

CORPORATE ALERT

DELAWARE SUPREME COURT ADDRESSES STANDARDS OF REVIEW, OFFICER FIDUCIARY DUTIES AND SHAREHOLDER RATIFICATION DOCTRINE

The Delaware Supreme Court recently reinstated a shareholder suit alleging that directors and officers of a bank breached their fiduciary duties by rejecting a merger proposal in favor of a proposal to privatize the bank through a reclassification of shares (*Gantler v. Stephens*, No. 132, 2008 (Del. Jan. 27, 2009)). Although ruling on an appeal of a motion to dismiss, the Supreme Court's opinion clarified certain Delaware law issues relating to the business judgment and entire fairness standards of review, the fiduciary duties of officers and the common-law doctrine of shareholder ratification.

Specifically, the Delaware Supreme Court held that—

- A board's rejection of an acquisition offer, without more, is not a defensive action that triggers the *Unocal* enhanced scrutiny standard of review. The *Unocal* standard would only apply if there were allegations of additional defensive measures taken by the board. The court held that the board's decision should, however, be subject to the entire fairness standard rather than the business judgment rule, because the facts provided a sufficient basis to conclude that directors acted disloyally.
- Officers owe the same fiduciary duties as directors.
- Shareholder ratification is limited to circumstances where fully informed shareholders specifically approve director action that does not legally require shareholder approval to become effective, and shareholder ratification does not extinguish all claims relating to the director action but merely subjects them to business judgment review.

BACKGROUND

The board of directors of First Niles Financial, Inc., a holding company that owns and operates a savings and loan bank, decided to put First Niles up for sale and engaged financial and legal advisors to assist in the sale process. The board received three separate bid letters, all of which were in the suggested range, according to First Niles' financial advisor. With respect to the three bids, (1) one offer, in which the bidder stated it had no plans to retain the board, was not pursued at all by the board; (2) another offer was withdrawn after defendants failed to comply in a timely manner with the bidder's due diligence requests; and (3) a third offer was rejected by the board without any discussion or deliberation. The board ultimately decided to go forward with a plan to privatize First Niles through a share reclassification, rather than sell the company. The share reclassification became effective after a majority of the company's outstanding shares were voted in its favor. In the complaint, plaintiffs challenge the board's decision to reject the merger proposal and to go forward instead with the share reclassification. Particularly, plaintiffs allege that—

- defendants breached their duties of loyalty and care as directors and officers of First Niles by abandoning the sale process
- defendants breached their duty of disclosure by disseminating a materially false and misleading proxy statement regarding the reclassification, and
- defendants breached their duty of loyalty by effecting the reclassification.

The Chancery Court granted a motion to dismiss all three claims, which decision was reversed with respect to all three claims by the Supreme Court. A discussion of the Delaware law issues addressed in the Supreme Court's opinion follows.

BUSINESS JUDGMENT REVIEW AND ENTIRE FAIRNESS STANDARD

With respect to the first claim, the Supreme Court agreed with the Chancery Court's determination that the heightened *Unocal* enhanced scrutiny standard did not apply to the board's decision to abandon the sale process, because this decision was not a defensive action by the board, as is required under *Unocal*. The Supreme Court did not, however, agree with the lower court's application of the business judgment standard. Typically, a board's decision not to pursue a merger opportunity is reviewed within the traditional business judgment framework. But to merit the business judgment presumption, the board must have reached its decision in the good faith pursuit of a legitimate corporate interest *and* must have done so advisedly. If plaintiffs submit facts that support director self-interest, the business judgment presumption can be rebutted, and entire fairness review may be applied. The Supreme Court emphasized that facts related to a director defendant's disloyalty must go beyond a mere assertion that the directors desired to retain corporate control. The plaintiffs did assert that defendants rejected the bid to retain their positions and maintain corporate control, but they also alleged additional facts, including

the failure of certain directors either to timely respond to diligence requests or to inform the board of their failure to do so, and various conflicts with certain directors who did business with the bank and would potentially lose a client. The court held that these facts provided a sufficient basis to conclude that a majority of the board acted disloyally, and, therefore, the board's decision should be subject to the entire fairness review.

When considering transactions, boards must carefully review any situations where a director could be considered to have a conflict of interest, including any business or other interests that could arguably differentiate the director's interests from the interests of other shareholders. If not properly addressed, such conflicts could subject the board's actions to the entire fairness standard of review.

OFFICERS OF DELAWARE CORPORATIONS OWE FIDUCIARY DUTIES OF CARE AND LOYALTY

Along with finding sufficient basis to conclude that the directors acted disloyally, the Supreme Court also found sufficient factual allegations of wrongdoing to support the plaintiffs' claim that officer defendants breached their duty of loyalty. Although alluded to in the past, the Delaware Supreme Court explicitly held for the first time that corporate officers owe the same fiduciary duties of care and loyalty as directors of Delaware corporations.

PROXY DISCLOSURES WERE MISLEADING

In overturning the Chancery Court's decision regarding whether the final proxy statement contained misleading material representations, the Supreme Court seized on a statement in the document that the board had rejected one of the offers after "careful deliberation." Although a board is not required to disclose details of failed merger negotiations, the Delaware Supreme Court concluded that it is materially misleading to claim that the board engaged in careful deliberation if, in fact, it rejected the merger transaction without serious consideration. This ruling highlights the importance of carefully reviewing and confirming the language in proxy statements to ensure such language is truthful and correct.

SHAREHOLDER RATIFICATION DOCTRINE

The Chancery Court held that claims that defendants breached their duty of loyalty were extinguished, because a disinterested majority of shareholders ratified the share recapitalization by voting in favor of it. The Supreme Court disagreed, concluding that the shareholder ratification doctrine is limited to circumstances approving director action that does not legally require shareholder approval to become effective. Because the share recapitalization required shareholder approval, such approval did not ratify the board's actions. What's more, shareholder ratification is limited to those director actions or conduct that shareholders are specifically asked to approve and does not include all related actions taken by

directors. Further, shareholder ratification does not extinguish claims relating to the director action that was ratified but merely subjects the director action to the business judgment standard.¹ Through this decision, the Supreme Court has narrowed the application of the shareholder ratification doctrine to make it clear that such ratification does not “cleanse” all aspects of a board’s decision, as many had thought, but rather subjects the challenged action to business judgment review.

¹ The Supreme Court did provide one exception to this statement in a footnote, stating that the only species of claim that shareholder ratification can validly extinguish is a claim that the directors lacked the authority to take action that was later ratified.

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