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# Recent Developments in Delaware Corporate Law

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# RECENT DEVELOPMENTS IN DELAWARE CORPORATE LAW

R. FRANKLIN BALOTTI, CATHERINE G. DEARLOVE, AND J. TRAVIS LASTER

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## I. NO SOLICITATION CLAUSES

In the fall of 1999, the Court of Chancery issued three decisions relating to strict no solicitation clauses in stock-for-stock merger agreements that limited the ability of a board of directors to engage in negotiations with or provide information to a third-party bidder. In a later decision, the Court upheld the use of a no-shop provision coupled with other lock-up devices under the business judgment rule, because the lock-up mechanisms were not employed as a defensive response to a perceived threat from a potential acquirer making a competing bid.

In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,<sup>1</sup> Phelps Dodge Corporation sought a preliminary injunction against implementation of a no solicitation clause in a stock-for-stock merger agreement that prohibited the

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<sup>1</sup> *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. No. 17398, 17383, 17427, Chandler, C. (Del. Ch. Sept. 27, 1999) (bench ruling).

merger partners not only from soliciting alternative bids, but also from engaging in discussions of any kind with a third-party bidder until the merger agreement was terminated. Phelps Dodge argued that this provision prevented the boards of directors of the merging companies from fulfilling their duty of care in deciding whether to recommend the merger to their stockholders, because the boards could not gather the information about third-party bids that they needed to make their decisions. Phelps Dodge also challenged as unreasonable the termination fee in the merger agreement, which represented approximately 6.3% of the market capitalization of one of the merging parties.

Although the Court denied the motion for preliminary injunction after finding that Phelps Dodge had not shown irreparable harm, the Court found that Phelps Dodge had established a probability of success on the merits. First, the Court noted that although parties to a stock-for-stock merger of equals have no obligation to negotiate with unsolicited bidders, the decision not to negotiate must be an informed one. The Court found that the strict no-talk provision with no fiduciary out, short of terminating the agreement, imposed "the legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care; that is, the duty to take care to be informed of all material information reasonably available."<sup>2</sup> Second, the Court found that the 6.3% termination fee "probably stretches the definition [of reasonableness] beyond its breaking point."<sup>3</sup>

In *Ace Limited v. Capital Re Corp.*, Ace sought to temporarily restrain Capital Re from terminating its stock-for-stock merger agreement with Ace (which Capital Re's board of directors wanted to do in order to accept an offer from a third party), and otherwise enforce a no solicitation clause in the merger agreement.<sup>4</sup> The clause permitted Capital Re to engage in discussions with, and provide information to, third-party bidders without terminating the agreement, *only* if the board concluded, "based on the written advice of its outside legal counsel," that engaging in discussions or providing information was "required in order to prevent the [b]oard . . . from breaching its fiduciary duties to its stockholders under [Delaware law]."<sup>5</sup> Capital Re had engaged in negotiations with a third party which resulted in a proposal that the Capital Re board determined was superior to the Ace/Capital Re merger agreement, but did not obtain written advice from its legal counsel stating that the negotiations were required. Ace argued that such written advice was required by the merger agreement, that Capital Re

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<sup>2</sup> *Id.* at 5.

<sup>3</sup> *Id.*

<sup>4</sup> *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999).

<sup>5</sup> *Id.* at 98-99.

had breached the merger agreement by failing to obtain the advice prior to entering into negotiations, and that as a result Capital Re was not entitled to terminate the merger agreement, which by its terms could not be terminated by a party in material breach of the agreement.

It is noteworthy that Ace held 12.3% of Capital Re's stock and had entered into voting agreements with holders of 33.5% of Capital Re's stock requiring the stockholders to support the Ace/Capital Re merger if the Capital Re board did not terminate the merger agreement in accordance with its terms. Thus, Ace would control nearly 46% of the vote on the merger agreement, which the Court concluded virtually guaranteed approval of the merger agreement, unless the Capital Re board terminated it.

The Court found that Ace had failed to establish a likelihood of success on the merits (under the circumstances of the case the Court gave more weight to the merits than is traditionally the case on a motion for TRO) and denied the motion for temporary restraining order. The Court noted that Ace's position depended on a literal reading of the no solicitation clause, under which the Capital Re board could not negotiate unless it obtained a specific opinion from counsel. In the Court's view, such a requirement would "involve... an abdication by the board of its duty to determine what its own fiduciary obligations require."<sup>6</sup> The Court also noted that if indeed there was no fiduciary duty to negotiate with third-party bidders in the context of a stock-for-stock "merger of equals," the fiduciary out in the no solicitation clause was illusory. The Court explained that a no solicitation provision that lacked a fiduciary out would be "particularly suspect when a failure to consider other offers guarantees the consummation of the original transaction, however more valuable an alternative transaction may be and however less valuable the original transaction may have become since the merger agreement was signed."<sup>7</sup> The Court observed that such a provision might be permissible if the stockholders could freely vote for or against the existing stock-for-stock merger and thus choose between that merger, a subsequent proposal, or no merger at all. The Court also suggested that such a provision might be acceptable if the board agreed to the provision as an auction-ending measure after a thorough canvass of the market.

The *Ace* decision also is noteworthy because the Court discussed extensively a theoretical framework for setting aside contract provisions approved by boards of directors in violation of their fiduciary duties. While noting the tension between a vested contract right and the fiduciary doctrine articulated most fully in *Paramount Communications, Inc. v. QVC Network*,

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<sup>6</sup> *Id.* at 106.

<sup>7</sup> *Id.*

*Inc.*,<sup>8</sup> the Court concluded that the following factors are to be considered when deciding if a contract right must give way: 1) if “the acquirer knew, or should have known, of the target board’s breach of fiduciary duty,” 2) if the “transaction remains pending,” making the parties’ contractual expectations less settled, and 3) if “the board’s violation of fiduciary duty relates to policy concerns that are especially significant.”<sup>9</sup>

In *In re IXC Communications, Inc. Shareholders Litigation*, a stockholder of IXC Communications, Inc. challenged a strict no solicitation clause, which, like the *Phelps Dodge* clause, barred any discussions with third-party bidders unless the merger agreement was terminated.<sup>10</sup> Before agreeing to this provision, however, IXC had announced publicly that it was exploring strategic alternatives and conducted a thorough canvass of the market for potential strategic partners. In addition, after the *Phelps Dodge* ruling, the parties amended the merger agreement to permit discussions with third-party bidders. In reliance on *Phelps Dodge*, the plaintiff argued the no solicitation clause nevertheless had tainted the sale process, and that the board had “willfully blinded” itself by approving the provision.<sup>11</sup> The Court rejected this claim, emphasizing that IXC had canvassed the market thoroughly, and that the provision had been adopted late in the exploration process. The Court also stated that “[p]rovisions such as these are common in merger agreements and do not imply some automatic breach of fiduciary duty.”<sup>12</sup> The Court did not mention *Phelps Dodge* or *Ace*.

In *State of Wisconsin Investment Board v. Bartlett*, the Court of Chancery ordered a stockholder meeting to vote on a merger agreement between Medco Research and King Pharmaceutical be delayed for 15 days in order to allow Medco stockholders sufficient time to consider supplemental disclosures made by Medco regarding the background of the merger agreement.<sup>13</sup>

After announcement of the Medco-King merger, plaintiff, a Medco stockholder, sued alleging, among other things, that the proxy materials disseminated about the merger failed to disclose material facts regarding the background of the merger. The meeting of Medco stockholders to vote on the merger was scheduled for February 10, 2000. On January 31, 2000, in an

<sup>8</sup> *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 105-06 (Del. 1994).

<sup>9</sup> *Ace Ltd.*, 747 A.2d 95.

<sup>10</sup> *In re IXC Communications, Inc. S'holder Litig.*, Consol. C.A. No. 17324, Steele, V.C. (Del. Ch. Oct. 27, 1999).

<sup>11</sup> *Id.* at 14.

<sup>12</sup> *Id.*

<sup>13</sup> *State of Wisconsin Inv. Bd. v. Bartlett*, C.A. No. 17727, Steele, V.C. (Del. Ch. Feb. 9, 2000) (Order).

attempt to address some of the alleged omissions in the proxy statement, the defendants distributed supplemental proxy materials (as well as a new proxy card) which the Court found "directly and materially enrich the quality of information potentially available to the shareholder and might reasonably affect their vote or motivate them to change a vote already cast."<sup>14</sup> Plaintiff moved to enjoin the February 10 meeting on the grounds that stockholders had not had sufficient time to consider the supplemental proxy materials and change their vote if they desired.

The Court held that it could not conclude with confidence that the 10 days between January 31 and February 10 gave Medco stockholders the time necessary to receive and consider the supplemental materials, and to modify their votes if they chose to do so. The Court further held that in light of this conclusion, the Medco stockholders would suffer irreparable harm as a matter of law if they voted for or against the merger on February 10, 2000. Accordingly, the Court enjoined the vote on the merger agreement for an additional 15-day period in order to permit the shareholders sufficient time to consider the supplemental information.

Subsequently, the Court issued a memorandum opinion denying a motion to enjoin the shareholder vote on the Medco-King merger at the postponed meeting. The plaintiff alleged that the members of the Medco board had breached their duties of loyalty, care, and disclosure in approving the merger. In particular, the plaintiff argued that the supplemental disclosures failed to cure certain material misdisclosures in the proxy materials, and thus continued to be materially misleading, that the Medco board members breached their duty of care by improperly delegating to one director (the Chairman) the responsibility to negotiate the transaction, by failing to inform themselves of the Chairman's actions, by agreeing to pay the Chairman a fee of .75% of the transaction value, which allegedly created an improper financial incentive in the Chairman that placed him in a conflict with the interests of the other Medco stockholders, by failing to reconsider and reaffirm the board recommendation of the merger agreement in light of the supplemental disclosures made, the delay in the date of the stockholder meeting, and that the Medco board members breached their duty of loyalty by agreeing to pay the Chairman an excessive fee for negotiating the transaction and by agreeing to include termination fee, no talk/no shop, and stock option provisions in the merger agreement.<sup>15</sup> The Court rejected each of these claims, finding that the Medco board members were disinterested, and that there was no evidence that they had acted other than in the

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<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

informed, good faith exercise of their business judgment. In so doing, the Court expressly found that the payment of a negotiating fee to a director of .75% of the transaction value was a matter within the business judgment of the Medco board and did not constitute waste. The Court also reiterated the view, expressed in *IXC*, that the inclusion of provisions such as no talk, no shop, termination fees, and cross options in a merger agreement is to be reviewed under the business judgment rule absent a pre-existing acquisition proposal from a third party. Finally, the Court rejected a claim that the Medco board, in light of the delay in the previously set shareholder vote, breached the duty of care by failing to reconsider and update its recommendation that the Medco stockholders vote in favor of the merger.

In the aftermath of *Phelps Dodge*, *Ace*, *IXC*, and *Bartlett*, it appears that the Delaware Court of Chancery will evaluate more closely the use of no solicitation clauses in merger agreements. The analysis appears fact specific, with the exact terms of the clause and the context in which it was approved (and perhaps judicially reviewed) figuring heavily in the analysis. *Phelps Dodge* and *Ace* suggest that no solicitation provisions that forbid discussions with or providing information to third-party bidders with no fiduciary out or with only a highly restrictive fiduciary out are suspect. *Ace*, *IXC* and *Bartlett* indicate, however, that such clauses may be permissible if the board has canvassed the market fully or agreed to the provision to obtain an auction-ending bid. The presence of a third-party bidder offering a topping bid, as in *Phelps Dodge* and *Ace*, has significant implications for the analysis. The facts in *IXC* and *Bartlett*, where no topping bid emerged and the target appears to have adequately canvassed the market, provide a scenario where such provisions may be deemed acceptable. *Phelps Dodge* and *Ace* also suggest that provisions in stock-for-stock merger agreements that have defensive or protective features may be reviewed by Delaware courts under enhanced scrutiny, even if the decision to enter into the merger itself is subject only to business judgment review.

## II. STOCKHOLDER VOTING RIGHTS

Several recent decisions of the Court of Chancery have addressed the voting rights of stockholders of Delaware corporations. These decisions reflect the central importance of the stockholder franchise under Delaware law.

In *Chesapeake Corp. v. Shore*,<sup>16</sup> the Court of Chancery held that a supermajority bylaw adopted by the board of directors of Shorewood

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<sup>16</sup> *Chesapeake Corp. v. Shore*, C.A. No. 17626, Strine, V.C. (Del. Ch. Feb. 11, 2000).

Packaging Corp. in response to a threatened tender offer and consent solicitation by Chesapeake Corporation constituted a breach of the Shorewood directors' fiduciary duties. The decision marks only the third time since 1989 that the Court of Chancery has found that the directors of a Delaware corporation breached their fiduciary duties in responding to a takeover threat.

Chesapeake responded to a bear-hug letter from Shorewood by counter-proposing an acquisition of Shorewood by Chesapeake. The Shorewood board rejected Chesapeake's proposal as inadequate. The board subsequently adopted a package of six bylaw amendments designed to cut off Chesapeake's ability to conduct a proxy fight or consent solicitation, including a provision requiring a 66 2/3% supermajority of Shorewood's outstanding stock to amend Shorewood's bylaws. Chesapeake then announced a tender offer and consent solicitation. Chesapeake also filed litigation challenging the supermajority bylaw and obtained an expedited schedule for trial. Shorewood subsequently rejected the tender offer as inadequate. Barely one week before trial, Shorewood held a brief telephonic meeting during which the directors reduced the voting requirement under the supermajority bylaw from 66 2/3% to 60%.

The Court found that the Shorewood directors breached their fiduciary duties by adopting and later amending the supermajority bylaw. While the Court found that the directors had a good faith basis for believing that the price offered by Chesapeake was inadequate, it rejected the directors' claim that they also identified a risk of substantive coercion due to stockholder confusion. The Court found no persuasive evidence that the directors actually considered the issue of stockholder confusion when they adopted the supermajority bylaw. Moreover, the Court found that if the directors had considered it, the threat would have been unfounded in light of Shorewood's stockholder profile, the ample coverage of Shorewood by public analysts, Shorewood's thorough public disclosures, and the testimony of Shorewood's own directors about Shorewood's ability to communicate effectively with its stockholders. Based on these factors, the Court concluded that the purported threat of stockholder confusion was a "post hoc, litigation-inspired rationale."<sup>17</sup>

The Court then evaluated whether the supermajority bylaw was a proportionate response to the threats the board identified. The Court found that the Shorewood board had never considered whether the supermajority bylaw would make it mathematically impossible for Chesapeake to succeed in its consent solicitation. The Court concluded that the board's

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<sup>17</sup> *Id.*



“impoverished deliberations” constituted a breach of the duty of care.<sup>18</sup> The Court further found that the supermajority bylaw was preclusive as a factual matter, irrespective of the information (or lack thereof) considered by the board.

The Court also found that even if the supermajority bylaw were not preclusive, the Shorewood directors had failed to show that it was reasonable. The Court described the defensive measure as “an extremely aggressive and overreaching response to a very mild threat.”<sup>19</sup> The Court also rejected the board’s assertion that it adopted the supermajority bylaw with the goal of placing the decision to amend the bylaws in the control of a majority of Shorewood’s disinterested shares. The Court found that when the expected voter turnout and the shares controlled by management were taken into account, the effect of the bylaw amendment would be that Chesapeake would be required to obtain the vote of at least 88% of the disinterested shares for its proxy solicitation to be successful. This not only was “pretty wide of the target at which the board aimed” but also was beyond any “level within the realm of reason.”<sup>20</sup>

The Court also concluded the Shorewood board adopted the supermajority bylaw purposefully, to interfere with, or impede the exercise of the stockholder franchise; the directors therefore had to show a compelling justification for their actions. The Court found the directors had not offered any compelling justification for the supermajority bylaw.

Having concluded that Chesapeake was entitled to judgment on its claims, the Court turned to Shorewood’s counterclaims. First, the Court rejected a claim that under Section 141(k) of the General Corporation Law the Shorewood directors had “a vested right to serve out the remainder of their terms, even if their constituents... decide to eliminate [Shorewood’s] classified board structure.”<sup>21</sup> The Court found that the Shorewood stockholders had clear authority to amend the company’s bylaws to eliminate the classified board structure, and that as “soon as that validly happens, the Shorewood directors will no longer serve as directors of a ‘corporation whose board is classified’... [and] will at that time be removable without cause.”<sup>22</sup> Second, the Court considered Shorewood’s argument that by purchasing a 14.9% block of Shorewood’s stock from Shorewood’s largest stockholder, Chesapeake in fact had entered into an agreement under which that stockholder would vote its entire 20% block of stock in favor of Chesapeake

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Shore*, C.A. No. 17626.

<sup>22</sup> *Id.*

in the consent solicitation, making Chesapeake an "interested stockholder" of Shorewood under the Section 203 of the General Corporation Law. (there should be a footnote cite here and other places where statutes are referenced unless the complete cite and format is in the text) The Court rejected this claim based on the plain meaning of the stock purchase agreement and, assuming *arguendo* that the agreement were ambiguous, based on all of the available extrinsic evidence. The Court also rejected a related argument that upside protection that Chesapeake agreed to in the stock purchase agreement, pursuant to which the seller would enjoy all of the additional value of any higher Chesapeake bid and half of the additional value of any higher third-party bid, gave rise to an ownership interest for purposes of Section 203.

In *BBC Capital Market, Inc. v. Carver Bancorp, Inc.*,<sup>23</sup> BBC sought preliminarily to enjoin Carver from counting the votes of shares representing approximately 8.3% of the outstanding voting power which had been issued to two allegedly friendly investors, Morgan Stanley Dean Witter and Provender Capital Opportunities Fund. BBC had previously indicated its intention (and subsequently undertook) to initiate a proxy solicitation for the two seats (of the eight-member board) to be voted upon at the upcoming annual meeting. BBC argued that the preferred stock issuance was done for the primary purpose of impeding its ability to win the proxy solicitation and therefore should be subject to the onerous *Blasius* standard of review. Unlike in *Chesapeake*, BBC did not argue, nor did Carver concede, that the preferred stock issuance was done as a defensive measure, which should more properly be subject to review under the heightened scrutiny of *Unocal*. Moreover, BBC did not contend that the preferred stock issuance would preclude it from success in its solicitation. Rather, BBC argued that all it needed to show was the electoral process was tainted, and that the issuance was done for the primary purpose of affecting the election.

Although finding that plaintiff had produced sufficient evidence to withstand a motion to dismiss if one had existed, the Court denied the motion for preliminary injunction. First, the Court concluded that the relevant facts as to the board's motive in issuing the preferred stock were hotly contested and that it could not grant injunctive relief "where important questions of material fact turn on the credibility of witnesses, with a focus upon actions they did or did not take based upon their subjective intent."<sup>24</sup> Second, the Court held that because granting BBC's application would result in full, final and complete relief tantamount to summary judgment in view of the fact that Morgan Stanley and Provender would forever be denied the

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<sup>23</sup> *BBC Capital Mkt., Inc. v. Carver Bancorp., Inc.*, C.A. No. 17743, Steele, V.C. (Del. Ch. Feb. 16, 2000) (bench ruling).

<sup>24</sup> *Id.*

opportunity to vote at the annual meeting, the harm to defendants would far outweigh the harm to plaintiff by denying the relief. Because the Court based its holding on these grounds, it did not reach the defendants' argument that plaintiff could not show irreparable harm where it offered no evidence that Carver's actions precluded it from succeeding at the annual meeting.

In *Rohe v. Reliance Training Network, Inc.*, plaintiffs brought suit under 8 Del. C. Section 225 seeking restoration of their seats on the Reliance board after they were removed "for cause."<sup>25</sup> The plaintiffs argued that their removal violated Reliance's certificate of incorporation, bylaws and a series of corporate and stockholder agreements naming them as directors, specifying the method of director removal and effectively guaranteeing their seats on the board for at least three years. Reliance originally was incorporated in Texas, but later redomiciled in Delaware, ostensibly for the sole purpose of having its internal affairs governed by Delaware corporate law. Plaintiffs' interpretation of their rights arguably was correct as a matter of Texas law. The question was whether such rights were consistent with Delaware law.

The plaintiffs argued: 1) the designation of specific directors in the various corporate instruments overrode the statutory requirement in 8 Del. C. Section 211 of an annual election of directors, and 2) the sole method of director removal was contained in the bylaws. The Court rejected both of these arguments, stating that "except in the case of a properly classified board, all directors must face the electorate on [an] annual basis at the corporation's annual stockholders' meeting" and that therefore a certificate of incorporation can only specify the board of directors for an initial period of time.<sup>26</sup> The Court further held that the right to remove a director is vested in the stockholders by 8 Del. C. Section 141(k), and this right could not be superseded by a contrary provision in a corporate instrument. "Like the right to elect directors, Delaware law considers the right to remove directors to be a fundamental element of stockholder authority."<sup>27</sup> The Court simply was unwilling to read the corporate governance documents and agreements in a way that did violence to the stockholder franchise under Delaware law, and accordingly dismissed the plaintiffs' claims.

In its ruling, the Court also addressed the question of whether a stockholder could "cast a vote for or against removal of the four [Reliance] directors it [did] not exclusively appoint."<sup>28</sup> The Court explained that Section

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<sup>25</sup> *Rohe v. Reliance Training Network, Inc.*, C.A. No. 17992, Strine, V.C. (Del. Ch. July 21, 2000).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 27.

<sup>28</sup> *Id.* at 31.

141(k)(2) draws a distinction between stockholder voting rights in for-cause and without-cause removal votes. In a without cause vote, Section 141(k)(2) limits participation to those stockholders who are entitled to vote for the class of directors whose seats are at stake, whereas that section places no restrictions on the power of stockholders to remove a director for cause. "Logically, the failure of the statute to permit such a limitation on a vote on the 'for cause' removal of a director implicitly means that a stockholder with the right to vote on the election of [a] single member of the board of directors may participate in the vote to remove for cause any of the other members of the board of directors."<sup>29</sup>

In *State of Wisconsin Inv. Bd. v. Peerless Systems Corp.*, the Court of Chancery considered the plaintiff's challenge to an adjournment of the annual stockholders meeting of defendant Peerless Systems Corporation by Peerless's Chairman and CEO, as authorized by the company's bylaws, which postponed the closing of the polls on a proposal to add 1,000,000 shares to the company's stock option plan.<sup>30</sup> Had the annual meeting not been adjourned, the proposal would have been defeated, but the proposal was approved by a slim margin when the meeting was reconvened thirty days later. In its complaint, the plaintiff asserted that the defendants inequitably, and in breach of their fiduciary duties, interfered with and manipulated the voting at the annual meeting, deprived Peerless stockholders of their voting rights, and omitted material information and made false and misleading statements concerning the adjournment.

In considering the parties' cross-motions for summary judgment, the Court applied *Blasius* and concluded that "the primary purpose behind the adjournment was to ensure the passage of [the proposal] by interfering with the shareholder vote and allowing [the proposal] to have more time to gain votes."<sup>31</sup> The Court based its conclusion on the inconsistent actions of the Peerless board in closing the polls on other proposals while adjourning the voting on the stock option proposal, uncontroverted testimony from Peerless employees concerning the purpose of adjourning the meeting, and the lack of formal disclosures by the company which would support its claimed goal of increasing voter turnout at the reconvened meeting. The Court also found, however, that the evidence produced by the parties did not resolve important issues of fact with respect to whether the defendants had demonstrated a compelling justification for their actions. Therefore, while the Court believed "it is doubtful that at the end of the day, based on the

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<sup>29</sup> *Id.* at 32.

<sup>30</sup> *State of Wisconsin Inv. Bd. v. Peerless Sys. Corp.*, C.A. No. 17637, Chandler, C. (Del. Ch. Dec. 4, 2000).

<sup>31</sup> *Id.* at 30.

factual record presently before me, the defendants will have provided a compelling justification for their actions," it nonetheless denied the parties' cross-motions for summary judgment on the plaintiffs' claims under *Blasius*.<sup>32</sup> The Court granted summary judgment for the defendants on the plaintiffs' disclosure claims, finding that the defendants complied with Delaware law concerning the required notice for reconvened shareholders meetings and did not omit material information relating to their intention to adjourn the annual meeting or the procedures to be followed at the reconvened meeting.

### III. REVLON DUTIES

Over the past few years, the Delaware courts have continued to refine the boundaries of the so-called *Revlon* duty to maximize shareholder value concerning a change in control transaction.

In *In Re Lukens Inc. Shareholders Litigation*, the Court of Chancery dismissed a complaint filed by shareholders of Lukens, Inc. alleging that the Lukens board breached its fiduciary duties in connection with the merger of Lukens with Bethlehem Steel Corporation.<sup>33</sup> In particular, the plaintiffs alleged that the directors had breached their duty under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, by, *inter alia*, allowing Bethlehem and a competing bidder for Lukens to reach a secret side agreement pursuant to which Bethlehem, if successful in merging with Lukens, would sell certain Lukens' assets to the competing bidder.<sup>34</sup> No one ever brought a motion for injunctive relief.

The Court dismissed the complaint under Rule 12(b)(6), finding that the complaint, which alleged no interest on the part of a majority of the Lukens board, and assuming *arguendo* that *Revlon* duties applied, failed to allege a breach of those duties. In reaching this conclusion, the Court made several important rulings. First, the Court clarified the relationship between so-called *Revlon* duties and the duties of care and loyalty, rejecting plaintiffs' contention that "when so-called *Revlon* duties are alleged, the duties of care, good faith and loyalty become 'intertwined' so that directorial failure to obtain the highest price, even if solely due to gross negligence, amounts to a breach of the duty of loyalty."<sup>35</sup> The Court explained that a "corporate board's failure to obtain the best value for its stockholders may be the result of illicit motivation (bad faith), personal interest divergent from shareholder

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<sup>32</sup> *Id.*

<sup>33</sup> *In re Lukens Inc. S'holder Litig.*, 757 A.2d 720 (Del. Ch. 1999).

<sup>34</sup> *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>35</sup> *Lukens*, 752 A.2d 720, at 730.

interest (disloyalty) or a lack of due care.”<sup>36</sup> The Court held that the complaint failed to allege facts which would implicate anything other than due care, such that Lukens’ Section 102(b)(7) provision would operate to protect the directors from personal liability.

Additionally, although the Court did not base its holding on this ground, the Court rejected, in a lengthy footnote, defendants’ argument that the heightened scrutiny of *Revlon* would be inapplicable in any event because over 30% of the merger consideration consisted of shares of the common stock of Bethlehem, a widely held company with no controlling stockholder. While noting that the Delaware Supreme Court “has not set out a black line rule explaining what percentage of the consideration can be cash without triggering *Revlon*,” the Court found that the Lukens merger, which involved approximately 60% cash, would constitute a change in control, reasoning that “for a substantial majority of the then-current shareholders, there is no long run.”<sup>37</sup>

In *In Re Pennaco Energy, Inc. Shareholders Litigation*, Marathon Oil sought to acquire Pennaco Energy through a tender offer and cash-out merger.<sup>38</sup> In an attempt to enjoin the close of Marathon’s tender offer, two Pennaco stockholders sued Pennaco Energy, the Pennaco board, and Marathon Oil. Plaintiffs alleged that the Pennaco Board had violated its duty under *Revlon* to obtain the best value reasonably available for the Pennaco stockholders. Specifically, plaintiffs took issue with the board’s failure to conduct an auction and its approval of generous severance and non-compete packages for the inside directors. Plaintiffs also alleged violations of the duty of disclosure. The complaint alleged that Marathon had aided and abetted these violations. The Court found none of the allegations sufficient to enjoin the close of the tender offer.

The Court began by evaluating plaintiffs’ *Revlon* claims. Although an auction is the standard means by which a board of directors ensures that it has secured the best available transaction, the Court emphasized that it is not the only means. Here, the board’s decision that an auction was unnecessary was supported by the following circumstances: Pennaco had long been a source of industry interest, the board had extensive knowledge about Pennaco and its worth, the board negotiated a better price, and the merger agreement lacked onerous deal-protection mechanisms, as well as allowed for a post-agreement market check. Thus, the Court found the board’s choice

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<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 731 n.25 (citing *TW Servs., Inc. v. SWT Acquisition Corp.*, C.A. Nos. 10427, 10298, Allen, C. (Del. Ch. Mar. 2, 1989)).

<sup>38</sup> *In re Pennaco Energy, Inc. S’holder Litig.*, Consol. C.A. No. 18606, Strine, V.C. (Del. Ch. February 5, 2001).

to deal only with Marathon not so unreasonable as to justify enjoining the tender offer.

The Court also concluded that the process by which the board approved severance and non-compete packages for the inside directors was not so flawed as to merit injunctive relief. The Court did find the process to have been less than ideal, by the compensation committee allowing management to steer the process. Nonetheless, the Court found a number of factors mitigated against issuing an injunction, including: Delaware courts' reluctance to second-guess compensation decisions, the Board's consideration of the packages before Marathon's expression of interest, valid tax reasons to approve the agreements, and that the packages represented only 1% of the total transaction value.

Finally, the Court turned to plaintiffs' allegations that the directors had violated their duty of disclosure, most notably by failing to disclose an e-mail sent by Pennaco's CFO to Marathon. The undisclosed e-mail contained valuations that, if true, would justify a per share price significantly higher than that being offered by Marathon. After a second deposition of the CFO was held and the transcript given to the Court for review, the Court concluded that the e-mail appeared to be a bargaining ploy, unsubstantiated by reliable valuations and designed solely to elicit a higher offer from Marathon. The Court thus found its omission insufficient to warrant injunctive relief; however, the Court did note that it would not be surprised if omission of the e-mail and its valuations were held to be material after a full hearing on the merits.

#### IV. REVIEW OF DISMISSAL UNDER RULE 23.1

In an *en banc* decision, the Delaware Supreme Court recently clarified that the dismissal of a complaint for failure to plead demand futility in a derivative action will be reviewed under a *de novo* standard of review.

In *Brehm v. Eisner*,<sup>39</sup> plaintiffs, stockholders of The Walt Disney Company, appealed the Court of Chancery's dismissal under Chancery Court Rule 23.1 of their complaint challenging the board's action in approving certain compensation arrangements with Disney's former president, Michael Ovitz. The Court of Chancery had dismissed the complaint, with prejudice, finding that the plaintiffs had failed to allege facts creating a reasonable doubt that the directors were disinterested or independent, or that their conduct was protected by the business judgment rule, so as to excuse pre-suit demand upon the board. On appeal, the

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<sup>39</sup> *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (*en banc*).

Delaware Supreme Court, in an *en banc* decision, affirmed the dismissal of the complaint, but reversed the Court of Chancery's determination that such dismissal should be with prejudice, and remanded the action to allow plaintiffs to file an amended complaint.

This opinion is notable in at least three respects. First, as a substantive matter, the Supreme Court indicated that "the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions,"<sup>40</sup> suggesting that there may well be an outer limit to business judgment protection where compensation decisions are concerned. Equally important, as a procedural matter, the Supreme Court held that its review of a dismissal under Rule 23.1 "is *de novo* and plenary," notwithstanding that all parties to the appeal had agreed that the appropriate standard of review was the abuse of discretion standard.<sup>41</sup> In this regard, the Supreme Court effectively overruled those portions (which it characterized as *dicta*) of the opinion in *Aronson v. Lewis*, that had been interpreted as holding that review of a dismissal under Rule 23.1 was "deferential, [and] limited to a determination of whether the Court of Chancery abused its discretion."<sup>42</sup>

Finally, the opinion recognizes the distinction between principles of corporation law and good corporate governance practices. In prefacing the analysis under Rule 23.1, the Delaware Supreme Court wrote:

This is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decision making process and for waste of corporate assets. This case is not about the failure of the directors to establish and carry out ideal corporate governance practices.<sup>43</sup>

All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. However, the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes

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<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 253.

<sup>42</sup> *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984); *Brehm*, 746 A.2d at 253.

<sup>43</sup> *Brehm*, 746 A.2d at 255-56.



reduce litigation, and can usually help directors avoid liability; but they are not required by the corporation law and do not define standards of liability.<sup>44</sup>

## V. INDEMNIFICATION AND EXECUTIVE COMPENSATION

In a series of recent decisions, the Delaware courts have addressed the indemnification rights of directors, and other issues relating to executive compensation. In *Cochran v. Stifel Financial Corp.*, the Court of Chancery considered a motion to dismiss plaintiff's complaint seeking indemnification.<sup>45</sup>

The plaintiff, a former director, officer and employee of Stifel Nicolaus, a wholly-owned subsidiary of Stifel Financial, filed suit against Stifel Financial for indemnification, claiming that he served Stifel Nicolaus in those capacities at the request of Stifel Financial and therefore was Stifel Financial's agent. The plaintiff's indemnification claims arose out of a SEC investigation of the subsidiary, which led to federal indictments against the plaintiff. After trial, the plaintiff was acquitted on thirteen counts, but convicted on eight counts. On appeal, his conviction was reversed. Subsequently, the subsidiary initiated arbitration against the plaintiff, alleging various contractual and fiduciary duty claims. The arbitrator awarded the subsidiary \$1.2 million on certain of the contract claims, but determined that the plaintiff had not violated his fiduciary duties. The plaintiff sought indemnification from Stifel Financial for the costs he incurred in the SEC investigation and criminal proceeding, the \$1.2 million judgment against him in the arbitration, and for his expenses in defending the arbitration.

Stifel Financial first argued that the complaint should be dismissed because it was barred by the one-year statute of limitations in 10 *Del. C.* Section 8111. The Court rejected this defense, concluding that the three-year statute of limitations found in 10 *Del. C.* Section 8106 applied. The Court reasoned that the Delaware Supreme Court had given a broad construction to Section 145 in order to advance the statute's pro-indemnification approach; the Court declined to narrow that construction through application of a statute of limitations. The Court also concluded that where there is doubt as to which of two statutes of limitations should be applied, that doubt should be resolved in favor of the longer period.

Second, Stifel Financial argued that the complaint should be dismissed because the plaintiff did not make a demand for indemnification before commencing litigation. The Court rejected this argument because it was not

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<sup>44</sup> *Id.*

<sup>45</sup> *Cochran v. Stifel Financial Corp.*, C.A. No. 17350, Strine, V.C. (Del. Ch. Mar. 8, 2000), *appeal refused*, 750 A.2d 530 (Del. 2000).

supported by Section 145. Section 145(k) vests the Court of Chancery with exclusive jurisdiction over indemnification claims; “[t]his authority is not dependent on a prior demand by the plaintiff seeking indemnity.”<sup>46</sup> Further, the text of Section 145(d) contemplates that a judicial determination of whether indemnification is warranted can be made, instead of such a determination by the corporation. The Court noted that although a corporation that wishes to make a demand a predicate to permissive indemnification can do so by requiring such a demand in its bylaws, the defendant corporation had chosen not to employ such a provision.

Third, Stifel Financial argued that the plaintiff was not entitled to indemnification for the \$1.2 million arbitration award because the arbitration claims were brought “by or in the right” of Stifel Financial by its wholly owned subsidiary, Stifel Nicolaus, thereby bringing the plaintiff’s claim within Section 145(b), which is more restrictive than Section 145(a). The Court rejected this contention, concluding that the corporation referred to in the phrase “by or in the right of the corporation” in Section 145(b) is the corporation from which indemnity is sought.<sup>47</sup>

Finally, with respect to the plaintiff’s claim for mandatory indemnification for expenses arising out of the defense of claims on which he was either exonerated or held not liable, Stifel Financial claimed that the plaintiff could not rely on Section 145(c) because the complaint failed to allege facts sufficient to support an agency relationship between the plaintiff and Stifel Financial. Because the indemnification claims were for acts that occurred before the amendment of Section 145(c) on July 1, 1997, the prior version of Section 145(c) (which provided for mandatory indemnification of corporate agents) applied. The Court concluded that the complaint failed to allege facts sufficient to support the existence of a principal-agent relationship between the plaintiff and Stifel Financial, although it granted the plaintiff’s request to replead the claim. The Court further opined that the issue may be academic, since Stifel Financial’s “maximally broad” indemnification bylaw may require mandatory indemnification regardless of whether the plaintiff is an agent of Stifel Financial.<sup>48</sup>

In a later decision in the *Stifel* action, the Court of Chancery addressed the parties’ cross motions for summary judgment. In *Cochran v. Stifel Financial Corporation*, the Court granted Stifel’s motion as to certain claims, and Cochran’s motion as to others.<sup>49</sup>

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<sup>46</sup> *Id.* at 24.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 45-46.

<sup>49</sup> *Cochran v. Stifel Financial Corp.*, C.A. No. 17350, Strine, V.C. (Del. Ch. Dec. 19, 2000).

Cochran was not a director, officer, or employee of Stifel. Stifel elected Cochran to the board of Stifel Nicolaus ("SN"), its wholly owned subsidiary. Cochran also served as an officer and employee of SN. Cochran, however, sought indemnification directly from Stifel as an agent of Stifel, rather than from SN. Cochran's motion arose out of two separate matters. First, after Cochran left the employ of SN, the U.S. attorney charged him with numerous counts of criminal fraud (the "Criminal Proceeding"). He was convicted at trial, but the conviction was overturned on appeal, and the dismissal of the charges became final. Cochran sought indemnification for costs and expenses in the criminal action based on Stifel's indemnification bylaw (the "Indemnification Bylaw"). Second, Cochran also sought indemnification for an arbitration initiated by SN against him before the National Association of Securities Dealers, Inc. (the "Arbitration Proceeding"), in which SN alleged that Cochran received unearned compensation (the "Excessive Compensation Claim"), breached his fiduciary duties to SN (the "Breach of Duty Claim") and breached a non-competition clause in his employment contract (the "Non-compete Claim"). There was also a claim on a promissory note (the "Promissory Note Claim"). Ultimately, the arbitrator awarded SN \$1.2 million on the Excessive Compensation and Promissory Note Claims, but determined that Cochran was not liable for a fiduciary violation. SN abandoned the Non-compete Claim. Therefore, Cochran sought indemnification arguing that he was successful on the Breach of Duty Claim and the Non-compete Claim. Cochran also sought indemnification for the Promissory Note and Excessive Compensation Claims, under Section 145(a).

The motions came down to two primary contentions. First, that Stifel was entitled to summary judgment on the Excessive Compensation, Promissory Note, and Non-compete Claims because those claims were not brought against Cochran by reason of his service in his indemnifiable capacities. Second, that Cochran was entitled to summary judgment on the Criminal Proceeding and Breach of Duty Claim under the Indemnification Bylaw because he was successful in defending those matters.

Cochran claimed that Stifel owed him indemnification for the Excessive Compensation, Promissory Note and Non-compete Claims because his status as director, officer and employee of SN was essential to the claims, so they arose by reason of the fact that he held those positions at SN. The Court found that obligations an employee accepts under a contract are personal obligations. Therefore, the Excessive Compensation, Promissory Note and Non-compete Claims were brought against Cochran by reason of the fact that he had allegedly breached personal contractual obligations owed to SN rather than "by reason of the fact" that he was serving in indemnification-eligible positions at SN, so he was not entitled to indemnification under

section 145 or the Indemnification Bylaw. Therefore, the Court granted Stifel's motion for summary judgment on the Excessive Compensation, Promissory Note, and Non-compete Claims.

Cochran's summary judgment motion as to the Criminal Proceeding and the Breach of Duty Claim centered on the Indemnification Bylaw that requires Stifel to indemnify any individual serving "any other enterprise as a director, officer or employee at the request of" Stifel "to the full extent authorized by law."<sup>50</sup> This required Stifel to indemnify Cochran if such indemnity would be permissible under the General Corporation Law. Under Section 145(c) a corporation must indemnify directors and officers who have been successful on the merits or otherwise in any defense of an action covered by Section 145(a) or 145(b). Sections 145 (a) and (b) permit the corporation to indemnify its directors (including officers, employees and agents) for attorneys' fees and other expenses that arose by reason of their capacity as directors (if their conduct was in good faith and in a manner reasonably believed to be in the best interests of the corporation), and for judgments rendered against directors, or amounts paid in settlement of civil cases in third-party actions by directors. Both the Criminal Proceeding and the Breach of Duty Claim arose by reason of Cochran's service in his various capacities at SN, and in both cases, he was successful on the merits or otherwise. If Cochran were an officer or director of Stifel, his right to indemnification would be mandatory. Under Section 145(f), a corporation may provide broader indemnification rights than those set forth in Section 145, unless those rights are contrary to the limitations set forth in Section 145, other statutes, court decisions, or public policy. The Court found that since Stifel would be required to indemnify its own CEO under the same circumstances, it would be permissible for Stifel to indemnify Cochran under Section 145(f). The Court also found that because Stifel's Indemnification Bylaw required Stifel to indemnify Cochran if it could lawfully do so, it was contractually bound to do so. Therefore, the Court granted Cochran's motion for summary judgment as to the Criminal Proceeding and the Breach of Duty Claim.

In *Sanders v. Computer Associates, Int'l, Inc.*, the Court of Chancery considered claims that directors of Computer Associates had improperly administered a key employee stock option plan ("KESOP").<sup>51</sup> Section 3.1 of the KESOP authorized the compensation committee of the Computer Associates board to grant up to 6 million shares of the company's common stock to the KESOP's participants (three directors who also were the

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<sup>50</sup> *Id.*

<sup>51</sup> *Sanders v. Computer Assoc., Int'l, C.A. No. 16640, Steele, V.C. (Del. Ch. Nov. 8, 1999).*

company's top executives). The KESOP did not specifically permit the compensation committee to adjust the number of shares granted to account for stock splits or recapitalizations, although Section 6.2 granted the plan's administrators broad authority to interpret and administer the plan. By 1998, the compensation committee had granted the participants 20.25 million shares, which was equivalent to 6 million shares adjusted for three stock splits. The plaintiffs alleged that the defendants granted more shares than the number authorized by the KESOP and asserted various claims against the directors flowing from the grants. The plaintiffs moved for judgment on the pleadings or, alternatively, summary judgment; the defendants moved to dismiss under Rules 12(b)(6) and 23.1 and for judgment on the pleadings.

The Court first determined that demand was excused because the facts alleged in the complaint raised a reasonable doubt that the share grants resulted from a valid exercise of business judgment. At a minimum, the plaintiffs had alleged facts which, if true, showed that the board violated an express KESOP provision limiting the number of shares they were authorized to award.

Addressing the remaining motions, the Court concluded that the KESOP clearly limited to 6 million the total number of shares that could be granted under the plan. While Section 6.2 gave the board authority to interpret and administer the KESOP, it did not provide authority to ignore the express 6 million share limitation. The Court rejected defendants' argument that the award of shares more than 6 million carried out the purpose and intent of the KESOP. Accordingly, the Court ordered the recipients to return the excess shares to the corporation, imposed a constructive trust on the recipients, and ordered an accounting rendered for any economic benefit derived from the excess shares.

In *Hills Stores Co. v. Bozic*, the Court of Chancery rejected a challenge to the validity of severance payments made to corporate officers, upon a change in control of the corporation.<sup>52</sup>

In 1994, Dickstein Partners initiated a consent solicitation to remove and replace certain members of the Hills board of directors. As part of its response to Dickstein's overtures, the Hills board approved employment agreements for seven of Hills' top executives. Under the new employment agreements, the right to severance payments was triggered upon the demotion or discharge of the executive within one year of a change of control, or the occurrence of any change of control which was not approved by a majority of the Hills board. The rationale for the double trigger was to

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<sup>52</sup> Hills Stores Co. v. Bozic, C.A. Nos. 14527, 14460, 14787, Strine, V.C. (Del. Ch. Feb. 22, 2000).

provide the Hills board with leverage in negotiations with any potential acquirer and to reassure Hills' creditors that a change in control would not necessarily result in the exodus of the company's management with substantial severance payments. Certain stockholders of Hills subsequently filed a derivative and class action challenging the adoption of the employment agreements. As part of a settlement of that action the Court of Chancery approved, Dickstein agreed not to pursue any claims regarding the adoption of the employment agreements.

In May 1995, Dickstein proposed to acquire all of Hills' outstanding shares and commenced a proxy contest to replace the incumbent members of the Hills' board. The Hills board rejected Dickstein's initial proposal and a later revised proposal because, among other reasons, the Hills board supported management's business strategy, the company's stock was trading near its twelve month low, Dickstein's professed strategy to leverage the company had forced other similar companies into bankruptcy, and Dickstein had not secured firm financing. The Hills board did not adopt any additional defensive measures, and instead focused on attempting to win the proxy contest.

Shortly before the meeting of the Hills stockholders, the Hills board considered whether to approve the potential Dickstein-initiated change in control solely for eliminating the executives' right to substantial severance payments under their employment agreements. At that time, the Hills board knew of the probability that the Dickstein slate would win the election. Upon the advice of counsel, the Hills board declined to approve the prospective change in control solely for purposes of the employment agreements because such action would be inconsistent with the overall opposition of the Hills board to the Dickstein acquisition proposal and proxy contest.

After the Dickstein slate won the election, the covered executives resigned and received their substantial severance payments from rabbi trusts established by Hills. Dickstein (acting through the company) and other Hills stockholders initiated actions alleging, among other things, that the former Hills directors breached their fiduciary duties and committed waste by refusing to approve the Dickstein change of control to eliminate Hills' obligation to make the severance payments under the executives' employment agreements.

The Court determined that the Hills board was required to demonstrate that, after reasonable investigation, it determined in good faith that the corporation faced a threat warranting a defensive response and that its defensive measures were proportionate to the identified threat. The Court concluded that because Dickstein had waived its right to challenge the validity of the employment agreements in connection with the 1994 litigation

settlement, Dickstein could not in good faith claim that the severance payments were a disproportionate response to a change of control proposal which the Hills board concluded was adverse to the interests of Hills and its stockholders. The Court emphasized that plaintiffs had failed to challenge the determination of the Hills board that the Dickstein change of control constituted a threat to Hills and its stockholders. The Court rejected plaintiffs' attempt to focus narrowly on whether the members of the Hills board breached their fiduciary duties by refusing to approve the change of control solely for purposes of the employment agreements. Recognizing that the executives had remained with the company during a proxy contest in which the Hills board opposed the Dickstein change of control as well as the fact that the board had determined that the Dickstein change in control would be harmful to the company, the Court found that the Hills board members would have breached the employment agreements if they had voted to approve the Dickstein change of control simply to avoid the severance payments. The Court concluded that the Hills board acted reasonably because the former directors believed that Dickstein posed a threat and that Hills should comply with its contractual obligations under the employment agreements. Accordingly, the Court granted defendants' motion for summary judgment on plaintiffs' breach of fiduciary duty and waste claims.

## VI. MAJORITY STOCKHOLDER TRANSACTIONS

In two recent decisions, the Delaware Courts have addressed the duties of directors in transactions involving majority stockholders.

In *McMullin v. Beran*,<sup>53</sup> the Delaware Supreme Court reversed the Court of Chancery's dismissal of a complaint filed by a stockholder of Atlantic Richfield Chemical Company ("ARCO") alleging that ARCO Chemical's board breached its fiduciary duties in approving a transaction with Lyondell Petrochemical Company pursuant to which Lyondell acquired all shares of ARCO Chemical's stock for \$57.75 per share. Atlantic Richfield Company, an 82% stockholder of ARCO Chemical, was primarily responsible for negotiating the transaction with Lyondell. Among other things, the plaintiff argued that the ARCO Chemical board breached its fiduciary duties under *Revlon* and improperly abdicated its fiduciary responsibilities and delegated them to ARCO. The Court of Chancery granted the defendants' motion to dismiss, finding that the transaction did not constitute a change of control as contemplated by *Revlon* since the minority stockholders never had a right to,

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<sup>53</sup> *McMullin v. Beran*, 765 A.2d 910 (Dec. 2000).

and therefore could not be deprived of, a control premium. The Court of Chancery further held that the ARCO Chemical board had no duty to take a more active role in the sale process led by ARCO since it would have been fruitless for ARCO Chemical to pursue any transaction in which ARCO had no interest.

On appeal, the Supreme Court first noted that “[t]he statutory duties and common law fiduciary responsibilities that directors of a Delaware corporation are required to discharge depend upon the specific context that gives occasion to the board’s exercise of its business judgment.”<sup>54</sup> In the context of a proposed sale of a corporation at the behest of the majority stockholder, the Court posited that, even if a “change in control” is not anticipated, the board of directors must nonetheless seek to maximize the value of the minority stockholders’ shares:

When a board is presented with the majority shareholder’s proposal to sell the entire corporation to a third party, the ultimate focus on value maximization is the same as if the board itself had decided to sell the corporation to a third party. When the entire sale to a third party is proposed, negotiated and timed by a majority stockholder, however, the board cannot realistically *seek* any alternative because the majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board’s consideration. Nevertheless, in such situations, the directors are obliged to make an informed and deliberate judgment, in good faith, about whether the sale to a third party that is being proposed by the majority shareholder will result in a maximization of value for the minority shareholders.<sup>55</sup>

Therefore, the Court continued, even though the ARCO Chemical directors “did not have the ability to *act* on an informed basis to *secure* the best value reasonably available for all shareholders in any alternative to the third-party transaction with Lyondell that ARCO had negotiated,” they nonetheless had “the duty to act on an informed basis to independently ascertain how the merger consideration being offered in the third party transaction with Lyondell compared to Chemical’s value as a going concern.”<sup>56</sup> The ARCO Chemical directors were required to fulfill this duty “faithfully and with due care so that the minority shareholders would be able

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<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*



to make an informed decision about whether to accept the Lyondell transaction tender offer price or to seek an appraisal of their shares.”<sup>57</sup>

The Court found that the allegations of the plaintiff’s amended complaint adequately pled claims that the ARCO Chemical directors breached their fiduciary duties of care and loyalty in considering and approving the sale to Lyondell proposed by ARCO.

In *In re Digex, Inc. Shareholders Litigation*, the Court of Chancery considered a motion by minority stockholders of Digex, Inc. (“Digex”) to preliminarily enjoin a proposed merger between WorldCom, Inc. (“WorldCom”) and Intermedia Communications, Inc. (“Intermedia”), the controlling stockholder of Digex.<sup>58</sup> In July 2000, Intermedia publicly announced that it had retained an investment bank to explore its strategic alternatives concerning its majority-owned subsidiary Digex, including the possible sale of Intermedia’s ownership position in Digex to another company. After various offers for the acquisition of Digex were received, Intermedia ultimately agreed to be acquired by WorldCom, with the public minority stockholders of Digex remaining as such. In their complaint, the plaintiffs alleged: 1) that the defendants usurped a corporate opportunity that rightfully belonged to Digex by preventing Digex’s sale to the highest bidder, and 2) that in the face of the three disinterested Digex directors (including the two members of the special committee formed by Digex in connection with Intermedia’s decision to explore its strategic alternatives) voting against the waiver of the protections afforded to Digex by 8 Del. C. Section 203 (“Section 203”), the four interested Digex board members breached their fiduciary duties when they voted to waive such protections.

The Court rejected the plaintiffs’ corporate opportunity claim, finding that Digex did not have a legally cognizable interest or expectancy in a WorldCom-Digex deal, as opposed to the ultimate WorldCom-Intermedia structure. While the plaintiffs argued that the defendants, by allegedly steering WorldCom away from a deal with Digex and toward a deal with Intermedia, misappropriated an opportunity belonging to Digex, the Court found that the opportunity identified by plaintiffs – *i.e.*, the right to sell Digex to the highest bidder – rightfully belonged not to Digex, but rather to its stockholders. Moreover, because Intermedia could lawfully vote its majority holdings to block any proposed sale of Digex, the Court found it unlikely that Digex and its shareholders would have a legally cognizable interest or expectancy in a WorldCom-Digex transaction. The Court found further that, based on the evidentiary record before it, the plaintiffs had not

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<sup>57</sup> *Id.*

<sup>58</sup> *In re Digex, Inc. S'holder Litig.*, Consol. C.A. No. 18336, Chandler, C. (Del. Ch. Dec. 13, 2000).

demonstrated a reasonable likelihood of success on the merits of their claim that the defendants breached their fiduciary duty of loyalty in allegedly usurping the corporate opportunity.

In reviewing the Section 203 claim, the Court strongly suggested, but ultimately did not decide on ripeness grounds, that in calculating the 85% of the voting stock of the corporation for purposes of determining the applicability of the Section 203(a)(2) exception to the restrictions on business combinations, the Delaware General Assembly had intended the exception to apply to shares of stock and not the voting power of stock.

The Court also addressed the conduct of four directors of the subsidiary corporation who had been appointed by the parent and who voted for the waiver. The Court described the decision before the board: “[T]he decision put before the Digex board was simply whether or not to grant WorldCom the Section 203 waiver. *That is, was whatever Digex was being offered for this waiver worth the granting of the waiver and could Digex negotiate for more?*”<sup>59</sup> The Court chastised the directors for failing to discuss the subject of the waiver before taking action to decide whether to approve it, even in the face of conflicting advice from counsel to the Company and counsel to the special committee of the Board relating to the appropriateness of voting by interested board members. Citing *Smith v. Van Gorkom*,<sup>60</sup> the Court expressed doubt that the directors’ conduct in voting to waive the protections of Section 203 “could even pass the most deferential business judgment review.”<sup>61</sup>

In addition to its analysis of the Section 203 claim, the Court also had occasion to examine the work of the special committee of the Digex board formed to address the conflicts inherent in the transaction. While not at all critical of the special committee, the Court made clear that because the special committee was not afforded legal authority to block the transaction, or to determine whether or not to grant the Section 203 waiver, it was legally unable to stop the apparent breach of duty of the interested directors, and therefore did not cause any burden-shifting effect in the transaction. In commenting on the failure to structure the committee in a meaningful way, or to allow it to assume active control of the decision, the Court wrote:

The Section 203 waiver negotiation, however, is exactly where the Special Committee should have been most relevant in this whole process. But this is precisely the point at which the Special Committee is missing in action - not through any failure of its own,

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<sup>59</sup> *Id.* at 80 (emphasis added).

<sup>60</sup> *Smith v. Van Gorkham*, 488 A.2d 858 (Del. 1985).

<sup>61</sup> *Digex*, Consol. C.A. No. 18336, at 75.

but as a result of the control by the conflicted directors over the process. *Weinberger's* suggestion of either an "independent negotiating structure" or "total abstention" is not to be taken lightly.... [T]here is a strong role under Delaware law for meaningful independent director committees. Although this Special Committee may have been created with precisely this role in mind, it certainly was not permitted to act in keeping with this role.<sup>62</sup>

While the Digex Court ultimately denied the request for a preliminary injunction stopping the Intermedia-WorldCom merger because the Section 203 claim was based on a past decision of the Digex Board, rather than prospective harm, the Court concluded that "[i]n the wake of this Opinion, the defendants' choice becomes whether they will proceed with a WorldCom-Intermedia merger knowing that this Court seriously questions the integrity of the Section 203 waiver decision and knowing that certain of the defendant fiduciaries stand accused of faithless acts that under the stringent standard of the entire fairness test, could well give rise to a range of equitable remedies, including monetary remedies."<sup>63</sup>

## VII. SHAREHOLDER RIGHTS PLANS

Recently, the Court of Chancery has reaffirmed the validity of poison pill rights plans.

In *Leonard Loventhal Account v. Hilton Hotels Corp.*, the Court of Chancery dismissed a complaint filed by a stockholder of Hilton Hotels Corp. challenging a stockholder rights plan adopted by the Hilton board of directors in November 1999.<sup>64</sup> The Hilton rights plan included provisions commonly found in many other stockholder rights plans adopted by Delaware corporations. Nonetheless, the plaintiff challenged the rights plan on five separate grounds, asserting that: 1) the plan was not a valid and enforceable contract between Hilton and its common stockholder; 2) the plan imposed unlawful transfer restrictions on Hilton common stock; 3) the plan violated 8 *Del. C.* Sections 151 and 242 by altering the rights of Hilton stockholders without an amendment to Hilton's certificate of incorporation; 4) Hilton violated 8 *Del. C.* Section 202, its bylaws and 6 *Del. C.* Section 8-401 by failing to issue unlegended stock certificates for shares of common stock upon request; and 5) the plan violated 8 *Del. C.* Sections 102(b)(7) and

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<sup>62</sup> *Id.* at 71-72.

<sup>63</sup> *Id.* at 88.

<sup>64</sup> *Leonard Loventhal Account v. Hilton Hotels Corp.*, C.A. No. 17803, Chandler C. (Del. Ch. Oct. 10, 2000).

141(a) by attempting to eliminate any liability on the part of Hilton's board of directors. In doing so, the plaintiff "challenged several provisions and aspects of the Hilton rights plan that were not only contained in the Household rights plan, but figured prominently in the litigation that led to the decisions of the Delaware courts."<sup>65</sup>

With respect to plaintiff's first three claims, the Court dismissed each under the doctrine of *stare decisis*. The Court further held that Hilton did not violate its bylaws or Delaware law by failing to issue unlegended stock certificates because the legend was authorized by 8 *Del. C.* Section 157, was validly approved by the Hilton board, was appropriate as it continued to evidence the validly issued rights, and did not constitute a refusal to register a transfer. Finally, the Court dismissed as moot the plaintiff's claim that the rights plan, which provided that any actions taken in good faith by the Hilton directors in administering the plan "shall... not subject the Board to any liability to the holders of the Rights," improperly limited the liability of the Hilton directors for breaches of fiduciary duty. The Court's holding, however, was based on Hilton's representation that the provision in question had no effect on the rights of Hilton's stockholders, *qua* stockholders, and did not bar claims that may be brought by stockholders as such concerning the rights plan. Accordingly, the Court explicitly qualified its dismissal to recognize that the rights plan "affects neither the rights of the Hilton shareholders in relation to the Hilton Board nor the duties owed by the members of the Hilton Board to the Hilton shareholders."<sup>66</sup>

The *Hilton* decision currently is on appeal.

### VIII. FIDUCIARY DUTY ISSUES

Several important Delaware cases have addressed other aspects of directors' fiduciary duties, including directors' duties in connection with mergers, or other extraordinary transactions.

In *Nagy v. Bistricher*, plaintiff Ernest J. Nagy challenged a merger in which Riblet Products Corporation ("Riblet") became a wholly owned subsidiary of Coleman Cable Acquisition ("Coleman").<sup>67</sup> Nagy was the sole minority stockholder of Riblet. The co-defendants were the majority stockholders and sole directors of both Riblet and Coleman. The agreement governing the Coleman merger contained a unique provision that allowed Coleman to adjust the merger consideration upward or downward, after closing, based on consultations with an independent investment bank. Nagy alleged that the

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<sup>65</sup> *Id.* at 10.

<sup>66</sup> *Id.* at 28.

<sup>67</sup> *Nagy v. Bistricher*, C.A. No. 18017, Strine, V.C. (Del. Ch. Nov. 22, 2000).

provision forced the Riblet board to breach its fiduciary duty of care and constituted an improper abdication of the board's obligation to approve merger terms that are fair to its stockholders and to make a recommendation on the merger to its stockholders. He also challenged the disclosures provided about the merger. The defendants moved to dismiss the complaint on various grounds, including that appraisal was the plaintiff's exclusive remedy. Nagy cross-moved for summary judgment.

In ruling on the parties' motions, the Court first held that Delaware law now clearly rejects the argument that appraisal can be a stockholder's exclusive remedy when a stockholder has alleged a colorable claim for breach of fiduciary duty against a long-form merger. The Court rejected the defendants' reliance on *Weinberger v. UOP, Inc.*, as establishing that in some cases, appraisal can be a stockholder's exclusive remedy.<sup>68</sup> The Court rejected the defendants' motion to dismiss Nagy's disclosure claims and granted Nagy's motion for summary judgment. The Court found that the defendants had failed to disclose a series of categories of information, which resemble the line-item disclosures required by the federal securities laws. The Court rejected the defendants' argument that *Stroud v. Grace*,<sup>69</sup> provides for a reduced disclosure obligation in the private company context. Finally, the Court granted Nagy's motion for summary judgment on his improper delegation claim, finding that a board of directors has a non-delegable obligation to determine that the consideration in a long-form merger is fair, and to make a recommendation to the corporation's stockholders. The Court rejected the argument that Coleman's failure to alter the initial merger consideration mooted Nagy's challenge. Dictum in the Court's opinion can be read to restrict the extent to which a board can approve a merger in which the price term is dependent upon facts ascertainable outside a merger agreement, as expressly contemplated by Section 251 of the General Corporation Law. The future impact of this dictum remains unclear.

In *Strassburger v. Earley*,<sup>70</sup> plaintiff filed a derivative action arising out of a share repurchase by nominal defendant Ridgewood Properties of 83% of its outstanding common stock from two of its largest stockholders. The plaintiff argued that the Ridgewood directors breached their fiduciary duties to Ridgewood's minority public stockholders by effectuating a self-dealing transaction that was unfair to the minority, improperly expending corporate funds to repurchase stock to perpetuate control in a single board member, and wasting corporate assets. Specifically, the plaintiff alleged that Ridgewood's president orchestrated the repurchase to give himself control

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<sup>68</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>69</sup> *Stroud v. Grace*, 606 A.2d 75 (Del. 1992).

<sup>70</sup> *Strassburger v. Earley*, 752 A.2d 557 (Del. Ch. 2000).

of Ridgewood, which would allow him to retain his position and compensation package, and also allow him to secure a control premium in the event that Ridgewood was sold.

In its analysis, the Court of Chancery concluded that the stock repurchases were in fact entrenchment-motivated. The Court also applied the entire fairness test, and placed the burden of persuasion on the defendants, notwithstanding the existence of a single member special committee, finding that the special committee did not conduct any of the negotiations, did not consider all relevant information, did not retain advisers, and, most importantly, did not consider the effect of the repurchases on the minority stockholders. Although finding the price paid was entirely fair, the Court found that the transaction was not the result of fair dealing, and ruled the repurchases invalid. Significantly, the Court held that partial rescission and rescissory damages were appropriate, notwithstanding its holding that the price paid was fair. Further, the Court noted that rescissory damages might only be recovered for a breach of the duty of loyalty. Accordingly, the Court explained that an individual director's liability for rescissory damages would depend upon his or her individual culpability. The Court found that three directors had violated their duty of loyalty and therefore were liable for rescissory damages, including two directors who had not acted intentionally or in bad faith, but had subordinated the interests of the minority stockholders to Ridgewood's majority shareholder.

In *Andra v Blount*, Meadowcraft's 73% owner, director, chair, and chief operating officer, Mr. Blount, acting through an acquisition vehicle, instituted a tender offer to purchase the company's remaining shares.<sup>71</sup> In addition to the tender offer, Blount announced an intention to cash-out those stockholders who did not tender their shares in the tender offer. Given his ownership interest in the company, Blount already possessed the votes needed to effectuate the back-end merger once it had been approved by the board of directors and presented to the stockholders for their approval. Following the announcement of the tender offer and back-end merger, Andra, a stockholder of the company, instituted an action challenging the disclosures made in connection with the tender offer.

Andra brought the case on an expedited basis, seeking to enjoin the consummation of the tender offer until a time when the minority stockholders had been provided with adequate disclosures. This motion to enjoin, however, was subsequently withdrawn. The plaintiff explained her reasoning in withdrawing the motion, stating that a damage award after a full

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<sup>71</sup> *Andra v. Blount*, C.A. No. 17154, Strine, V.C. (Del. Ch. Mar. 29, 2000).

trial would provide her with an adequate remedy. More specifically, the plaintiff explained, via her attorney, that “[i]f plaintiff prevails at trial, damages could be awarded which would be equivalent to the appraised value of Meadowcraft stock thereby giving the shareholders complete relief for the wrongs complained of in this action.” The tender offer was subsequently consummated. Andra refused to relinquish her shares in either the tender offer or back-end merger, choosing instead to preserve her appraisal rights. However, Andra never instituted an appraisal action, but subsequently filed an amended complaint asserting the defendants had breached their fiduciary duties of loyalty and due care in failing to disclose all material facts surrounding the tender offer, and in instituting the tender offer/back-end merger on terms unfair to the minority stockholders. The defendants moved to dismiss Andra’s claims, arguing that she lacked standing to challenge the disclosures made in connection with the merger and that, in any event, she should be relegated to the exclusive remedy of appraisal in challenging the price of the back-end merger.

The Court first addressed the standing issue with respect to Andra’s disclosure allegations. Andra’s disclosure claims were premised on the theory that the minority stockholders suffered injury from inadequate disclosures in connection with the tender offer/back-end merger, because they induced stockholders to tender their shares pursuant to the tender offer and forego their right to appraisal. The defendants challenged Andra’s standing to bring this claim, arguing that she had not suffered any injury, as she had in fact exercised her appraisal rights. The Court agreed with this argument, noting that to hold otherwise would discourage stockholders from bringing their disclosure claims “at a time when such claims can still be used to promote a genuinely free stockholder choice—before the vote.”

Turning to the defendants’ exclusivity of appraisal argument, the Court began by noting that “[i]n the wake of *Rabkin v. Philip A. Hunt Chemical Corp.* and [*Cede & Co. v. Technicolor, Inc.*], it has become nearly impossible for a judge of this court to dismiss a well-pled unfair dealing claim on the basis that appraisal is available as a remedy and is fully adequate.”<sup>72</sup> This case presented a unique factual situation, however, in that the plaintiff expressly agreed that damages equivalent to the appraised value of her stock would serve as a complete remedy for the wrongs alleged in her complaint. The Court even acknowledged that all of the fiduciary breaches alleged in the plaintiff’s complaint ultimately related to issues of fair value. Despite this finding, the Court held that a plaintiff in Andra’s situation should not be relegated to the implicitly less adequate remedy of appraisal, due to the

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<sup>72</sup> *Id.* at 23 (citations omitted).

unavailability of certain "Litigation-Cost Benefits" in an appraisal action—namely the ability to bring a class action and fee shifting. By way of further explanation, the Court stated that in an unfair dealing action, a class action may be brought where attorneys' fees and expenses will be taken against any class-wide recovery, whereas in an appraisal action, fees and expenses may only be offset against the appraisal award, which is usually allocated to the much smaller group of plaintiffs who actually asserted their appraisal rights. Based on these Litigation-Cost Benefits, the Court concluded that a plaintiff would not be limited to an appraisal of his shares where that plaintiff has set forth a well-pled unfair dealing claim.

The full implications of the Court's decision in *Andra* remain to be seen. One possibility was the creation of a *per se* rule in the context of long-form mergers under Section 251. As stated in the opinion:

[I]f the unavailability of a class action and an attorneys' fee award renders appraisal an inadequate remedy for a plaintiff such as *Andra* who concedes that a fair value award is otherwise sufficient, that would create a clear *per se* rule that every well-pleaded claim that a merger is unfair as a result of fiduciary breaches may proceed on an equitable, non-statutory basis, alongside any appraisal action. Put another way, if *Andra* may press an unfair dealing claim in this context, then any plaintiff with appraisal rights may also.<sup>73</sup>

In *In re Unocal Exploration Corporation Shareholders Litigation*, Unocal Corporation indirectly held 96% of the common stock in Unocal Exploration Corporation ("UXC").<sup>74</sup> In February 1992, Unocal announced its intention to effectuate a short-form merger pursuant to Section 253, whereby the minority shares of UXC stock would be exchanged for stock in Unocal. Two UXC stockholders filed suit naming Unocal, UXC and UXC's board of directors as defendants. The plaintiffs alleged entire fairness claims, attacking both the fair dealing and fair price of the merger transaction. The plaintiffs' claims focused on, among other things, the independence of UXC directors on a special committee formed to represent the interests of the minority stockholders, the reliance by that committee on certain opinions issued by Paine Webber, the scope of the committee's investigation, the price received by the stockholders for their shares, and the disclosures made in the information statement regarding the merger. The defendants argued, among

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<sup>73</sup> *Id.* at 25.

<sup>74</sup> *In re Unocal Exploration Corp. S'holder Litig.*, C.A. No. 12453, Lamb, V.C. (Del. Ch. June 13, 2000).



other things, that plaintiffs' exclusive remedy was appraisal, as the entire fairness test did not apply to mergers effected pursuant to Section 253.

After exploring the history of the exclusivity argument, the Court ultimately agreed that the merger at issue should not be examined under this heightened level of scrutiny. In arriving at this conclusion, the Court held that the principles set forth in *Stauffer v. Standard Brands, Inc.*, and *Braasch v. Goldschmidt*, were still good law.<sup>75</sup> These cases collectively held that appraisal is the sole remedy available to a minority stockholder whose investment was eliminated in a short-form merger, absent a showing of illegality or fraud. The Court also gave a significant amount of weight to the purpose behind Section 253, namely to provide a parent corporation with a means to eliminate the minority interest in a subsidiary. The Court discussed how this purpose was both inconsistent with, and undermined by, the application of a heightened judicial standard of review. Accordingly, the Court stated that a different standard should apply to a long-form merger with a controlling stockholder that requires both fair dealing and fair price and a short-form merger, which does not require any dealing. Simply put, the Court found the application of the heightened standard under the entire fairness test inconsistent with the unilateral procedure created by the legislature under Section 253. In light of the fact that plaintiff had not shown illegality or fraud, the Court entered judgment for the defendants.

The case is currently being appealed.

## IX. FINALITY OF CLASS ACTION SETTLEMENTS

In negotiating the terms of a settlement of a class action challenging a merger, the parties often include language releasing both federal and state claims. A recent case from the Court of Chancery involved an attempt by stockholder plaintiffs to vacate a settlement order and final judgment entered over seven years ago.<sup>76</sup> The MCA case arose out of the tender offer made by Matsushita Electrical Industrial Company for MCA, Inc. MCA stockholders first challenged the transaction by filing an action in the Delaware Court of Chancery. Not long thereafter, a second purported class action was brought in the United States District Court for the Central District of California. The Delaware action was eventually settled and the final order which was entered released both state and federal claims related to the underlying transaction except as to those asserted by stockholders who had opted out of

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<sup>75</sup> *Stauffer v. Standard Brands, Inc.*, 187 A.2d 78, 80 (Del. 1962); *Braasch v. Goldschmidt*, 199 A.2d 760 (Del. Ch. 1964).

<sup>76</sup> *See In re MCA, Inc. S'holder Litig.*, Consol. C.A. No. 11740, Chandler, C. (Del. Ch. Aug. 4, 2000).

the Delaware settlement. Subsequently, the California plaintiffs, who had *not* opted out, asserted in the California District Court that a state court lacked the authority to approve a release which purported to encompass claims which were exclusively federal in nature. The California case eventually resulted in multiple Ninth Circuit decisions, and two appeals to the United States Supreme Court. However, the ultimate result of the California litigation was that the Delaware final judgment was held to be entitled to be given full faith and credit by the California District Court. Several weeks after the United States Supreme Court denied the California plaintiffs' petition for a writ of certiorari, the plaintiffs filed a motion to intervene and vacate the 1993 order and judgment entered by the Delaware court.

On August 4, 2000, the Court of Chancery issued a decision denying the motion to intervene and vacate judgment. The Court concluded the petitioners chose not to avail themselves in 1993 of the opportunity either to object to the settlement at the Court of Chancery level, or to seek intervention and Rule 60(b) relief after the Delaware Supreme Court had affirmed the decision approving the settlement. The Court concluded, in light of the fact that petitioners had chosen for "purely strategic reasons, to pursue a collateral attack in federal court," the Court would "refuse to countenance a belatedly filed motion borne out of a desire to litigate elsewhere."<sup>77</sup>

The case is currently on appeal to the Delaware Supreme Court.

## X. CORPORATE OPPORTUNITY DOCTRINE

Two recent decisions have helped to further define the corporate opportunity doctrine.

In *Kohls v. Duthie*, the Court of Chancery declined to dismiss a complaint which alleged that the directors of Kenetech Corporation ("Kenetech") had breached their fiduciary duties in connection with the purchase by the president and CEO of 12.8 million shares of the company's stock for \$1,000.<sup>78</sup> Kenetech's president had been advised by the largest holder of the company's common stock that it was shopping its interest in the company, and asked him if he would be interested in purchasing the stock if another buyer could not be found. The complaint alleged that the other members of the board of directors were also made aware of this possible opportunity, but did not choose to pursue it on behalf of the company. After the stockholder

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<sup>77</sup> *Id.* at 12.

<sup>78</sup> *Kohls v. Duthie*, C.A. No. 17762, Lamb, V.C. (Del. Ch. July 26, 2000).

could not find another buyer for the stock, the president purchased the shares for \$1,000. The plaintiffs filed a derivative action alleging that the president usurped the opportunity of the company to purchase the shares, claiming that the 12.8 million shares had been worth more than \$1,000 when purchased, and were presently valued at over \$8 million.

Defendants moved to dismiss the complaint for failure to state a claim, and failure to comply with the requirements of Rule 23.1 of the Rules of the Court of Chancery. In analyzing the Rule 23.1 motion, the Court concluded that based upon the allegations of the complaint, there was no business decision that had been made by the Kenetech board of directors regarding the purchase of the stock. As a result, the Court followed the Delaware Supreme Court's reasoning in the case of *Rales v. Blasband*, in which the Court found absent a business decision having been made by the board, the appropriate question is: "[W]hether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."<sup>79</sup>

It was uncontested that two of the four members of the Kenetech board were capable of impartially considering a demand, while the president had mixed feelings from doing so. In analyzing the question with respect to the remaining director, the Court concluded that given that "the complaint alleges the forfeiture or usurpation of an opportunity for the corporation to realize a substantial windfall for the benefit of its stockholders," the allegations of the complaint, if true, would establish that the fourth director faced a substantial likelihood of personal liability for breach of fiduciary duty and aiding and abetting liability, and thus was not disinterested for the purposes of considering a potential demand.<sup>80</sup>

In addressing the motion to dismiss for failure to state a claim, the Court concluded that the allegations of the complaint, if true, would state a claim for breach of fiduciary duty as a result of the plaintiffs' allegations that the president had usurped a corporate opportunity. In so concluding, the Court rejected the argument by the defendants that the company had no expectancy in the alleged opportunity. Defendants also argued that Section 160(a)(1) of the General Corporation Law prohibited the company from repurchasing its shares, as a result of the fact that Kenetech's capital was impaired in the approximate amount of \$131 million on a balance sheet basis. The Court concluded that because Delaware law permits the revaluation of assets and

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<sup>79</sup> *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

<sup>80</sup> *Kohls*, C.A. No. 17762, at 16, 17.

liabilities to establish surplus, and because the major asset of the company was being carried at a low book value at the time of the transaction, Section 160(a)(1) may not have been a barrier to a potential stock repurchase by the company. Defendants also argued that the company was contractually restricted from repurchasing its own shares because of its then-current situation involving default in payment on senior debt. The Court concluded that it could not dismiss the complaint on this basis because the complaint alleged the debt holders had already waived their rights in other circumstances. Consequently, there was reason to believe that the debt holders would not have objected to the repurchase of the block of stock. Similarly, the defendants argued that because of the arrearages in dividends on preferred stock, the certificate of designations prohibited any repurchase of shares. The Court concluded that it could not dismiss the complaint on this basis because no steps had been taken by the company to amend the charter provision to avoid that barrier. Finally, the Court concluded that although the complaint did not specifically allege that the president had become aware of the opportunity to purchase the stock in his official capacity, it was appropriate to draw such an inference. Thus, the Court concluded that the complaint stated a claim against the president for usurpation of a corporate opportunity and a claim against the other defendants for breach of fiduciary duty for knowing acquiescence in the alleged usurpation, and failure to take steps to protect the company's interest in purchasing the shares itself.

In *Kohls v. Duthie*, ("Kohls II"), the Court of Chancery denied a motion for preliminary injunction that sought to enjoin a tender offer and a back-end merger.<sup>81</sup>

Prior to the announcement of the transaction at issue, plaintiffs filed a derivative action against Kenetech and certain of its present and former directors alleging that Mark D. Lerdal, the president and chief executive officer and a director of Kenetech, usurped a corporate opportunity by purchasing approximately one-third of the outstanding shares of Kenetech common stock for \$1,000. During the pendency of the derivative action, ValueAct Capital Partners, L.P. ("ValueAct") contacted Lerdal about the possibility of acquiring Kenetech.

After ValueAct suggested the possibility of Lerdal participating in the acquisition, a special committee of the board was formed. In appointing the special committee, the board determined that it would not approve any transaction without a prior favorable recommendation of the special committee. The special committee was comprised of Charles Christenson,

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<sup>81</sup> Kohls v. Duthie, C.A. No. 17762, Lamb, V.C. (Del. Ch. Dec. 11, 2000).

a defendant in the underlying derivative action, and Gerald R. Morgan, Jr., a personal friend of Lerdal and the chief operating officer of a \$1.3 billion fund in which Kenetech agreed to invest \$5 million over a six-year period.

After months of negotiations, ValueAct and Kenetech reached an agreement whereby ValueAct would acquire Kenetech by means of a tender offer for all the outstanding shares of Kenetech at a price of \$1.04 per share in cash, followed by a back-end merger at the same consideration. The tender offer was conditioned on, among other things, the valid tender of at least 85% of the Kenetech shares not owned by Lerdal.

Following the announcement of the proposed transaction, the plaintiffs amended their complaint in the derivative action to assert class claims alleging, among other things, that the terms of the proposed tender offer and merger were not entirely fair. The plaintiffs' main line of attack against the transaction was that the consideration was inadequate in light of the derivative action, and that the disclosures with respect to its value were inadequate as well. The Court found that the plaintiffs did not satisfy any of the requisite elements for preliminary injunctive relief.

First, the Court held the plaintiffs did not have a reasonable probability of success on the merits of their challenge to the transaction. The Court based this conclusion on the finding it was likely the evidence regarding the existence and functioning of the special committee, would result in the application of the business judgment rule. The Court rejected the plaintiffs' claim that Christenson was interested in the transaction because the merger would eliminate his exposure to personal liability in the derivative action. The Court noted that the record in the action contained clear evidence of the weakness of the corporate opportunity claim. In particular, the Court noted that seller of shares that Mr. Lerdal purchased testified he did not offer, and would not have offered, to sell the shares to Kenetech. Accordingly, Kenetech was unable to take advantage of the alleged opportunity. The Court also found the likely remedy to the plaintiffs, if the derivative claim were ultimately successful, would be cancellation of Lerdal's shares, not money damages assessed against the directors. The Court also rejected the plaintiffs' claim that Morgan's personal relationship with Lerdal, and the fact that Kenetech invested in Morgan's fund, rendered Morgan interested or compromised his independence. Moreover, the Court noted the evidence indicated the special committee engaged in vigorous arm's-length negotiations.

Second, the Court held that the plaintiffs did not establish the requisite irreparable harm, stating "loss of standing to bring a derivative action is not irreparable harm," due in part to the fact that the derivative claim could be valued in a subsequent appraisal action.

Finally, the Court determined the balance of the hardships tipped in defendants' favor. The Court found if the proposed transaction were enjoined, Kenetech's stockholders could suffer real injury because there was no alternative to the proposed transaction. The Court concluded "[i]n light of the full disclosures made by the corporation, as well as protective mechanisms of the 85 percent Minimum Tender Condition, I see no reason ... why shareholders should not be the final authority on whether this cash-out transaction takes place."

## XI. ISSUES AND PROBLEMS IN ADVISING BOARDS OF DIRECTORS

### *A. Assertions of the Attorney-Client or Business Strategy Privileges May Impact Presentation of Defense in Takeover Cases*

Two decisions have highlighted the consequences that may flow from the tactical decision to assert the attorney-client, or business strategy privileges, to bar inquiry into the nature and substance of the board's deliberations, particularly in cases governed by the heightened scrutiny of *Unocal* and its progeny, in which the board bears the burden of justifying its actions. These cases reveal the importance of carefully considering privilege issues early in, or even before, litigation arising from corporate control contests.

The battle for control of Quickturn Design Systems, Inc. was well publicized for its invalidation of no-hand poison pills in Delaware.<sup>82</sup> Perhaps less well publicized, but equally important, is an interim ruling in that case by the Court of Chancery that reveals certain risks involved in the assertion of the attorney-client privilege in the context of takeover litigation.

The *Quickturn* litigation involved a challenge to certain defensive measures adopted by the board of directors of Quickturn, in response to an unsolicited tender offer made by Mentor Graphics Corporation. This included the amendment of bylaws to encompass an advance notice provision, and the amendment of Quickturn's poison pill rights plan to include a deferred redemption provision. During the course of expedited discovery, Mentor specifically targeted the board's reasons for adopting these defensive measures. Throughout discovery, Quickturn repeatedly asserted the attorney-client privilege to bar inquiry into the board's deliberations regarding these measures, and Quickturn's counsel, in asserting these objections, repeatedly stated that the board's deliberations with regard to the

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See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

defensive measures *only* took place with counsel and that all such deliberations were shielded from disclosure by the attorney-client privilege.

Concerned that Quickturn would attempt to introduce evidence at trial regarding the board's deliberations despite having blocked inquiry into these matters in discovery, Mentor filed a motion *in limine* to preclude Quickturn from introducing, or referring to, any evidence regarding the existence or substance of any communication among the board and its legal advisors. The Court of Chancery ruled on the motion *in limine* on the third day of trial. Although technically denying the motion, the Court ruled that "the plaintiffs are entitled to some preclus[ive] relief, but relief of a more limited kind, not as a consequence of the motion but as a consequence of the position defendants have taken during discovery." Specifically, Vice Chancellor Jacobs ruled as follows:

By blocking discovery into these subjects, the defendants have, as a legal and evidentiary matter, thereby precluded themselves from arguing or placing into evidence the content of the legal advice they received or of the collective deliberations into which discovery was blocked. It must be emphasized that under *Unocal* and *Unitrin* the defendants have the burden of showing the reasonableness of their investigation, the reasonableness of their process and also of the result they reached. One would think that a board having that burden would want to expose their deliberative process to full view, but they are not legally required to do so.

The defendants are the masters of the evidence they will present in their defense, but they must accept the consequences of their tactical choice. Here the defendants' tactical decision to bar on privileg[e] grounds discovery into what the board was advised was their fiduciary duty, and into the content of the board's deliberations, will in turn preclude them from proving those deliberations at trial to defend their position that their decision was reasonable and made with due care.<sup>83</sup>

As a consequence of this ruling, Mentor was in a position to argue, post-trial, that the Quickturn directors could not meet their burden under *Unocal* and its progeny, to demonstrate that they identified a threat to corporate policy and effectiveness in good faith and after reasonable investigation, or that the defensive response they selected was not preclusive, not coercive and

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<sup>83</sup> *Id.*

fell within a range of reasonableness. The trial court ultimately invalidated the defensive measures without addressing Mentor's arguments based on the evidence preclusion order. However, the evidence preclusion ruling in *Quickturn* is significant because it highlights that defendants face a tactical choice in deciding whether or not to assert the attorney-client privilege to bar inquiry into the deliberations of the board in cases where they bear the burden of demonstrating the reasonableness of the board's decision. Further, it may suggest the importance of structuring board deliberations to ensure that some nonprivileged deliberations may be disclosed in discovery, and at trial, to meet the board's burden of proof, without waiving the privilege.

A similar ruling, applying the evidence preclusion principle to assertions of the business strategy privilege, was made by the Court of Chancery in the post-trial opinion in *Chesapeake Corporation v. Shore*.<sup>84</sup>

In *Chesapeake*, the Court of Chancery noted that Shorewood's assertion of the attorney-client and business strategy privileges had "limited [the Court's] ability to determine the course of events as precisely as [the Court] would have liked."<sup>85</sup> In particular, the Court noted that "the Shorewood board has invoked the business strategy and attorney-client privileges whenever it could do so. As a result, virtually all of the professional advice given to the Shorewood board has been kept from Chesapeake and its counsel – and thus the court."<sup>86</sup> The Court found, however, that having so limited the inquiry of the plaintiff, defendants had improperly also "attempted to use some of this concealed advice as a sword," by, for example, attempting to "establish that they have hired reputable investment bankers to look at strategic alternatives."<sup>87</sup> Further, the Court found, that the defendants had "refused to allow Chesapeake to inquire even as to the basic nature of such alternatives."<sup>88</sup>

Relying upon the evidence preclusion ruling in *Quickturn*, the Court of Chancery held that the only fair way to proceed is not to give any weight to any advice of this nature, or to the defendants' supposed search for alternatives. The potential for abuse is simply too great. For example, the defendants could be looking only at strategic alternatives that involve the continuation in office of Shorewood's management. Having denied Chesapeake and the court any opportunity to determine whether this is so, the defendants cannot use their hiring of advisors as evidence that they are willing to sell Shorewood at the right price, to a party who intends to replace

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<sup>84</sup> *Chesapeake Corp. v. Shore*, C.A. No 17626, Strine, V.C. (Del. Ch. Feb. 11, 2000).

<sup>85</sup> *Id.* at 11.

<sup>86</sup> *Id.* at 12.

<sup>87</sup> *Id.* at 12-13.

<sup>88</sup> *Id.* at 13.



the Shorewood board and management. To allow the defendants to do so would be inequitable.<sup>89</sup>

Ultimately, the Court in *Chesapeake* struck down the challenged defensive measures, finding that the board had not met its burden of demonstrating the reasonableness of its investigation, or of the defensive measures themselves. While it is difficult to gauge just how significant the evidentiary point was to the ultimate decision, the Court's focus upon the evidentiary issue in its opinion demonstrates that the effect was, at least, not *de minimis*.

*B. Corporate Counsel Performing Multiple Roles Bears Burden of Establishing the Applicability of the Attorney-Client Privilege*

In *Grimes v. LCC International, Inc.*, the Court of Chancery was asked to resolve a motion to compel production of documents withheld based on the attorney-client privilege and/or work-product immunity.<sup>90</sup> The underlying case involved allegations by the minority stockholders of Microcell Management, Inc., a majority-owned subsidiary of LCC International, Inc., that LCC had failed, in violation of its contractual and fiduciary duties, to provide adequate financial assistance to Microcell. At issue on the motion to compel were 140 documents created or reviewed by "corporate counsel," Peter DeLiso, who served in at least three different capacities: as general counsel for LCC, as general counsel for Microcell and as a director (and later chairman of the board) of Microcell.

The Court of Chancery referred the matter to a special discovery master, but issued a letter ruling providing guidance to the special master. In essence, the Court of Chancery gave the special master direction with regard to four categories of documents. First, documents reviewed or created by DeLiso solely as a director would not be protected by the attorney-client privilege (unless they contained legal advice to the board or DeLiso *qua* client). Second, documents relating solely to DeLiso's status as general counsel of LCC would be privileged, and further would not be subject to a "good cause" exception to the privilege, since plaintiffs were stockholders of Microcell, not LCC. Third, documents relating solely to DeLiso's capacity as general counsel of Microcell would be privileged, but the privilege could be overcome by a showing of "good cause." Most importantly, as to the fourth category of documents, consisting of all documents "that do not disclose in a clear-cut way which of Mr. DeLiso's three hats he was wearing

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<sup>89</sup> *Id.*

<sup>90</sup> *Grimes v. LCC Intl., C.A. No. 16957, Jacobs, V.C. (Del. Ch. Apr. 23, 1999).*

at the time he generated or received the communication in question,” the Court held that “any doubt about the status of this ‘indeterminate’ category of documents should be resolved against the claim of privilege.”<sup>91</sup> As the Court explained:

[I]t was the defendants who would have created the problem, by placing Mr. DeLiso in multiple – and potentially conflicting – fiduciary roles. Having created that conflict and its resulting ambiguity, and having been in a position to prevent the conflict from arising in the first place, the defendants, as fiduciaries for Microcell’s minority stockholders, cannot be allowed to benefit from the ambiguity by asserting a privilege that might not otherwise have been available.<sup>92</sup>

This decision highlights the risks inherent in having corporate counsel perform multiple functions within the corporate family, and the importance of clearly establishing under which role the corporate counsel is acting.

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<sup>91</sup> *Id.* at 6.

<sup>92</sup> *Id.* at 6-7.

