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Putting Del. Officers Under The Microscope

Law360, New York (May 15, 2009) -- In a Jan. 27, 2009, reversal of a Chancery Court decision, the Delaware Supreme Court provided insight as to when directors and officers might lose the protection of the business judgment rule based on their behavior in the conduct of a sales process.

The court also made explicitly clear that officers of a Delaware corporation, like directors, owe stockholders a duty of care and loyalty in the execution of their responsibilities, possibly without the same rights as directors to exculpation.

Lastly, the court clarified the limitations of common law stockholder ratification as a means of cleansing board actions.

While this case might not blaze any new trails in terms of legal theory, it does present a cautionary tale that Delaware corporations and their directors and officers should heed, particularly before embarking on a sale process.

Background

In August 2004, the board of directors of First Niles Financial Inc., a publicly traded bank holding company, decided to explore the possible sale of First Niles with the help of an outside financial adviser.

With the approval of the board, the financial adviser contacted six financial institutions. The board received three initial bids. The first two bidders indicated early on that they did not intend to retain the company's existing directors or its senior officers. The third bidder did not indicate its retention plans.

All three bids were within the range suggested by the financial models that the financial adviser presented to the board, and the board directed the financial adviser and management of First Niles to provide further due diligence to two of the bidders, including the one that had not indicated its retention plans.

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The first of these bidders withdrew from the process after William L. Stephens, the chairman, president and CEO of First Niles, allegedly refused to provide due diligence materials requested by the bidder.

Stephens also allegedly failed to provide materials requested by the second bidder and refused to set a date for a due diligence meeting with this bidder.

The second bidder nonetheless submitted a revised offer in March 2005. However, without any discussion or deliberation, the board promptly rejected this offer 4 to 1.[1]

Five weeks later, Stephens proposed reclassifying the shares of holders of 300 or fewer shares of common stock into a new issue of preferred stock that would pay higher dividends but would lose almost all voting rights.

This reclassification of its smaller stockholders would leave First Niles with fewer than 300 record holders of its common stock, thereby allowing First Niles to deregister as a reporting company under the Securities Exchange Act of 1934. The board authorized the formation of a special committee to investigate the reclassification.[2]

In December 2005, the board voted 3 to 1, with Gantler again dissenting, to proceed with the reclassification. However, for reasons that are not apparent from the decision, these plans were delayed further.

In June 2006, after Gantler had left the board, the board determined, with the advice of management and the company's general counsel, that the reclassification was fair to both the stockholders who would receive preferred stock in the reclassification as well as those who would continue to own common stock, and the board members voted unanimously in favor of the reclassification.

The reclassification of course required that the company's certificate of incorporation be amended to authorize and designate the preferred stock. A stockholders meeting was called to act upon the proposed charter amendment.

The proxy statement disseminated to the stockholders prior to the meeting stated that First Niles had received one firm offer to acquire the company, but that "[a]fter careful deliberations, the board determined in its business judgment the proposal was not in the best interests of the company or our shareholders and rejected the proposal."

The proxy also disclosed that each of the directors and officers had "a conflict of interest with respect to [the reclassification] because he or she is in a position to structure it in such a way that benefits his or her interests differently from the interests of unaffiliated shareholders." The stockholders approved the reclassification at the meeting.

Gantler and other First Niles stockholders brought suit, alleging, among other things, that the company's officers and directors had breached their fiduciary duties to the

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stockholders by sabotaging the due diligence process, rejecting the second merger offer and abandoning the sales process.

The plaintiffs further alleged that the company's discussion in the proxy statement of the sales process and the bid rejection, as well as the reclassification, was materially misleading. The defendants moved to dismiss the complaint in its entirety, and the Chancery Court granted their motion.

In reversing the Chancery Court, the Delaware Supreme Court addressed several issues, including:

1) whether the board's decision to reject the merger offer and abandon the sales process should be reviewed under the presumption of the business judgment rule or the more stringent "entire fairness" standard,

2) whether the company's officers owe fiduciary duties to stockholders in line with those of the directors, and

3) whether the common law doctrine of stockholder ratification was available.

Business Judgment Rule and Entire Fairness

Under Delaware law, directors of a corporation are presumed to have acted on an informed basis, in good faith and in the honest belief that the actions they take are in the best interests of the company and its stockholders.

This "business judgment" presumption is, however, rebuttable, and a stockholder challenging board action must rebut this presumption to survive a motion to dismiss.

For the stockholder, rebutting the presumption requires the filing of a complaint that pleads specific facts which support a reasonable inference that in making the challenged decision, the board breached either its duty of loyalty or care.

If the stockholder rebuts the business judgment presumption, the burden of proof will be shifted to the directors to establish the "entire fairness" of the transaction to the company's stockholders.[3]

Given the time and cost involved in proving "fairness," a court's determination as to the applicable legal standard — business judgment rule or entire fairness — often is dispositive.

In Gantler, the Delaware Supreme Court concluded that the board's decision to reject the merger offer and abandon the sales process should be reviewed under the entire fairness standard because the stockholders' complaint rebutted the business judgment presumption.[4]

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The court recognized that, when a board decides not to pursue a transaction, it is entitled to a strong presumption in its favor. In this case, however, the court held that there was a reasonable inference that a majority of the board, three of four directors who voted against the transaction, labored under disabling conflicts of interest and breached their duty of loyalty to the company.[5]

First, the court found a reasonable inference that Stephens, the CEO and chairman, had acted disloyally when he failed to respond to the first bidder's due diligence request. The court reasoned that Stephens knew he would be terminated if the bid were accepted.

Therefore, it was reasonable to infer that his unexplained failure to respond to the request was motivated by his personal financial interest, as opposed to the interests of the stockholders.

The court drew the same inference from his response to the second bidder's request for due diligence — the court observed that his attempts to "sabotage" the second due diligence request by failing to provide the materials in a timely manner and by refusing to set up a due diligence meeting were acts of disloyalty.

The court also held it was reasonable to infer that another director, Kramer, had acted disloyally in the process. Kramer was the president of a company that provided heating and cooling services to the bank. Kramer's business had few assets and was highly leveraged.

The court inferred that Kramer feared his business would lose the bank as a major client if it were sold, and would subsequently suffer significant injury to his personal business. The court concluded that these facts supported a reasonable inference he acted disloyally.

The court further concluded that the complaint raised a reasonable inference that a third director, Zuzolo, also had acted disloyally. Zuzolo was a principal in a small law firm that frequently provided legal services to First Niles and the bank. In addition, he was the sole owner of a real estate title company that provided nearly all of the title services for the bank's real estate transactions.

The court reasoned that Zuzolo, like Kramer, had a strong personal interest in not having the sales process go forward because of his business interest with First Niles and the bank.

Because the complaint pled facts that gave rise to a reasonable inference that these three directors, a majority of the board, labored under conflicts of interest and acted disloyally, the board's decision to reject the merger offer and abandon the sales process were not entitled to the business judgment presumption.[6]

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It is important to note how the board's decision appears to have lost the protection of the business judgment rule in this case.

Generally, a plaintiff's bare allegation that a director or officer acted disloyally because he could lose his position or a commercial relationship should not be sufficient to rebut the presumption that the directors acted faithfully.[7]

However, in Stephens' case, the additional fact that he had failed to provide the due diligence materials in a timely manner and had refused to set up a due diligence meeting with the second bidder might have been enough to tip the scales to an entire fairness review in light of the potential for a conflict of interest.

Stated differently, if you are a director or officer of a company that has undertaken a sale process and the specter of losing your job or losing a key customer looms on the horizon, delay or distraction in executing your responsibilities may subject your actions to enhanced scrutiny.

As in any sale process, the dramatic effect of these relationships might have been dampened had the record made clear that the board was aware of these potential conflicts, considered them carefully and implemented reasonable checks and balances designed to ensure that no director or officer could derail the process.

Similarly, the board members weren't helped by the company's boilerplate disclosure that the directors and officers had conflicts because they were in a position to structure the reclassification in a way that would benefit them differently from other stockholders.

They might have been better served by more thoughtful disclosure as to the nature of the potential conflicts that existed among some of the directors as well as explaining how, once these potential conflicts were identified, the board deliberated carefully as to how best to ensure that these potential conflicts did not creep into the process.

The court does not expressly address whether the records of the First Nile board meetings failed to reflect any such deliberation, but we believe this is a reasonable inference.

Fiduciary Duties of Officers

The Delaware Supreme Court on several past occasions has implied that officers owe fiduciary duties of care and loyalty, just like directors.[8] However, the Delaware Supreme Court in Gantler explicitly confirmed this position.

Again, while not necessarily blazing any new trails, this aspect of the Gantler decision does offer a healthy reminder for officers of Delaware corporations.[9]

Furthermore, the court notes a potentially important nuance in the Delaware corporate code. Section 102(b)(7) of the Delaware General Corporation Law permits a

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corporation, in its certificate of incorporation, to exculpate its directors from monetary liability for certain breaches of the duty of care.[10]

However, this section of the Delaware Code does not provide for the same type of charter-based exculpation of officers. Accordingly, it would appear that a breach of a fiduciary duty claim could have graver consequences for an officer in some respects than for a director. The court suggests that the Delaware legislature could solve this dilemma.

In the meantime, however, officers of Delaware corporations could be well served to request contractual assurance from their employers that they will be indemnified for any liabilities for which they would be entitled to exculpation if Section 102(b)(7) allowed for such protection.

Common Law Stockholder Ratification

The Gantler court also clarified that the common law stockholder ratification doctrine only will cleanse director actions where a fully informed stockholder vote is sought to approve director actions that otherwise do not require stockholder approval to become effective.[11]

In Gantler, one reason the stockholder vote did not operate to ratify the actions of the directors was that the stockholder vote was required under Delaware law to amend the certificate of incorporation to effect the reclassification.

In addition, the court noted that stockholder ratification will only serve to cleanse director actions that stockholders are asked specifically to approve.[12]

Finally, the court notes that generally stockholder ratification will subject the challenged action to business judgment review rather than extinguish the claim altogether.

However, as a corollary to a point made earlier about the effect of the entire fairness standard, in most cases, the application of the business judgment rule should be viewed as a successful outcome from the board’s perspective.

Conclusion

In the weeks following the Gantler decision, there was much debate about its importance. In our view, it is difficult to see Gantler as groundbreaking legal precedent. However, it is a useful and important cautionary tale.

We can’t help but speculate that little in this case would have played out the same had the board exercised an ounce of prevention in the manner in which it conducted the sale process and documented and disclosed its rationale regarding its handling of potential conflicts and for its decision not to pursue a transaction.

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Lastly, with the ever-increasing scrutiny being brought upon corporate officers, a Delaware corporate board may want to consider whether it should offer officers some contractual assurance that they would be indemnified for those matters to which DGCL Section 102(b)(7) would permit exculpation if it applied.

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[1] The one dissenting board member was Leonard Gantler, one of the plaintiffs in this case. He remained a member of the board until April 2006.

[2] The director appointed to chair this committee, Ralph Zuzolo, died in August 2005, before any other directors were appointed to the committee.

[3] In some instances that are not relevant to this case, most notably, a squeeze-out merger by a controlling stockholder, the directors may be able to shift the burden to the plaintiffs to prove that a transaction was not “fair” if the directors undertake procedural safeguards such as the formation of a committee of independent and disinterested directors, with its own legal and financial advisors, to represent the interests of the minority stockholders. Kahn v. Lynch Communication Systems Inc., 638 A.2d 1110 (Del. 1994).

[4] The court affirmed the Chancery Court’s determination that enhanced scrutiny under Unocal did not apply. The plaintiffs had argued that, since the defendants stood to lose the benefits of corporate control if First Niles were sold, their actions were, therefore, defensive. The court rejected this argument on the basis that Unocal did not apply where the claims related to allegations of a breach of the duty of loyalty and not defensive measures taken in response to an external threat.

[5] The court also appears to have been influenced by the lack of evidence as to the board’s rationale for rejecting the offer, noting, as did the Chancery Court, that “a board’s decision to decline a merger is often rooted in distinctively corporate concerns, such as enhancing the corporation’s long term share value ...” Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *19 (Del. Jan. 27, 2009).

[6] The court concluded it need not address the question as to whether the defendants breached their duty of care since the cognizable claim of disloyalty was sufficient to rebut the business judgment rule. However, the court does note in passing, but with some interest, that the plaintiffs allege the board repeatedly disregarded its financial advisor’s advice throughout the conduct of the sale process.

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[7] Indeed, the court acknowledges that a claim of this kind must be viewed with caution since a plaintiff could always assert that a board had an entrenchment motive in rejecting a merger proposal.

[8] See, e.g., Guth v. Loft Inc., 5 A.2d 503, 510 (Del. 1939); Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993).

[9] The Chancery Court also held that there was lack of personal jurisdiction over Csontos because he merely was the chief compliance officer and corporate secretary, and neither such office met the definition of an officer under Delaware law. 10 Del C. 3114(b). The plaintiffs did not appeal from the dismissal of Csontos and, therefore, the court did not address the question as to what officers in name might be subject to these same fiduciary duties. In contrast, Section 2.02(b)(5) of the Model Business Corporation Act (4th edition) permits a corporation to include mandatory or permissible indemnification of an officer for liability in its certificate or articles of incorporation. Thirty states have adopted the Model Business Corporation Act in whole or in part.

[10] Section 102(b)(7) states that “the certificate of incorporation may also contain ... [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.”

[11] Interestingly, the court later refers only to director actions for which stockholder approval is not “statutorily required”. Gantler v. Stephens, No. 132, 2008, 2009 WL 188828, at *35 (Del. Jan. 27, 2009). This leaves for another day the question as to whether ratification would have a cleansing effect where a contract or other non-statutory restriction (e.g., exchange listing standards) required stockholder approval.

[12] The court cites a prior case, in which a stockholder approval of a merger did not preclude breach of fiduciary duty claims relating to pre-merger defensive measures. See In re Santa Fe Pac. Corp. S’holder Litig., 669 A.2d 59, 68 (Del. 1995).

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