Keeping current: corporate governance

By Julie Kaufer and Justin Radell

Standards of Review; Officer Fiduciary Duties; and Shareholder Ratification

The Delaware Supreme Court recently clarified issues of Delaware law in its unanimous *en banc* opinion in *Gantler v. Stephens*, No. 132, 2008 (Del. Jan. 27, 2009). 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;

• officers owe the same fiduciary duties of loyalty and care as directors; and

• shareholder ratification is limited to circumstances where fully informed shareholders specifically approve director action that does not legally require shareholder approval to become effective.

In *Gantler*, the board of directors of First Niles Financial, Inc., a small bank holding company, 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:

• one offer, in which the bidder stated it had no plans to retain the board, was not pursued at all by the board;

• another offer was withdrawn after defendants failed to comply in a timely manner with the bidder's due diligence requests; and

• 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 shareholders voted in favor of it.

In the complaint, plaintiffs challenge the board's decision to reject the third offer and to go forward instead with the share reclassification. Plaintiffs' allegations include that defendants breached their duties of loyalty and care as directors and officers of First Niles by abandoning the sale process, and defendants breached their duty of loyalty by effecting the reclassification. The chancery court granted a motion to dismiss each of plaintiff's claims. The supreme court reversed with respect to all claims and reinstated the suit.

Standard of Review

The supreme court determined that the *Unocal* enhanced scrutiny standard did not apply to the board's decision to abandon the sale process because that decision was not a defensive action by the board as is required under *Unocal*. The supreme court also determined that the board's decision not to pursue the merger opportunity should not have received the benefit of the business judgment rule. For the business judgment rule to apply, directors must show that they reached their decision in the good faith pursuit of a legitimate corporate interest *and* must have done so advisedly. If plaintiffs assert facts that support director self-interest, the business judgment presumption can be rebutted, and the entire fairness review may be applied. Here, the supreme court held that the entire fairness standard should apply because the plaintiffs alleged sufficient facts to conclude that a majority of the board acted disloyally and did not reach its decision in good faith.

The plaintiffs' allegations included that the defendants rejected the bid to retain their positions and maintain corporate control, certain officers failed to respond timely to diligence requests or to inform the board of their failure to do so in an effort to sabotage the sale process, and there existed conflicts with certain directors who did business with the bank and would potentially lose a significant client if the bank were sold. The supreme court emphasized that facts related to a director's disloyalty must go beyond a mere assertion that the director desired to retain corporate control—as is the case here.

Care and Loyalty Owed by Officers

The supreme court also found sufficient factual allegations of wrongdoing to support the plaintiffs' claim that officer defendants breached their duty of loyalty. Although the Delaware Supreme Court alluded to it in the past, the 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.

Kaufer is a partner at the Los Angeles office of Akin Gump Strauss Hauer & Feld, and is a member of the firm's Corporate practice group. Radell is an associate at the firm's Los Angeles office and is a member of the Corporate practice group. Their respective e-mails are jkaufer@akingump.com and jradell@akingump.com.

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 reclassification 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. 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 rule.

> While the fiduciary duties of officers are the same as those of directors, their respective liability exposure is different.

Observations from the *Gantler* Decision

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

Inform Officers of Duties. Legal counsel typically advises directors of a corporation of their fiduciary duties at the commencement of any sales process. The corporation should ensure that its officers also are informed of and understand their fiduciary duties.

Officers' Liability Exposure. While the court made clear that the fiduciary duties of officers are the same as those of directors, their respective liability exposure is different. Delaware law permits the inclusion of provisions in charter documents that eliminate directors' liability for damages arising from a breach of the duty of care; these provisions do not extend to corporate officers.

Limits to Shareholder Ratification. This decision narrowed the application of the shareholder ratification doctrine and made it clear that shareholder ratification does not "cleanse" all aspects of a board's decision, as many had thought, but rather subjects the challenged action to the business judgment rule.