HUNTON & WILLIAMS

CORPORATE LAW UPDATE

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2009 Review of Significant Delaware Law Developments

The Delaware courts issued several significant decisions in 2009 that we have summarized below. These decisions have direct ramifications for Delaware entities, but they may also be relevant to non-Delaware entities to the extent they drive "best practices" or are looked to by other jurisdictions for guidance. We have also noted certain important amendments to the Delaware General Corporation Law ("DGCL") that became effective in 2009.

Mergers & Acquisitions

Revlon Duties

Notwithstanding low levels of M&A activity, the Delaware courts issued several important M&A and change-in-control decisions last year. Undoubtedly, the most important was the Supreme Court's decision in Ryan v. Lyondell Chemical Company (client alert). The court established a high threshold for holding directors personally liable for failing their so-called *Revlon* duties to obtain the best price reasonably available. The court held that only an "utter failure" by directors to perform their duties or "knowingly and completely fail[ing] to undertake their responsibilities" would support bad faith claims necessary for the imposition of personal liability. As we explained in our client alert, the decision largely insulates disinterested and independent directors in third-party mergers.

The *Lyondell* standard was subsequently applied in *Wayne County Emp. Ret. Sys. v. Corti*, where the Delaware Court of Chancery refused to "second guess the business judgment" of the directors in a sale process. It bears noting, however, that *Lyondell* involved a post-closing challenge as to whether directors acted in good faith. As we noted at the time, *Lyondell* should cause stockholder-plaintiffs to seek pre-closing remedies, such as injunctions, in order to preserve duty of care and disclosure claims. This happened in June 2009 in *Police & Fire Ret. Sys. v. Bernal*, for example, when the court granted expedited hearings in a challenge to certain deal protection provisions. The *Bernal* court reasoned that, in the context of a preliminary injunction, it could grant relief if the directors acted negligently or in bad faith.

We note that in 2009 the Delaware courts avoided answering a lingering question as to when *Revlon* duties apply to a cash-stock merger. Traditionally, cash mergers have triggered *Revlon* while stock mergers have not. A prior Court of Chancery opinion held that a merger in which 60 percent of the consideration was cash was likely a change-in-control transaction triggering *Revlon*, while the Delaware Supreme Court has held that a 33 percent cash merger did not. In *In re NYMEX S'holder Litig.*, decided in September, the Court of Chancery refused to address whether a 44 percent cash/56 percent stock merger triggered *Revlon*, thus leaving continued uncertainty in this area.

Deal Protections

One of the last opinions issued in 2009 was the December decision in NACCO Industries, Inc. v. Applica Incorporated (client alert), where the Court of Chancery upheld a jilted buyer's claims brought against a target for breaching an exclusivity provision in a merger agreement. The court also refused to dismiss fraud and tortious interference claims against a hedge fund that made a successful topping bid to acquire the target corporation. Importantly, the fraud claims were based on allegedly false statements made by the hedge fund in its Schedule 13D filings. The decision demonstrated Delaware courts' willingness to enforce reasonable deal protection provisions.

Terminating the Sale Process

The Delaware Supreme Court held in Gantler v. Stephens (client alert) that a board's decision to terminate a sale process is subject to review under the deferential business judgment rule. The court rejected the stockholder-plaintiff's claim that the decision be reviewed under the *Unocal* standard, which is an intermediate level of judicial review that Delaware courts apply to defensive actions taken by directors. The court made clear that "[r]ejecting an acquisition offer, without more, is not 'defensive action' under *Unocal*." In order to be protected by the business judgment rule, however, a majority of the board must be disinterested and independent. In *Gantler*, the complaint adequately alleged that three of the four directors had potentially disloyal motives and, therefore, their actions would be subject to review under the "entire fairness" standard. The entire fairness standard is the strictest level of review applied by Delaware courts and examines the challenged action for both "fair price" and "fair dealing."

Go-Private Transactions

As noted above, the *Lyondell* decision largely insulates disinterested and independent directors from liability in a third-party merger. In contrast, the Court of Chancery's July decision in *Louisiana Mun. Police Employees' Ret. Sys. v. Fertitta (client alert)* demonstrates that conflict of interest transactions continue to pose the greatest risks to directors. As explained in our earlier client alert, *Fertitta* involved a failed go-private transaction led by a company's chief executive officer. Although the defendant-directors appear to have been disinterested and independent, the court upheld the stockholder-plaintiff's claims for breach of fiduciary duty and corporate waste. The court found that the complaint adequately alleged that the board "breached its duty of loyalty in permitting [a] creeping takeover," in which the CEO acquired majority control of the company through open-market purchases after signing the merger agreement. The court also faulted the board for eventually terminating the merger agreement in a manner that triggered a $15 million reverse termination fee payable to the CEO. Finally, the court upheld the plaintiff's claims against the directors for permitting the CEO to negotiate a refinancing commitment on behalf of the company in connection with the merger.

M&A Contract Disputes

In *Ivize of Milwaukee, LLC v. Compex Litigation Support, LLC*, the court addressed a buyer's claim against a seller for breaching its interim operating covenants. Prior to the closing, certain employees of the seller left to form a competing business and allegedly stole various records and equipment. After closing, the buyer sued the seller for breaching its covenant to operate "only in the usual and ordinary course" of business. While the court agreed that the covenant had been breached, it limited damages to the buyer's "fair chance" to hire the employees. The court reasoned that, in the absence of an employment agreement, the buyer never had a definitive right to employ the departed employees. The decision reinforces the importance in some situations of either entering into employment agreements at signing or making such employment agreements a condition to the buyer's obligations to close when the target business is dependent on its human capital.

In *Airborne Health, Inc. v. Squid Soap, LP*, the court addressed a post-closing dispute over an earn-out provision in an asset purchase agreement. The seller's lawsuit failed largely because the purchase agreement did not have any specific covenants requiring the buyer to maximize the assets subject to the earn-out. The court also held that a standard "integration" clause in the purchase agreement, which provided that the contract represented the entire agreement among the parties, did not bar fraud claims based on pre-signing misrepresentations. Rather, a purchase agreement must contain an explicit disclaimer of extra-contractual statements before a court will dismiss allegations of pre-signing fraud.

Private Equity M&A

Two decisions reinforced the limited recourse available in the conventional private equity M&A structure, in which private equity funds use shell subsidiaries without direct contractual obligations at the parent-fund level. In the first decision, *Alliance Data Systems Corp. v. Blackstone Capital Partners*, the court dismissed a target's claim against Blackstone Capital Partners for failing to obtain government approval of the merger. The Office of Thrift Supervision ("OTS") had requested that Blackstone, at the parent-fund level, make various concessions before the OTS would approve the merger. Blackstone, which was not a party to the merger agreement, refused the OTS's requests and the transaction was terminated. The court found that Blackstone's shell subsidiaries, which were parties to the merger agreement, had fulfilled their contractual "best efforts" obligations to consummate the merger and never agreed to cause their affiliates, including the parent-fund, to take all actions necessary to satisfy the OTS.

In the second decision, *James Cable LLC v. Millennium Digital Media Systems, L.L.C.*, the Court of Chancery dismissed tortious interference and promissory estoppel claims brought against a parent-level hedge fund that allegedly refused to fund its acquisition vehicle. As in *Alliance Data Systems*, the parent was not a party to the purchase agreement. The court dismissed the claims largely on the absence of any contractual financing obligation on the part of the parent. The court's analysis suggests that, had the parent been contractually obligated to fund its acquisition subsidiary, the seller might have been more successful with its tortious interference claim.

Hostile Takeovers & Rights Plans

In *In re Atmel Corp. S'holder Litig.*, the Court of Chancery denied a stockholders' request for an injunction against a stockholder rights plan (or "poison pill"). Like other recent plans, the Atmel plan expanded the definition of "beneficial ownership" to account for derivative instruments held by a stockholder. In determining whether to grant an injunction, the court rejected the plaintiff's claim that the provisions were too vague to be enforceable. Before the court could issue an opinion on the merits, the case settled for relatively minor adjustments to the rights plan provisions.

We note that important litigation initiated in early 2009 remains pending in *Selectica, Inc. v. Versata Enter., Inc.*, over the first modern-day triggering of a rights plan. The Court of Chancery is expected to deliver an opinion soon as to whether Selectica's board of directors acted properly in adopting and then utilizing the exchange feature of a rights plan to dilute an "acquiring person." Selectica's rights plan was designed to protect the company's net operating loss carry-forwards and appears to have been intentionally tripped. Although trading in the company's shares was halted for several weeks following the triggering event, the rights plan worked as intended and diluted the acquiring person.

Preferred Stockholders

In light of the number of distressed transactions taking place in the past two years, many practitioners and companies backed by private equity or venture capital took note of the Court of Chancery's decision in *In re Trados, Inc. S'holders Litig*. There, a board approved a merger in which consideration was paid almost exclusively to the company's preferred stockholders and left nothing for its common holders. In upholding breach of fiduciary duty claims against the directors, the court explained that "when the interests of the preferred stockholders diverge from those of the common stockholders, the directors generally must 'prefer the interests of common stock … to the interests created by the special rights, preferences, etc., of preferred stock.' " Important to the court's ruling were allegations that the company was becoming profitable and that the common shares might soon have value. This decision was also driven by the fact that a majority of the directors who approved the merger were affiliated with the preferred stockholders. The decision is a lesson to board members who represent or are affiliated with particular stockholders.

Controlling Stockholder Transactions

In October, the Court of Chancery issued what may be the definitive opinion for third-party transactions that are driven by the target company's controlling stockholder. In *In re John Q. Hammons Hotels Inc. S'holder Litig. (client alert)*, the company's founder and controlling stockholder initiated the sale of the company and negotiated for a control premium not shared with the company's other stockholders. Although the court concluded that the transaction should be reviewed for entire fairness (i.e., Delaware's stringent test for "fair price" and "fair dealing"), it created a roadmap for avoiding heightened scrutiny in the future. Specifically, the court stated that the deferential business judgment rule would have applied if there had been "robust procedural protection in place" in the form of (1) an independent special committee and (2) a non-waivable condition that the merger be approved by a majority of the minority stockholders. The court also said that, to be effective, the majority-of-the-minority condition must be based on a majority of the outstanding minority shares rather than those actually voted.

Stockholder Ratification

The Delaware Supreme Court's decision in *Gantler v. Stephens*, discussed above, was also significant with respect to the doctrine of stockholder ratification. Delaware law was previously unsettled as to when stockholder approval of a board action would extinguish subsequent stockholder claims challenging that action. In *Gantler*, the Supreme Court held that ratification is available only when the stockholder vote is not required by the DGCL. As a result, directors will not be able to raise ratification as a defense to mergers, sales of substantially all assets, dissolutions and other actions requiring a stockholder vote. Moreover, the Supreme Court held that ratification, when available, will result in review under the deferential business judgment rule, but it will not extinguish claims altogether.

Appraisal

The Delaware Supreme Court significantly expanded the remedy of appraisal in short-form mergers in *Berger v. Pubco Corporation*. There, a company failed to comply strictly with the DGCL when it provided minority stockholders with an outdated copy of the Delaware appraisal statute and failed to disclose how the controlling stockholder set the merger consideration. Typically, appraisal is the exclusive remedy of minority stockholders in a short-form merger. The Supreme Court concluded, however, that the appropriate remedy for the disclosure violations was to create a "quasi appraisal" proceeding in which all stockholders (including those who initially did not seek appraisal) would automatically be included and have the right to seek the fair value of their shares.

Stockholder Meetings

Stockholder meetings continue to be a focal point in contested elections and other close votes. Thus, it is notable that in *In re Waddell & Reed Fin., Inc.*, the Court of Chancery issued an order, but no opinion, directing an inspector of elections to reopen the voting polls to include votes that had been improperly transmitted. Under Section 231(c) of the DGCL, no proxies or ballots can be accepted after the polls close without a court order.

Fiduciary Duties

In *Gantler v. Stephens (client alert)*, discussed above, the Delaware Supreme Court confirmed what practitioners have long believed to be true: that officers of Delaware corporations owe the same fiduciary duties as directors. Officers should be aware, however, that they are not protected by the exculpatory provisions available to directors under Section 102(b)(7) of the DGCL. There has also been academic commentary debating whether officers are, or should be, protected by the business judgment rule.

In *Bin v. Heckmann Corp.*, the Court of Chancery held that fiduciaries owe a duty of disclosure when entering into a release with the corporation. In that case, a director executed a release in connection with his resignation, which relieved him of all potential claims, whether known or unknown, that the corporation might have against him. The corporation subsequently discovered evidence of fraud and sued the director, who raised the release as a defense. The court reasoned that the release constituted an interested transaction and, therefore, required full disclosure by the director of his personal interests in obtaining it. Absent full disclosure, the release could be voided.

Majority Voting

In recent years, a significant number of public companies have abandoned plurality standards in favor of majority voting standards for director elections. At some of those companies, directors have not received the requisite number of votes and, consequently, have been required to tender their resignations. Thus, it is notable that in *City of Westland Police & Fire Ret. Sys. v. Axcelis Techn., Inc.*, the Court of Chancery rejected a stockholder's request to inspect a company's books and records under Section 220 of the DGCL relating to its board's refusal to accept the resignations of directors who did not receive the requisite majority vote. The court ruled that the refusal to accept the resignations was neither evidence of misconduct nor an attempt to thwart a stockholder vote. Instead, the majority voting policy simply triggered a procedure under which the board considered, but was not required to accept, the tendered resignations.

Change-in-Control Provisions

In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc. (client alert)*, the Court of Chancery expressed concern with change-in-control provisions found in indentures, credit agreements and other commercial contracts. Sometimes known as "poison puts," these provisions can trigger redemption, acceleration or similar rights upon a change in control of the company or a majority change in board composition. The court noted that a provision that discourages stockholders from waging a proxy contest raises serious concerns, and that a board must be "especially solicitous to its duties both to the corporation and its stockholders" when negotiating such change-in-control triggers.

Duty of Oversight

Directors' duty of oversight continues to be an important issue, especially in light of the renewed focus on risk management policies in the wake of the recent financial crisis. In 2009 the Court of Chancery issued two notable decisions on these so-called "*Caremark* duties," named after the 1996 decision of *In re Caremark Int'l Inc. Deriv. Litig.* In the first decision, *American Int'l. Group, Inc., Consol. Deriv. Litig.*, Vice Chancellor Strine refused to dismiss "failure of oversight" claims brought against the defendant directors in light of what appears to have been a well-crafted complaint. This decision is a rare instance in which a *Caremark* claim has survived a motion to dismiss.

In the second decision, *In re Citigroup Inc. S'holder Deriv. Litig.*, the court dismissed the plaintiff's claims relating to the board's oversight of a company's activities in the subprime market. In doing so, the court held that "oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk." It further confirmed that plaintiffs face an "extremely high burden" in pleading a *Caremark* claim and that "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is necessary condition for liability."

DGCL Amendments

Finally, Delaware corporations should take note of several important amendments to the DGCL that became effective in August. First, the DGCL was amended to add new Sections 112 and 113 to expressly authorize bylaws that provide for stockholder access to a company's proxy statement and reimbursement of a dissident's expenses incurred in a proxy contest. The impact of these amendments is unclear pending the SEC's final proxy access rules (client alert), which are expected in early 2010. We note that at least one Delaware corporation has adopted a proxy expense reimbursement bylaw.

Second, Section 213 of the DGCL was amended to permit corporations to declare separate record dates for determining which stockholders are entitled to notice of and to vote at stockholders meetings. The purpose of this amendment is to reduce the instances of "empty voting" (i.e., voting by stockholders who no longer own their shares) and similar issues. By setting a record date for voting that is closer to the date of the stockholders meeting, corporations can better ensure that the voting stockholders more closely reflect the stockholder base on the meeting date. At least one merger of a publicly-held Delaware corporation has taken advantage of the new law.

Third, Section 145 of the DGCL was amended to provide that advancement and indemnification rights cannot be unilaterally amended. The amendment reverses the Court of Chancery's 2008 decision in *Schoon v. Troy Corp.*, in which the court upheld a board's decision to unilaterally terminate a former director's advancement rights. The amendment gives greater certainty to directors and officers that their advancement and indemnification rights will be honored following their service to corporations.

Conclusion

In sum, the Delaware courts issued many important decisions in 2009 that addressed a wide variety of areas. Many of those decisions are reminders that Delaware courts continue to look closely at the process employed by boards in executing business strategies. Decisions approved by a majority of disinterested and independent directors will generally be entitled to the protections of the business judgment rule. The Supreme Court's decision in *Gantler* is also a reminder that officers should be educated about their fiduciary duties.

Looking into 2010, we expect the implications of the *Lyondell* decision discussed above to be further explored as M&A activity rebounds. Companies should also be prepared for increased stockholder activism. The DGCL amendments governing proxy access and expense reimbursement bylaws will be watched closely by practitioners and companies, but their ultimate effect will depend on the SEC's final course of action in that area. In the boardroom, 2010 will continue focus on executive compensation, stockholder relations, risk management and directors' duty of oversight. If you have any questions about these cases or issues, please consult with your Hunton & Williams LLP contact.

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