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EXECUTIVE SUMMARY

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Recent Delaware Corporate Governance Decisions

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In three separate decisions within the past year—*Gantler v. Stephens*,[1] *McPadden v. Sidhu*,[2] and *Schoon v. Troy Corp.*[3]—Delaware courts have addressed several issues of particular interest to corporate governance practitioners. Each decision and its principal implications to corporate governance practitioners is summarized below.

Gantler

In *Gantler*, the plaintiffs, shareholders of First Niles Financial Inc., a publicly held bank holding company, brought suit against certain officers and directors of First Niles alleging that they breached their fiduciary duties by rejecting a sale transaction, approving a reclassification of First Niles' shares in order to benefit themselves and recommending the reclassification to First Niles shareholders.[4] The plaintiffs also alleged that the defendants disseminated a materially misleading proxy statement to shareholders.[5] As discussed below, the Delaware Supreme Court's decision specifically addresses, for the first time, the fiduciary duties owed by officers and clarifies the application of the common law doctrine of shareholder ratification.

Underlying Facts

In August 2004, the board of directors of First Niles decided to put the company up for sale. Shortly thereafter, First Niles' management began advocating the abandonment of

[1] 965 A.2d 695,, 2009 WL 188828 (Del. Jan. 27, 2009) (hereafter, *Gantler*).
[2] 964 A.2d 1262, 2008 WL 5704775 (Del. Ch. Aug. 29, 2008) (hereafter, *McPadden*).
[3] 948 A.2d 1157 (Del. Ch. 2008) (hereafter, *Schoon*).
[4] *Gantler*, at *1.
[5] *Id.*

the sale process in favor of a privatization transaction. The sale process continued, however, resulting in bids from three potential purchasers. The board subsequently directed its financial advisor and management to conduct due diligence in connection with a possible transaction with two of the bidders. However, one bidder withdrew its bid after management failed to furnish requested due diligence materials. The other bidder, First Place Financial Corp., eventually received diligence materials and submitted several revised bids, the last of which represented a significant premium over the market price of First Niles' common stock. The First Niles board ultimately rejected this offer without discussion or deliberation.[6]

The First Niles board subsequently voted to proceed with a privatization plan proposed by management. The privatization plan contemplated, among other things, a reclassification of existing shares of holders of 300 or fewer shares of First Niles common stock into a new issue of non-voting preferred stock. In June 2006, the First Niles board approved the privatization plan and filed a proxy statement with the Securities and Exchange Commission seeking shareholder approval of amendments to the First Niles certificate of incorporation to implement the reclassification. The proxy statement included, among other things, disclosure that, after "careful deliberations," the First Niles board had determined that the offer it had received was not in the best interests of the company or its shareholders. The reclassification was approved by First Niles' shareholders in December 2006.[7]

Decision and Analysis

The Court of Chancery had granted the defendant's motion to dismiss.[8] The Delaware Supreme Court found that the chancery court erroneously dismissed plaintiff's complaint and reversed the court of chancery's decision as to all counts.[9]

In *Gantler*, the Delaware Supreme Court for the first time expressly held that officers owe the same fiduciary duties as corporate directors.[10] While not a surprise, the supreme court's confirmation of the fiduciary duties owed by officers had not previously

[6] *Id.* at *2-*3.
[7] *Id.* at *3-*5.
[8] *Gantler v. Stephens*, 2008 WL 401124 (Del. Ch. Feb. 14, 2008) (unpublished opinion).
[9] *Gantler*, at *14.
[10] *Id.* at *9.

been addressed by the court.[11] The court concluded that the plaintiffs had alleged sufficiently detailed acts of wrongdoing by the defendants to state a cognizable claim that the defendants acted disloyally.[12] The court noted in particular the plaintiffs' allegations that the officer defendants sabotaged the diligence process and that at least a majority of the director defendants rejected the First Place bid to preserve personal benefits, including retaining their positions and pay, as well as personal interests through outside business relationships with First Niles that would likely have ended upon a sale to a third party.[13] The court concluded that because a claim of disloyalty is subject to the higher "entire fairness" standard of review, the court of chancery erred in determining that the defendants' actions were entitled to protection under the business judgment rule.[14]

Gantler is also noteworthy for its discussion of the common law doctrine of shareholder ratification.[15] The court of chancery originally dismissed the plaintiffs' third count, which alleged that the defendants breached their duty of loyalty by recommending the reclassification to shareholders for purely self-interested reasons on the ground that a disinterested majority of the shareholders had "ratified" the reclassification by voting to approve it.[16] Noting prior confusion regarding the appropriate application of the common law doctrine of shareholder ratification, the court held that the doctrine "must be limited to its so-called 'classic' form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder

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[11] "In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold." *Id.* The Court of Chancery had previously concluded that officers and directors owed the same fiduciary duties. *See, e.g.*, *Ryan v. Gifford*, 935 A.2d 258, 266 (Del. Ch. 2007). This was not in dispute in *Gantler*. *Gantler*, at *9.

[12] *Id.* at *8-*9.

[13] The court also remarked that the proxy itself disclosed that certain directors had conflicts of interest because they were in a position to structure the reclassification in a way that benefits them differently. *Id.* at *8.

[14] Under Delaware law, the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (internal citations omitted). The court in *Gantler* noted that a cognizable claim of disloyalty rebuts the business judgment rule. *Gantler*, at *9.

[15] The common law doctrine of shareholder ratification is different from an approving vote of disinterested shareholders with respect to interested director transactions under 8 Del. Code § 144.

[16] *Id.* at *12.

approval in order to become legally effective."[17] The court then held that the shareholder ratification doctrine was inapplicable in this case because a shareholder vote to approve the reclassification was required.[18] The court also clarified that with one exception, the "cleansing" effect of a ratifying vote is to subject the challenged action to business judgment review, as opposed to extinguishing the claim altogether, and overruled *Smith v. Van Gorkom*[19] "[t]o the extent that *Smith v. Van Gorkom* holds otherwise."[20]

Finally, as to the plaintiffs' claim regarding allegedly misleading proxy disclosure, the supreme court reversed the court of chancery, refusing to conclude (as the court of chancery had) that, at as a matter of law, the "careful deliberations" proxy disclosure would not alter the total mix of information provided to shareholders.[21]

McPadden

McPadden involved a derivative claim brought on behalf of i2 Technologies Inc., in connection with the June 2006 sale of Trade Services Corporation (hereafter, TSC), a division of i2 Technologies. The plaintiff alleged that i2 Technologies' board of directors and then-vice president, Anthony Dubreville, breached their fiduciary duties to shareholders by approving the sale of TSC to a management team led by Dubreville for a price that the directors knew to be well below TSC's market value.[22] The plaintiff also alleged unjust enrichment against Dubreville. As discussed below, the court's decision addresses the distinction between gross negligence and bad faith in the context of an exculpatory charter provision limiting director liability.

Underlying Facts

In December 2004, the i2 Technologies board decided to sell TSC. Even though Dubreville had previously discussed the possibility of leading a management buyout of

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[17] *Id.* at *13 (emphasis in original). The court also concluded that the alleged claims that the proxy disclosure contained a material misrepresentation precluded a determination that, as a matter of law, the shareholders were fully informed when they voted. *Id.*
[18] *Id.* at *14.
[19] 488 A.2d 858 (Del. 1985).
[20] *Gantler,* at *13 n.54. The court noted that a situation where the directors lacked the authority to take action that was later ratified by shareholders is the only situation where shareholder ratification extinguishes a claim. *Id.*
[21] *Id.* at *11-*12.
[22] Dubreville was CEO and president of TSC when it was acquired by i2 Technologies, and remained in charge of TSC after the acquisition. *McPadden,* at *1.

TSC, the board allowed Dubreville to conduct the sale process. The board's investment banker provided two preliminary valuations of TSC—both of which were based on projections created by TSC management under Dubreville's direction. Dubreville ultimately used the second set of projections, which were significantly lower than the first set, to solicit bids.[23]

The sale process resulted in three bids, including a $3 million bid from the Dubreville-led group.[24] Even though one TSC competitor had offered to acquire TSC for $25 million in January 2003—a fact known to Dubreville and at least some of the directors—neither this competitor nor any other TSC competitor was contacted during the sale process.[25] In April 2005, the i2 Technologies board approved the sale of TSC to the Dubreville-led group for $3 million. Shortly after completing the sale, the Dubreville-led group offered to sell TSC to the competitor who had offered to buy TSC in 2003. That sale did not occur, but TSC was sold two years later to another competitor for more than $25 million.[26]

Decision and Analysis

The defendants filed a motion to dismiss the complaint. As discussed below, the court granted the motion to dismiss as to the director defendants based on the exculpatory provision in i2 Technologies' certificate of incorporation, but denied the motion to dismiss as to defendant Dubreville.[27]

As an initial matter, the court found that the plaintiff had pled particularized facts demonstrating that the board was grossly negligent in its oversight of the sale process.[28] The court noted in particular the board's decision to allow Dubreville to run the sale process knowing his interest in purchasing TSC. The court also noted that direct competitors were never contacted and that the use of projections provided by TSC

[23] *Id.* at *3-*4.
[24] Of the other two bids, one bid was valued at $4.3 million and the other bid was for $1.8 million. *Id.* at *4.
[25] TSC had filed a lawsuit against the competitor in 2002 for copyright infringement, which lawsuit was settled in mid-2004. *Id.* at *2.
[26] *Id.* at *5-*6.
[27] *Id.* at *11.
[28] *Id.* at *9.

management at a time when TSC management was a prospective buyer should have alerted the board to carefully consider whether Dubreville's offer was high enough.[29]

Despite this finding, however, the court granted the motion to dismiss in favor of the director defendants based on the exculpatory provision in i2 Technologies' certificate of incorporation. Under 8 Del. Code § 102(b)(7), a corporation may include in its certificate of incorporation an exculpatory provision that limits the personal liability of directors for breaches of fiduciary duties, including breaches of the duty of care. The i2 Technologies certificate of incorporation contained such a provision.[30] However, a Section 102(b)(7) exculpatory provision cannot limit liability for breaches of the duty of loyalty, including bad faith conduct.[31] The court reaffirmed that gross negligence and bad faith conduct are not synonymous, and concluded that the plaintiff had not sufficiently alleged that the director defendants had acted in bad faith through a conscious disregard for their duties.[32] Since liability for gross negligence was exculpated under i2 Technologies' certificate of incorporation, the court granted the motion to dismiss as to the director defendants.[33] The court noted, however, that Dubreville was not entitled to the protections afforded by the exculpatory provision in i2 Technologies' charter because he was not a director.[34]

McPadden illustrates the significance of the previously recognized distinction between gross negligence (duty of care) and bad faith (duty of loyalty), particularly as it relates to exculpation of director liability under a Section 102(b)(7) exculpatory provision. The decision also highlights the distinction between director and officer liability exposure for breaches of fiduciary duties because officers cannot avail themselves of a Section

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[29] *Id.* at *7-*8.
[30] *Id.* at *9.
[31] Under 8 Del. Code § 102(b)(7), such a provision cannot eliminate or limit liability for, among other things, "any breach of the director's duty of loyalty to the corporation or its stockholders" or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."
[32] *McPadden*, at *9-*10 (citing *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006), which noted, among other things, that only "the intentional dereliction of duty or the conscious disregard for one's responsibilities" must be treated as "non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith").
[33] *Id.* at *10.
[34] *Id.* (noting that "an officer does not benefit from the protections of a Section 102(b)(7) exculpatory provision, which are only available to directors").

102(b)(7) exculpatory provision even though, as discussed above, officers owe the same fiduciary duties as corporate directors.

Schoon

In *Schoon*, the plaintiffs, a former director and a current director of Troy Corporation, brought suit against Troy seeking advancement of expenses in connection with defending various claims asserted by Troy against the plaintiffs in multiple actions. As discussed below, the court's holding seems to undercut the protections commonly thought to have been afforded to former directors under mandatory advancement of expense and indemnification provisions in corporate bylaws.

Underlying Facts

The plaintiffs were William Bohnen, a former director, and Richard Schoon, a current director, of Troy. Bohnen and his family were major stockholders of Troy, primarily through Steel Investment Company. Bohnen served as Steel's board designee until February 2005, at which time Bohnen resigned and Schoon (a longtime financial consultant to Steel and the Bohnen family) was elected to replace Bohnen on the Troy board of directors.[35]

In January 2004, Steel decided to sell its interest in Troy. Both Steel and Schoon made books and records demands on Troy under 8 Del. Code § 220. Unsatisfied with Troy's response, in September 2005 Schoon filed an action against Troy in the court of chancery under 8 Del. Code § 220 (hereafter, the Schoon Action). In its answer, filed in October 2005, Troy alleged that Schoon, in breach of his fiduciary duties, planned to share with Steel and other third-parties any document he might receive from Troy.[36]

[35] *Schoon*, at 1160. After Mr. Bohnen passed away, the executrix of his estate was substituted in his place. *Id.*

[36] *Id.* at 1160-61. Steel subsequently filed a separate 8 Del. Code § 220 action against Troy and, on November 9, 2005, Schoon's and Steel's actions were consolidated by the court. *Id.*

In November 2005, the Troy board (excluding Schoon) approved amendments to the Troy bylaws, including removal of the word “former” from its definition of the directors entitled to advancement of legal fees and expenses.[37]

In January 2006, Troy attempted to countersue Schoon in the Schoon Action asserting breach of fiduciary duty claims against Schoon and Bohnen, among other things. The court of chancery denied Troy’s motion, and in February 2006, Troy filed a plenary action (hereafter, the Troy Action) against eight defendants, including Schoon and Bohnen, asserting the same fiduciary duty claims it attempted to raise as counterclaims in the Schoon Action.[38]

Schoon and Bohnen, through their counsel, requested advancement of fees and expenses under the mandatory advancement provision in Troy’s bylaws to defend against the breach of fiduciary duty claims alleged by Troy (with respect to both the Schoon Action and the Troy Action). The Troy board created a committee to review and consider the requests for advancement. The committee subsequently recommended approval of a fraction of the amounts Schoon and Bohnen sought to be advanced. Schoon and Bohnen then filed this lawsuit.[39]

Decision and Analysis

Ruling on cross-motions for summary judgment, the court concluded that Schoon was entitled to advancement of expenses, but that Bohnen was not entitled to any additional advancement of expenses under Troy’s amended bylaws.[40]

With respect to Bohnen, the court concluded that the November 2005 bylaw amendments removed Bohnen’s right to further advancement of requested expenses.[41] The court noted in particular that Bohnen was not named as a defendant at the time the bylaw amendments were approved nor was there evidence indicating that, at that time, Troy was “even contemplating claims against Bohnen.”[42] As a result, the court

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[37] *Id.* at 1161.
[38] *Id.* at 1161-62.
[39] *Id.* at 1162-63.
[40] *Id.* at 1177.
[41] *Id.* at 1168. Troy had previously advanced a portion of the expenses to Bohnen in connection with Bohnen’s defense of Troy’s effort to bring counterclaims against Bohnen in the Schoon Action. *Id.* at 1163.
[42] *Id.* at 1165-66.

concluded that Bohnen did not have a vested right to advancement of the requested expenses before the Troy bylaws were amended.[43]

In reaching this conclusion, the court distinguished the decision of the Delaware Superior Court in *Salaman v. National Media Corp.*[44] In *Salaman*, the defendant corporation began advancing expenses with respect to a pending claim against a former director, but then amended its bylaws to repeal the basis for the advancement.[45] The court in *Salaman* held that the former director's right to advancement was a contract right, which vested (and could not thereafter be unilaterally terminated) when the advancement obligation was triggered – i.e., the date the claim was filed against the former director.[46] The court in *Schoon* concluded, however, that the timing of the assertion of the claim was a key factor that distinguished the situation in *Salaman* from Bohnen's situation.[47]

Finally, the court held that Schoon was entitled to advancement, including with respect to expenses incurred in defending the fiduciary duty counterclaims asserted by Troy in the Schoon Action after the court denied Troy's request to amend its answer in the Schoon Action.[48]

The court's decision in *Schoon* came as a surprise to many practitioners who viewed advancement and indemnification rights under corporate bylaws as vested contract rights that could not be unilaterally terminated. The adverse impact of this decision, however, may be relatively short-lived. In March 2009, proposed amendments to the Delaware Code were submitted to the Delaware state legislature, including a proposed amendment to 8 Del. Code § 145(f) to address the decision in *Schoon.*[49] This amendment is designed to clarify that a right to indemnification or advancement of expenses under a charter or bylaw provision cannot be eliminated by an amendment after the occurrence of the act or omission to which indemnification or advancement

[43] *Id.* at 1166-67.
[44] 1992 WL 808095 (Del. Super Ct. Oct. 8, 1992) (hereafter, *Salaman*).
[45] *Salaman*, at *6.
[46] *Id.*
[47] *Schoon*, at 1166.
[48] *Id.* at 1170. The court also awarded Schoon prejudgment interest and partial reimbursement for costs incurred in enforcing Schoon's rights to advancement, but refused to award attorneys' fees. *Id.* at 1173, 74 and 1176-77.
[49] H.R. 19, 145 Gen. Assem., Reg. Sess. (Del. 2009).

relates (unless the provision contains an explicit authorization of such elimination at the time of the act or omission). If approved by the Delaware state legislature, this amendment is expected to become effective on or about August 1, 2009.

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