analysis. After negotiating over the terms of the offer, Simon and CP agreed on September 10, 2001 to a price of $10.50 per share, which would be supported by a fairness opinion from the special committee's financial advisor. The IIC board met later that day and discussed the process leading up to the

$10.50 per share offer. At this meeting, Simon announced his decision to recommend the tender offer to the stockholders as fair from a financial point of view. The full board, however, declined to make a recommendation.

Due to the events of September 11, 2001, the commencement of the tender offer was delayed until October 15, 2001. Despite three extensions of the offer period, the tender offer resulted in only 20% of the unaffiliated shares being tendered, which increased CP's total ownership to approximately 84%. Unable to effect a short-form merger, CP decided to proceed with a conventional merger. In late January of 2002, CP's finance director discussed the proposed merger with Simon and provided him with information regarding the performance of IIC. The finance director advised Simon of the need to include the independent director's view of the fairness of the merger consideration in the proxy materials. Believing that he had already satisfied his duty to represent the minority stockholders, Simon conducted no new research as to the fairness of the merger, engaged in no new negotiations with CP and did not seek or obtain a new fairness opinion from the financial advisor. Nonetheless, he concluded that he was prepared to recommend the merger to the IIC stockholders. On February 1, 2002, IIC's board convened to vote on the merger. Simon was not in attendance but purported to appoint the finance director as his proxy to vote in favor of the merger.

In examining the plaintiff's claims, the Court found that the merger was a self-interested transaction subject to entire fairness review. Although the Court noted that the establishment of an independent special committee could serve as evidence of fair dealing, it could only do so if certain procedural safeguards were observed. In this regard, the Court reiterated the importance of the composition of the special committee, stating that "independence is the *sina qua non* of the entire negotiation process." The Court observed that multiple-member special committees are entitled to more trust than single-member committees, noting that where a special committee by necessity must be comprised of one member, such member must be beyond reproach. In addition, the Court noted that a special committee should have a clear mandate, including "the power to fully evaluate the transaction at issue and, ideally, to include what this court has called the 'critical power' to say 'no' to the transaction." Finally, the Court noted that the discussions between the parent and the special committee "should be conducted in a way that is consistent with arm's-length negotiations" that are sufficiently vigorous to ensure that the parent and the special committee are not "colluding to injure the minority stockholders."

In light of the foregoing, the Court found that the process followed by CP to effect the merger did not establish fair dealing. The Court noted several flaws in the special committee process, beginning with the appointment of Simon as the sole member thereof. That the special committee was comprised of a single member caused the Court to examine the entire process with a higher level of scrutiny. The Court indicated that the "moderating influence" of a second director could have enhanced the process followed by the special committee by making it more difficult for CP to exert such a significant degree of influence. Moreover, the Court noted that Simon's mandate as a special director was "fatally incomplete" and that the resolution pursuant to which he was appointed authorized him to provide only a "vague recommendation" as to the transaction. Moreover, the authorization did not clearly empower Simon to veto the transaction. The Court noted that after CP abandoned its tender offer and proceeded with the merger, it undertook no significant formalities to ensure that the new transaction would be fair to the minority stockholders and that the legal and financial advisors assisting Simon were far from independent. The Court specifically remarked upon the fact that CP's finance director was receiving information from the special committee's financial advisor, noting that this flow of information was "inimical to the special committee's power to negotiate a fair transaction." Based on this record, the Court found that the merger was not the result of fair dealing, noting that "any transaction that relies on so transparently corrupt a process cannot possibly be found to satisfy the high standard of entire fairness."

In addressing the fairness of the price, the Court found the consideration offered in the merger to be similarly inadequate. As to the defendants' claim that the attacks of September 11 resulted in a decrease in the value of IIC's stock, the Court noted that the defendants had failed to show that the attacks had a significant effect on IIC. Further, the Court noted that the defendants had offered no reason for the Court to believe that the price was fair on either side of September 11. In fashioning the remedy, the Court noted that "the calculation of damages in a consolidated entire fairness and appraisal action decided on the basis of entire fairness is a flexible process" and that the Court was empowered to fashion "'any form of equitable and monetary relief as may be appropriate.'" Noting the inherent difficulty of assessing the value of IIC—which had wide ranging holdings in divergent markets—the Court decided to evaluate the reports of the experts furnished by both sides, to conduct its own discounted cash flow analysis based on those reports and to test the results against the facts presented in the case. The Court found that because such process would yield a value at least as high as a formal appraisal, it would not perform a separate appraisal but instead use the value ascertained as a basis on which to compensate all individual and class plaintiffs. Based on this approach, the Court arrived at a value of $14.30 per share of IIC common stock.

The Court next addressed the question of Simon's liability in light of the exculpatory clause of IIC's charter adopted pursuant to Section 102(b)(7) of the General Corporation Law. The Court noted that all of the individual director defendants, other than Simon, implicitly conceded that they were not entitled to protection under the exculpatory clause in IIC's certificate of incorporation. Simon argued that even if the merger was unfair, and even if he breached his duty of care in authorizing an unfair merger, he was entitled to raise the exculpatory clause as an affirmative defense and thus could not be liable for monetary damages. In making this determination, the Court stated that it was faced with the question of whether Simon violated his fiduciary duty of loyalty or acted with a lack of good faith. The Court found no evidence that Simon was personally conflicted in the merger or derived a personal benefit from it. Moreover, the Court found that there was no evidence showing that Simon colluded with the interested directors and IIC in their "scheme to squeeze out the IIC minority at an unfair price." The Court found evidence showing that Simon was not aware of the key facts that made the merger unfair from a process standpoint, noting in particular that Simon was unaware of the facts suggesting that the financial advisor and legal counsel supplied to him had divided loyalties. In addition, the Court noted that Simon's efforts to seek an increase in the price offered in the tender offer, though based on the flawed analysis of the financial advisor, evidenced a good faith effort on the part of Simon to negotiate with CP. Based on the foregoing, the Court found that Simon attempted to fulfill his obligations as the sole member of the special committee but failed to do so as a result of a breach of the duty of care—a breach that was brought about in part by the efforts of the controlling stockholder and its agents. Accordingly, the Court held that Simon had proved that he was entitled to exculpation under IIC's exculpatory provision and was thus not liable for the damages awarded by the Court.

b. *In re Cox Communications, Inc. S'holders Litig.*, 79 A.2d 604 (Del. Ch. 2005).

In *In re Cox Communications, Inc. S'holders Litig.*, 79 A.2d 604 (Del. Ch. 2005), the Delaware Court of Chancery used a ruling on an application for attorneys' fees to review and comment on the standard of review applied under current Delaware law to mergers involving controlling stockholders. The Vice Chancellor suggested that the Delaware courts may be willing to consider modifying the standards set out in *Kahn v. Lynch Communications, Inc.*, 638 A.2d 1110 (Del. 1994).

The *Cox* case arose out of a public announcement by the Cox family (the "Family"), which owned 74% of Cox Communications, Inc. ("Cox"), of a proposal to acquire by merger all of the publicly owned shares of Cox for a price of $32 per share (the "Proposal"). The Proposal was conditioned on agreement to final merger terms with a special committee of the independent directors of Cox (the "Special Committee"). After the public announcement of the Proposal, the Cox board formed the Special Committee, the Special Committee hired legal counsel and financial advisors, and merger negotiations began. During the same time period, a number of Cox stockholders filed suit challenging the potential transaction. The plaintiffs then began negotiations with the Family along a separate track. After several rounds of negotiations with the Special Committee, the Family communicated its best and final offer of $34.75 per share, conditioned on approval by a majority of the minority stockholders, a fairness opinion by Goldman Sachs, settlement of the litigation, and negotiation of a definitive merger agreement. The Family's litigation counsel contemporaneously informed the plaintiffs of the Family's offer. The Special Committee accepted the offer and recommended it to the Cox board, and the board unanimously approved the merger. The plaintiffs also accepted the Family's offer, with the Family acknowledging that they took into account the desirability of settling the lawsuit and the efforts of the plaintiffs' counsel in raising their offer and agreeing to the majority of the minority approval condition. The following day the parties signed a merger agreement.

After the transaction was completed, the plaintiffs sought an award of attorneys' fees based on the benefits conferred by the litigation. Other Cox stockholders filed an objection to the fee petition. The objectors argued that "the common law rules that Delaware uses to govern mergers with controlling stockholders create inefficient incentives for plaintiffs' lawyers and corporate defense counsel, leading to lawsuits that exist . . . almost entirely as a vehicle for the payment of attorneys' fees. . . ." In reviewing the applicable law, the Court noted that under *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994), a merger with a controlling stockholder is always subject to the entire fairness standard of review, regardless of whether the transaction was negotiated by a special committee or subject to the approval of a majority of the minority stockholders. The use of such protective devices only shifts the burden of persuasion on the issue of fairness from the defendants to the plaintiffs. The doctrine therefore creates strong incentives for plaintiffs' lawyers to file lawsuits as soon as a negotiable proposal is announced, then later claim partial responsibility for the inevitable price increase. The Court suggested that such unintended side effects of *Lynch* could be eliminated through a "relatively modest alteration of *Lynch*" in which "if a controller proposed a merger, subject from inception to negotiation and approval of the merger by an independent special committee and a Minority Approval Condition, the business judgment rule should presumptively apply. In that situation, the controller and the directors of the affected company should be able to obtain dismissal of a complaint unless: 1) the plaintiffs plead particularized facts that the special committee was not independent or was not effective because of its own breach of fiduciary duty or wrongdoing by the controller (e.g., fraud on the committee); or 2) the approval of the minority stockholders was tainted by misdisclosure, or actual or structural coercion."

The Court then turned to the fee application. The objectors argued that the plaintiffs were not entitled to a fee award under *Chrysler Corp. v. Dann*, 223 A.2d 384 (Del. 1966), because their complaints were not meritorious when filed. Although the Court agreed that the complaints were not meritorious when filed because they were premature, the Court found that Dann did not apply to a situation where "an application for attorneys' fees . . . is objected to, not by objectors who will be economically injured by the payment of the fee, but by objectors who, as a general policy matter, find it offensive that the plaintiffs' counsel are being rewarded for bringing a meritless suit." Instead, the Court held that "the views of an objector of that kind should be considered by the court in applying the traditional factors that govern the size of the fee that should be awarded to the plaintiffs when they have been party to a settlement that the court found to be fair and reasonable to the class." After considering all of the factors, the Court reduced the amount of the requested fee, holding that "no risk premium should be awarded in fee applications in cases of this kind, when a plaintiff suing on a proposal settles at the same level as the special committee."

Because *Cox* is a Court of Chancery decision, its comments on *Lynch* do not represent controlling Delaware law. If adopted, however, the principles set forth in *Cox* would make it more difficult for stockholder plaintiffs to challenge properly structured transactions. At the same time, they would make it more difficult for defendants to settle cases and obtain class-wide releases. The *Cox* approach also would enhance the bargaining leverage of special committees.

c. *In re Emerging Communications, Inc. S'holders' Litig.*, Consol. C.A. No. 16415 (Del. Ch. June 4, 2004).

In *In re Emerging Communications, Inc. Shareholder's Litigation*, Justice Jacobs, sitting by designation on the Court of Chancery, considered whether 8 *Del. C.* § 102(b)(7) could serve to exculpate the former chairman and CEO of Emerging Communications, Inc. from alleged breaches of fiduciary duty.

Jeffrey J. Prosser owned 100% of Innovative Communication Company, LLC ("ICC"), which in turn owned 52% of Emerging Communications, Inc. ("ECM"). Prosser also was the Chairman, CEO and a director of ECM. Prosser briefly considered merging an ICC subsidiary into ECM (the "Aborted Merger"), and hired financial and legal advisors to advise him of its fairness. Because the market significantly undervalued ECM, Prosser decided instead to take ECM private through a cash-out merger in which ECM would merge into a wholly owned subsidiary of ICC (the "Privatization"). He hired the financial and legal advisers from the Aborted Merger to represent him in the Privatization.

Although Prosser had valued ECM at $13.25 per share, and his new financial advisors had estimated (while working on the Aborted Merger) that $25-30 was a fair price, Prosser proposed an acquisition at $9.125 per share, which represented a $2 premium over ECM's market price. ECM's board formed a special committee of directors (the "Committee"), which retained financial and legal advisors and negotiated on behalf of its minority stockholders. The Committee eventually pushed Prosser to $10.25 per share, a price that he falsely told the Committee would strain the limits of his financing. After its financial advisors opined that $10.25 was fair, the Committee recommended that ECM's board approve the Privatization, which it did with Prosser abstaining. The Privatization occurred after receiving the approval of a majority of ECM's minority stockholders.

The plaintiffs brought separate actions seeking appraisal and alleging breaches of fiduciary duty by Prosser and the board. The actions were later consolidated. In deciding the appraisal case, the Court determined ECM's fair value to be $38.05 per share. Although the $10.25 merger price was clearly unfair, the Court considered the fair dealing aspect to determine the nature of fiduciary breaches, for purposes of the defendants' Section 102(b)(7) defense. The defendants had the burden of proof, because neither the Committee's nor the minority stockholders' approval of the Privatization was based on proper disclosure. Prosser withheld ECM's most recent financial projections from the Committee and its advisors, providing them only to his financial advisor and lender, while proxy disclosures provided only earlier projections and affirmatively misstated that it contained all the projections available to Prosser.

The Court found the structure of the Privatization to be unfair. The Court reasoned that cash-out mergers by majority stockholders tend to involve unfair dealing. The Privatization also was timed to take advantage of ECM's artificially depressed stock price. Prosser's co-opting of advisers who represented ECM's minority stockholders in connection with the Aborted Merger was similarly unfair. Further, a majority of the Committee and the ECM board were beholden to Prosser by virtue of six-figure directors' fees, which they were told would continue after the Privatization, and various longtime lucrative business relationships and current consulting agreements with Prosser.

Although the one arguably independent Committee member did most of its work, including all negotiations, he was rendered ineffective by Prosser's withholding of financial projections and misrepresentation that a $10.25 price would strain the limits of his financing. Further, his use of Prosser's secretary to send faxes to other Committee members, which he attempted to justify as convenient, suggested he was careless to the possibility of disclosing confidential inter-Committee communications to Prosser.

ECM's board approval was also ineffective due to an undisclosed agreement entered into contemporaneously with the Privatization under which Prosser agreed to pay one director, who was not a Committee member but who voted in favor of the Privatization as part of the full board, $2.4 million for past services.

Minority stockholder approval of the Privatization was ineffective because the proxy statement (i) did not disclose that the most recent financial projections had been given to Prosser's advisors, but were withheld from the Special Committee and its advisors, (ii) did not disclose the directors' compensation from other entities controlled by Prosser, and (iii) falsely disclosed that a majority of the ECM board that voted to approve the transaction served on the Committee, when in reality only 3 of the 6 voting directors were on the Committee.

The Court held that Prosser could not benefit from a Section 102(b)(7) defense, as he breached his duty of loyalty in seeking to profit at the expense of ECM's minority stockholders. ICC and its subsidiary, the mechanisms through which Prosser accomplished the Privatization, were found liable as aiders and abettors. Although he did not directly benefit from the Privatization, the director who entered into the $2.4 million side agreement with Prosser, whom the Court found had loyalties and economic interests that were tied solely to Prosser, breached his duties of loyalty and/or good faith. Another director was held unable to prove a Section 102(b)(7) defense because his experience as a principal of an investment advisory firm that specialized in telecommunications companies suggested that "he knew, or at the very least had strong reasons to believe" that the merger price was unfair. The remaining directors at most breached their duties of care and so were entitled to Section 102(b)(7) exculpation.

5. <u>Disclosures in Short-Form Mergers.</u>

***Gilliland v. Motorola, Inc.*, C.A. No. 411-N (Del. Ch. Mar. 4, 2005).**

In *Gilliland v. Motorola, Inc.*, C.A. No. 411-N (Del. Ch. Mar. 4, 2005) ("*Motorola II*"), the Court of Chancery was required to fashion a remedy for the disclosure violation it found to exist in *Gilliland v. Motorola, Inc.*, 859 A.2d 80 (Del. Ch. 2004) ("*Motorola I*") in connection with the second step of a going-private transaction involving Motorola, Inc. ("Motorola") and Next Level Communications, Inc. ("Next Level"). The Court determined that a quasi-appraisal remedy that replicated an appraisal proceeding was the appropriate remedy.

In 2003, Motorola, the holder of 74% of the common stock of Next Level, acquired publicly held minority shares of Next Level in a tender offer. Following the tender offer, the remaining minority stockholders of Next Level were cashed out pursuant to Delaware's short-form merger statute. In connection with the tender offer, but not the subsequent short-form merger, comprehensive disclosures about Next Level and the transaction, including financial information relating to Next Level, were disseminated to the Next Level stockholders. A former stockholder of Next Level sued Next Level and Motorola, alleging that Motorola, as a controlling stockholder of Next Level, violated its fiduciary duty of disclosure by not including in the notice of merger and appraisal rights *any* information regarding the value of Next Level to help the former stockholders of Next Level to decide whether or not to pursue their right of appraisal. Motorola argued that, because it made public the requisite information in connection with the tender offer, the duty of disclosure did not require it to include any financial information in the merger notice. In *Motorola I*, the Court noted that while most Next Level stockholders had no practical need for even a summary of the information, there were likely some stockholders who were not so well informed or well equipped, who needed both the summary of the financial information and references to the other sources of publicly available data. Thus, the Court held that, despite the dissemination of Next Level financial information in connection with the first-step tender offer, the defendants breached their fiduciary duty of disclosure by not providing any disclosure relating to Next Level's financial condition in connection with the second-step merger.

In fashioning the remedy for the disclosure violation, the Court in *Motorola II* rejected the plaintiff's request of a class-wide quasi-appraisal remedy which would entitle all minority stockholders eliminated in the short-form merger to receive the difference between the merger price already paid and the court-determined fair value of the shares, notwithstanding that most of those stockholders already made an informed decision to forego their appraisal remedy. The Court found that this remedy was extreme and unwarranted in light of the technical disclosure violations. Instead, the Court opted to create a quasi-appraisal remedy that more closely replicated an appraisal action. The Court noted that there were three characteristics of an appraisal remedy. First, the appraisal statute requires that stockholders opt-in by making a demand for appraisal. Second, the appraisal statute requires stockholders who seek appraisal to forego the merger consideration and take the risk that the court-determined fair value is less than the merger consideration. Finally, the appraisal statute awards minority stockholders the fair value of the shares as of the merger date. In this case, the Court held that it would be appropriate to require the minority stockholders to make a choice to participate in the action in order to replicate the situation they would have faced if they had received proper notice. Thus, any of the minority stockholders could affirmatively choose to have the fair value of their shares determined by the Court. In addition, the Court structured the remedy to replicate some of the risk that the minority stockholders would face if this was an actual appraisal action. Any stockholder who opted into the action would be required to pay into escrow a portion of the merger consideration they had already received. If the Court appraised the shares at less than the merger consideration, the class would be exposed to a potential loss, but that loss was limited to a maximum of $.14 per share. Finally, the Court held that the valuation would be the fair value of the shares as of the merger date.

The *Motorola II* decision confirms that the Court of Chancery has broad discretion to tailor a remedy for a disclosure violation regarding appraisal rights. In *Motorola II*, where there was an unintentional technical disclosure violation and where most minority stockholders had made a knowing decision not to seek an appraisal remedy, the Court determined that a quasi-appraisal remedy that replicated a real appraisal action was appropriate.

6. <u>Allocation of Merger Consideration.</u>

***In re Tele-Communications, Inc. S'holders Litig.*, C.A. No. 16470 (Del. Ch. Dec. 21, 2005).**

In *In re Tele-Communications, Inc. S'holders Litig.*, C.A. No. 16470, Chandler, C. (Del. Ch. Dec. 21, 2005), the Delaware Court of Chancery issued an opinion denying, in part, defendants' motion for summary judgment on plaintiffs' class action claims alleging breaches of fiduciary duties by the directors of Tele-Communications, Inc. ("TCI") in connection with TCI's merger with a subsidiary of AT&T Corp. ("AT&T"). The Court found that the record raised triable issues of fact as to whether the merger was entirely fair to certain stockholders and with respect to certain disclosure claims. The Court thus denied summary judgment as to those claims, but granted summary judgment in favor of the defendants as to all other claims.

Plaintiffs were holders of Series A TCI Group Common Stock ("TCOMA"), a tracking stock reflecting the performance of the TCI Group division of TCI. Five of the director defendants were holders of TCOMB, a second class of tracking stock that was entitled to ten votes per share, compared to TCOMA's one vote per share. On June 23, 1998, the board of directors of TCI (the "TCI Board") approved a merger agreement negotiated at arm's length pursuant to which AT&T would acquire TCI. Under the terms of the merger agreement, each

TCOMA share would be exchanged for .7757 of a share of AT&T common stock, while each TCOMB share would be exchanged for .8533 of a share of AT&T common stock. TCI's stockholders voted to adopt the merger agreement, and the merger was consummated on March 9, 1999. By that time, the market price of AT&T stock had risen such that holders of TCOMA and TCOMB would receive premiums well above the 37% and 52% premiums for their respective shares that had been contemplated on the date the TCI Board approved the merger.

Although AT&T was a third-party buyer that was previously unaffiliated with TCI, the Court reviewed the merger under the entire fairness standard. Several factors led the court to impose this stringent standard: (i) of the TCOMA and TCOMB shares held by the TCI directors, nearly 70% were TCOMB shares; (ii) 84% of all outstanding TCOMB shares were held by five of the director defendants, constituting a majority of the TCI Board; and (iii) those five directors would have collectively received $220 million as a result of the TCOMB premium if the merger had been consummated on the date it was approved by the TCI Board, but instead received $300 million as a result of the increase in the market price of AT&T stock. The Court stated that "[b]ecause a clear and significant benefit of nearly $300 million accrued primarily (over 84% of the total TCOMB premium proceeds) to such directors controlling such a large vote of [TCI], at the expense of another class of shareholders to whom was owed a fiduciary duty, then a standard of entire fairness applies." Because the five director defendants received sums ranging from $500,000 to $100,000,000 as a result of the TCOMB premium, the Court found that such consideration was material and substantial enough to render each of the five directors interested.

Under an entire fairness analysis, the defendants bear the burden of proving the fairness of a transaction. Ratification of a transaction by a majority of disinterested directors may shift the burden to the plaintiffs if the defendants establish that the special committee was independent, fully informed and free to negotiate at arm's length. At this summary judgment stage, when the Court was required to draw all reasonable inferences in favor of the plaintiffs, the Court found that certain facts in the record suggested that the two-person special committee was not fully disinterested. First, one member of the special committee held 246,271 shares of TCOMB while both he and the other member of the special committee only owned 161,244 shares of TCOMA collectively, suggesting that such members' judgment may be biased in favor of the holders of TCOMB. Second, each member of the special committee received $1 million as compensation for his service on the special committee, an amount that was determined only after the special committee had approved the transaction.

Because the defendants bore the burden of proof under the entire fairness review, they were required, in order to prove fair dealing, to address any "flaws" in the process suggested by the record. The Court found that the defendants had not adequately addressed such flaws, even though they might be later explained at trial. The Court cited deposition testimony from the special committee members suggesting that each of the two members understood his task on the special committee differently, which the Court construed as "a structural flaw" because of the "confusion" and "ambiguity" it created. The Court also viewed as a flaw the appointment to the special committee of directors with potentially conflicting interests as a result of their stock ownership. In addition, the Court noted that the defendants did not explain why another director who suffered a loss of $13 million due to the TCOMB premium was not selected to be on the special committee.

The Court also found that the special committee's choice of financial advisor "raised questions regarding the quality and independence of the counsel and advice received," creating another issue of fact for trial. Departing from prior precedent, the Court suggested that the contingent compensation of the financial advisor of $40 million created an issue as to whether the financial advisor could provide an independent opinion with regard to the merger. The Court also found fault with the special committee's failure to consider the historical transactional price difference between TCOMB and TCOMA, noting that the plaintiffs had presented data showing that, in the eighteen months leading up to the announcement of the merger, the historical TCOMB premium over TCOMA was 10% or greater only during a single five-day trading period.

The special committee's financial advisor rendered an opinion that concluded that the consideration received by holders of TCOMA and by holders of TCOMB was fair. The Court interpreted this to mean that the financial advisors considered the fairness of the consideration to each class of stock in relation to its intrinsic value. Even though the price obtained by TCOMA holders was substantially higher than the market price thereof and was within the financial advisor's range of valuations, the Court suggested that the premium received by TCOMB holders may be unfair to the TCOMA holders. The Court read *Levco Alternative Fund Ltd. v. Reader's Digest Association, Inc.*[5] as requiring that "the relative impact of a preference to one class be fair to the other class." This was so even though the TCOMB premium, as the court noted, only lowered the price paid to holders of TCOMA by approximately 1.2%.

As this opinion was issued at the summary judgment stage of the proceedings, the defendants in this case may still prevail at the trial stage. Nonetheless, the opinion provides insight into the Court of Chancery's entire fairness analysis and the scrutiny the Court will apply with respect to the structure, composition and conduct of special committees and of mergers in which different classes of stock receive different premiums.

7. Allocating Risk in Negotiating Acquisition -- Stock Purchase Agreements.

***ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).**

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), the Delaware Court of Chancery established a bright-line rule regarding when a seller in a negotiated acquisition may insulate itself against claims of fraud by contractually limiting a buyer's remedies. The Court concluded that a seller may not so insulate itself where it makes representations and warranties in an agreement that it knows are false but nonetheless misleads or defrauds the buyer as to the accuracy of such representations and warranties. However, the Court found that a seller may protect itself against claims based on misrepresentations as to matters that the parties specifically agreed to leave outside the scope of the contract.

[5] 803 A.2d 428 (Del. 2002).

The dispute in ABRY arose out of the sale by Providence Equity Partners (the "Seller") of F&W Publications, Inc. ("F&W"), a portfolio company, to ABRY Partners, a private equity firm (the "Buyer"), pursuant to a stock purchase agreement (the "SPA"). The SPA contained a "non-reliance" provision whereby the Buyer agreed that neither F&W nor the Seller made any representation or warranty as to the accuracy of any information about F&W except as set forth in the SPA and that neither F&W nor the Seller would assume any liability for any extra-contractual information made available to the Buyer in connection with the sale of F&W. Therefore, under the SPA, the Buyer was precluded from relying on any representations of the Seller or F&W not contained in the SPA itself or in an officer's certificate. The SPA also contained an exclusive remedy provision that capped the Seller's liability for misrepresentation to $20 million in damages (the "Indemnity Claims") and barred any rescission claim by the Buyer. The SPA specifically provided that the exclusive remedy provision was bargained for and was reflected in the sale price. The SPA also required Indemnity Claims to be arbitrated in Massachusetts but governed by Delaware law.

Shortly after the closing of the SPA, the Buyer alleged that several of the representations, including the representation as to F&W's financial statements, were materially false and that the Seller knew they were false. Specifically, the Buyer alleged that the Seller and F&W manipulated F&W's financial statements to fraudulently induce the Buyer into purchasing F&W at an exorbitant price. F&W never gave the Buyer pre-closing notice of any problems, and the Seller certified in an officer's certificate delivered at closing that no material adverse effect had occurred prior to closing. After discovering the alleged problems and irregularities with F&W, the Buyer requested that the Seller rescind the transaction. When the Seller refused to do so, the Buyer sued for negligent misrepresentation and fraudulent inducement and sought rescission of the SPA. The Seller moved to dismiss the rescission claim, arguing that the parties had carefully negotiated and drafted the exclusive remedy provision so as to limit the Buyer to monetary relief. The Buyer claimed that dismissing the rescission claim, and thereby immunizing the Seller from such liability, would "sanction unethical business practices of an abhorrent kind and … create an unwise incentive system for contracting parties that would undermine the overall reliability of promises made in contracts."

The Court held that, despite the exclusive remedy provision set forth in the SPA, the Seller could not insulate itself from the possibility of rescission if the Buyer could show that either (i) the Seller knew that F&W's contractual representations or warranties were false or (ii) the Seller itself lied to the Buyer about a contractual representation and warranty. This required the Buyer to prove that "the Seller acted with an illicit state of mind, in the sense that the Seller knew that the representation was false and either communicated it to the Buyer directly itself or knew that [F&W] had." Conversely, the Buyer could not seek rescission where its claim was premised on intentional misrepresentation by the Seller regarding those matters that the Buyer expressly agreed to exclude from the scope of the representations and warranties in the SPA. The Court reasoned that Delaware law permits sophisticated commercial parties to draft contracts that insulate a seller from some rescission claims. However, in cases of actual fraud, public policy considerations against outright fraud in commercial transactions trump traditional principles of freedom of contract, even where both parties are sophisticated and have equal bargaining power. Accordingly, the Court granted the Seller's motion to dismiss the rescission claim based on negligent misrepresentation, but denied the motion as it related to the fraudulent inducement claim.

The Court also addressed the SPA's choice of law provision. The Buyer claimed that the law of Massachusetts, not Delaware, governed the fraudulent inducement claim because the Buyer's operations were located in Massachusetts. The Court rejected that argument, stating that Delaware courts must respect the law chosen by the parties to govern an agreement as long as it has a material relationship to the transaction. In this case, Delaware law clearly had a material relationship to the transaction as the Seller was a Delaware corporation that sold a Delaware corporation to a Delaware limited partnership that used a Delaware corporation to effect the acquisition. The Buyer also argued that, while Delaware law governed the contractual misrepresentation claim, it did not govern the fraudulent inducement tort claim. The Court rejected the Buyer's proposed contractual misrepresentation/fraudulent tort misrepresentation dichotomy, making it clear that whether the claim is asserted as a tort claim, contract claim or otherwise should not affect the governing law when the parties plainly provide for disputes to be governed by the law of a chosen jurisdiction.

B. Stockholder Litigation.

1. Director Independence.

a. *In re General Motors (Hughes) S'holder Litig.*, C.A. No. 20269 (Del. Ch. May 4, 2005).

The plaintiffs filed a lawsuit against General Motors Corporation ("GM"), a group of individuals who were directors of GM at all the relevant times (the "Individual Defendants") (collectively, the "GM Defendants"), and The News Corporation Limited ("News") challenging a series of transactions (the "Split-off") by which News acquired a significant interest in Hughes Electronics Corporation (later renamed The DIRECTV Group, Inc) ("Hughes"). Hughes was previously a wholly owned subsidiary of GM, and the plaintiffs were holders of GM's Class H common Stock ("GMH"), which was a "tracking stock" representing the financial performance of Hughes while Hughes was wholly owned by GM. Both the GM Defendants and News filed motions to dismiss, which were granted on the grounds that the plaintiffs failed to state a claim upon which relief could be granted.

The operative complaint in this case (the "Complaint") contained seven counts, which included allegations against the GM Defendants for breaches of the duty of loyalty, unjust enrichment, breach of the duty of disclosure and breaches of GM's Restated Certificate of Incorporation, and against News for aiding and abetting the Individual Defendants' breaches of fiduciary duty. The Court found all of the allegations in the Complaint to be without merit and labeled the Complaint a "'door stop' weight tome that … contains some facts, but also offers a rich stew of conclusory allegations and legal arguments."

Included in the Complaint was an allegation that the Individual Defendants were neither disinterested nor independent because their loyalties were to GM in order to preserve their directorships, which put them in conflict with the soon to be spun-off GMH shareholders, and that this conflict led the Individual Defendants to approve a transaction that secured liquidity for GM's pension plan while unfairly allocating the consideration from the Split-off between the GMH stockholders and GM and its other classes of stock. Specifically, the plaintiffs argued that the $200,000 annual retainer paid to non-employee GM directors motivated them to stay in GM's good graces and presented a conflict of interest in the Hughes transaction. However, the Court noted that the Complaint failed to allege that the compensation paid to the non-employee directors was in any way material to them. The Court also noted that although the Complaint did allege that the two "professional directors" derived "substantial income" from serving on various boards of directors, the Complaint did not allege that the income received from GM is material to them. The Court did note that the Complaint did, however, allege that the financial well-being of GM is material to board member John F. Smith, Jr., formerly GM's CEO, who receives a substantial pension and other benefits from GM.

The plaintiffs also alleged that certain of the other Individual Defendants were conflicted because of various business relationships with GM. For example, Lloyd D. Ward was on the GM board and was also the CEO of the U.S. Olympic Committee (the "U.S.O.C."). The Complaint alleged that because GM was a major sponsor of the 2002 Salt Lake City Olympic Games and contributed a total of $23.25 million in cash and vehicles to the U.S.O.C., Ward would not oppose a transaction that was supported by one of the U.S.O.C.'s major sponsors. However, the Court noted that the plaintiffs did not allege that GM's sponsorship conferred a material benefit on Ward personally, and that the plaintiffs ignored the fact that U.S.O.C. received significant donations from many other sponsors and could have obtained another automobile sponsor in place of GM. Furthermore, GM's contribution to the Salt Lake City Games occurred at least a year before the Split-Off occurred, leading to the Court's conclusion that there was absolutely nothing in the Complaint that would suggest that GM's professional relationship with the U.S.O.C. provided GM with any leverage over Ward so that Ward's decision to approve the Split-Off was tainted by his desire to receive a material benefit that only GM could bestow.

Similarly, the Court concluded that other alleged director conflicts were not strong enough to rebut the business judgment rule. These conflicts include one director's service on the boards of both GM and Hughes at the time the transaction was approved, another director's service on the boards of both GM and Goldman Sachs (which was one of Hughes' financial advisors in the Split-Off), and a third GM director who was the CEO of Merrill Lynch & Co. (which was one of GM's financial advisors). The Court stated that a member of the Hughes board would be required to act in the best interest of its parent company (GM) and its shareholders (including the GMH holders) and therefore that director's fiduciary duties were not misaligned. Regarding the other two directors, the Court concluded that neither director had the ability to dominate or control the GM board, leading to the conclusion that the plaintiffs could not impugn the entire GM board with any putative conflicts those two directors may have had.

Furthermore, the plaintiffs alleged that the fact that GM was in the midst of a pension funding crisis gave rise to a conflict due to the Investment Funds Committee of GM's board of directors' role as an ERISA fiduciary for certain of GM's pension plans.[6] The Court stated that directors are frequently required to make difficult decisions that affect the allocation of value between various classes of stock and that this fact alone does not necessarily implicate the directors' good faith or loyalty.

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[6] Six members of the GM board of directors were on the Investment Funds Committee.

As part of the Split-Off, Hughes paid GM a special dividend of $275 million in cash, and GM also received additional cash and stock from News. The plaintiffs alleged that part of the GM Defendants' motivation for entering into this transaction was to help solve a crisis created by the underfunding of GM's pension plans and the downgrading of GM's debt rating, and that this unjustly enriched GM at the expense of the GMH shareholders. Although the plaintiffs acknowledged that a special dividend to GM would be necessary, they argued that the amount of the dividend was excessive. GM responded that the dividend was justified because the GMH shareholders were receiving increased value by becoming direct shareholders in Hughes as opposed to holding tracking stock. The Court saw no reason to dispute the GM board's business judgment in making this decision.

Part of the process that GM employed in dealing with the GMH holders was the creation of the "Capital Stock Committee," which would determine the terms of any material transaction between GM and Hughes and ensure fairness to all shareholders. In addition, GM obtained four fairness opinions in connection with the Split-Off: two opinions stating that the Split-Off was fair to GM, and two opinions stating that it was fair to Hughes. The plaintiffs attacked the impartiality of the opinions on several grounds, including the fact that a large portion of the financial advisors' compensation for the fairness opinion was conditioned on the consummation of the Split-Off and that each of the four financial advisors had and would continue to have a business relationship with GM, Hughes and/or News.

The plaintiffs further alleged that GM manipulated the shareholder vote because of the fact that 35% of the GMH stock was held by various GM pension plans and other employee benefits plans. The plaintiffs also alleged that the GM Defendants deliberately moved up the mailing date for the shareholder solicitation because they knew that the GMH stock price was about to increase.

The Court concluded that the plaintiffs did not assert the necessary facts or make sufficient, well-pled allegations to rebut the presumption that the GM directors acted loyally. The Court also concluded the plaintiffs' claims were largely without merit, that none of the alleged violations or conflicts were significant enough to warrant the application of either the Blasius standard or the entire fairness standard, and that the GM Defendants' conduct was protected by the business judgment rule. The Court's decision to apply the business judgment rule was buttressed by the fact that the shareholder ratification of the Split-Off was found to be valid and free from any disclosure or "vote-rigging" violations. In addition, the Court found that there was no breach of GM's Restated Certificate of Incorporation because one of the provisions in question was permissive rather than mandatory and the other provision in question was amended by the shareholder vote.

The plaintiffs' main assertion against News was that it aided and abetted the Individual Directors' breach of fiduciary duty by agreeing to acquire a slightly smaller percentage of Hughes in exchange for GM taking a bigger special dividend. Upon reviewing the timing of the various components of the transaction and the fact that the percentage of Hughes that was eventually acquired by News was within the original range set forth by GM, the Court concluded that there was no evidence to support the plaintiffs' claim against News and granted summary judgment in favor of News.

b. ***In re J.P. Morgan Chase & Co. S'holder Litig.*****, C.A. No. 531-N (Del. Ch. Apr. 29, 2005).**

The plaintiffs filed a lawsuit against the directors of J.P. Morgan Chase & Co. ("JPMC") (the "JPMC Directors") alleging that the JPMC Directors paid an unnecessary premium in JPMC's acquisition of Bank One Corporation ("Bank One") (the "Merger"). On January 14, 2004, JPMC and Bank One published a joint press release announcing the Merger, which had previously been approved by the boards of directors of both companies. The merger agreement stated that JPMC would pay a 14% premium over the closing price of Bank One on the day of the announcement of the Merger, and it also called for a succession plan which provided that William B. Harrison, Jr., the JPMC CEO, would continue as CEO of the combined company for two years, at which time James Dimon, the Bank One CEO, would succeed him. Harrison was chairman of JPMC prior to the Merger, and he would continue in that role beyond his two-year term as CEO. Dimon would serve as president and COO of the combined company until it was time for him to ascend to the CEO position. The Merger closed on July 1, 2004. On June 26, 2004, *The New York Times* printed an article describing preliminary negotiations between Dimon and Harrison. The article reported that Dimon offered to sell Bank One to JPMC at no premium if Dimon were appointed CEO of the combined company immediately. The key sentence in the article reads as follows: "Mr. Dimon, always the tough deal maker, offered to do the deal for no premium if he could become the chief executive immediately, according to two people close to the deal."[7] The plaintiffs allege that this one sentence proves that JPMC could have acquired Bank One at no premium and failed to do so for the sole reason that Harrison wanted to retain the CEO title for two more years, and that the JPMC Directors acquiesced to Harrison's wishes due to their lack of independence, resulting in a breach of their fiduciary duties. In the alternative, the plaintiffs allege that Harrison secretly refused Dimon's no-premium offer and withheld this information from the JPMC Directors.

The plaintiffs sought damages in the amount of the merger exchange ratio premium, approximately $7 billion. They alleged that by approving the unnecessary premium, the JPMC Directors diluted the plaintiffs' interests in JPMC, resulting in a smaller stake in the combined company. The plaintiffs claimed that this dilution constituted a direct claim, rather than a derivative one. The defendants argued that the claim was derivative and should therefore be dismissed for failure to make an appropriate demand on the JPMC board of directors (the "JPMC Board"). In the alternative, the plaintiffs argued that if the suit was indeed derivative, demand should be excused on futility grounds. The Court found that the suit was derivative and demand was not excused. The Court therefore granted the defendants' motion to dismiss.

In reviewing the plaintiffs' claim for demand futility, the Court applied the disjunctive two-part test from *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). The first prong asks whether a shareholder has pled *with particularity* facts that establish that demand would have been futile because the directors are not independent or disinterested. The Court stated that disinterested means that the director in question did not stand on both sides of the transaction, which none of them did in this case. Independence means that a director's decision must be

[7] Landon Thomas, Jr., *The Yin, the Yang, and the Deal*, N.Y. TIMES, June 27, 2004, §3 (Sunday Business) at 1.

based on the corporate merits of the subject before the board rather than extraneous influences. The plaintiffs' claims center on independence and they argued that at least eight of the twelve directors were not independent because the various business, charitable or family relationships listed below disabled them from exercising independent judgment and that they were beholden to Harrison and unable to act independently of Harrison's influence. The defendants argued that the majority of the JPMC board was independent, and therefore the JPMC board's decision to authorize the Merger should be governed by the business judgment rule. The independence of eight of the JPMC Directors was challenged based on the following connections to JPMC and/or Harrison:

1. Riley Bechtel is the chairman, CEO, and a director of the Bechtel Group, Inc. The Bechtel Group does business with the Trade Bank of Iraq, which is managed by JPMC. JPMC and the Bechtel Group also share additional financial interests, such as an investment partnership that is jointly owned by the partners of the Bechtel Group and a private equity firm affiliated with JPMC.

2. Lawrence Bossidy's son is employed as a JPMC vice president. The plaintiffs allege that Bossidy would be unable to vote against Harrison because it would potentially endanger his son's career.

3. Ellen Futter is the president, as well as a trustee, of The American Museum of Natural History. JPMC is a significant benefactor to the museum. Futter's brother-in-law used to be employed as a managing director of JPMC. The Court disregarded this fact because Futter's brother-in-law was terminated a week before the JPMC board approved the Merger.

4. Helen Kaplan is vice-chair and a trustee of The American Museum of Natural History.

5. William Gray is president and CEO of the United Negro College Fund ("UNCF"). In 2003, JPMC matched over $1 million in UNCF donations from its employees. Since 1990, JPMC and its employees have contributed over $18 million to UNCF. In addition, Harrison has served as the treasurer of UNCF.

6. Frank Bennack is chairman of the executive committee and vice chairman of the board of the Hearst Corporation. He was instrumental in creating Hearst-Argyle Television, Inc., which has a credit facility with a consortium of banks led, in part, by JPMC.

7. John Stafford is a consultant to Wyeth and was chairman of the board of Wyeth from 1986 until 2003. JPMC is the administrative agent and a lending bank under Wyeth's credit facilities. JPMC serves as indenture trustee, paying agent, and conversion agent for $4.5 billion of Wyeth's debt securities.

8. M. Anthony Burns is the chairman emeritus and former CEO of Ryder Systems, Inc. JPMC serves as indenture trustee for Ryder, including its recent August 2003 registration of $800 million of securities.

The Court held that the plaintiffs failed to meet their burden of proof with regard to any of the JPMC Directors. With regard to directors Bennack, Stafford and Burns, whose independence was questioned due to certain financial ties, the Court noted that JPMC is a national commercial and investment bank and that the fact that it provided financing to large American companies should not come as a shock to anyone, and that these financial ties were the only evidence the plaintiffs pleaded to attack the independence of these directors. The plaintiffs failed to allege that there was any connection between financing arrangements between JPMC and the companies these directors are involved with and these directors themselves. The Court held that these allegations, without more, were simply not enough to raise a substantial question about the independence of these three directors.

With regard to Bechtel, his dealings with JPMC were allegedly more substantial than those of Bennack, Stafford and Burns. However, the plaintiffs failed to allege how these facts impinged on Bechtel's ability to act independently of Harrison and did not allege that Bechtel's continued relationship with JPMC would be jeopardized if Bechtel voted against Harrison. Regarding Futter and Kaplan, the plaintiffs did not mention any potential influence that JPMC's contributions to the museum may have had on them, nor did they indicate what percentage of the museum's overall contributions were made by JPMC. The Court did note in a footnote that philanthropic relationships with institutions may give rise to questions about a director's independence, but held that the particularized facts pleaded in those cases were absent here.

The Court relied on NYSE corporate governance rules when considering Bossidy's independence, and held that although family employment ties can give rise to concerns about the ability of directors to act independently of a company's management, that fact that Bossidy's son is not an executive officer and does not live with him renders him independent under the NYSE rules. For that reason the plaintiffs' attack on Bossidy's independence fails. Finally, the Court stated that upon first glance, the reciprocal relationship between JPMC and UNCF, as evidenced by the positions held by Gray and Harrison, could call into question the independence of Gray. However, the plaintiffs' failure to plead particularized facts caused their attack on Gray's independence to fail.

In addition, the Court noted approvingly that the JPMC board is dominated by outsiders: eleven of the twelve directors are not employed by JPMC and Harrison has no power to fire them, nor can he vote them out because he is not a controlling stockholder. The Court also concluded that the plaintiffs have not presented any evidence that would lead the Court to call into the doubt whether the challenged transaction is entitled to the protection of the business judgment rule. To do so, the plaintiffs would have had to plead particularized facts sufficient to raise (i) a reason to doubt that the action was taken honestly and in good faith or (ii) a reason to doubt that the board was adequately informed in making the decision. Because the plaintiffs failed to do so, the second prong of the *Aronson* test fails as well.

The Court stated that the current standard for determining whether a claim is direct or derivative, as determined by the Delaware Supreme Court in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004), turns on the answers to the following two questions: (i) who suffered the alleged harm (the corporation or the suing stockholders individually); and (ii) who would receive the benefit of any recovery or other remedy (the corporation or the suing stockholders, individually). The Court determined that the alleged harm would have been suffered by the pre-merger JPMC as an entity rather than just the suing stockholders individually, and that any recovery would belong to JPMC. Any harm suffered by the stockholders would only be as a natural and foreseeable consequence of the harm to JPMC. The Court reiterated prior precedent which stated that although dilution claims emphasizing diminishment in voting power have been categorized as direct claims, they are only individual in nature when a significant stockholder's interest is increased at the sole expense of the minority (citations omitted). This was not the case here -- all JPMC shares would have been harmed equally. The Court also noted that the Court's choice of consideration (cash or stock) has no effect on the direct/derivative analysis.

c. *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004).

The Chief Justice of the Delaware Supreme Court, E. Norman Veasey, retired from the Court when now Chief Justice Steele was sworn in on May 26, 2004. In one of his last opinions on corporate matters, the Supreme Court recently affirmed the Court of Chancery dismissal of a plaintiff derivative action, *see Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003) ("*Beam I*"), regarding Martha Stewart Living Omnimedia, Inc. ("MSO") and the well-known allegations of insider trading against MSO's founder and controlling stockholder, Martha Stewart. In *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) ("*Beam II*"), the Delaware Supreme Court reaffirmed the settled Delaware principle that mere allegations of friendship, without more, do not threaten director independence.

In *Beam II*, the plaintiff stockholder in MSO alleged that Stewart had breached her fiduciary duties of loyalty and care by illegally selling her stock in ImClone Systems, Inc. on an indirect tip from friend and ImClone CEO, Samuel D. Waksal, and mishandling the ensuing media focus. The plaintiff argued that demand was futile based on the lack of independence of at least half of MSO's six-member board of directors. The Court of Chancery concluded that only two directors lacked independence and, thus, dismissed the plaintiff's amended complaint.

On appeal, the plaintiff argued that additional directors were interested based upon social ties with Stewart. The plaintiff prominently cited *In re Oracle Corporation Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003). In *Oracle*, the company had appointed a special litigation committee (an "SLC") to investigate charges of insider trading against the director defendants. The SLC was composed of two tenured faculty members of Stanford University (including Professor Joseph Grundfest, a well-respected former commissioner of the SEC), its counsel interviewed seventy witnesses, and it produced a report totaling 1,110 pages. Notwithstanding these efforts, the Court of Chancery rejected a motion to dismiss brought by the SLC, basing its holding on extensive relationships between the SLC members, Stanford University and the defendant directors. *Id*. at 947.

In a section of *Beam II* entitled "A Word About the *Oracle* Case," the Delaware Supreme Court advocated a limited reading of *Oracle*. Chief Justice Veasey pointed out the difference between the demand futility context and the SLC context, noting that in the latter the SLC (not the plaintiff) has the burden of proof and discovery is available to the plaintiff. The Chief Justice emphasized the fact that the extensive ties between the SLC and the defendant directors had gone largely unrevealed by the SLC's otherwise lengthy report. Chief Justice Veasey pointed out that the nature of the relationships unearthed in *Oracle* were factually distinct from those alleged in Beam II.

The Delaware Supreme Court also clarified Delaware law on the subject of social ties and director independence in the demand futility context. Mere allegations that a director and the interested person moved in the same social circles, attended the same weddings, developed business relationships, and described each other as friends are insufficient to establish demand futility. This should be true regardless of whether the relationship formed before or during board membership. On the other hand, Chief Justice Veasey explained that reasonable doubt might arise "either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently *vis à vis* an interested director." In any event, the Delaware Supreme Court pointed out the serious risk a director would take in protecting a social acquaintance at the possible expense of the destruction of that director's hard-earned reputation. Thus, not only must such allegations be factually specific, they must support a reasonable inference that the director was more willing to risk his or her reputation than the relationship.

The plaintiff had alleged that director Darla M. Moore had a close personal relationship with Stewart and Stewart's friend Charlotte Beers, that Moore had replaced Beers on the board, and that Moore had attended a wedding reception for the daughter of Stewart's personal lawyer at which Stewart and Waksal were present. The Court of Chancery had called the allegations a "close call," *Beam I*, 833 A.2d at 980, but the Supreme Court disagreed: "In our view, these bare social relationships clearly do not create a reasonable doubt of independence." *Beam II*, slip op. at 20. The Court similarly rejected the plaintiff's other allegations of interestedness. *Beam II* thus illustrates the high bar plaintiffs must meet in pleading demand futility based solely on allegations of social relationships.

2. <u>Scrutiny of Settlements.</u>

a. *In re Fairchild Corp. S'holder Derivative Litig.*, C.A. No. 871-N (Del. Ch. May 18, 2005) (settlement hearing).

At the May 18, 2005 settlement hearing in the *In re Fairchild Corporation Shareholder Derivative Litigation*, C.A. No. 871-N (the "Action"), Vice Chancellor Strine declined to approve the settlement that the parties presented to the Court.

The principal allegations of the consolidated derivative complaint (the "Complaint") in the Action were that (i) The Fairchild Corporation (the "Company" or "Fairchild") improperly paid legal expenses of approximately $5.5 million on behalf of its chairman and chief executive officer Jeffrey Steiner ("J. Steiner") in connection with certain criminal and civil charges against him in France involving Elf Acquitaine SA (the "French Litigation"), with respect to which J. Steiner was recently acquitted except for one charge on which he was found guilty; (ii) payments by the Company to J. Steiner, Eric I. Steiner, a director and president of the Company ("E. Steiner" and together with J. Steiner, the "Steiners"), certain other of the Steiners' family members and certain entities in which J. Steiner has interests were unjustified; (iii) the Company's employment of certain members of J. Steiner's family was and is inappropriate; (iv) loans made by the Company to certain members of the Fairchild board of directors (the "Board") and certain Fairchild officers to purchase Fairchild common stock were improper; and (v) the Company made excessive and unjustified compensation, change of control, non-compete and consulting payments to J. Steiner and certain other officers and directors.

The principal terms of the concessions made primarily by the Steiners in connection with the proposed settlement of the Action were secured through simultaneous negotiations involving the plaintiffs' counsel, a special committee of the Board and the Company's counsel. The terms of the settlement as presented to the Court contained a very broad release of claims and included (i) a payment by J. Steiner of $1,500,000 to the Company as reimbursement for certain legal expenses advanced on his behalf in connection with the French Litigation; (ii) the adoption by the Board of a bylaw specifying that any proposed transactions between the Company and any director or officer of the Company (or any entity controlled by an officer or director of the Company) will be submitted for approval to the Conflict Committee (which is a committee that will be comprised of three disinterested directors of the Company who are not officers or employees of the Company) and will be approved by the Board only with the prior recommendation of the Conflict Committee; (iii) the amendment by J. Steiner and the Company of J. Steiner's Employment Agreement to provide that J. Steiner's current term of employment with the Company will be reduced by half to a two-and-one-half-year rolling term, and his base salary from the Company and all its subsidiaries will be reduced by twenty percent; (iv) the reconfirmation by the Board of the Company's policy that the Company will not lease any aircraft or helicopters from Steiner-related entities; (v) the execution by the Company and J. Steiner of an agreement confirming that the Company's obligations under J. Steiner's split-dollar life insurance policy are irrevocably released; (vi) the execution by the Company and J. Steiner of an agreement confirming that the Company and J. Steiner irrevocably release each other from any and all obligations for any matters arising out of or relating to the French Litigation; and (vii) the amendment by E. Steiner and the Company of E. Steiner's Employment Agreement to provide that E. Steiner's current term of employment with the Company will be reduced by a year to a two-year term and his base salary will be reduced by fifteen percent.

At the May 18 hearing, the Court cited its "fiduciary responsibilities" to the unrepresented Fairchild stockholders and expressed four main concerns in declining to approve the settlement: (i) the Court was not comfortable that the $1.5 million being paid by J. Steiner to the Company as reimbursement for amounts advanced in connection with the French Litigation was sufficient, given the fact that J. Steiner was advanced amounts and ultimately indemnified by the Company in connection with charges that resulted in J. Steiner having been found criminally liable in connection with actions that may not have been taken in his capacity as an officer or director of Fairchild; (ii) the Company has historically granted "Barry Bonds sized" compensation packages for "not Barry Bonds-level performance" operationally and in the market; (iii) the Steiners and other executives have received consulting/change of control/severance payments in connection with transactions that ultimately did not result in significant gains/benefits to the Company and its stockholders; and (iv) the new Conflicts Committee as proposed in the settlement would not have enough power or authority to bring real reform to the way Fairchild operates and was subject to repeal by a stockholder vote (and J. Steiner, as a controlling stockholder, can easily change the composition, power and authority, and existence of the committee by his vote). The Vice Chancellor cautioned plaintiffs' counsel that if they are going to bring "meaty" cases like this one in which it appears the claims brought have some chance of success on the merits and in which significant corporate issues are raised, plaintiffs' counsel must either present the Court with a "real" settlement or be prepared to litigate the cases.

The Court then suggested that it would be willing to consider approving the settlement if the settlement terms were revised. In particular, the Court suggested (i) the Conflicts Committee charter be redrafted to give the committee more power and involvement in general corporate oversight, including compensation decisions, and to lock the committee in and protect it from being abolished or modified by a controlling stockholder vote; (ii) the Company consider revising its policies with respect to the reimbursement of the business expenses of its officers; (iii) the Company provide in connection with a revised settlement a better explanation for the issues raised in the French Litigation, how the claims brought in the French Litigation relate to J. Steiner in his capacity as a director or officer of the Company, and how the $1.5 million reimbursement by J. Steiner was sufficient consideration in light of the total amount advanced by the Company on J. Steiner's behalf; (iv) the implementation of additional structural and prophylactic reforms to provide greater involvement of outside directors in the oversight and management of the Company; (v) the Company consider tying compensation of its executives to the Company's performance; (vi) the Company consider adding one or two new independent directors to its Board and (vii) a possible increase in the consideration being paid by defendants in exchange for the broad release of claims sought in the original settlement agreement. The Court instructed the parties to confer and report back in thirty days.

Following the court's instruction, the parties reconvened settlement negotiations to address the court's concerns and suggestions. Additional discovery, including document production and deposition testimony, was completed to address various existing and new issues relating to the claims to be released as part of the settlement. The additional settlement negotiations concluded with the parties' agreement to an Amended and Supplemental stipulation of Settlement (the "Amended and Supplemental Settlement"). The terms of the Amended and Supplemental Settlement incorporated the terms of the initial settlement with the following modifications and additions: i) additional reimbursement to the company by J. Steiner totaling two-thirds of the company's $5,645 million expenditure on behalf of J. Steiner in the French Litigation; ii) the company's adoption of a bylaw creating an Oversight Committee, which will be required to review and give prior approval for all transactions, compensation or other payments resulting in benefits to any executive officer or director of the company; iii) substantial reforms to the process by which business expenses are approved and reimbursed; iv) the company's implementation and formalization of structural reforms to embrace the oversight of the company's outside directors by increasing the role of the company's outside directors in various ways; v) substantial compensation reform, including the adoption of policies requiring that regular bonus and compensation be directly related to the company's performance; vi) closure of the company's Paris office with $370,000 in estimated annual savings, and vii) several other structural reforms. At the second settlement hearing on November 23, 2005, Vice Chancellor Strine signed the Final order and Judgment approving the parties Amended and Supplemental Settlement. No objection to the Amended and Supplemental Settlement was filed.

b. *In re Prime Hospitality, Inc. S'holders Litig.*, C.A. No. 652-N (Del. Ch. May 4, 2005).

In *In re Prime Hospitality, Inc. Shareholders Litigation*, C.A. No. 652-N (Del. Ch. May 4, 2005), the Court rejected a proposed class action settlement primarily due to concerns regarding the quality of the confirmatory discovery conducted by class counsel. The plaintiff stockholders in *In re Prime Hospitality* challenged the acquisition of Prime Hospitality, Inc. ("Prime") by certain affiliates of The Blackstone Group ("Blackstone"). The parties to the litigation agreed to settle the action based upon the issuance of supplemental disclosures prior to the stockholder vote. Following the consummation of the merger, Blackstone sold certain of the assets previously owned by Prime. An article regarding the sale prompted a former Prime stockholder to object to the proposed settlement.

In rejecting the settlement, the Court noted three areas of concern. First, the Court found that the record with respect to Prime's market check was "full of gaps." Second, the Court noted that it could not assess the reasonableness of the deal protection devices because it could not determine from the record "whether or not the board possessed a reliable body of evidence." Third, the Court was concerned that Prime's chief executive officer -- "the one Prime insider who possessed the most information concerning the Blackstone transaction" -- was never deposed. The Court summarized its concerns in the conclusion of its opinion:

> It is the long-standing policy of this Court to favor settlement over litigation--nothing here changes that. Still, in a class action suit, the Court must remain vigilant in protecting the interests of the unrepresented class. In this role, the Court must act as a fiduciary for the absent members and must use its own business judgment in weighing the terms of the settlement. This task necessarily requires the proponents of a settlement to submit a sufficient record. Sufficiency will be weighed on the facts of each case, but at a minimum, blatant inconsistencies should be explored and explained and adversarial assertions tested. Given the record before me, however, it appears that counsel engaged in a discovery process that was long on style and short on substance. I will not approve the Proposed Stipulation and Agreement of Comprise, Settlement and Release as presented.

3. <u>Section 102(b)(7) and Creditor Claims.</u>

a. *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, C.A. No. 1571-N (Del. Ch. Aug. 10, 2006).

Trenwick America involved a suit brought by a litigation trust created as a result of the bankruptcy of a public company parent and its principal subsidiary. In the Court of Chancery, the Trustee sued the directors of the public parent company and the advisors to that company, alleging that various acquisitions by the parent had been ill advised and contributed to the "deepening insolvency" of the subsidiary. The Court dismissed the case prior to discovery, and expounded upon the duties of directors of a subsidiary corporation, as well as several developing bankruptcy law concepts such as the tort of "deepening insolvency".

In dismissing the claims asserted by the litigation trust, the Court focused on the fact that both the parent and its subsidiary had failed and filed for bankruptcy and held that a claim for "deepening insolvency" did not state an independent claim for purposes of Delaware state law. The Court also found that the Trust had failed to plead any factual basis to support an inference that the parent or its subsidiary were insolvent at the time of the transactions complained of. Given the absence of any such facts, the Court concluded that settled law was that the holding company owned no fiduciary duty to its subsidiary or the creditors of that entity.

The Court also offered guidance to directors of wholly owned, solvent subsidiary corporations. The Court noted that, as a general rule, "a subsidiary board is entitled to support a parent's business strategy unless it believes pursuit of that strategy will cause the subsidiary to violate its legal obligations." The Court also noted that a subsidiary board was not expected "to replicate the deliberative process of its parent's board when taking action in aid of its parent's acquisition strategies."

b. *The Litigation Trust of MDIP, Inc. (formerly known as Mosler, Inc.) v. Rapoport,* C.A. No. 03-779 (GMS) (D. Del. Nov. 29, 2004).

In *The Litigation Trust of MDIP, Inc.* (formerly known as Mosler, Inc.) *v. Rapoport*, C.A. No. 03-779 (GMS) (D. Del. Nov. 29, 2004), the United States District Court for the District of Delaware declined to dismiss an action alleging breach of fiduciary duty and fraudulent transfer. In 1986 and 1990, Kelso & Co., Inc. ("Kelso") acquired control of Mosler, a manufacturer of physical security products and systems, and installed the defendants Marquard, Wall and Young (collectively the "Kelso Directors") on Mosler's Board of Directors. In 1995, defendant Rapoport was hired as President and CEO of Mosler despite the fact that he had no prior experience as a CEO of a company of Mosler's stature. The Kelso Directors allegedly consented to his hiring on the basis of two lines in a one-page memorandum written by the outgoing CEO.

Plaintiff, Litigation Trust of MDIP, Inc. (the trustee of the now-bankrupt Mosler) alleged that defendants breached the fiduciary duties of due care, good faith and loyalty in several ways. First, in connection with Mosler's acquisition of another security business, LeFebure, from De La Rue, Rapoport assumed responsibility for Mosler's due diligence without formal board approval and the Kelso Directors agreed to the transaction without the benefit of any tangible information concerning the proposed acquisition (which ultimately resulted in "a serious deterioration of Mosler's liquidity" because Mosler grossly overpaid for LeFebure, Rapoport failed to retain key personnel from LeFebure and otherwise mismanaged the integration of the two businesses). The plaintiff claimed the defendants further breached their fiduciary duties in failing to exercise the requisite care in connection with Mosler's attempted conversion to a new enterprise software system, which was essential to the proper functioning of its business. Specifically, plaintiff alleged that Rapoport and the Kelso Directors were advised by Mosler's in-house information technology employees that this type of conversion would require them to hire outside specialists but ignored this advice causing difficulty invoicing customers, collecting receivables and tracking inventory for the next several years. Third, plaintiff argues that defendants breached their duty of good faith by ignoring reports of mismanagement, by failing to address the internal problems that caused the company's accounts receivable to rise from $46 million in 1995 to nearly $100 million in 1999 and by actively taking "steps to ensure that any additional concerns of Mosler's employees would not be brought to the Board's attention."

In 1999 Mosler's financial problems because so serious that its outside auditor and independent accountant, Deloitte & Touche, issued a reportable conditions letter. Neither Rapoport nor the Kelso Directors took any corrective action in response to Deloitte's warning. In November 2000, Deloitte issued another letter to the board this time identifying over fifty problem areas, many of which were identified in the 1999 letter. Again, neither Rapoport nor the Kelso Directors took any remedial action. In August, 2001, Mosler filed for bankruptcy and several months later Mosler's assets were sold at auction for nearly $28 million. Mosler filed the action in 2004 in an attempt to recover on behalf of the unsecured creditors of the company who are owed more than $200 million damages for breach of fiduciary duties by Rapoport and Kelso Directors, as well as management fees fraudulently transferred to Kelso by Mosler in the years prior to bankruptcy.

The Kelso Directors argued that plaintiff's fiduciary duty claims are barred pursuant to 8 *Del. C.* § 102(b)(7). The Court held that Delaware law permits defensive use of § 102(b)(7) provisions even when the suit is for the benefit of a creditor. However, "[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or involve 'intentional misconduct' [of the type contemplated by § 102(b)(7)]." Thus, regardless of whether the claim is labeled as a breach of the duty of care, loyalty, or good faith, when a Section 102(b)(7) provision is involved the underlying alleged facts must tend to show that the defendants "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholder to suffer injury or loss." The Court denied defendants' motion to dismiss the breach of fiduciary duty claims, holding that that Mosler met this burden. The Court also declined to dismiss the claims relating to the allegedly improper management fees transferred to Kelso on this basis.

c. *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004), the Delaware Court of Chancery addressed an action for the appointment of a receiver over a debtor corporation and, more importantly, discussed at length a claim that the directors of the debtor corporation breached their fiduciary duties owed to a judgment creditor. In 1999, Production Resources Group, L.L.C. ("PRG") installed computer controlled audio systems for NCT Group, Inc. ("NCT"). When NCT failed to pay for the installation as required, PRG entered into a "resolution agreement" with NCT, pursuant to which NCT agreed to pay PRG $1,906,221 and to register 6.7 million shares of its stock in the name of PRG. After NCT breached its obligations under the resolution agreement, PRG sought and obtained a judgment in Connecticut state court against NCT in the amount of $2 million, plus interest and costs. Since the Connecticut court's entry of judgment on January 17, 2002, PRG has been trying, with little success, to collect the award. To protect its interests as a judgment creditor, PRG brought an action under Section 291, which permits the Court of Chancery, upon application by a stockholder or creditor, to appoint a receiver over an insolvent corporation. In addition, PRG alleged that NCT's directors had breached their fiduciary duties of due care and loyalty owed to PRG.

In support of its Section 291 claim, PRG asserted several facts tending to show that NCT was insolvent. PRG alleged, among other things, that NCT (i) had a working capital deficit $57.1 million as of September 30, 2003; (ii) had negative net tangible assets of $53.7 million as of December 31, 2002; (iii) had little cash and cash equivalents on hand and virtually no ability to raise additional capital; and (iv) had issued close to all of the shares of stock it was authorized to issue -- 642 million out 645 million -- and had no intention of seeking a shareholder vote on a charter amendment to increase the authorized share capital until the filing of its S-1, the occurrence of which, in light of NCT's condition, seemed dubious.

In assessing these claims, the Court noted that NCT, which had steadily lost money since its inception, had been kept afloat only by the munificence of its primary creditor, Carole Salkind, who from 2001 to the time of the decision had made secured loans in an aggregate principal amount of approximately $28 million to NCT and, in connection therewith, had obtained liens on nearly all of NCT's assets and had received numerous share pledges. As of December 2003, Ms. Salkind and her affiliates owned more than 1.2 billion shares of NCT stock on a fully converted basis -- far exceeding the 645 million shares authorized by NCT's charter.

NCT argued that PRG failed to allege facts sufficient to show that NCT is insolvent for purposes of Section 291. The Court rejected this argument, noting that, to meet the burden to establish NCT's insolvency, PRG was only required to show that (i) NCT's assets were not sufficient to allow for its business to successfully continue or (ii) NCT was unable to meet its obligations as they came due in the ordinary course of business. Although NCT essentially conceded that its liabilities did exceed its assets, it maintained that PRG had not established that NCT would have no reasonable prospect of continuing as a going concern. The Court disagreed, finding that NCT would be deemed insolvent by almost any reasonable metric. The Court pointed to, among other things, the fact that NCT's liabilities represented close to five times the value of its assets and that NCT's working capital deficit and its net capital deficit exceeded its combined revenue for the five years ending December 1, 2002. The Court also noted that NCT's ability to forestall its complete demise by pledging billions of shares to its principal creditor, Ms. Salkind, did not transform NCT into a viable going concern.

As an alternative argument, NCT asserted that PRG's sole purpose in bringing the Section 291 claim was to collect on a corporate debt and that the Court was not entitled to grant such a request. In support of this argument, NCT pointed to *Keystone Fuel Oil v. Del-Way Petroleum, Co.*, 1977 WL 2572 (Del. Ch. June 16, 1977), where the Chancery Court stated that "[appointment of] a receiver is normally a remedy of an auxiliary nature incidental to primary relief bottomed upon fraud or inequitable conduct under the given circumstances, and the appointment of a receiver should not be the sole object of a suit." In dismissing NCT's reliance on *Keystone* as misplaced, the Court noted that the defendant in that case was solvent and that there was accordingly no justification for appointing a receiver. The Court proffered its own reading of *Keystone*; namely, that the Chancery Court should not undertake a decision to appoint a receiver lightly. After undertaking a lengthy analysis of its own, the Court denied NCT's motion to dismiss PRG's claim under Section 291.

The Court then turned to PRG's claims charging the members of NCT's board of directors and its chief financial officer with a breach of their fiduciary duties. In response to these claims, NCT argued that PRG had raised derivative claims that were not properly pled in accordance with Rule 23.1. In the alternative, NCT argued that PRG's fiduciary duty claims -- at least as to the directors -- were nonetheless barred by the exculpatory provision in NCT's charter. PRG countered that, as a creditor of NCT, its claims for breach of fiduciary duty were direct and that the exculpatory provisions therefore did not apply.

The Court noted that, as a general matter, creditors may not allege fiduciary duty claims against corporate directors, since creditors are capable of protecting themselves through contractual arrangements and are additionally protected by the law of fraudulent conveyance. In discussing this issue, the Court referred to the opinion in *Credit Lyonnais*, which generally held that directors would be entitled to the protection of the business judgment rule if they pursued a less risky business strategy because they feared a riskier strategy would render the firm unable to meet its legal obligations to creditors and other constituencies. The Court pointed out that some legal observers had read the decision in *Credit Lyonnais* broadly so as to expose directors to a new set of fiduciary duty claims -- those brought by disgruntled creditors. The Court queried whether, once the myriad legal and contractual protections afforded to creditors were considered, an inequitable conduct claim would be extant. Ultimately, the Court determined that it was not required to resolve the issue as to whether directors owe a fiduciary duty to creditors when the corporation is within the zone of insolvency.

The Court then recited what it referred to as "settled Delaware law" providing that once a corporation has traveled through the "zone of insolvency" and entered the realm of actual insolvency, its directors owe fiduciary duties to the creditors. According to the Court, the fact of insolvency places creditors in the position normally occupied by the shareholders (*i.e.*, residual risk bearers). Once a corporation has become insolvent, its creditors become exposed to substantial business risks as the entity goes forward -- *e.g.*, poor decisions on the part of the directors erode the value of the remaining assets, reducing the pool from which creditors will be paid. The Court held, however, that the transformation of a creditor into one to whom a fiduciary duty is owed does not change the nature of the underlying claim. Considering that any recovery received by creditors in connection with any such claim would flow to the corporation directly and benefit the creditor-plaintiffs indirectly, the claims would necessarily be derivative in nature. Whether a corporation is solvent or insolvent, it owns a claim that a director has mismanaged the corporation or otherwise engaged in activities that would otherwise damage the corporation. The Court stated that Section 102(b)(7), which permits a corporation to exculpate its directors from liability arising from certain claims, applies to all claims belonging to the corporation itself, regardless of whether those claims are brought derivatively by stockholders or creditors. The Court argued that there is no justification for carving derivative claims brought by creditors out of Section 102(b)(7), stating that such protective provisions restrict third parties to the extent that they seek to enforce rights on behalf of corporations.

The Court next raised the issue as to what pleading standard should apply to creditors bringing derivative claims -- specifically, whether they should be required to plead demand excusal. The Court declined to squarely address this issue but noted that, on one hand, the specific pleading rules for derivative claims articulated in *Aronson* provide a useful framework and should apply to all derivative claims. On the other hand, the Court expressed the view that the *Aronson* test should not apply to creditors bringing such claims since, unlike shareholders, they are not entitled to elect directors and do not have rights to review the corporation's books and records. Following this mildly peripatetic discussion, the Court expressed its relief in not being required to rule on the matter.

Finally, the Court sought to locate the bounds of direct and derivative claims. PRG had argued that all of its claims became direct as a result of NCT's insolvency. The Court acknowledged that PRG's claim as a particular creditor of NCT had the flavor of a direct action, but it declined to resolve the motion on these grounds. The Court held that insofar as PRG's complaint advanced due care claims against the defendant directors, such claims were barred by the exculpatory provision in NCT's charter. Denying NCT's motion to dismiss PRG's fiduciary duty claims, the Court suggested that that PRG may succeed on a direct fiduciary duty claim and on a derivative claim, but emphasized that its holding was not based on the notion that it is a breach of fiduciary duty for the board of an insolvent company to engage in vigorous negotiations with a judgment creditor.

4. Preferred Stock Issues.

a. *Thoughtworks, Inc. v. SV Investment Partners, LLC,* C.A. No. 1695-N (Del. Ch. June 30, 2006).

Thoughtworks, Inc. v. SV Investment Partners was a dispute relating to a put right owned by a preferred stockholder and contained in the company's certificate of incorporation, as well as the right of the preferred holder to approve the issuance of certain additional borrowings by the company. The Court interpreted the plain language of the charter to require redemption of the preferred and to prohibit a new $10 million borrowing absent the consent of the preferred holder.

The evidence at trial showed the preferred stockholder made its investment expecting a quick IPO. The charter, however, provided for mandatory redemption of the preferred in five years in the event that no IPO took place. However, the charter also defined the funds from which the redemption would be made to include "funds legally available therefore" with the caveat that the company would not be required to utilize funds for redemption "which have been…designated by the Board of Directors as necessary to fund the working capital requirements of the Corporation for the fiscal year of the Redemption Date…"

Since it was anticipated that the redemption could take place over a series of years, the issue of interpretation turned on whether the carve out set forth above related solely to the initial year in which the redemption was to take place, or whether the company's board could, in future years, designate all of its funds as "working capital" funds, thereby effectively precluding the redemption. After briefly reviewing the negotiating history of the provision, the Court concluded that the "working capital" carve out was available only in the first year in which the securities were to be redeemed, and did not apply thereafter.

The Court also addressed whether a prohibition on "any contractual arrangement" which provided for the payment of more than $500,000 per year would prohibit the incurrence of a $10 million debt facility. While noting the absence of a material debt covenant in the preferred, the

Court nonetheless applied the plain language of the charter to reach the proposed \$10 million borrowing (which would have involved payment of more than \$500,000/year by its terms).

b. *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broadcasting Corp.*, C.A. No. 2205-N (Del. Ch. June 29, 2006).

In *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broadcasting Corp.*, C.A. No. 2205-N, Lamb, V.C. (Del. Ch. June 29, 2006), the Delaware Court of Chancery addressed whether redeemable preferred stock of Granite Broadcasting Corporation ("Granite") constituted a debt or equity instrument for purposes of determining whether a holder of such stock had standing to sue Granite in the capacity as a creditor of Granite. For the reasons that follow, the Delaware Court of Chancery found that the redeemable preferred stock represented an equity interest in Granite and, as a result, any holder of such stock had no standing to sue Granite as a creditor.

Plaintiff Harbinger Capital Partners Master Fund I, LTD. ("Harbinger") owns approximately 39% of Granite's 12¾% Cumulative Exchangeable Preferred Stock (the "Preferred Stock"). The terms of the Preferred Stock require Granite to redeem the stock at a fixed price plus accumulated dividends on April 1, 2009. Granite also has the exclusive right to redeem such stock at any time prior to the redemption date, subject to certain conditions. If Granite fails to redeem the stock or pay accumulated dividends on the redemption date, then Harbinger's "exclusive remedy" is the right to elect the lesser of two Granite directors or that number of Granite directors constituting 25% of the members of the Granite board of directors. Further, the certificate of designations provides for certain additional contractual protections for the holders of the Preferred Stock, *inter alia*, in connection with mergers, consolidations and sales of Granite's assets.

Defendant Granite is an owner and operator of television stations. Granite, which has been in financial distress, entered into agreements to sell two of its television stations in May 2006. Harbinger argued that the transactions violated the terms of an indenture governing senior notes issued by Granite and fraudulent conveyance laws. Granite moved to dismiss the case on the basis that Harbinger was not a creditor of Granite and, thus, had no standing to bring the claims asserted. The Court began its analysis with the proposition that the rights of holders of preferred stock are primarily contractual in nature and are strictly construed. According to the Court, this contractual level of analysis will exhaust the judicial review of challenges as a wrong to a holder of preferred stock except in the limited circumstances where the holder also has a right to pursue its claims on fiduciary duty grounds. The Court then found that the body of case law (primarily in the bankruptcy context) almost unanimously favored a finding that the Preferred Stock was an equity interest in Granite. These cases focused on the fact that even where a certificate of designation confers on the holders of preferred stock redemption and dividend rights, such rights are not guaranteed in the way that a creditor's claim is guaranteed since such rights are dependent on the solvency of the corporation. Similarly, the Court noted that while holders of preferred stock often enjoy a preference on liquidation vis-à-vis holders of common stock, the right of such preferred holders to a preference on liquidation is subordinated to the rights of secured creditors.

Harbinger argued that the 2003 change in Generally Accepted Accounting Principles, promulgated by the Financial Accounting Standards Board under the name FAS150 required Granite to treat the Preferred Stock as debt on its balance sheets and that such accounting rule should control the outcome of the case. The Court rejected this argument on the basis that "the foundational issue of standing pursuant to a statute limiting suits to a certain kind of plaintiff is too weighty to rest on the slender reed of a corporation's decision to marginally revise its financial reporting in order to comply with FAS150."

* * *

Harbinger is the first decision by the Delaware Court of Chancery directly addressing whether preferred stock is a debt or equity instrument, although it is in the context of considering the issue of standing for purpose of a New York fraudulent conveyance claim.

c. *Matthews v. Groove Networks, Inc.*, C.A. No. 1213-N (Del. Ch. Dec. 8, 2005).

In *Matthews v. Groove Networks, Inc.*, C.A. No. 1213-N, Chandler, C. (Del. Ch. Dec. 8, 2005), the Delaware Court of Chancery considered the application of a deemed liquidation provision to the May 2005 merger between Groove Networks, Inc. ("Groove Networks") and Microsoft Corporation ("Microsoft"), pursuant to which Microsoft acquired Groove Networks. The Groove Networks' common stockholders received no consideration in the merger based on the application of the liquidation preference in Groove Networks' Certificate of Incorporation (the "Liquidation Preference") to the merger. Prior to the merger, Groove Networks had eight series of preferred stock and only one class of common stock. Under Groove Networks' construction of the Liquidation Preference, all of the merger consideration was required to be paid to the preferred stockholders with the common stockholders receiving nothing. The plaintiff, a common stockholder of Groove Networks, sued and claimed that the Groove Networks' interpretation of the Liquidation Preference was incorrect. Groove Networks and the individual defendant directors of Groove Networks moved for summary judgment.

The Liquidation Preference expressly governed the distribution of Groove Networks' assets upon the occurrence of a "Liquidation Event" -- a defined term that expressly included a merger. Upon the occurrence of such event, the preferred stockholders were entitled to be paid from "Distributable Assets," which included Groove Networks' assets "whether from capital, surplus, or earnings." The Liquidation Preference expressly stated that, in the event of a *sale* of Groove Networks' assets, "the Distributable Assets shall be the net proceeds of such sale." In addition, the Liquidation Preference stated that, in the event Groove Networks was acquired by a public company, the Liquidation Preference could be paid in common stock of the acquiring company. The Liquidation Preference, however, did not state that in the event of a merger, the merger consideration would constitute "Distributable Assets" payable to preferred stockholders. The plaintiff thus argued that this omission was deliberate and that only Groove Networks' "capital, surplus, or earnings" -- and not the merger consideration -- constituted "Distributable Assets" payable to the preferred stockholders.

The Court rejected the plaintiff's interpretation and held that the Liquidation Preference provided for only one preference scheme under which all of the merger consideration was payable to the preferred stockholders. The Court found that the plaintiff's competing interpretation of the Liquidation Preference (*i.e.*, that only the "capital, surplus and earnings" should be distributed to the preferred stockholders) was nonsensical because, in a merger, the "capital, surplus and earnings" of the target corporation are not distributed to the target's stockholders; rather, they are transferred to the acquiring corporation in exchange for the merger consideration. The plaintiff's interpretation also failed to account for the Liquidation Preference's statement that the stock of an acquiring corporation could constitute "Distributable Assets" payable to the preferred stockholders. The Court reasoned that this express provision, which would seem to apply to a merger in which the consideration paid to the target was the acquirer's stock, would be rendered meaningless under the plaintiff's restrictive reading of "Distributable Assets." Accordingly, the Court granted the defendants' motion for summary judgment.

Groove Networks is one of the first Delaware cases addressing a deemed liquidation provision and illustrates some of the uncertainty that can arise when a corporation must determine how to apply a deemed liquidation provision to the distribution of merger consideration in a merger if the provision is not clearly drafted.

d. *FGC Holdings Ltd. v. Teltronics*, C.A. No. 883-N (Del. Ch. Sept. 14, 2005).

In *FGC Holdings Limited v. Teltronics*, C.A. No. 883-N, Parsons, V.C. (Del. Ch. Sept. 14, 2005), the Delaware Court of Chancery addressed, *inter alia*, whether a provision in a certificate of designation providing that the holders of a series of preferred stock with an "exclusive and special right" to elect one director "voting separately as one class" meant that, if the preferred stockholders failed to elect a director pursuant to their special director election rights, the holders of the corporation's common stock were precluded from electing a director to fill the preferred stock directorship. The Court found that the holders of common stock could elect a director to fill the preferred stock directorship, but the director so elected held the directorship subject to defeasance by the preferred stockholders at any time.

Section 4(b) of the Series B Certificate of Designation of Teltronics, Inc. ("Teltronics") provided, in pertinent part:

> The holders of the Series B Preferred Stock, voting separately as one class, shall have the exclusive and special right at all times to elect one (1) director ("[the Series B director]") to the Board of Directors of the Corporation provided, however, that so long as any shares of Series B Preferred Stock are outstanding, the Board of Directors shall not consist of more than five (5) members. The [Series B director] shall be elected by the vote of the holders of a majority, and removed by the vote of the holders of two-thirds (2/3), of the shares of Series B Preferred Stock then outstanding....

Thus, Section 4(b) provided the holders of the Series B Preferred Stock with the "exclusive and special right" to elect one director "voting separately as one class" and limits the size of the Teltronics board of directors to five directors. At the 2001-2004 Tectonics annual meetings, the holder of Teltronics' Series B Preferred Stock did not elect a Series B director, and the common stockholders elected five directors. In September 2004, FGC Holdings Limited ("FGC") acquired all of Teltronics' Series B Preferred Stock, and in November 2004 (after the 2004 annual meeting), FGC purported to elect a Series B director by written consent. After Teltronics declined to recognize FGC's designee, FGC brought this action seeking, among other things, an order compelling Teltronics to recognize immediately its designee as the Series B director.

The Court agreed with FGC's contention that the Series B Certificate of Designation vests FGC with the right to elect a Series B director at any time. Teltronics argued, but the Court rejected, that FGC only had a right to elect a director if the board consisted of less than five members. The Court found that the limitation on the size of the board did not divest FGC of its right to designate a director at any time. Rather, the Court found that, in the absence of any language providing that the holders of common stock had "only" the right to elect four directors, the common stockholders had a right to elect a fifth director in the event that the holders of the Series B Preferred Stock failed to elect a Series B director. However, such fifth director held a directorship that was subject to defeasance by the holders of the Series B Preferred Stock at any time. The Court further noted that "as a practical matter, [] Teltronics would need to identify the 'fifth director' in connection with the stockholders' election of directors, because the terms under which the person would be serving as a director would differ from the other common directors." Having failed to do so, and there being no mechanism in the Series B Certificate of Designation by which FGC's designee could be easily seated on the board, the Court declined to order that FGC's designee take its place on the board prior to Teltronics' next annual meeting of stockholders.

Pursuant to this decision, it is not enough to state that preferred stockholders have the "exclusive and special right" to elect directors "voting separately as one class" in order to assure that a "designated director seat" remains just that. Rather, common stockholders also should be specifically denied the right to elect a director to a designated director seat. Alternatively, a specific mechanism could be put in the certificate of designation by which the preferred stockholders may exercise their immediate right to have a preferred designee seated on the board.

e. *Benihana of Tokyo, Inc. v. Benihana Inc.*, 891 A.2d 150 (Del. Ch. 2005), *aff'd.*, __ A.2d __ (Del. Aug. 24, 2006).

In *Benihana of Tokyo, Inc. v. Benihana Inc.*, plaintiff Benihana of Tokyo, Inc. ("BOT") sued Benihana Inc. ("Benihana"), the directors of Benihana and BFC Financial Corporation ("BFC") in connection with the issuance of Benihana convertible preferred stock to BFC (the "Transaction").

Benihana needed capital to fund its plan to construct new restaurants and renovate its older restaurants (the "Plan"). The Board considered borrowing money from a commercial bank, but ultimately deemed that financing option unsatisfactory due to performance covenants insisted upon by the bankers. Benihana retained the investment banking firm of Morgan Joseph & Co., Inc. ("Morgan Joseph") to discuss financing options. After reviewing Benihana's financial projections and the Plan and determining that Benihana needed long-term capital, Morgan

Joseph recommended that Benihana issue convertible preferred stock. Eventually an agreement was made for BFC to purchase the preferred stock.

BOT, the largest holder of Benihana stock, challenged the Transaction on several grounds: (1) the Transaction violated Section 151 of the DGCL and Benihana's charter; (2) the Board adopted the Transaction for an improper primary purpose of diluting BOT's interest in Benihana and entrenching Benihana's directors; and (3) Benihana's directors breached their fiduciary duties of loyalty and care in approving the Transaction.

BOT first argued that the Transaction was invalid based on Section 151 and the lack of authorization in Benihana's charter for the Board to issue stock with preemptive rights. Section 151(a) states that the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of any class or series of a corporation's stock may be made dependent on facts ascertainable outside the charter, provided that the manner in which such facts will operate shall be set forth in the charter or a board resolution providing for such issuance. Benihana's charter stated that no stockholder shall have preemptive rights. However, the Agreement, which the certificate of designation for the convertible preferred stock incorporated by reference, granted BFC preemptive rights. The Court concluded that boilerplate language like that in Benihana's charter is included only to clarify that a stockholder lacks preemptive rights under common law. Such language does not limit or prohibit Benihana from contractually granting preemptive rights. Therefore, the Board was authorized to issue preferred stock with preemptive rights under Benihana's charter and the DGCL.

As to the other claims, the Court had to determine whether the entire fairness standard or the business judgment rule applied. The Transaction was an interested transaction based on the interest of John Abdo, a Benihana director, in BFC. Therefore, the defendant directors had to demonstrate that, under Section 144(a)(1) of the DGCL, a majority of informed, disinterested and independent Benihana directors approved the Transaction.

The Court found that BOT was unable to prove that the Transaction was not approved by a majority of independent and disinterested directors. Because the defendants satisfied the requirements of Section 144(a)(1), the Transaction was not void or voidable solely because of the conflict of interest. The Court went on to address the entire fairness standard based on BOT's entrenchment claim, and found that even if BOT's alleged facts demonstrated an entrenchment effect, the effect alone failed to prove that the primary purpose for the Transaction was entrenchment. The Court concluded that the Board's primary purpose in approving the Transaction was to secure the necessary funds for the Plan, not to entrench itself.

Having found that a majority of disinterested and independent directors approved the transaction in good faith and that the directors did not breach their duties of loyalty and care, the Court held that the Board validly exercised its business judgment in approving the Transaction that led to dilution of BOT's voting power. The Court, therefore, denied all of BOT's claims.

On appeal, the Supreme Court affirmed the trial court's interpretation of the Benihana certificate of incorporation and deferred to the trial court's findings of fact relating to the directors' motivation.

f. *Shintom Co. v. Audiovox Corp.*, 888 A.2d 225 (Del. 2005).

In *Shintom Co. v. Audiovox Corp.*, 888 A.2d 225 (Del. 2005), the Delaware Supreme Court affirmed a decision of the Delaware Court of Chancery holding that Section 151(c) of the General Corporation Law of the State of Delaware ("Section 151(c)") does not require that preferred stock confer dividend rights. The Court held that Delaware corporations may lawfully issue preferred shares without any dividend rights.

Plaintiff-appellant Shintom Co., Ltd. ("Shintom") initially purchased shares of non-cumulative preferred stock of Audiovox New York. Subsequently, Audiovox New York merged with defendant-appellee Audiovox Corporation, a Delaware corporation ("Audiovox"). As a result of the merger, the noncumulative preferred stock held by Shintom was converted into shares of non-dividend preferred stock of Audiovox. Shintom alleged that Section 151(c) requires, as a matter of law, that holders of preferred stock receive at least some dividends in some circumstances, and that because Audiovox's non-dividend preferred stock does not grant any dividend rights under any circumstances, it is void under Section 151(c).

Section 151(c) provides that holders of preferred stock "shall be entitled to receive dividends" based on the rates, times and conditions stated in the corporation's certificate of incorporation or applicable resolution. Section 151(a) of the General Corporation Law of the State of Delaware provides that a corporation "may" issue one or more classes of stock with varying rights and preferences as so stated in its certificate of incorporation or applicable resolution. The Court found:

> Section 151(c) does not mandate that all preferred stock confer a right to payment of dividends. Instead, it confirms--consistent with the enabling language of section 151(a)--that a corporation "may" determine to issue preferred stock that "may" have a contractually determined dividend right as one of its preferences. If preferred stock is issued, however, section 151(c) provides that the holders of such stock "shall" only be entitled to receive dividends at the rate and under the conditions stated in the certificate of incorporation or applicable resolution(s).

Under Delaware law, preferred stock must have some bona fide preference over other stock. A dividend right is only one of several permitted preferences. Accordingly, Audiovox's non-dividend preferred stock was valid because the Audiovox Certificate of Incorporation conferred upon preferred stockholders a liquidation preference. The liquidation preference, without more, was sufficient to create preferred stock.

The *Shintom Co. v. Audiovox Corp.* decision reaffirms that under the General Corporation Law of the State of Delaware, preferred stock must have some bona fide preference over other stock, and holds that Delaware corporations may lawfully issue preferred stock without any dividend rights.

g. *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005).

In *VantagePoint Venture Partners 1996 v. Examen, Inc.*, No. 127, 2005 (Del. May 5, 2005), the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision refusing to apply provisions of California law that purport to govern the internal affairs of non-California corporations. Rather, under the internal affairs doctrine, the Supreme Court found that the law of the state of incorporation applied to the dispute.

Plaintiff-Appellee Examen, Inc. ("Examen") was a privately held Delaware corporation with its principal place of business in California. Defendant-Appellant VantagePoint Venture Partners 1996 ("VantagePoint") was a Delaware limited partnership that owned 83% of Examen's preferred stock. In February 2005, Examen entered into a merger agreement with a subsidiary of Reed Elsevier, Inc. In connection with the anticipated merger, VantagePoint asserted that Examen was a "quasi-California" corporation pursuant to California General Corporations Law Section 2115 ("Section 2115"). Broadly speaking, Section 2115 provides that non-California corporations that are privately held and satisfy a set of factual tests (including conducting a majority of their business in California and having a majority of their stockholders with California addresses) are "quasi-California" corporations subject to certain provisions of California's corporation law. If applied in this situation, Section 2115 would provide Examen's preferred stockholders a separate class vote on the merger.

In response to VantagePoint's assertion, Examen brought suit in the Delaware Court of Chancery seeking a declaration that Section 2115 did not apply to the voting rights of its stockholders. Examen argued that the internal affairs doctrine required application of Delaware law. The Court of Chancery agreed and granted Examen's motion for judgment on the pleadings.

On appeal, the Delaware Supreme Court explained that the internal affairs doctrine was based on the premise that corporations should not be subject to inconsistent legal standards among the several states. The internal affairs doctrine requires that the law of the state of incorporation be applied to matters pertaining to the relationships among or between the corporation and its officers, directors and stockholders. In discussing the development of the doctrine, the Court reaffirmed its holding in *McDermott Inc. v. Lewis*, 531 A.2d 206 (Del. 1987), that the internal affairs doctrine "is mandated by constitutional principles." Specifically, under the Due Process Clause of the Fourteenth Amendment, the Court found that corporate directors, officers and stockholders have a right to know what law will apply to their actions and/or govern the accountability of their representatives. Further, under the Commerce Clause, the Court noted that a state "has no interest in regulating the internal affairs of foreign corporations." The Court stated that the internal affairs doctrine is trumped only where "the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce."

Turning to Section 2115, the Court found that application of the statute to foreign (i.e., non-California) corporations would "produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter." The Court was particularly troubled by the notion that a foreign corporation could fall within the ambit of Section 2115 one year but not the next due to the "vicissitudes of the ever-changing facts." Moreover, the Court reasoned that the application of Section 2115 would run afoul of the United States Supreme Court's decisions in *CTS Corporation v. Dynamics Corporation of America*, 481 U.S. 69 (1987), and *Kamen v. Kemper Financial Services*, 500 U.S. 90 (1991). In *CTS*, the United States Supreme Court held that the Commerce Clause "prohibits States from regulating subjects that 'are in their nature national, or admit only of one uniform system, or plan of regulation'" and acknowledged that the internal affairs of a corporation is a subject that requires uniform regulation. Similarly, the *Kamen* Court rejected the imposition of a federal universal-demand requirement upon the corporate law of the states, in part because of the uncertainties that could result from differences in federal and state corporation law. Accordingly, the Supreme Court affirmed the Court of Chancery's decision to apply Delaware law, rather than California law pursuant to Section 2115, to determine VantagePoint's voting rights.

The Court went on to address VantagePoint's claim that the California courts would apply Section 2115 in these circumstances. In making this argument, VantagePoint relied primarily upon the decision of the California Court of Appeals in *Wilson v. Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216 (1982), which upheld the application of California law to a Utah corporation pursuant to Section 2115. VantagePoint asserted that if Delaware refused to apply Section 2115, there would be an inconsistency among the states and litigants would engage in unseemly forum shopping. The Supreme Court firmly rejected this argument. The Court noted that *Wilson* was decided before *CTS*, *Kamen* and *McDermott*. Further, ten years after *Wilson*, the California Supreme Court cited with approval the Delaware Supreme Court's analysis of the internal affairs doctrine in *McDermott*. Finally, only two years ago, the California Court of Appeals questioned the continued validity of *Wilson* and also cited *McDermott* approvingly. Thus, the Court concluded that it "had no doubt" that today the California courts would apply Delaware law to the internal affairs of a Delaware corporation.

The *VantagePoint* decision reaffirms Delaware's strong commitment to the internal affairs doctrine and makes clear that the doctrine will be applied even where the law of a sister state purports to mandate a contrary rule.

h. *WatchMark v. Argo Global Capital*, C.A. No. 711-N (Del. Ch. Nov. 4, 2004).

In *WatchMark Corporation v. ARGO Global Capital, LLC*, C.A. No. 711-N (Del. Ch. Nov. 4, 2004), the Delaware Court of Chancery added to a long line of Delaware cases holding that protective provisions in a certificate of incorporation that provide for a separate series vote on an amendment to the corporation's certificate of incorporation that results in the diminution of the rights of the holders of such series does not apply to an amendment effected by merger, absent an express provision in the charter to the contrary.

In August, 2004 the board of directors of WatchMark Corp. ("WatchMark"), a privately held Delaware corporation, determined to raise capital for a pending acquisition through the offering of a new series of preferred stock, the Series F Preferred Stock (the "Series F"). The authorization of the Series F triggered protective provisions in WatchMark's certificate of incorporation that provided each existing series of preferred stock with a separate series vote on any amendment to the WatchMark certificate that altered the preferences, rights, privileges or powers of such series so as to affect them adversely. Thereafter, defendant ARGO Global

Capital, LLC ("ARGO"), the predominant holder of WatchMark's Series B Preferred Stock (the "Series B"), indicated that ARGO would veto the transaction through its separate series vote.

Faced with ARGO's threatened veto of the Series F financing, the WatchMark board determined to merge a wholly owned subsidiary into WatchMark and amend the WatchMark certificate of incorporation in the merger to remove the separate series voting requirements for each series of WatchMark's preferred stock. However, the proposed certificate of incorporation (as proposed to be amended) retained all other material provisions of the pre-merger WatchMark certificate of incorporation, including a provision requiring the affirmative vote of the holders of seventy percent (70%) of the outstanding preferred stock, voting together as a single class, to approve a merger. The WatchMark certificate also contained a "no impairment" provision, requiring WatchMark to seek the consent of the preferred stockholders whenever such consent was required by the protective provisions in the certificate of incorporation and otherwise act in good faith in the performance of its obligations under the certificate of incorporation.

WatchMark brought this action seeking a declaratory judgment regarding the rights of the holders of the Series B to vote as a separate series on the proposed merger. ARGO brought a counterclaim against WatchMark and its board of directors alleging that the proposed merger violated contractual and fiduciary obligations owed to the holders of Series B and moved for a preliminary injunction to enjoin the proposed merger. For the reasons that follow, the Court denied ARGO's request for a preliminary injunction, and found that the holders of the Series B were not entitled to a separate series vote and that the Watchmark board did not breach any fiduciary obligations to the holders of the Series B, each in connection with the proposed merger.

Relying on a long line of Delaware cases, including the Delaware Supreme Court's decision in *Elliot Associates, L.P. v. Avatex Corporation*, 715 A.2d 843 (Del. 1998) the Court found that the holders of Series B were not entitled to a separate series vote on the merger since the provision providing for a separate series vote on amendments to the WatchMark certificate did not expressly reference mergers. In addition, the Court found that the "no impairment" provision of WatchMark's certificate of incorporation did not provide the holders of Series B with any additional voting rights, but merely required WatchMark to perform its existing obligations under the certificate in good faith when undertaking a particular transaction, which in this case the Court found to be the obligation to obtain the vote of seventy percent (70%) of the holders of the preferred stock, voting together as a class, on the proposed merger. Finally, the Court found that ARGO failed to rebut the business judgment rule with respect to its fiduciary duty claims since ARGO did not show that the WatchMark board treated the holders of Series B disparately in connection with the proposed merger. On the contrary, the Court found that the proposed merger would accomplish only one objective -- the removal of the separate series votes of *each* of the series of WatchMark preferred stock on an amendment to the certificate of incorporation that adversely affected the rights of such series. Since this change affected all series of preferred stock equally, the Court found no disparate treatment.

The *WatchMark* decision reaffirms a long line of Delaware decisions holding that protective provisions giving blocking rights on charter amendments that do not expressly reference mergers do not provide any protection in connection with an amendment to a charter by merger. The *WatchMark* decision also is only the second decision of a Delaware court addressing "no impairment" clauses. Even more so than its predecessor, *Kumar Racing Corp. of*

Am. Inc., C.A. No. 12039 (Del. Ch. Apr. 26, 1999), the *WatchMark* decision suggests that impairment clauses will not afford investors any substantive protection on their investment.

5. Section 211 Annual Meeting Requirement.

***Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.*, C.A. No. 1485-N (Del. Ch. Nov. 15, 2005), *aff'd*, No. 562, 2005 (Del. Nov. 16, 2005) (Table).**

In *Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.*, C.A. No. 1485-N, Lamb, V.C. (Del. Ch. Nov. 15, 2005), the Delaware Court of Chancery ordered a Delaware corporation to hold an annual meeting even though the corporation was unable to distribute an annual report containing audited financial statements prior to the meeting. The Court held that SEC regulations requiring distribution of the annual report prior to the meeting do not conflict with the requirement of an annual meeting under Section 211 of the General Corporation Law of the State of Delaware ("Section 211").

Plaintiff Newcastle Partners, L.P. ("Newcastle"), a stockholder of defendant Vesta Insurance Group, Inc. ("Vesta"), brought suit in July 2005 under Section 211 to compel Vesta to hold an annual meeting of stockholders. Newcastle also announced its intent to conduct a proxy contest to elect three nominees to Vesta's eight-member classified board of directors at the meeting. At the time the action was filed, Vesta had not held a meeting of its stockholders since June 1, 2004, and had failed to file 10-Qs and 10-Ks since the 10-Q for the quarter ending June 30, 2004. After the action was instituted, but before trial, Vesta's board of directors scheduled the annual meeting for November 22, 2005.

The Court of Chancery held trial on August 19, 2005. At trial, Vesta's witnesses (including the CEO, the CFO and the chairman of the Audit Committee) testified that the corporation had been unable to complete its audited financial statements in a timely manner due in part to accounting errors in prior periods and the requirements of the Sarbanes-Oxley Act, but that Vesta expected that the auditing work would be completed by the end of September 2005, so that audited financial statements would be available in time for the scheduled November 22 meeting. Accordingly, at trial Vesta sought to hold the meeting on November 22. Newcastle requested that the Court order a meeting to occur as soon as possible, and in no event later than late September 2005.

Vesta also argued in the alternative that federal securities regulations prohibited the corporation from holding an annual meeting of stockholders for the election of directors when the corporation was unable to file an annual report containing audited financial statements. Specifically, Vesta argued that Rule 14a-3 requires prior dissemination of an annual report if a registrant intends to solicit proxies for the election of directors at a meeting, and that Rules 14c-2 and 14c-3 require prior dissemination of an annual report and an information statement if a registrant intends to hold an annual meeting to elect directors but does not intend to solicit proxies. Accordingly, Vesta argued that the Court should allow or order the meeting to take place on November 22, when the annual report was expected to be available.

In an oral ruling at the conclusion of trial on August 19, 2005, the Court ordered Vesta to hold its annual meeting on or before November 17, 2005, 90 days after trial. The Court declined to base its ruling on a possible conflict between Section 211's requirement of an annual meeting and the SEC rules' requirement of distribution of an annual report prior to an annual meeting. Instead, the Court based its ruling on its discretionary power under Section 211 and on the evidence suggesting that Vesta expected in good faith that the necessary filings would be ready by approximately the end of September. Accordingly, the public policy favoring an informed stockholder electorate counseled in favor of a meeting at a time when the annual report would be available. The Court issued an order of final judgment implementing its ruling, without written opinion, on September 1, 2005.

On November 10, 2005, Vesta moved for relief from judgment under Rule 60. In support of its motion, Vesta presented an affidavit from Vesta's CEO explaining that, contrary to the expectation expressed at trial, the audited financial statements were still not ready, and that Vesta could not predict with confidence when they would be ready. Vesta also presented an affidavit from outside counsel describing certain communications between the company's counsel and the SEC, the latest of which had occurred on November 10, concerning the possible conflict between the Court's order and the SEC rules described above. According to the affidavit, Vesta's outside counsel advised the SEC staff members that Vesta had determined that audited financial information would not be available in time to distribute an annual report and information statement prior to the November 17 meeting. According to the affidavit, the SEC staffers told Vesta's outside counsel that the staff did not want to be in the position of having to decide what position to take if Vesta held the meeting under court order without complying with the regulations requiring distribution of an annual report prior to the meeting. The SEC staffers then orally asked Vesta not to hold the meeting without complying with the proxy rules.

The Court heard oral argument on Vesta's application for relief from judgment on November 14, 2005, and denied the application from the bench at the conclusion of argument. In a written opinion issued on November 15, 2005, the Court further explained its rationale. The Court noted that it had allowed Vesta 90 days after trial (a period the Court regarded as "the outer bounds of … discretion"), rather than "the usual period of 30 to 45 days," to hold its meeting based on Vesta's trial witnesses' confident and factually supported predictions that the required disclosures would be ready in time for a mid-November meeting. Because Vesta could no longer predict with confidence when the audited financial statements would be available, the Court noted that Vesta's application for relief from judgment effectively sought an indefinite delay of the meeting.

The Court then turned to the potential conflict between Delaware's annual meeting requirement and the SEC's disclosure requirements. The Court noted that it had recognized at trial that "Vesta could not, of its own volition, convene a meeting at this time in conformity with SEC proxy regulations." However, the Court held that the evidence Vesta had presented in support of its motion was insufficient to show that the SEC would interpret its regulations to prohibit Vesta from holding the annual meeting pursuant to a Court order. The Court noted that the SEC staff members who had discussed the matter with Vesta had not threatened any enforcement action, nor stated definitively whether the SEC's position would be that federal regulations prohibited Vesta from holding a court-ordered meeting when audited financial statements were not available. The Court concluded, "Obviously, [Vesta's communication with the SEC] falls far short of a definitive interpretation of the SEC rules."

The Court then discussed the legislative history and purpose of the Securities and Exchange Act of 1934 and of Sections 14(a) and 14(c), concluding, "[n]othing in either that statute or regulation suggests any purpose to interfere with the power of state courts to require that stockholder meetings be held in accordance with the requirements of state corporation law in situations where the registrant corporation is delinquent in its SEC filing obligations and, thus, is unable to comply with the literal terms of the SEC proxy rules." The Court also noted that its order pursuant to Section 211 was "paradigmatically within the internal affairs doctrine," and held that any suggestion of an irreconcilable conflict between the Court's order and the SEC regulations would "both misconstrue the scheme of federal proxy regulation and weaken a basic premise of American corporate law that is a defining characteristic of our federal system." Accordingly, the Court denied Vesta's application for relief from judgment.

On November 15, 2005, Vesta appealed to the Supreme Court of Delaware. The Supreme Court issued an order the following day, affirming "on the basis of and for the reasons assigned by the Court of Chancery in its well-reasoned decision." *Vesta Insurance Group, Inc. v. Newcastle Partners, L.P.*, No. 562, 2005 (Del. Nov. 16, 2005) (Table). Vesta held its annual meeting of stockholders, pursuant to the Court of Chancery's order, on November 17, 2005.

Ultimately the *Vesta Insurance* decision indicates that Delaware courts will enforce Delaware's statutory annual meeting requirement on all corporations, even those that are unable to hold meetings of their own volition due to an inability to comply with SEC disclosure requirements.

6. Validity of Advance Notice Bylaw.

a. *Accipiter Life Sciences Fund, L.P. v. Lifepoint Hospitals, Inc.*, __ A.2d __, C.A. No. 2057-N (Del. Ch. Aug. 2, 2006).

Plaintiff Accipiter Life Sciences Fund, L.P. is a hedge fund which owned a position in Lifepoint Hospitals, Inc. Lifepoint, having received a shareholder proposal for its upcoming annual meeting, determined to trigger its advance notice by-law provision by giving notice of its upcoming annual meeting, thus causing any other potential shareholder proposals to be put forth promptly or barred. Having previously drafted and prepared for filing a press release relating to its earnings, Lifepoint added a sentence to that release relating to the setting of its annual meeting without specially calling attention to the fact that the press release dealt with the announcement of an annual meeting, either by special heading or sub-heading.

Accipiter's principals read the press release, but failed to notice the disclosure relating to the annual meeting. When they later nominated candidates for election at the meeting, and learned that they had missed the deadline, they sued seeking an order of the Court of Chancery setting aside the advance notice by-law's application on grounds that the failure to file a separate press release or otherwise call out the disclosure concerning the annual meeting was an inequitable manipulation of the corporate machinery, proscribed by Delaware law.

The Court denied the relief requested and entered judgment in favor of Lifepoint. While the Court made clear that the disclosure of the annual meeting date could have been enhanced by the simple expedient of a heading in the financial press release or a separate press release, the Court declined to find that the information was "buried" or otherwise not available upon the exercise of simple diligence. The fact that two principals of the plaintiff had missed the information was not, in the Court's view, enough to enjoin the operation of the by-law. After finding that the company did not act with the specific intent of limiting a dissident slate from emerging (the company had no word of the Accipiter's possible slate until it was filed), the Court determined that it would not exercise its equitable powers because the case lacked "compelling circumstances" suggesting that the company "unfairly manipulated the voting process in such a serious way as to constitute an evident or grave incursion into the fabric of the corporate law."

b. *Oliver Press Partners, LLC v. W. Patrick Decker*, C.A. No. 1817-N (Del. Ch. Dec. 6, 2005).

On December 2, 2005, plaintiffs in Delaware filed *Oliver Press Partners, LLC v. W. Patrick Decker*, C.A. No. 1817-N, which challenges the facial validity of the 120-150 day advance notice bylaw enacted by MatrixOne, Inc. ("MatrixOne") in connection with its initial public offering in March 2000. The advance notice bylaw at issue states, in part:

> To be timely, a stockholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the one hundred twentieth (120th) day nor earlier than the close of business on the one hundred fiftieth (150th) day prior to the first anniversary of the date of the proxy statement delivered to stockholders in connection with the preceding year's annual meeting; provided, however, that if either (i) the date of the annual meeting is more than thirty (30) days before or more than sixty (60) days after the first anniversary date of the preceding year's annual meeting or (ii) no proxy statement was delivered to stockholders in connection with the preceding year's annual meeting, notice by the stockholder to be timely must be so delivered not earlier than the close of business on the ninetieth (90th) day prior to such annual meeting and not later than the close of business on the later of the sixtieth (60th) day prior to such annual meeting or the close of business on the tenth (10th) day following the day on which public announcement of the date of such meeting is first made by the Corporation.

In April 2005, MatrixOne announced that it was conducting an internal investigation into its revenue accounting. The investigation led to a restatement of MatrixOne's financial statements that was not completed until early November 2005. On November 21, 2005, MatrixOne filed proxy materials for its 2005 annual meeting, noticing the meeting for December 22, 2005. Historically, the annual meeting has been held by MatrixOne between November 5 and November 9.

Plaintiffs desire to nominate a slate of directors for election at the annual meeting of MatrixOne; however, the advance notice bylaw prevents them from doing so. Therefore, plaintiffs filed an action to invalidate the advance notice bylaw on grounds that the bylaw is unreasonable and inequitable on its face and to delay the annual meeting. Rather than seeking injunctive relief, plaintiffs sought to conduct an expedited trial prior to the December 22 annual meeting. After oral argument, the Court denied plaintiffs' request for expedition based upon an unreasonable delay in filing suit and a lack of imminent irreparable harm to plaintiffs.

In drafting or providing advice regarding an advance notice bylaw, practitioners should be aware of the allegations (by at least one set of plaintiffs) that a 120-150 day advance notice bylaw is invalid per se.

7. <u>Section 141(a) Stockholder Power.</u>

***Unisuper, Ltd. v. News Corp.*, C.A. No. 1699-N (Del. Ch. Dec. 20, 2005)**

In *Unisuper, Ltd. v. News Corp.*, C.A. No. 1699-N, Chandler, C. (Del. Ch. Dec. 20, 2005), the Delaware Court of Chancery addressed the claim by a group of Australian institutional stockholders that News Corp. had breached its alleged agreement to implement and uphold a board policy providing that it would not extend its rights plan past a specified period in the absence of stockholder approval. The dispute in this case was borne out of News Corp.'s reorganization and migration to Delaware from Australia in April of 2004, the consummation of which was contingent on stockholder approval. In response to the proposed reorganization, the Australian Council of Super Investors Inc. ("ACSI") and Corporate Governance International ("CGI") raised several concerns with respect to the rights of stockholders and corporate governance issues. Specifically, they noted that, under Delaware law, News Corp.'s board of directors would have the power to adopt a rights plan without stockholder approval, while stockholder approval would be required under Australian law. To alleviate this concern, ACSI and CGI proposed an amendment to News Corp.'s post-reorganization charter that would prohibit News Corp.'s board from adopting a rights plan. News Corp.'s general counsel indicated that the proposed amendment was impractical due to time constraints imposed by the reorganization and related transactions. The plaintiffs alleged that a representative of News Corp. proposed that, as an alternative, the rights plan issue could be addressed through a board policy requiring a stockholder vote to approve the extension, past a one-year period, of any rights plan adopted by the board. The plaintiffs also alleged that a representative of News Corp. had agreed that News Corp.'s board would not circumvent the policy by adopting successive one-year rights plans with substantially similar terms and conditions. In October of 2004, News Corp. issued a press release disclosing that its board had adopted such a policy and sent a letter to its stockholders informing them of the policy.

On October 26, 2004, News Corp.'s stockholders, including the plaintiffs, voted to approve the reorganization. On November 8, 2004, Liberty Media Corporation emerged as a potential hostile acquirer of News Corp. and, in response thereto, News Corp.'s board adopted a rights plan. In the press release announcing the adoption the rights plan, News Corp. indicated that, on a going forward basis, it would determine whether to implement the board policy based on a consideration of the facts and circumstances existing at the relevant time. On November 8, 2005, News Corp.'s board extended the rights plan without obtaining a stockholder vote.

As a result of the foregoing actions, the plaintiffs filed a complaint alleging claims based on breach of contract, promissory estoppel, fraud, negligent misrepresentation and equitable fraud, and breach of fiduciary duty. The plaintiffs alleged that News Corp., in agreeing to adopt the board policy, entered into a contract with the plaintiffs. They further claimed that they had agreed to vote in favor of the reorganization in consideration of the promises contained in such contract. News Corp. moved to dismiss all of the plaintiff's claims. News Corp. conceded, for purposes of the motion, that it had entered into an agreement with the stockholders in respect of the policy, but argued that the parties never negotiated to make the policy irrevocable and that, in any event, Delaware law provides that a board policy is non-binding and revocable by the board at any time. In addition, News Corp. argued that, even if such a contract existed, it would be unenforceable as a matter of law.

In arguing that the contract was unenforceable, News Corp. first claimed that Section 141(a) of the General Corporation Law of the State of Delaware, which generally provides that the business and affairs of a Delaware corporation shall be managed by its board of directors, essentially prohibits a board from contractually ceding its powers to the stockholders. Specifically, News Corp. claimed that any limitation on the power of a board must be memorialized in the certificate of incorporation. The Court rejected that argument, stating that the "fact that the alleged contract in this case gives power to the shareholders saves it from invalidation under Section 141(a)." The Court further stated that when the stockholders exercise their right to control the corporation, the board "must give way [because] the board's power -- which is that of an agent's with regard to its principal -- derives from the shareholders, who are the ultimate holders of power under Delaware law."

News Corp. also claimed that any such contract should be unenforceable because Delaware law prevents a board from entering into an agreement that requires it to refrain from acting where it is compelled by its fiduciary duties to act. News Corp. cited several well known Delaware cases in support of this proposition, but the Court ultimately rejected the argument, stating that it was "an attempt to use fiduciary duties in a way that misconceives the purpose of fiduciary duties." In this regard, the Court noted that where the principals (*i.e.*, the stockholders) have made their intentions known to the agent (*i.e.*, the board), the agent must act in accordance with the principals' instructions.

The Court ultimately granted News Corp.'s motion as to the claims of fraud, negligent misrepresentation and breach of fiduciary duty, but held that the complaint adequately stated claims for breach of contract and promissory estoppel. As to such claims, the Court concluded that the plaintiffs stated a claim with respect to the alleged promise that the stockholders would be entitled to vote on any extension of a rights plan, even though the complaint did not describe such agreement with detail. The Court thus noted that the plaintiffs bore the burden of proving that a contract or promise providing that the board policy would be irrevocable had been made.

Following this decision, the defendants sought certification of interlocutory appeal as to the portions of the Chancery Court's opinion and order addressing whether the contract was unenforceable as a matter of law. *Unisuper Ltd. v. News Corp.*, C.A. No. 1699-N (Del. Ch. Jan. 20, 2006). The Chancery Court certified the interlocutory appeal, but the Delaware Supreme Court refused to hear the appeal.

The Court's suggestion, *in dicta*, that a board must defer to the will of a majority of stockholders would be a significant departure from a long line of case law indicating that Section 141(a) vests management authority in the board of directors. Until clarified after trial or on appeal, we believe the Court's comments regarding Section 141(a) should be limited to a context where the board enters into an agreement and induces action premised on an agreement to limit its management authority, and not read to encompass unilateral efforts by stockholders to limit board management authority.

8. <u>Construction and Validity of Charter and Bylaw Provisions.</u>

***Lions Gate Entm't Corp. v. Image Entm't Inc.*, C.A. No. 2011-N (Del. Ch. June 5, 2006).**

In *Lions Gate Entm't Corp. v. Image Entm't Inc.*, C.A. No. 2011-N, Chandler, C. (Del. Ch. June 5, 2006), the plaintiff, Lions Gate Entertainment Corp. ("Lions Gate"), sought declaratory relief in conjunction with various provisions of the certificate of incorporation (the "Charter") and bylaws (the "Bylaws") of the defendant, Image Entertainment, Inc. ("Image"). Specifically, Lions Gate sought a declaration as to (i) the effect of the staggered board provision set forth in the Bylaws (namely, the time at which it implemented the staggered director terms), (ii) the validity of Bylaw purporting to authorize Image's board of directors to amend the Bylaws and (iii) the validity of the provision of the Charter purporting to authorize Image's board to amend the Charter unilaterally. Image answered the complain, raised affirmative defenses and sought reformation of the Charter and Bylaws. The Court granted summary judgment in favor of Lions Gate as to all claims, affirmative defenses and counterclaims asserted in connection with the complaint.

The issues in *Lions Gate* arose in connection with the reincorporation of Image as a Delaware corporation (the "Reincorporation"). As part of the Reincorporation, which was approved at Image's 2005 annual meeting of stockholders, Image adopted the Charter and Bylaws. In September 2005, Lions Gate filed a Schedule 13D with the Securities and Exchange Commission disclosing its purchases of Image stock and offering to acquire Image at a substantial premium. The Board ultimately rejected Lions Gate's offer, and after determining that it had lost confidence in the desire and/or ability of the Board to maximize stockholder value, Lions Gate disclosed that it was considering nominating a slate of six directors for Image's 2006 annual meeting.

As part of the Reincorporation, the Board included a classified board provision in the Bylaws (the "Classified Board Provision"), which constituted the initial bylaws of Image as a Delaware corporation. Pursuant to Section 141(d) of the General Corporation Law, a Delaware corporation may adopt a classified board structure by including a classified board provision in the corporation's certificate of incorporation, by an initial bylaw or through a bylaw adopted by a vote of the corporation's stockholders. The Classified Board Provision stated that, "[a]t the 2006 annual meeting of stockholders, Class I directors shall be elected for a one-year term, Class II directors for a two-year term and Class III directors for a three-year term." A plain reading of this provision suggests that the entire Image board would stand for election at Image's annual stockholders meeting to be held during calendar year 2006, thereby permitting Lions Gate to nominate a full slate of directors.

In an effort to thwart Lions Gate's attempt to gain control of the Board, Image argued that the phrase "2006 annual meeting" in the Classified Board provision was intended to refer to the annual meeting to be held in fiscal year 2006, rather than calendar year 2006. Because Image's fiscal year 2006 ran from April 1, 2005 until March 31, 2006, interpreting the Classified Board Provision as being effective as of the annual meeting held during fiscal year 2006 would mean that the Board was classified as of the annual meeting held during September 2005, and that Lions Gate would only be able to nominate candidates for the two directorships whose one-year terms would expire one year after that meeting.

In determining whether the Classified Board Provision established a classified board that would become staggered at the annual meeting to be held during the calendar year 2006 or if the Board became staggered at the annual meeting held during the calendar year 2005, the Court applied the "plain meaning rule." This rule is applicable to construction of corporate charters and bylaws as well as statutes, contracts and other written instruments. The Court held that use of the phrase "2006 annual meeting" in the Classified Board Provision did not create any ambiguity, and that the plain meaning of that phrase leads to the conclusion that the board would become staggered at the annual meeting to be held during the calendar year 2006. This holding was buttressed by the fact that the Bylaws also state that "[e]lected directors shall hold office until the next annual meeting and until their successors shall be duly elected and qualified." The Court noted that this language is inconsistent with an immediately effective classified board and that allowing for an immediately effective classified board would violate one of the Delaware canons of interpretation, which states that "[w]hen a corporate charter [or in this case, the Bylaws] is alleged to contain a restriction on fundamental electoral rights of stockholders under default provisions of law … the restriction must be 'clear and unambiguous' to be enforceable."[8] The Court also refused Image's request to consider Image's proxy statements as parol evidence, but held that even if it were to consider such evidence, it would not change the outcome.

Turning to the second provision of the Bylaws at issue, the Court held that Section 109 of the General Corporation Law states that after a corporation has received any payment for any of its stock, a board of directors has the power to amend the corporation's bylaws only if the certificate of incorporation "confer[s] the power to adopt, amend or repeal bylaws upon the directors." Because the General Corporation Law explicitly requires that a board of directors can only be given the power to adopt, amend or repeal the bylaws by virtue of a provision in the corporation's certificate of incorporation, the provision was deemed to be invalid.

Regarding the Charter amendment purporting to grant the Board unilateral authority to amend the Charter, the Court held that the provision was invalid because it was in direct violation of Section 242 of the General Corporation Law, which requires the approval of both a corporation's board of directors and stockholders in order to amend the corporation's certificate of incorporation after it has received payment for its capital stock.

Finally, the Court rejected Image's argument that the contested provisions should be reformed in order to cure the aforementioned deficiencies, which were allegedly mutual or unilateral mistakes. The Court noted that although it has jurisdiction to reform a corporation's

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[8] *Harrah's Entm't v. JCC Holding Co., 802 A.2d 294, 309 (Del. Ch. 2002).*

governing documents to conform to the original intent of the parties, it may exercise such jurisdiction only when it is clear that all present and past stockholders intended the provisions to be included within the certificate of incorporation and/or bylaws and there is no intervening third-party interest. The Court noted that, aside from the fact that Image has thousands of stockholders and confirming their intentions regarding the governing documents would be virtually impossible, it was clear that Lions Gate, by virtue of its status as the plaintiff in this action, clearly did not share Image's intentions regarding the proposed reformation of the contested provisions. Therefore, Image was unable to meet the burden of proof required for reformation.

9. Effectiveness of Majority of the Minority Vote Provision.

***In Re PNB Holding Co. Shareholders Litig.,* C.A. No. 28-N (Del Ch. Aug. 18, 2006).**

Recently, the courts have suggested that the presence of a non-waivable "majority of the minority" vote provision may provide meaningful protection in certain types of transactions. What has been unanswered, until now, is how to calculate whether a "majority of the minority" has voted for a transaction: including all "minority" shares, whether or not voted, or only counting those shares which are actually voted?

In Re PNB Holding Co. provides the first detailed analysis of the question as a matter of Delaware law, and concludes that the proper calculation takes into account in the denominator of the fraction all of the minority shares outstanding, and not merely those actually voting, thus making the "majority of the minority" potentially more difficult to achieve (and potentially more valuable as a "cleansing" device).

C. Executive Compensation.

1. Recent Decisions.

a. *Teachers' Retirement System of Louisiana v. Aidinoff*, C.A. No. 20106 (Del. Ch. June 21, 2006).

In *Teachers' v. Aidinoff*, the plaintiff brought suit on behalf of American International Group (AIG) against Maurice R. Greenberg and others, relating to an alleged compensation scheme, pursuant to which senior AIG executives became stockholders of a separate company which collected substantial commissions and other payments from AIG, effectively for no separate services rendered. In upholding the complaint as against defendants' motions to dismiss, the Court rejected as determinative the defense that the relevant arrangements were approved annually by the board and focused upon the complaint's allegations that the Board relied "blindly" on Greenberg, an interested defendant, to approve the relationship "after hearing a short song-and-dance from him annually." The Court also noted that the outside directors "did not employ any integrity-enhancing device, such as a special committee, to review the…relationship and to ensure that the relationship was not tainted by the self-interest of AIG executives who owned large stakes" in the second company. *Id.* at 22. While stressing that the "informed approval of a conflict transaction by an independent board majority remains an important cleansing device under our law and can insulate the resulting decision from fairness review under the appropriate circumstances," the Court also made clear that to avail itself of that cleansing device, "the conflicted insider gets no credit for bending a curve ball past a group of uncurious Georges who fail to take the time to understand the nature" of the transactions at issue. *Id.* at 23.

b. *In re Walt Disney Co. Deriv. Litig.*, __ A.2d __, No. 411, 2005 (Del. June 8, 2006).

In the greatly anticipated decision on appeal, the Delaware Supreme Court, in *In re Walt Disney Co. Deriv. Litig.,* No. 411, 2005, Jacobs, J. (Del. June 8, 2006), affirmed Chancellor William B. Chandler III's post-trial opinion in which he found that the members of the board of directors of The Walt Disney Company ("Disney" or the "Company") did not breach any of their fiduciary duties and did not act in bad faith in connection with the hiring and subsequent firing of Michael Ovitz as Disney's president or the structuring of his employment contract.

This case began in January 1997 when several Disney stockholders brought derivative actions in the Court of Chancery on behalf of Disney against Ovitz and the directors of Disney, claiming that after only 14 months of employment, the $130 million termination payout on Ovitz's employment contract was the product of fiduciary duty and contractual breaches by Ovitz and breaches of fiduciary duty by the Disney directors and constituted a waste of the Company's assets. After trial, Chancellor Chandler entered judgment in favor of all defendants as to all claims in plaintiffs' second amended complaint, holding that none of the defendants had breached any fiduciary duty or committed waste. Richards, Layton & Finger, P.A. represented 13 of the 18 defendants. After thorough briefing and oral argument *en banc*, the Supreme Court upheld the Chancellor's 174-page opinion with an 89-page opinion of its own.

In the wake of the untimely death of Disney's prior president and the need for a potential successor to Chairman and CEO Michael Eisner, attention focused by the summer of 1995 on Ovitz, then-head of a powerful Hollywood talent agency. Negotiations with Eisner and Irwin Russell, Chairman of Disney's Compensation Committee, resulted in a proposed 5-year compensation arrangement as set forth in the Ovitz Employment Agreement (the "OEA"). This arrangement included stock options as well as non-fault termination ("NFT") payments in the event that Ovitz's termination was not for "good cause" under the OEA.

Russell and fellow committee member Ray Watson conferred multiple times with compensation expert Graef Crystal to solicit his views on Ovitz's proposed compensation and analyze his calculations as well as historical comparables and Watson's spreadsheets reflecting various scenarios. Russell and Watson also had telephone conversations with the two other members of the committee, Sidney Poitier and Ignacio Lozano. Meanwhile, Eisner called each board member to inform them of his desire to hire Ovitz. On September 26, 1995, the Compensation Committee met for what the Court found was one hour and (among other topics) discussed Ovitz's proposed compensation package; the full board met thereafter and elected Ovitz President. On October 16, the Compensation Committee met to award Ovitz his stock options under his contract, which contract, although becoming effective as of October 1, was not actually executed until December 16.

Ovitz's tenure at the Company did not work out as planned or hoped. Disney's directors had discussions at various times about these difficulties, discussions which eventually turned to Ovitz's anticipated termination. While Ovitz's tenure at the Company had been disappointing, Sanford Litvack, Disney's General Counsel, advised Eisner and other directors that the Company did not have cause to avoid the NFT payment. Eisner therefore reluctantly decided to terminate Ovitz on a not-for-cause basis, a decision which board members were informed of and supported. After 37 days of trial testimony and post-trial briefing, the Chancellor found no liability on behalf of any defendant with regard to the above-described events. Plaintiffs then appealed their case to the Delaware Supreme Court.

The Supreme Court analyzed plaintiffs-appellants' claims of error in two separate groupings: (i) the claims against Disney's directors; and (ii) the claims against Ovitz.

Claims against Disney's directors were that they breached fiduciary duties of care and good faith by approving the OEA and approving the NFT payment to Ovitz upon his termination. This payment was also alleged to have amounted to corporate waste. Plaintiffs did not contend that the Disney directors were directly liable for these actions; rather, plaintiffs argued that these breaches of duty required the defendants to prove the entire fairness of their actions because they were no longer entitled to the protections of the business judgment rule; thus, it was the defendants' burden of proof to carry. The Court rejected this theory stating that it was plaintiff's initial burden to prove such a breach had occurred in order to rebut the presumptions of the business judgment rule.

Although plaintiffs argued that the Chancellor had conflated the fiduciary duty of care and the duty to act in good faith in determining whether the defendants should be held liable, the Supreme Court parsed the Chancellor's opinion and found that he had, in fact, applied the legal tests separately. Rather than reviewing the good faith conduct of the directors in the Section 102(b)(7) context, as plaintiffs argued occurred, the Chancellor had correctly reviewed the good faith conduct of the directors in determining whether plaintiffs had rebutted the presumptions of the business judgment rule. The Court held that, although a bad faith determination can eliminate charter-authorized exculpation from monetary damage liability *after* liability has been established, a determination of bad faith can also be used to rebut the presumptions of the business judgment rule *before* liability is established.

Duty of Care

In determining whether any of the defendants had acted with gross negligence in the hiring and firing of Ovitz or the approval of the OEA, the Court held that the board was not required to approve the OEA as it had appropriately delegated decisions relating to employment and compensation of Company officers to its Compensation Committee, and nothing in the General Corporation Law mandates that such decisions cannot be delegated. Plaintiffs also asserted that the Chancellor erred in determining liability on a director-by-director basis rather than in a collective manner, despite the fact that they themselves had analyzed the issue that way in their arguments below. The Court dismissed this assertion, noting that plaintiffs could not show that they were prejudiced in any way by this method. Because the Chancellor had found each director not liable, plaintiffs bore the burden to show how a collective analysis would have yielded a different result—a burden they failed to carry.

In determining whether the compensation committee members breached their duty of care in the negotiation and approval of the OEA, the Court found no reason to overturn the Chancellor's conclusion that all of the members were adequately informed. This included Poitier and Lozano, who plaintiffs alleged had been uninvolved in the OEA negotiation process and were thus materially uninformed. The Court concluded that the evidence supported a finding that discussions regarding payout scenarios and total compensation had occurred and been analyzed among all of the Compensation Committee members. Most significantly, the Court held that under Section 141(e) of the General Corporation Law, Poitier and Lozano were entitled to rely on their fellow committee members to inform them of the status of the contract, just as the committee as a whole was entitled to rely on their executive compensation expert Graeff Crystal. The Court concluded that it was not legally relevant that Crystal had not attended the committee meetings nor had ever even met Poitier or Lozano, as long as Crystal's analysis and information were relayed by Russell, which they were. Thus, the committee members were entitled to rely on the expert's analysis.

Duty of Good Faith

In this appeal, plaintiffs claimed that the Chancellor used a different definition of good faith in his post-trial opinion than he did in an earlier motion to dismiss decision. In its analysis of the issues of good faith, the Supreme Court made clear that it was not holding, nor would it analyze in any way, "whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors." Rather, the Court discussed the categories of good faith or lack thereof that Delaware common law has developed.

The Court noted that there is the obvious type of lack of good faith – namely, conduct that is motivated by an actual intent to harm. On the opposite end of the spectrum is conduct that is grossly negligent without accompanying malevolent intent. This latter category, the Court held, cannot be a basis for a breach of the duty to act in good faith. If that were not so, the Court noted, the Delaware General Assembly would never had drawn the distinctions that exist in Section 102(b)(7) and Section 145 of the General Corporation Law between due care and good faith. A third category of conduct that falls between these two categories is that which the Chancellor attempted to capture in his opinions (both pre-trial and post-trial). Here, behavior motivated by an "intentional dereliction of duty, a conscious disregard for one's responsibilities" is the type of bad faith that would both rebut the business judgment rule presumptions as well as fall outside conduct that is otherwise exculpable and indemnifiable.

Using these guidelines, the Court found that the Chancellor's holding that the directors did not breach their duty to act in good faith in connection with Ovitz's termination was entirely correct. First, the board was not required to act in this regard. There was sufficient ambiguity in the Company's governing documents for the Court to conclude, based upon extrinsic evidence, that the board and Eisner as CEO had concurrent authority to terminate the president of the Company. Because Eisner had already undertaken the responsibility to effect such termination, the board did not have to do so. Finally, the determination that there was no cause to terminate Ovitz (and thus no grounds to avoid making the payout under the OEA) was made by Eisner and Litvack who, based upon facts supported by the Chancellor's credibility determinations that must be accepted on appeal, found that no such cause existed. The board was also allowed, for the same reasons discussed above relating to Section 141(e), to rely on this determination.

No Waste if Rational Business Purposes Exists

Lastly, the Court dismissed the plaintiffs' claims of waste noting that such claims arise only in the rarest of circumstances and are extremely difficult to prove. Because the payment to Ovitz was based upon a contractual obligation, such payment could not be considered waste unless the underlying contractual obligation irrationally squandered or gave away corporate assets. Thus, instead of analyzing the NFT payment, the Court analyzed the rationale underlying the creation of the OEA 14 months earlier. In that examination, the Court found that the NFT provisions had a rational business purpose—to induce Ovitz to leave his former employment in order to join Disney.

No Breach Before or After Fiduciary Relationship Created

The plaintiffs' claims against Ovitz were that he had breached his fiduciary duties of care and loyalty to Disney by negotiating for and accepting the NFT provisions of the OEA and negotiating a full NFT payout in connection with this termination. In a summary judgment opinion prior to trial, the Chancellor dismissed claims against Ovitz that had been based on a theory that he owed fiduciary duties prior to commencement of his employment. The Chancellor held, and the Supreme Court upheld, that until Ovitz became president and a director of Disney, he did not owe any fiduciary duties and thus could not breach them. The Court was not convinced by plaintiffs' argument that Ovitz had been a *de facto* officer before the start of his contract due to receipt of financial information, his use of Company letterhead and other acts. Rather, the Court found that Ovitz did not assume the duties of an officer before October 1—he merely prepared for taking office. After his employment ended, plaintiffs argued that he was not terminated but was acting to "settle out his contract" such that he had a duty to convene a board meeting to consider terminating him for cause. The Court viewed the overwhelming evidence that Ovitz was, in fact, terminated as dispositive as to the question whether Ovitz breached any duties with regard to settling up his contract. Having presented no authority either legal or factual to support their argument that Ovitz was obliged to call a meeting to discuss his termination, plaintiffs failed to carry their burden of proof that Ovitz breached any duty in that regard. In fact, after December 27, 1996, Ovitz was no longer an officer or director of Disney, so could no longer be considered a fiduciary subject to liability for breaches of duties to stockholders.

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The *Disney* decision demonstrates the continuing application of the bedrock business judgment rule to boards of directors of Delaware corporations with respect to subjects such as executive compensation, hiring and termination payments, and it clarifies the relationship between the fiduciary duty of care and the duty to act in good faith. Although both Chancellor Chandler's post-trial decision as well as the Supreme Court's decision on appeal describe what would have amounted to "best practices" in the hiring and firing of Michael Ovitz (and for which both decisions should be studied), such descriptions amounted to aspirational guidelines the failure of which to attain did not, under these circumstances, result in a finding of liability.

c. ***Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, C.A. No. 20228-NC (Del. Ch. Aug. 24, 2004).**

In *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, C.A. No. 20228-NC (Del. Ch. Aug. 24, 2004), the Court of Chancery addressed executive compensation in the wake of an opinion which had then denied defendants' motion to dismiss in *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (the "*Disney* Motion To Dismiss Opinion"), leading to the post-trial opinion which is discussed above. In the mid-1980s, defendant Robert N. Elkins ("Elkins") founded Integrated Health Services, Inc. ("IHS") to operate a national chain of nursing homes. IHS operated successfully until February 2000, when IHS commenced a voluntary bankruptcy proceeding after suffering the adverse effects of certain federal legislation. The Official Committee of Unsecured Creditors (the "Creditors") commenced certain actions on behalf of the estates of the debtors of IHS, including an action against former and current directors of IHS for, *inter alia*, breach of fiduciary duty in connection with their approval of certain compensation packages for Elkins. Because the U.S. Bankruptcy Court for the District of Delaware abstained from hearing the fiduciary duty dispute, the Creditors filed suit in the Delaware Court of Chancery.

The Creditors challenged eleven compensation arrangements that involved various loans, option grants and loan forgiveness programs in favor of Elkins. The Creditors alleged that Elkins and the other IHS directors breached their fiduciary duties by approving compensation packages without regard to the best interests of IHS and without adequate information, consideration or deliberation. Finally, the Creditors alleged that the defendants wasted corporate assets by approving certain compensation agreements. The defendant directors filed a motion to dismiss on the grounds that the Creditors failed to state a claim and that the directors were entitled to the protections of an exculpatory clause contained in the IHS certificate of incorporation.

After finding that the challenged compensation arrangements were approved by a majority of disinterested directors, the Court focused its inquiry on whether the defendant directors "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss" such that their decisions could not have been made in good faith. A finding that the decisions were not made in good faith would preclude the defendant directors from availing themselves of the exculpatory provision in IHS's certificate of incorporation.

In finding that the Creditors had stated a claim for breach of fiduciary duty with respect to some of the compensation arrangements but not others, the Court drew a distinction (based on the *Disney* Motion To Dismiss Opinion) between allegations of nondeliberation and allegations of not enough deliberation.[9] For example, the Court dismissed a claim that the defendants

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[9] In comparing the facts in *Elkins* with those presented in the *Disney* Motion To Dismiss Opinion, the Court stated:

breached their fiduciary duties by failing to consult a tax expert on the tax consequences of a compensation consultant's report and failing to set up a monitoring mechanism with regard to a loan program because the complaint did allege that the directors engaged in discussion regarding the report and the loan program, respectively. The Court noted that while the directors' actions may or may not have been negligent (or even grossly negligent), the Court could not draw an inference that its decision was not made in good faith, and therefore the Section 102(b)(7) provision of IHS's certificate of incorporation precluded the imposition of monetary liability. In contrast, the Court found that the Creditors had stated a claim for breach of fiduciary duty with respect to a loan made where the directors approved the loan without deliberation and one director justified the action by stating that he knew Elkins would never "pull anything behind anyone's back." The Court found that "directors of a public corporation must exercise more than blind faith in approving loans."

The Court also refused to dismiss the fiduciary duty of loyalty claim against Elkins. The Court noted that employees negotiating employment agreements have the right to seek the best terms possible for themselves. However, once the employee becomes a fiduciary, "he has a duty to negotiate further compensation agreements 'honestly and in good faith so as not to advantage himself at the expense of the [entity's] stockholders.'" With respect to Elkins' compensation packages, the Creditors alleged that Elkins: (i) sent out the agendas for the meetings, (ii) attended the meetings, (iii) spoke with the directors outside of the meetings, (iv) negotiated his agreements with the board and compensation committee, (v) spoke with a compensation consultant hired by the board, (vi) reviewed and revised the compensation consultant's reports, (vii) pressured the compensation consultant to justify his compensation, (viii) presented inaccurate facts to the board, (ix) caused IHS to disburse funds to him without corporate authority, and (x) insisted that IHS institute a loan forgiveness program with respect to all loans against the advice of a compensation consultant. The Court found that while individually these facts may not be sufficient to support a breach of loyalty claim, together they suggested that Elkins may have breached his fiduciary duties by dealing in self-interested transactions.

In contrast, the Court rejected the Creditors' waste claim. The Court noted that waste is an extreme test which is rarely satisfied. To succeed in proving waste, the Creditors had to plead facts showing "an exchange that is so one sided that no business person of ordinary, sound

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> The facts in this case are different from those in *Disney*. Elkins founded IHS and had been an executive of the company for over 10 years at the time of the first Challenged Transaction. Ovitz was at Disney for one year. No expert was retained by Disney, while [the compensation consultant] (regardless of questions over the method of his selection) was retained by IHS. Thus, a change in characterization from a *total* lack of deliberation (for that matter, a difference between the meaning of discussion and deliberation, if there is one), to even a short conversation may change the outcome of the *Disney* analysis. *Allegations of nondeliberation are different from allegations of not enough deliberation.*

Id. at 38 n.58 (last emphasis added).

judgment could conclude that the corporation has received adequate consideration." The Court also noted that decisions regarding executive compensation are entitled to great deference. IHS's proxy materials stated that the purpose of the compensation packages was to retain key employees, and Delaware law recognizes that the retention of key employees may be a corporate benefit. The Court found that the compensation arrangements subject to the waste claims could have induced Elkins to stay and therefore benefited IHS.

2. Indemnification and Advancement.

a. *Levy v. Hayes Lemmerz Int'l, Inc.*, C.A. No. 1395-N (Del. Ch. Apr. 5, 2006).

In *Levy v. Hayes Lemmerz Int'l, Inc.*, C.A. No. 1395-N, Lamb, V.C. (Del. Ch. Apr. 5, 2006), the Delaware Court of Chancery held that, absent a contractual duty, a newly formed holding company was not obligated to indemnify its operating subsidiary's former directors, and declined to read a prior written demand requirement into an otherwise silent indemnification agreement.

The dispute in *Levy* initially arose in September 2001, when the former outside directors of Hayes Lemmerz International, Inc. ("Old Hayes"), the plaintiffs in this case, were sued by Old Hayes' stockholders and bondholders for various statutory violations and breaches of fiduciary duty in connection with materially misleading financial statements issued by Old Hayes (the "2001 Suit"). In December 2001, Old Hayes entered Chapter 11 bankruptcy. While Old Hayes was in bankruptcy, the Securities and Exchange Commission (the "SEC") began an investigation into the misstated financials, which was pending at the time this decision was issued. Old Hayes emerged from bankruptcy in June 2003 as an operating subsidiary of a successor company also called Hayes Lemmerz International, Inc. ("New Hayes"). The reorganization plan excluded the former directors of Old Hayes from any release of Old Hayes' indemnification obligations in the bankruptcy, but capped those obligations at $10 million beyond any amount paid pursuant to Old Hayes' directors and officers insurance policies.

In June 2005, Old Hayes and former officers of Old Hayes (but none of the former directors) received "Wells Notices" from the SEC indicating that the SEC intended to recommend enforcement against them. Also during that month, the former directors settled the 2001 Suit for $27.5 million of which they personally paid $7.2 million (the "Settlement Payment"). Following the settlement, the former directors sought indemnification in connection with the Settlement Payment from both Old Hayes and New Hayes pursuant to their indemnification rights under the Old Hayes' bylaws, their indemnification agreements with Old Hayes and their rights under the reorganization plan. Both Old Hayes and New Hayes informed the former directors that they would not indemnify them for the Settlement Payment. As a result, the former directors filed their complaint in this case without delivering a written demand to the board of directors of either Old Hayes or New Hayes. Several months later, though, the former directors sent a letter to both defendant companies "reiterating" their demand for indemnification. Old Hayes refused to indemnify them until they agreed "to follow the procedures set forth in the Indemnification Agreements." Old Hayes' letter also requested that the former directors provide a wide range of information that would enable Old Hayes to make what the letter called an "informed decision" regarding the demand.

The defendant companies moved to dismiss all claims against them. They first argued that all claims against New Hayes should be dismissed because the former directors were never directors of New Hayes and because the reorganization plan did not extend Old Hayes' indemnification obligations to New Hayes. In response, the former directors argued that because the reorganization plan limited both Old Hayes' and New Hayes' liabilities, it necessarily implied that New Hayes was also bound by Old Hayes' indemnification obligations. The Court found that if the reorganization plan was meant to impose such indemnification obligations on New Hayes, it could have been drafted to reach that result. Because the reorganization plan did not explicitly impose such obligations on New Hayes, the Court found that there was no reason to believe that the indemnification provisions of the reorganization plan had any effect other than to limit New Hayes' indemnification liability. Accordingly, the Court dismissed the claims against New Hayes.

The only remaining claims for indemnification were against Old Hayes. In connection with those claims, the defendant companies argued that, whatever the former directors' eventual rights to indemnification, their case to compel payment was premature because they failed to satisfy certain contractual provisions of the indemnification agreements. The indemnification agreements stated that "the Company shall indemnify Indemnitee to the fullest extent permitted by law as soon as practicable, but in any event no later than thirty days after written demand is presented to the Company." The defendant companies argued that such provision would only make sense if read to extend "the thought … beyond the word 'practicable' to include the phrase 'after written demand is presented to the Company.'" Read that way, the defendant companies argued that such provision established a strict demand requirement and a contractually mandated thirty-day consideration period for any indemnification claim. The Court, however, found that it was designed to protect the potential indemnitee by requiring Old Hayes to respond to a request for indemnification "as soon as practicable" and by allowing the former directors to start the clock against Old Hayes by delivering a written demand.

The defendant companies also argued that the former directors violated their implied duties to perform the indemnification agreements with good faith and fair dealing when they refused to respond to Old Hayes' information requests. The Court recognized that a contracting party can violate the covenant of good faith and fair dealing in an indemnification agreement by withholding information. However, it also noted that an implied covenant would be an "extremely curious" way for sophisticated parties to structure the exchange of key documents. Given that so few facts about Old Hayes' requests were known at the time, the Court declined to conclude at that time that the former directors violated their implied duties of good faith and fair dealing as a matter of law.

Finally, the defendant companies claimed that the Court should stay the former directors' indemnification action because, arguably, the Court could not determine whether the former directors acted in "good faith" and in the "best interests" of Old Hayes, as required by Sections 145 of the General Corporation Law, until the SEC concluded its investigation of the misstated financial statements. Although no Wells Notices were issued against the former directors, and no litigation was pending against them individually, Old Hayes claimed that it could not indemnify the former directors without violating its statutory and fiduciary duties until the statute of limitations for action by the SEC against the former directors ran in 2007.

The Court noted that the defendant companies were correct in stating that Section 145 requires the board of directors of an indemnifying company to make a full determination of whether the indemnitees are entitled to indemnification, including an investigation as to whether the indemnitees acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation, and that such duty would be made easier if an SEC investigation produced additional information. While acknowledging that such concerns were legitimate, the Court held that the board of directors of Old Hayes could not use that rationale to abrogate its responsibility to determine the former directors' indemnification rights with respect to the Settlement Payment. For the foregoing reasons, the Court denied dismissal of the claims against Old Hayes.

b. *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005).

In *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005) (an appeal from a decision discussed infra), the Delaware Supreme Court reviewed the Chancery Court's decision regarding advancement of legal expenses and found that advancement serves the same public policy as indemnification: to attract the most capable individuals into corporate service. While advancement of defense costs benefits individual officers, indemnification and advancement rights afforded directors and officers provide more important benefits to shareholders, by providing "a desirable underwriting of risk by the corporation in anticipation of greater corporate-wide rewards."[10] Such benefit will be achieved only if indemnification agreements are enforced even when corporate officials are accused of serious misconduct.

After discovering accounting irregularities and subsequently restating its financial statements for several periods, Homestore, a Delaware corporation, and its directors and officers were named as defendants in civil actions, and became the subjects of an administrative investigation by the Securities and Exchange Commission ("SEC") and of a criminal investigation by the Department of Justice ("DOJ"). Tafeen, as a former officer of Homestore, has incurred and continues to incur substantial legal fees related to these investigations, civil actions, and to a criminal indictment. He brought this action in October, 2003 to compel advancement of his expenses in defending himself in these matters, and of his expenses incurred in seeking advancement. Homestore's relevant bylaws provide for indemnification of expenses a director or officer incurs "by reason of the fact" that he is a director or officer, and for the mandatory advancement of all such expenses.

At the trial level (discussed *infra*), the Chancery Court rejected cross motions for summary judgment and rejected as a matter of law all but one of Homestore's affirmative defenses. The Chancery Court further found that Tafeen was entitled to advancement of all reasonable expenses in connection with both his defense and with his action seeking advancement. When Homestore disputed the reasonableness of Tafeen's expenses, the Chancery Court appointed a Special Master to review the issue. The Special Master concluded that Tafeen was entitled to 96% of the fees and expenses incurred, and to pre- and post-judgment interest. The Chancery Court confirmed the Special Master's findings in April, 2005. Homestore filed this appeal the following month.

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[10] Citing *Scharf v. Edgcomb Corp.*, 1997 WL 762656, at *4 (Del. Ch. Dec. 4, 1997).

In its appeal, Homestore contested the denial of its laches and its "official capacity" defenses, the discovery restrictions placed on its ability to establish its unclean hands defense, the finding that Homestore failed to meet its burden of proof with respect to its unclean hands and unfair dealing affirmative defenses, and the adoption of the Special Master's Final Report on the reasonableness of Tafeen's expenses. The Court affirmed the Chancery Court's rulings in all respects.

Regarding the laches argument, Homestore argued that it was prejudiced because Tafeen's delay of eighteen months in seeking advancement would make it more difficult for Homestore to seek repayment should it ultimately be found that Tafeen was not entitled to indemnification. The Court affirmed the Chancery Court's rejection of this argument, finding that any error the Chancery Court may have made regarding this issue was harmless because Homestore had failed to show that Tafeen intended to shelter his assets from creditors.

The Court then considered the public policy purposes of advancement and indemnification, and found advancement to be especially important because it provides immediate relief from the financial burden of conducting a defense. Section 145(e) of Delaware General Corporation Law governs advancement, and allows corporations to advance expenses to a director or officer without an assurance that the director or officer will repay any sums to which he is ultimately not entitled. While the advancement allowed by Section 145(e) is permissive, many corporations, such as Homestore, have made it mandatory in their bylaws or corporate charter. The right to advancement, mandatory or otherwise, is independent of the right to indemnification, and does not require that the director or officer be successful on the merits, but recognizes that any sums advanced must be repaid if it is ultimately determined that the official is not entitled to be indemnified.

After this discussion of advancement generally, the Court considered the Chancery Court's rejection of Homestore's "official capacity" argument. Homestore argued that Tafeen was not entitled to advancement because the actions that necessitated his defense were motivated by personal greed rather than his "official capacity." The Court affirmed the Chancery Court's decision, explaining that "if there is a nexus or causal connection between any of the underlying proceedings contemplated by Section 145(e) and one's official corporate capacity, those proceedings are 'by reason of the fact' that one was a corporate officer, without regard to one's motivation for engaging in that conduct." Tafeen was a party to the underlying proceeding because of his alleged role in perpetrating the accounting irregularities. Here, advancement is more narrowly focused than indemnification, and provides for broader rights -- although Tafeen may not ultimately be entitled to indemnification, he is at least entitled to advancement.

The Court further found that the discovery restrictions the Chancery Court had placed on Homestore's ability to establish its unclean hands defense were appropriate as a proper exercise of discretion, and that the Chancery Court had properly based its rejection of Homestore's unclean hands and unfair dealings defenses on credible and sufficient evidence in the record. Finally, the Court affirmed the Court of Chancery's determination that the Special Master's Final Report was reasonable.

c. ***Tafeen v. Homestore, Inc.*, C.A. No. 023-N (Del. Ch. Mar. 22, 2004), *aff'd*, 886 A.2d 502 (Del. 2005).**

In this action for advancement, the Court denied the parties' cross motions for summary judgment on the basis that there were genuine issues of material fact concerning the defendant's affirmative defense of unclean hands, given the plaintiff's alleged intentional conduct of sheltering assets to defeat a potential claim for reimbursement of legal fees and expenses paid by the company on behalf of the plaintiff.

Plaintiff Peter Tafeen is a former officer of defendant Homestore, Inc. ("Homestore") who seeks advancement of legal fees and expenses in connection with various civil actions in which he was named as a defendant as well as ongoing investigations by the Securities and Exchange Commission ("SEC") and the United States Department of Justice ("DOJ"). Homestore is a Delaware corporation engaged in providing on-line media and technology to the real estate industry. Pursuant to Section 145 of the DGCL, Homestore's bylaws contained indemnification and advancement provisions for legal fees and expenses incurred by its directors and officers. Following an investigation by Homestore's audit committee, it was revealed that Homestore overstated its revenues by $41.4 million for fiscal year 2000 and $119 million for the first three quarters of fiscal year 2001. While the audit committee was conducting its investigation, the SEC and DOJ announced that they had commenced investigations into Homestore's prior accounting practices and financial reporting. Ten civil actions, both derivative and direct, were also filed against Homestore, where the plaintiff in this action was named as a defendant to the shareholder actions. In a letter request, the plaintiff sought advancement of legal fees for the defense of the government investigations as well as the ten civil actions (the "Proceedings"). In response to the plaintiff's request for advancement and indemnification, Homestore required that the plaintiff sign an undertaking to repay any legal fees advanced should he not ultimately be entitled to indemnification under Section 145. The plaintiff refused and the instant action ensued.

Homestore moved for summary judgment on nine of its affirmative defenses. The Court segregated the nine affirmative defenses into three categories: (i) those involving the plaintiff's conduct in the Proceedings; (ii) those involving the plaintiff's conduct in seeking advancement; and (iii) those not involving the plaintiff's conduct at all.

The Court first addressed the category encompassing the plaintiff's conduct in the Proceedings. Homestore first alleged that the plaintiff was not entitled to advancement because he was not a party to any of the Proceedings "by reason of the fact" that he was an officer of Homestore. The Court noted that the test for such a challenge was whether there was a causal connection or nexus between the underlying proceeding and the corporate function or official corporate capacity, noting that motivation of the individual is not a factor in the test. Reasoning that to follow Homestore's argument would be to transform the advancement provisions of its bylaws into invitations to a trial on the merits of the underlying action, the Court denied as a matter of law Homestore's "by reason of the fact" defense. Homestore next alleged that the plaintiff fraudulently induced Homestore to enter into an employment contract which entitled him to the protections of the advancement bylaw. The Court noted that application of the advancement bylaw was not dependent upon the plaintiff's employment contract but rather was to be determined under Homestore's governing rules. Accordingly, the Court denied as a matter of law Homestore's motion as to its contract argument. Similarly, the Court also denied as a matter of law Homestore's estoppel and ultimate entitlement arguments.

The Court next addressed Homestore's defenses involving the plaintiff's conduct in seeking advancement. Homestore advanced unclean hands and laches defenses. Regarding the unclean hands defense, Homestore alleged that the plaintiff should not be permitted to claim his entitlement in a court of equity when he purchased an expensive home in Florida, a state that has extremely protective "homestead" provisions against creditor claims, allegedly in order to shelter assets and avoid repayment should the plaintiff's claims ultimately be found to be non-indemnifiable. The Court reasoned that whether the plaintiff intentionally engaged in sheltering of assets (which would increase the difficulty of reimbursement should his advancement claims be found non-indemnifiable) was a question of fact to be determined at trial. The Court concluded that should these facts be true, such conduct would be sufficient to invoke the doctrine of unclean hands. Accordingly, Homestore's motion for summary judgment was denied, with trial on the merits to proceed. Homestore's motion for summary judgment as to the laches defense was denied as a matter of law in that any delay in filing suit was not the cause of any alleged prejudice; rather, the cause of the alleged prejudice was the plaintiff's sheltering of assets.

Lastly, the Court addressed the third category of defenses that did not involve the plaintiff's conduct at all. Homestore attempted to advance an argument that the bylaw provisions for a direct claim carve-out encompassed a stockholder derivative action that named the plaintiff as one of several defendants. The Court denied this motion as a matter of law, as Homestore's advancement carve-out applied only to actions brought directly by the corporation not actions brought derivatively. Homestore also advanced the defense that the Sarbanes-Oxley Act's prohibition against personal loans to directors or officers limited Section 145's application. Reasoning that the plain language of Section 402 of the Sarbanes-Oxley Act applies only to current directors and executive officers and the plaintiff was a former executive officer, the Court concluded that Section 402 had no application to the instant action.[11] Accordingly, Homestore's motion for summary judgment as to the limiting language of the Sarbanes-Oxley Act was denied as a matter of law. Finally, Homestore argued that the company, would be placed in position of severe financial hardship if it had to advance expenses to the plaintiff. The Court concluded that this argument, without more, was not a legally cognizable defense to advancement as Section 145(e) allowed for Homestore to lessen its credit risk simply by drafting its bylaws differently. The Court cautioned: "Given the high incidence of advancement proceedings, directors should be mindful of their fiduciary duties to stockholders and the possibility of stockholder action, when reviewing and adopting advancement and indemnification bylaws. In my view, the fact that Section 145 is a broad, enabling statute does not confer license to adopt loosely written bylaws and impose excessive credit risks on a company and its stockholders." Accordingly, Homestore's motion for summary judgment as to undue financial hardship was denied as a matter of law.

[11] Also noting that, as such, the underlying issue of the application of Section 402 of the Sarbanes-Oxely Act to Section 145 was not ripe for discussion.

d. *In re Delta Holdings, Inc.*, C.A. No. 18604 (Del. Ch. July 26, 2004).

In *In re Delta Holdings, Inc.*, C.A. No. 18604 (Del. Ch. July 26, 2004), the Court of Chancery addressed the nature of the claims of a corporation's former directors and officers under an indemnification provision contained in the corporation's certificate of incorporation for purposes of Section 281(b) of the General Corporation Law. Section 281(b) requires a corporation to pay or make provision to pay certain types of claims in its plan of dissolution. The Court found such indemnification claims to be present, contingent contractual claims under Section 281(b)(i) of the General Corporation Law for which the corporation was required to make reasonable provision in its plan of dissolution.

Delta Holdings, Inc. ("Delta") was a Delaware corporation that had been in the business of acquiring and holding insurance and reinsurance companies, including Delta Re, of which Robert E. Norton, Hugh C. Brewer III and James D. McGurty were officers and directors (the "Objectors"). Delta's certificate of incorporation provided for mandatory indemnification of directors and officers to the fullest extent permitted under Section 145 of the General Corporation Law. In 1997, Delta voluntarily dissolved under Section 275 of the General Corporation Law. Subsequently, a court-appointed receiver sought approval of Delta's plan of dissolution under Section 281(b) of the General Corporation Law. The receiver proposed to reserve $124,000 of Delta's $9.57 million in liquid assets for miscellaneous post-distribution expenses and $81,000 for the payment of premiums for D&O insurance providing $1 million in coverage for a period of six years -- with the remaining $9.365 million to be distributed to Delta's stockholders. Since Delta began liquidation, its directors and officers had incurred over $32 million in legal defense costs. The Objectors claimed that the plan of dissolution failed to make sufficient provision for their mandatory indemnification rights under Delta's certificate of incorporation in the event they were sued because of their status as former managers of Delta Re.

Section 281(b) requires that a dissolved corporation that has opted to follow the short-form dissolution procedures in Section 281(b) of the General Corporation Law pay or make reasonable provision to pay: (i) all known claims, including contingent contractual claims, (ii) claims that are the subject of pending proceedings, and (iii) unknown claims that, based on facts known to the corporation, are likely to arise within ten years. The Court found that "[i]ndemnification rights (including the right to advancement) that are contained in a mandatory, expansive indemnification provision, are present contractual rights, contingent only on meeting the requirements of Section 145."

Next, the Court analyzed whether Delta's D&O policy reasonably provided for the Objector's indemnification claims. In determining the reasonableness of the D&O policy, the Court took into account "the likelihood of the contractual indemnification claim vesting, the likely value of that claim, and the financial condition of the distributing company." While the Court thought it unlikely that the Objectors would be found personally liable for Delta Re's obligations under its insurance policies under a common-law indemnification theory, or for its reinsurance obligations as nonsignatory officers of a signatory corporation, the Court found that it was possible that the Objectors could be found liable in tort, relying on New York precedent suggesting tort claims survive liquidation. Nonetheless, the Court believed that the possibility of such claims surviving any jurisdiction's statute of limitations was low. In addition, the Objectors would have to prove their good faith as a condition precedent to the vesting of indemnification rights. Given these factors, it was not necessary to set aside enough money to cover all potential claims to meet Section 281(b)'s reasonableness standard. Accordingly, the Court ordered that the receiver set aside an additional $120,000 (2.1% of net liquid assets) to pay for a D&O policy providing for $5 million in coverage for a period of twenty years.

D. <u>Equitable Limits on Acts By Controlling Stockholders.</u>

a. *Superior Vision Services, Inc. v. Reliastar Life Ins. Co.,* C.A. No. 1668-N (Del. Ch. Aug. 25, 2006).

Perhaps the first question to answer when dealing with case law concerning "controlling shareholders" is 'what is a controlling shareholder'? Of course, shareholders who hold more than 50% of the outstanding stock of a company present the easy case. The more nuanced (and often difficult) case is presented by a less than majority owner who exerts some degree of actual control over the company and its affairs.

In *Superior Vision Services* the Court of Chancery dismissed, at the motion to dismiss stage, a complaint asserting that a 44% stockholder which held a veto right over the payment of dividends was a "controlling" stockholder under Delaware law. The Court focused on the stockholder's lack of direct control over the board of directors of the company in reaching the conclusion that it was not a controlling stockholder. Importantly, the Court held that the mere ownership of a contract right, even a "strong" contract right which prevented the company from paying dividends, did not equate to the "actual exercise" of control over the company. Instead, the Court held that the less than majority stockholder, in order to be impressed with fiduciary duties, had to hold powers which gave it "the ability to dominate the corporate decision-making process." In light of the fact that the board here had passed a dividend (an act disfavored by the supposedly controlling stockholder), and in light of the lack of actual control of that stockholder over the board, the Court found that the stockholder's 44% stock ownership position was not enough, even when coupled with contractual veto rights, to give rise to controlling stockholder status (and concomitant fiduciary duties).

The *Superior Vision Services* Court also disposed of a claim that the failure of the stockholder to consent to the payment of dividends breached the implied duty of good faith and fair dealing. Interestingly, the Court's analysis focused on whether the law would imply a "reasonableness" standard where the contractual right to withhold consent to payment of the dividend was *not* expressly so conditioned, and other provisions of the contract were. Holding that the Court would not impose a "reasonableness" term where sophisticated drafters knew how to do so and didn't, the Court dismissed this claim, as well.

b. *Abraham v. Emerson Radio Corp.,* C.A. No. 1845-N (Del. Ch. July 5, 2006).

In *Abraham v. Emerson Radio Corp.* the Court of Chancery dismissed claims asserted against a controlling stockholder which asserted that the selling stockholder should have known that the buyer would extract illegal benefits from a non-wholly owned subsidiary. Finding that the complaint failed to plead any facts which would tend to show that the selling stockholder knew that it was being paid for rights other than the right to control the company, and that the pleading was "vague, unspecific, and conclusory" with respect to post purchase conduct of the new controlling party, the Court held that "pure control premium envy is not a cognizable claim for a minority stockholder under Delaware law." The Court further characterized the circumstances in which a controlling stockholder might not be free to sell its stock at a premium as "very narrow" under Delaware law.

In *dicta*, the Court also questioned whether a controlling stockholder was entitled to rely on an exculpatory provision in the company's certificate of incorporation, and whether a negligence based claim would survive against a controller. The Court reasoned that since the "premise for contending that the controlling stockholder owes fiduciary duties in its capacity as a stockholder is that the controller exerts its will over the enterprise in the manner of the board itself" it follows that the statutory protections available to the board should arguably be available to the controlling party. Further development of this issue, however, must await another day. Given that the power to exculpate for duty of care liability is statutory and in derogation of the common law, the Court's ruminations in *dicta* may not necessarily indicate how the matter would be decided if properly presented to an appellate court.

c. *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, Consol. Nos. 130, 2004, 292, 2004 and 304, 2004 (Del. Apr. 19, 2005).

In a recent decision, the Delaware Court of Chancery addressed statutory and equitable limitations with respect to stockholder-adopted bylaws as well as the permissibility of a corporation adopting a stockholder rights plan to prohibit the stockholders of the corporation's controlling stockholder from selling the controlling stockholder to a third party.

Specifically, in *Hollinger International, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), plaintiff Hollinger International ("International") sued Conrad M. Black ("Black"), the indirect controlling stockholder of Hollinger, Inc. ("Inc."), International's controlling stockholder, as well as Inc. (Inc. and Black collectively, (the "Defendants")) to (i) enjoin the sale of Inc. to a third party, (ii) obtain a declaratory judgment as to the invalidity of bylaw amendments adopted by Inc. (the "Bylaw Amendments"), and (iii) obtain a declaratory judgment as to the validity of the stockholder rights plan (the "Rights Plan") adopted by a committee of the International board of directors which would essentially prohibit the sale of Inc. to a party not approved by International's board of directors.

In June 2003, International's board formed a special committee (the "Special Committee") to investigate the propriety of non-competition payments in excess of $70 million made to Black and certain other executives of Inc. and International. The Special Committee subsequently concluded that certain of the non-competition payments may not have been appropriately authorized or publicly disclosed. On November 15, 2003, Black and representatives of International entered into a "Restructuring Proposal," the terms of which included, among other things, the repayment of the disputed non-competition payments, Black's agreement to devote his time and energy towards a strategic process (the "Strategic Process") whereby International would seek to consummate a transaction (including a sales transaction) for the benefit of all of International's stockholders and to not take actions to negatively affect

International's ability to consummate a transaction resulting from the Strategic Process, and Black's retirement as chief executive officer of International.

Black subsequently negotiated and entered into a transaction whereby Inc. would be sold to the Barclay family (the "Barclay Brothers"). Following the public announcement of the transaction with the Barclay Brothers on January 18, 2004, the International board of directors formed a board committee designated the Corporate Review Committee (the "CRC") comprised of all directors except for Black, his wife and an alleged affiliate of Black. The CRC was delegated broad authority to act on behalf of International, including the ability to adopt a stockholder rights plan. In response to the formation of the CRC, Inc. purported to act by written consent to adopt the Bylaw Amendments to, among other things, disband all board committees (including the CRC) other than the Special Committee and audit committee, and to require unanimous board approval of all "special board matters" (including a merger, sale of assets having a value in excess of $1 million, and changing the number of directors on the International board). Two days later, the CRC met and adopted the Rights Plan, which would be triggered by, among other things, consummation of the transaction with the Barclay Brothers.

In a 130-page decision, the Court held that Black had breached the Restructuring Proposal and his fiduciary duties to International with respect to the transaction with the Barclay Brothers in various respects, including (i) Black's failure to inform the International board of an earlier indication of interest from the Barclay Brothers with respect to one of International's most valuable assets and Black's unilateral rejection of such offer; (ii) Black's disclosure of inside confidential information to the Barclay Brothers to encourage the Barclay Brothers to make a bid for Inc.; and (iii) Black's failure to disclose to the International board of directors his dealings with the Barclay Brothers "under circumstances in which full disclosure was obviously expected."

Of particular interest to corporate practitioners is the Court's analysis of the Bylaw Amendments and Rights Plan. With respect to the Bylaw Amendments, International contended that the bylaw amendment that abolished the CRC was statutorily invalid because (i) Section 141(c)(2) of the DGCL (which authorizes the creation and regulation of board committees in a corporation's bylaws) does not explicitly authorize a bylaw to eliminate a board committee and, (ii) such bylaw amendment ran afoul of Section 141(a) of the DGCL (which generally provides for the management of the business and affairs of a corporation by the board of directors). The Court rejected these arguments, first concluding that Section 141(c)(2)'s specific reference to the regulation of board committees through the bylaws was sufficient to include the elimination of committees by stockholders through a bylaw amendment. The Court likewise found that the bylaw amendment to eliminate the CRC did not violate Section 141(a) of the DGCL, holding that Section 109 of the DGCL (which broadly provides for stockholder amendments to bylaws), when read together with express language of Section 141(c)(2), clearly permitted a stockholder-adopted bylaw such as the one at issue.

Although finding the Bylaw Amendments to be statutorily permissible, the Court nonetheless invalidated the Bylaw Amendments. Citing *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401 (Del. 1985), the Court stated that the Schnell doctrine – that inequitable action does not become permissible because it is legally possible – applies to bylaw amendments and that bylaw amendments adopted by majority stockholders may be reviewed to ensure that they are consistent with common law rules and were reasonable in application. The Court concluded that, unlike in *Frantz* where the bylaws at issue were adopted by a majority stockholder who committed no acts of wrongdoing and acted to protect itself from dilution, the Bylaw Amendments here were "clearly adopted for an inequitable purpose and have an inequitable effect." While noting the significance of striking down bylaw amendments adopted by a controlling stockholder, the Court stated that "action is required here because those amendments complete a course of contractual and fiduciary improprieties … to end-run the Strategic Process [Black] had agreed to lead and support."

With respect to the Rights Plan, the Court stated that the Defendants' primary argument was the assertion that common law principles prohibit the "board of a non-wholly owned subsidiary from using a rights plan that would deter the ability of the parent company to sell itself (or its control bloc of subsidiary shares)." Framing the issue as the extent to which equitable duties owed by directors to a controlling stockholder preclude those directors from using a rights plan to inhibit such controlling stockholder from alienating its shares or other property, the Court noted, "put bluntly, the permissibility of the Rights Plan hinges on the equities."

The Court analyzed the adoption of the Rights Plan under the *Unocal* standard of review, concluding that the CRC easily passed the first prong of the two-prong *Unocal* standard -- identifying a threat to the corporation's best interests after reasonable investigation -- in light of, among other things, the fact that, if consummated, the transaction with the Barclay Brothers would "thwart the effective and thorough completion of the Strategic Process Black had contractually promised to support." The Court then addressed the second prong of *Unocal* -- whether the Rights Plan is a proportionate response to the threat posed. While noting that, in the ordinary case, the adoption of a rights plan would be a disproportionate response because the replacement of a subsidiary's controlling corporate stockholder with another through a transaction at the parent level should not pose a threat to the subsidiary, the Court nonetheless found the deployment of the Rights Plan to be proportionate "in view of the extraordinary circumstances International confronts." In so holding, the Court noted that corporate law has recognized circumstances in which a subsidiary has a legitimate right in contesting a parent's sale of its control position -- such as a sale to a known looter. The Court reasoned that if actual dilution of the controlling stockholder may be justified in certain instances, the less extreme act of adopting a rights plan should not be eliminated as a permissible response to "serious acts of wrongdoing" by a controlling stockholder to a corporation. Although rejecting the application of the "compelling justification" standard under *Blasius* to the adoption of the Rights Plan, the Court stated that, even if *Blasius* did apply to the Rights Plan, "a sufficiently compelling justification exists for any incidental burden on Inc.'s voting rights."

Following the Court's decision, the Defendants moved for certification of an interlocutory appeal. *Hollinger Int'l. Inc. v. Black*, C.A. No. 183-N (Del. Ch. Mar. 17, 2004) (TRANSCRIPT). In denying the application, the Court rejected the Defendants' claims that the earlier opinion decided novel issues of Delaware law, stressing the primary importance to its decision of its finding that Black breached the Restructuring Proposal. The Court summarized that it found that "there was a contract in place, signed by Mr. Black, who was a fiduciary of International, and that contract limited him in a very significant way, as the ultimate controlling stockholder of Inc., … and he breached that obligation." While the Supreme Court declined to certify the interlocutory appeal, it did grant an appeal of the aspects of the decision that were made final, *i.e.*, the claims involving the bylaws and the rights plan and delayed consideration of that appeal until the summary judgment decision on the remaining non-expedited claims was made. In late May 2004, Vice Chancellor Strine granted summary judgment in favor of the plaintiff on the remaining non-expedited claims. In April 2005, the Delaware Supreme Court affirmed this and the issues tried to final judgment contained in Vice Chancellor Strine's March 2004 decision.

The *Hollinger* decisions indicate that where the Delaware Court of Chancery determines that a controlling stockholder has engaged in inequitable conduct with a subsidiary corporation involving breaches of contractual obligations to such subsidiary corporation, the Court will utilize its equitable powers to prohibit otherwise valid action by the controlling stockholder and permit the subsidiary corporation to employ significant defensive mechanisms to protect its interests. *Hollinger* also confirms the broad power of stockholders under the DGCL to amend a corporation's bylaws to alter the powers of, or eliminate altogether, board committees in light of specific provisions of Section 141(c) of the DGCL providing for board committees to be regulated through a corporation's bylaws.

d. *Oliver v. Boston Univ.*, C.A. No. 16570-NC (Del. Ch. Apr. 14, 2006).

In *Oliver v. Boston Univ.*, C.A. No. 16570-NC, Noble, V.C. (Del. Ch. Apr. 14, 2006), the Delaware Court of Chancery found that a controlling stockholder and the directors of the corporation it controlled breached their fiduciary duties for not valuing potential derivative claims in connection with the allocation of merger consideration where they had "inquiry notice" of such claims. Moreover, after finding that the defendants' actions were to be evaluated under the entire fairness standard, the Court found that the fair price aspect of the standard had been met, but not the fair dealing element—a rare result.

In June 1995, Seragen Inc. ("Seragen") was in severe financial distress. At that time, Boston University ("BU") was Seragen's controlling stockholder, and the board of directors of Seragen was comprised of three persons who were affiliated with BU (Messrs. Cassidy, Condon and Silber), two persons who were members of management of Seragen (Messrs. Prior and Nichols) and one independent director (Mr. Jacobs). BU and persons affiliated with BU entered into a series of transactions with Seragen that were designed to infuse Seragen with the additional working capital it desperately needed. These transactions involved: (1) the assumption by BU, Cassidy and Condon of certain of Seragen's loan obligations in exchange for the issuance of warrants and newly issued "Series B" preferred stock; (2) the issuance by Seragen to BU of newly created "Series C" preferred stock; (3) the sale by Seragen of its operating division to Marathon Biopharmaceuticals, LLC ("Marathon"), an entity created by BU expressly for that purpose; and (4) the grant of certain intellectual property rights by Seragen to United States Surgical Corporation ("USSC"), a corporation founded by Hirsch. No fairness opinions were obtained and no independent committee was formed in connection with any of the transactions set forth above. In addition, the same law firm represented both BU and Seragen in connection with the Series B and Series C transactions.

Despite the foregoing transactions, Seragen was still suffering financially. As a result, Seragen entered into merger talks with Ligand Pharmaceuticals, Inc. ("Ligand") in early 1998.

Under the proposed merger, Ligand would acquire Seragen and its operating assets, including Marathon, for $75 million. Although the initial agreement allocated $70 million of the merger proceeds for Seragen and the remaining $5 million for Marathon, the final agreement allocated $67 million to Seragen and $8 million to Marathon (the "Accord Agreement").

The plaintiffs argued, *inter alia*, that BU and the Seragen directors breached their fiduciary duties by not considering the value of potential derivative claims deriving from the pre-merger transactions when allocating the portion of the $67 million allocated to Seragen's minority stockholders in connection with the merger. The plaintiffs further claimed that the allocation of the merger consideration under the Accord Agreement was not entirely fair. For the reasons that follow, the Court found that the defendants were on "inquiry notice" of four potential derivative claims and breached their fiduciary duties by failing to consider such claims when allocating merger consideration to the minority stockholders of BU. Moreover, the Court found that the allocation of merger consideration pursuant to the Accord Agreement was not entirely fair. Entire fairness applied to the claims since a majority of Seragen's directors were interested in the transactions, either personally or because of their relationship with BU.

The Court found that Seragen's board of directors was required to value potential derivative claims when allocating merger consideration in this context. According to the Court, any fair allocation of those proceeds could not ignore Seragen's derivative claims because the purpose of the process was to determine the relative entitlements of the Seragen stockholders to the $75 million in aggregate merger proceeds. Therefore, the Seragen directors should have evaluated the possible derivative claims of which they had "inquiry notice" during the negotiation and merger processes, and their failure to do so resulted in a breach of the fiduciary duty of loyalty. "Inquiry Notice" was defined by the Court as existing "when the directors become aware of facts sufficient to put a person of ordinary intelligence and prudence on inquiry which, if pursued, would lead to the discovery of the injury." According to the Court, the board had inquiry notice of four potential derivative claims that could have affected the merger consideration allocation process because of the interested nature of the pre-merger transactions and the fact that a small group of Seragen's stockholders, including one of the plaintiffs in this action, had made their concerns about the pre-merger transactions known to the Seragen board. These four claims were: (1) equity dilution and other harm to Seragen from the Series B transaction that resulted from a breach of the fiduciary duty of loyalty; (2) equity dilution and other harm to Seragen from the Series C transaction that resulted from a breach of the fiduciary duty of loyalty; (3) waste of corporate assets in connection with the Marathon transaction that resulted from a breach of the fiduciary duty of loyalty; and (4) a breach of the fiduciary duty of loyalty in connection with the USSC transaction.

As to the first two of the four derivative claims, the Court found that the directors should have assessed the Series B and Series C transactions as derivative claims because the BU defendants were on both sides of the transaction and there were no procedural safeguards to assure the fairness of the transactions. The Court then considered whether the Series B and Series C transactions were entirely fair. The Court found that, in light of the defendants' expert testimony and the poorly supported testimony of the plaintiffs' expert (who was merely an appraiser who took "a leap of faith (not logic)" in valuing Seragen's stock), the price for the Series B and Series C transactions was fair. In particular, the defendants' expert demonstrated that: (1) the Series B transaction did nothing to change the value of Seragen's common stock, since it created no new liabilities or obligations for Seragen; (2) the Series C transaction was functionally an interest-free loan from BU to Seragen which benefited Seragen's minority stockholders, since no other lender would provide such loan without charging interest; and (3) the market did not react negatively to the Series B and Series C transactions, and, in fact, the price of Seragen's common stock increased on the day of the announcement of the Series B transaction. However, the Court found that the defendants were unable to prove that the treatment, during the negotiation of the Accord Agreement, of the Series B and Series C transactions was fair because there was no process to protect the interests of the minority common stockholders. Therefore, although the BU defendants breached their duty of loyalty and were unable to demonstrate the entire fairness of the Series B and Series C transactions, the price was fair and the weight the defendants gave the derivative claims—zero—was fair. The Court assigned only nominal damages based on this claim.

In evaluating the possible derivative claim relating to the Marathon transaction, the Court found that the sale of the facility to a BU-controlled entity did not amount to corporate waste. Marathon was sold to BU for $5 million plus a significant agreement to meet Seragen's ongoing operating expenses. The plaintiffs could offer no basis, beyond the fact that Ligand later paid $8 million for Marathon, to bolster their claim that the consideration BU paid was so little as to amount to corporate waste. The Court next assessed whether the Marathon transaction was entirely fair. As with the Series B and Series C derivative claims, the Court found that the price paid was fair but the process was deficient, and thus only nominal damages were warranted.

The Court then evaluated the potential derivative claim arising from the USSC transaction. The plaintiffs argued that the defendant directors breached their duty of loyalty in this transaction because of their relationship with Hirsch, a major benefactor and the founder of USSC, and therefore the claim had value that the defendants failed to assess. The Court rejected this claim, finding that the plaintiffs had failed to show that any special benefit devolved upon any of the defendants as a result of the transaction. Moreover, the defendants produced evidence that showed that the USSC transaction was at a fair price, and thus the potential derivative claim had no value as a bargaining chip in the allocation negotiations. Any harm that resulted from failing to consider the claim was merely procedural. Thus, damages for the failure to consider the potential derivative claim from the USSC transaction were only nominal.

The Court next considered whether the allocation of the merger proceeds in the Accord Agreement was entirely fair. As in the pre-merger transactions, the Court found that the process was not fair to the minority stockholders because there was no representative who negotiated on behalf of the minority common stockholders. According to the Court, this defect in process resulted in mis-allocations of $4,809,244, which the Court awarded to the plaintiffs as actual damages. The Court also awarded the plaintiffs nominal damages for the other process failures associated with the negotiation and implementation of the Accord Agreement.

* * *

Oliver v. Boston Univ. again makes clear that in controlling stockholder transactions, there must be a process in place to protect the controlled corporation's minority stockholders. Otherwise, the fair-dealing prong of the entire fairness standard will be found not to have been satisfied.

E. Directors' Duties of Oversight and Disclosure.

1. Duty of Oversight.

a. *Saito v. McCall*, C.A. No. 17132-NC (Del. Ch. Dec. 20, 2004).

Saito v. McCall, C.A. No. 17132-NC, (Del. Ch. Dec 20, 2004), is the latest addition to a line of cases dealing with directors' duty of oversight under the standard set out in *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). In *Saito*, the plaintiffs brought a derivative suit to recover damages from the directors, senior officers, merger advisors and outside accountants of each of HBO & Company ("HBOC"), McKesson Corporation ("McKesson") and McKesson HBOC, Inc. (the "Company"), the surviving corporation in the 1999 merger of HBOC and McKesson. The plaintiffs' principal allegations were that: (i) HBOC's directors and officers presided over a fraudulent accounting scheme; (ii) McKesson's officers, directors and advisors uncovered HBOC's accounting improprieties during their due diligence, but nonetheless proceeded with the proposed merger; and (iii) the Company's board did not act quickly enough to rectify the accounting fraud following the merger. The defendants moved to dismiss all counts. The Court dismissed most of the claims on procedural grounds, with the notable exception of the claim against the Company's directors alleging *Caremark* violations.

In 1998, the audit committee of HBOC, a healthcare software provider, met with representatives of Arthur Andersen ("Andersen"), HBOC's outside auditor, to discuss HBOC's 1997 audit. During this meeting, Andersen informed the audit committee that the 1997 audit was "high risk." Andersen then discussed with the audit committee risks affecting software companies in general and risks related to HBOC's sales practices in particular. Although a subsequent SEC investigation established that HBOC was misapplying GAAP, the Andersen partner overseeing the HBOC audit at the time did not inform HBOC of this fact, but instead reported that there were "no significant problems or exceptions and that Andersen enjoyed the full cooperation of HBOC management."

During the summer of 1998, HBOC held discussions with McKesson, a healthcare supply management company, regarding a potential merger. McKesson engaged Deloitte & Touche LLP ("Deloitte") and Bear Stearns & Company ("Bear Stearns") to assist it in evaluating the proposed merger. On July 10, 1998, in a meeting with Deloitte and Bear Stearns, McKesson's board of directors discussed the proposed merger and the due diligence issues raised in connection therewith. At this meeting, McKesson's board first learned of HBOC's questionable accounting practices; however, there was no indication that the McKesson board actually knew of any of HBOC's material accounting violations. Shortly after this meeting, Deloitte held a conference call with McKesson's chief financial officer and Bear Stearns and identified three areas where HBOC's accounting practices were questionable, two of which implicated violations of GAAP.

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

After the merger was consummated, the plaintiffs brought a duty of oversight claim against the directors of the Company alleging, *inter alia*, that the Company directors had failed to (i) correct HBOC's false financial statements, (ii) monitor the accounting practices of the Company, (iii) implement sufficient internal controls to guard against wrongful accounting practices that were uncovered following the merger, and (iv) disclose HBOC's false financial statements. The Court noted that, under *Caremark*, "a derivative plaintiff must allege facts constituting 'a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information reporting system exists.'" To survive a motion to dismiss, the plaintiffs were required to show that the Company board should have known that the alleged accounting problems had occurred or were occurring and made no good faith effort to rectify the accounting improprieties. Noting that the plaintiffs were entitled to the benefit of all reasonable inferences drawn from the applicable facts, the Court concluded that the facts at hand implicated the *Caremark* standard. The Court found that the plaintiffs had alleged sufficient facts to infer that the boards of each of McKesson and HBOC -- members of which comprised the board of the Company -- knew, or should have known, of HBOC's accounting irregularities. To support this finding, the Court noted that HBOC's audit committee became aware of the accounting problems when it learned that its 1997 audit was "high risk" and that the McKesson board learned of some of the problems during the July 1998 board meeting at which due diligence issues were discussed. In addition, the Court noted that the Company's audit committee had considered, but failed to act swiftly upon, HBOC's accounting problems. On these facts, the Court concluded that the Company board knew or should have known that HBOC's accounting practices were unlawful and that, despite this knowledge, failed to take any remedial action for several months. While noting that facts later adduced could prove that the Company directors did not violate their duties under Caremark, the Court allowed the plaintiffs' claim to survive a motion to dismiss. While the Company's certificate of incorporation included an exculpatory provision adopted pursuant to Section 102(b)(7), the parties did not raise, and the Court did not address, the impact of that provision.

The *Saito v. McCall* decision demonstrates that the Delaware Court of Chancery will not dismiss well-pled allegations of a breach of the duty of oversight.

b. ***David B. Shaev Profit Sharing Plan v. Armstrong*, C.A. No. 1449-N (Del. Ch. Feb. 13, 2006) and *Stone v. Ritter*, C.A. No. 1570-N (Del. Ch. Jan. 26, 2006).**

In both *David B. Shaev Profit Sharing Plan v. Armstrong*, C.A. No. 1449-N, Lamb, V.C. (Del. Ch. February 13, 2006), and *Stone v. Ritter*, C.A. No. 1570-N, Chandler, C. (Del. Ch. January 26, 2006), the Delaware Court of Chancery addressed so-called "*Caremark*" claims that the directors of Citigroup, Inc. ("Citigroup") and AmSouth Bancorporation ("AmSouth") breached their fiduciary duties by failing to take appropriate oversight responsibility, resulting in liability to their respective corporations.

In *Shaev*, plaintiffs brought a derivative action on behalf of Citigroup alleging that the directors' failure to exercise reasonable and prudent supervision over the management, policies, controls and financial affairs of Citigroup resulted in the directors breaching their fiduciary duties because they failed to detect and stop improper transactions involving Citigroup's clients, WorldCom and Enron. As a result, Citigroup incurred $5 billion in write-offs, settlement costs and fines. Defendants moved to dismiss the action on grounds that the plaintiffs failed to make a demand under Rule 23.1. The Court noted that "when a board fails to act, under Delaware law, a claim will survive a motion to dismiss based on Rule 23.1 only if the plaintiff presents well-pleaded facts to suggest a reasonable inference that a majority of the directors consciously disregarded their duties over an extended period of time." Plaintiffs alleged that only a board violating its fiduciary duties could have remained ignorant of Citigroup's relationship with Enron and WorldCom. The Court found these allegations were "precisely the type of conclusory statements that do not constitute a *Caremark* claim." While accepting that a director could be found liable for remaining ignorant of large fraud occurring in plain sight, even where there are supervisory controls, the Court concluded that plaintiffs' allegations provided no basis to believe that the Citigroup directors had ignored a mammoth fraud. The Court, therefore, granted defendants' motion to dismiss.

In *Stone v. Ritter*, plaintiffs brought a derivative action on behalf of AmSouth alleging that the directors breached their fiduciary duties by failing to institute sufficient internal controls to guard against violations of the Bank Secrecy Act and anti-money laundering regulations, resulting in AmSouth paying a $50 million fine. Plaintiffs' claims were based upon a report of the United States Department of Treasury, Financial Crimes Enforcement Network which concluded that AmSouth's anti-money laundering program "lacked adequate board and management oversight." The Court noted that plaintiffs' complaint only restated the conclusions set forth in the report and did not plead with particularity the facts underlying the report. The Court also found that plaintiffs did not plead any facts showing the board was aware that AmSouth's internal controls were inadequate or that the board chose to do nothing about problems they knew existed. The Court found that plaintiffs' allegations were conclusory. While hindsight showed the internal controls were inadequate, the Court held that this was not sufficient to force the conclusion that a majority of the board was disqualified from considering the demand. Thus, the Court granted defendants' motion to dismiss under Rule 23.1.

It is interesting to note that, in both cases, the plaintiffs took advantage of the "tools at hand" (*i.e.*, they made a books and records demand), but were unable to uncover sufficient facts to survive a motion to dismiss. *Shaev* and *Stone* demonstrate the difficulty in alleging a *Caremark* claim and make clear that, for such a claim to survive a motion to dismiss under Rule 23.1, a plaintiff must make more than conclusory allegations.

2. **<u>Duty of Disclosure.</u>**

a. ***Shamrock Holdings of California, Inc. v. Iger*, C.A. No. 1330-N (Del. Ch. June 6, 2005).**

In *Shamrock Holdings of California, Inc. v. Iger*, C.A. No. 1330-N (Del. Ch. June 6, 2005), the Court of Chancery denied a motion to dismiss a complaint alleging that certain defendant directors of The Walt Disney Company (the "Company") had violated their duty of disclosure by making statements in connection with the selection of the Company's new CEO.

Plaintiffs Roy Disney and Stanley Gold are former directors of the Company. In November 2003, Disney and Gold resigned as directors as a result of disputes with management. Disney and Gold were outspoken critics of the Company's corporate governance and campaigned to have stockholders vote to withhold authority to vote on Michael Eisner, George Mitchell and Judith Estrin as directors at the Company's 2004 Annual Meeting. Despite the absence of a competing slate, a significant percentage of stockholders withheld their votes from these candidates, including 45.37% for Eisner.

In September 2004, Eisner announced that he would retire as CEO of the Company effective September 30, 2006. Thereafter, on September 13, 2004, fearing that the Company would appoint Robert Iger as the Company's new CEO, Disney and Gold sent a letter to the non-employee directors of the board encouraging them to begin an outside search for a replacement for Eisner and threatening to propose an alternative slate of directors if this was not done. Shortly thereafter, the board released a statement indicating its intention to engage in a "thorough, careful and reasoned" CEO search and to consider both internal and external candidates. The Company also announced that Eisner would step down as CEO and as a director as soon as a replacement was installed.

On the basis of this announcement, Disney and Gold determined not to run a 2005 slate of directors. After the 2005 Annual Meeting, the Company held a press conference in which it announced that Iger would succeed Eisner as CEO. Disney and Gold filed suit against certain of the Company's directors and officers, alleging that defendants' false and misleading statements had breached their duty of disclosure and constituted equitable fraud. Plaintiffs alleged that the Company had not in fact engaged in a good faith search for a CEO as it had promised. Plaintiffs alleged that only one external candidate was interviewed, that Mitchell told her that "she was not a serious candidate," and that Eisner was present or was expected to be present at interviews of external candidates in what was intended to, and did, chill their candidacies.

With respect to plaintiffs' disclosure claim, the Court held that the facts in the complaint allowed it to reasonably infer that the board materially misled and deliberately misinformed plaintiffs and the other stockholders regarding its intent to conduct a bona fide executive search process. The Court also held that the complaint adequately pled equitable fraud by alleging that these material misstatements were intended to, and did, induce plaintiffs not to nominate a 2005 slate of directors.

Quickly after the Court's decision, the suit was settled in an agreement by which the Company agreed to make Roy Disney a nonvoting director emeritus and consultant to the Company in return for Disney agreeing to support Iger as CEO.

b. *In re J.P. Morgan Chase & Co. S'holders Litig.*, No. 218, 2005 (Del. Mar. 8, 2006).

In *In re J.P. Morgan Chase & Co. Shareholders Litigation,* No. 218, 2005 (Del. Mar. 8, 2006), the Delaware Supreme Court affirmed the Court of Chancery's dismissal of the plaintiffs' disclosure claim. Plaintiffs brought a derivative and class action lawsuit in the Court of Chancery challenging the merger through which J.P. Morgan Chase ("JPMC") acquired Bank One Corporation ("Bank One") in July 2004.

The transaction at issue was a stock-for-stock merger between JPMC and Bank One. Pursuant to the terms of this merger, JPMC issued JPMC common shares to Bank One shareholders at a premium of 14% over the closing price of Bank One's common stock at the time the merger was announced. JPMC and Bank One announced the proposed merger in January 2004, and filed a joint proxy statement with the SEC in February of that year. In May, over 99% of JPMC's shareholders voted in favor of the merger, and the merger closed on July 1, 2004.

Plaintiffs -- who were stockholders of JPMC -- brought suit solely on the basis of a newspaper article in the *New York Times* which reported that James Dimon, the CEO of Bank One, offered to sell Bank One to JPMC at no premium on the condition that he be appointed CEO of the merged entity immediately after the merger closed. On these facts, plaintiffs alleged that JPMC's board caused JPMC to overpay Bank One's shareholders to the extent of the 14% premium. Plaintiffs also alleged that JPMC's board breached its duty of disclosure by failing to report Dimon's offer in its proxy statement.

Plaintiffs claimed that the JPMC directors had breached their fiduciary duties in two ways: (1) by approving a merger exchange ratio that paid an unnecessary and excessive premium to Bank One shareholders; and (2) by publishing a proxy statement that contained materially inaccurate or incomplete disclosures. The Court of Chancery dismissed the overpayment claim under Rule 23.1, because that claim was derivative in nature and plaintiffs failed to make a pre-suit demand or demonstrate that they were excused from doing so. The Court of Chancery also dismissed the proxy disclosure claim under Court of Chancery Rule 12(b)(6), because the disclosure claim did not state a cognizable claim for money damages. The Court of Chancery rejected plaintiffs' argument that a breach of the fiduciary duty of disclosure automatically warrants an award of nominal damages. Plaintiffs appealed the dismissal only as to the proxy disclosure claim.

In their appeal, plaintiffs claimed that the Court of Chancery erred in dismissing the proxy disclosure claim, because plaintiffs were entitled to recover compensatory damages for the allegedly incomplete disclosure, or, in the alternative, at least nominal damages. Plaintiffs argued that they were entitled to compensatory damages equal to the $7 billion premium that the JPMC board paid to Bank One's shareholders. The Court of Chancery ruled that a claim for compensatory damages arose out of the underlying claim of overpayment, which was derivative rather than direct and the Supreme Court agreed. Plaintiffs did not dispute that the overpayment claim was derivative, but argued that the disclosure claim was direct and therefore entitled plaintiffs to recover the entire $7 billion in compensatory damages.

Plaintiffs argued that where a disclosure violation arises from a corporate transaction and results in the dilution of economic and voting power, that the shareholders are entitled to recover the same damages on their disclosure claim that the corporation would be entitled to recover on its derivative claim. Thus, under plaintiffs' theory of recovery, the JPMC board could be liable to the corporation for $7 billion, and to the shareholders for $7 billion. The Supreme Court stated: "That simply cannot be." Plaintiffs attempted to rely on *In re Tri-Star Pictures, Inc.* as support for the proposition that shareholders may recover compensatory damages where a corporate transaction that harmed their economic or voting rights is consummated through the directors' breach of their duty of disclosure. The Supreme Court rejected this argument and clarified that *Tri-Star* stands for the proposition that where a breach of the duty of disclosure has impaired economic and voting rights, the shareholders may be entitled to recover at least nominal damages.

Alternatively, plaintiffs requested nominal damages under *Tri-Star*, claiming *Tri-Star* established a *per se* rule of damages for breach of the fiduciary duty of disclosure. The Supreme Court held that under *Loudon v. Archer-Daniels-Midland Co.*, that there is no such *per se* rule, and that shareholders will recover damages only where "disclosure violations are concomitant with deprivation to stockholders' economic interests or impairment of their voting rights." The Supreme Court stated that dilution claims are direct claims only where a significant shareholder's interest is increased at the sole expense of the minority. Since the merger of JPMC and Bank One was not such a case, the Court rejected plaintiffs' contention that they were entitled to nominal damages. Accordingly, the Supreme Court affirmed the Court of Chancery's dismissal of plaintiffs' disclosure claim and awarded plaintiffs no damages.

II. 2006 AMENDMENTS TO THE GENERAL CORPORATION LAW.

The below amendments to the General Corporation Law were effective August 1, 2006.

A. <u>Director Resignations.</u>

Pursuant to Section 141(b) of the General Corporation Law, any director may resign as a director of the corporation at any time upon notice given in writing or by electronic transmission to the corporation. The amendment to Section 141(b) provides that a resignation may be made effective upon the happening of a future event or events, coupled with the authority granted in the same section to make certain resignations irrevocable. By permitting a corporation to enforce a director resignation conditioned upon the director failing to achieve a specified vote for reelection, e.g., more votes for than against, coupled with board acceptance of the resignation, these provisions permit corporations and individual directors to agree voluntarily, and give effect in a manner subsequently enforceable by the corporation, to voting standards for the election of directors which differ from the plurality default standard in Section 216 (see below). Such amendments do not, however, address resignations submitted in other contexts may be made irrevocable.

B. <u>Classified Board of Directors.</u>

Section 141(d) of the General Corporation Law permits the certificate of incorporation (or an initial bylaw or a bylaw adopted by stockholders) to divide the board of directors into one, two or three classes with staggered terms usually of three years each. The amendments to Section 141(d) (i) clarify that the classified terms of directors commence after the classification of the board of directors becomes effective, thereby expressly permitting certificate of incorporation or bylaw provisions that provide for classification effective at a point in time after such provisions are adopted and (ii) provide that the certificate of incorporation or bylaw provision dividing the directors into classes may authorize the board of directors to assign members of the board already in office to such classes at the time such classification becomes effective.

C. <u>Required Vote for Election of Directors.</u>

Section 216 provides that, unless otherwise provided in the certificate of incorporation or bylaws, directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors. If the bylaws specify the requisite vote for the election of directors, then, pursuant to Section 109(a) General Corporation Law, the stockholders may adopt an amendment to such a provision, unless otherwise prohibited by the certificate of incorporation. The amendment to Section 216 provides that a board of directors is prohibited from further amending any bylaw amendment adopted by the stockholders which specifies the requisite vote for the election of directors. The amendment does not address any other situation in which the board of directors amends a bylaw adopted by stockholder vote.