

NATIONAL ASSOCIATION OF CORPORATE DIRECTORS ANNUAL MEETING
Panel Discussion: Lessons from Recent Litigation Involving Directors' Fiduciary Duties
Oct. 20, 2008
Summary of Discussion Materials

SEC Certification to the Supreme Court and Supreme Court Decision in CA

In 2007, the Delaware Constitution was amended to enable the U.S. Securities and Exchange Commission to certify questions of law to the Delaware Supreme Court. In July 2008, in *CA, Inc. v. AFSCME Employees Pension Plan*,¹ the Delaware Supreme Court issued its first decision under that provision. At issue was a shareholder-proposed bylaw that would require the board of directors, subject to certain conditions, to reimburse a shareholder for reasonable expenses incurred in connection with nominating candidates in a contested election. AFSCME submitted the proposed bylaw for inclusion in the proxy statement of CA, Inc., for its upcoming annual meeting. The court determined that the proposed bylaw, as drafted (1) was a proper subject for shareholder action but (2) would impinge on the statutory province of the board to exercise its business judgment in managing corporate affairs.

The decision is important for a number of reasons. The court addressed for the first time the long-debated interplay between the board's statutory authority to manage the business and affairs of the corporation and the shareholders' statutory authority to adopt bylaws relating to the management of the corporation's business and the conduct of its affairs or regulating the powers of shareholders and directors. The decision holds that the shareholders' power to adopt bylaws is limited by the board's management prerogatives, without attempting to delineate the exact contours of this limitation.

The decision found that the bylaw could preclude the board from discharging its fiduciary duty and thus would be inconsistent with the management role of the board contemplated by the statute. Changes in the board's management role could be provided in the certificate of incorporation but not in the bylaws.

The court stated that, in providing reimbursement of election expenses of successful rival candidates, the bylaw would facilitate the shareholders' right to participate in selecting the candidates for election to the board, a "a subject in which the shareholders ... have a legitimate and protected interest." Because the bylaw would facilitate that purpose, the fact that it would require the expenditure of corporate funds would not, by itself, make the bylaw an improper subject of shareholder action.

Rather, the deficiency of the proposed bylaw arose from violating the prohibition against "arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders." The court's discussion raises the possibility that a similar bylaw might be considered valid if it contained a "fiduciary out" provision—under which the board could deny reimbursement if it determined that under particular circumstances application of the corporation's funds to reimbursement would be contrary to the best interests of the corporation and its shareholders.

¹ 953 A.2d 227 (Del. 2008).

The court eschewed articulating “with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt . . . from those which they may not,” noting that such a determination is highly contextual. It pointed out that the proposed bylaw “would encourage candidates other than board-sponsored nominees to stand for election” and even suggested how the bylaw could have been written to be on its face validly process-oriented.

The CA decision is likely to be much discussed in the ongoing debate over the role shareholders should play in corporate governance and the relative roles that federal and state law should play in establishing and regulating shareholder rights.

The court’s discussion leaves open whether a shareholder-adopted bylaw providing for reasonable shareholder access to company proxy materials for shareholder nominees would be valid, even though an expenditure of corporate funds would be entailed in providing such access.

Bylaws

Concerns over boardroom confidentiality have led some companies to enact, as a director qualification, a bylaw requiring each director and director-nominee to agree in writing to comply with all corporate governance, conflict of interest, confidentiality, and securities ownership and trading policies and guidelines of the corporation, and to submit an irrevocable resignation as a director, to take effect if the director is found to have materially breached that agreement.

Another recent bylaw innovation employs a corporate bylaw to enable the board to identify potential activist stockholders and to anticipate and therefore more effectively respond to prospective proxy fights. Federal rules require investors accumulating more than 5% of a company’s stock to disclose their ownership position in a 13D filing. But the economic exposure achieved by hedge funds through total return swaps may give these investors a voice in corporate governance, raising the question in some circumstances whether and when 13D disclosure is required.² Thus, directors may not be aware of the investors’ positions until the investors initiate a proxy contest. A bylaw that requires investors to disclose whenever they exceed a certain economic exposure, such as 7.5% or 10% can address this issue. The bylaw may also require investors who are seeking to nominate directors or make shareholder proposals to document their economic exposure.

Corporations with advance notice bylaws should review those provisions in light of the recent *Levitt Corp. v. Office Depot, Inc.*³ decision by the Delaware Court of Chancery. In *Levitt*, the court held that a bylaw requiring advance notice of “business” to be proposed by a stockholder at an annual meeting applied to director elections and

² See *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (holding that hedge funds violated disclosure rules by acquiring economic interests by using derivatives, but declining to enjoin the funds from voting their shares in a proxy contest). An appeal of *CSX* is pending before the Second Circuit.

³ 2008 Del. Ch. LEXIS 47 (Del. Ch. Apr. 14, 2008).

director nominations. But it also held that a stockholder attempting to nominate two candidates for the board did not have to comply with the bylaw because the company had given notice that the business of the meeting would include the election of directors, without limitation to a vote on the corporation's nominees. The stockholder therefore did not have to give separate advance notice. After *Levitt*, many corporations have amended their advance notice bylaws to explicitly discuss nominations.

Fiduciary Duties of Directors in Decisionmaking and Oversight

Directors have fiduciary duties of care and loyalty. They apply both in decisionmaking and oversight. The duty of loyalty encompasses the obligation of directors to act in good faith. Section 102(b)(7) of the Delaware General Corporation Law permits the certificate of incorporation to provide that directors may be exonerated from personal liability in damages for due care violations, but not if they violate the duty of loyalty or engage in acts or omissions not in good faith, intentional misconduct, a knowing violation of law, take an improper personal benefit or pay an unlawful dividend.

The seminal case on decisionmaking is the 2006 decision in the *Disney* case, affirming a decision by the Court of Chancery after trial that the directors exercised their business judgment (though somewhat sloppily) and did not violate their duty of loyalty or engage in bad faith in the hiring and termination of Michael Orvitz.⁴

Two modern Delaware cases form the framework for the directors' duty of oversight: the 1996 *Caremark*⁵ case and the 2006 *Stone v. Ritter* case. In *Stone v. Ritter*,⁶ the Delaware Supreme Court held that:

... *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.

Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.⁷

⁴ *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006). See also H. Stephen Grace, Jr., *An Insider Revisits the Disney Case*, DIRECTORS MONTHLY, Aug. 2008, at 1.

⁵ *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

⁶ *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

⁷ *Id.* at 369-70.

The *Stone* Court further noted that a claim against directors for liability arising out of unknown employee failures is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”⁸

Section 220: Demands for Corporate Books and Records

Beginning with *Rales v. Blasband*,⁹ the Delaware courts have encouraged putative plaintiffs, before filing a complaint in a derivative action, to seek books and records under section 220 of the Delaware General Corporation Law in order to comply with Chancery Rule 23.1 to plead facts with particularity.¹⁰ Numerous later cases have repeated that admonition, perhaps the most notable being the Chancellor’s decision in *Disney* denying the motion to dismiss.¹¹

As a result of this dynamic and for other reasons involving stockholder activism, there have been a plethora of section 220 cases. In a comprehensive 2006 article, Stephen A. Radin noted that from 2003 to 2006 alone there had been over fifty section 220 cases of various types.¹²

Demands for books and records have surfaced in a variety of contexts. One recent case, *Highland Select Equity Fund, L.P. v. Motient Corp.*,¹³ involved a demand in the context of a proxy contest, where the Court of Chancery refused the demand as improperly motivated and not in the best interest of the corporation. In another, *Dobler v. Montgomery Cellular Holding Co.*,¹⁴ the court approved several requests for documents that included emails showing the company’s decision making process.

Another interesting dimension is the right of directors to demand books and records. The cases in this area are highly contextual.¹⁵

⁸ *Id.* at 372 (citing *Caremark*, 698 A.2d at 967).

⁹ 634 A.2d 927, 934 n.10 (Del. 1993).

¹⁰ *See Brehm v. Eisner*, 746 A.2d 244, 266-67 (Del. 2000) (remanding to permit plaintiffs to seek books and records and replead).

¹¹ *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

¹² Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands—Reprise*, 28 CARDOZO L. REV. 1287 (2006).

¹³ 906 A.2d 156 (Del. Ch. 2006), *aff’d* 2007 Del. LEXIS 157 (Del. Apr. 4, 2007); *see also Disney v. Walt Disney Co.*, 857 A.2d 444 (Del. Ch. 2004).

¹⁴ 2001 Del Ch. LEXIS 126 (Del. Ch. Oct. 19, 2001).

¹⁵ *Schoon v. Troy Corp.*, 2006 Del. Ch. LEXIS 123 (Del. Ch. June 27, 2006); *McGowan v. Empress Entm’t, Inc.*, 791 A.2d 1 (Del. Ch. 2000); *Kortum v. Webasto Sunroofs Inc.*, 769 A.2d 113 (Del. Ch. 2000); *Intrieri v. Avatex*, 1998 Del. Ch. LEXIS 96 (Del. Ch. June 12, 1998); *Havens v. Attar*, 1997 Del. Ch. LEXIS 12 (Del. Ch. Jan. 30, 1997); *Hall v. Search*

Constituency Directors

One increasingly common situation that presents tensions for a growing number of directors is board service and allegiances by individuals who may be elected to the board by, and thus may seemingly “represent,” particular constituencies of the public corporation. This raises concerns about to whom or to what a constituency director is loyal or beholden, and questions about the fiduciary duty liability of those constituency directors. Constituency directors owe their fiduciary duties to the corporation, and the standards of liability for breaches of fiduciary duty should not change in the constituency director context. The existing standards of conduct and liability incorporate the necessary flexibility to balance the potentially competing duties of constituency directors with protection of the interests of the various corporate constituencies.¹⁶

Risk Management

The board, particularly the Audit Committee, should establish clear processes in four areas of risk management: (a) compliance, (b) financial risk, (c) Enterprise Risk Management (ERM) in areas other than financial risk, and (d) reputational risk.

Some of the following common sense principles might be used to frame a robust board-management discussion around major strategic risks:

- What are we aiming to accomplish, and how (corporate strategy)?
- What could derail our strategy?
- What assumptions is our strategy based on?
- Which of those assumptions could change/be wrong?
- What process did management use to identify risks?
- How is management dealing with the natural conflict between views of risk at the business unit level and the corporate level?
- Have we achieved a common understanding of what triggers a decision to bring an issue to the board’s attention?
- What capabilities are required to address the risks, and where do we have capability gaps?
- Is there a common understanding about rights, roles, responsibilities and accountabilities on strategic risk?
- How can this discussion become a part of the regular routine?¹⁷

Capital Group, 1996 Del. Ch. LEXIS 139 (Del. Ch. Nov. 15, 1996); *Holdgreiwe v. Nostalgia Network, Inc.*, 1993 Del. Ch. LEXIS 71 (Del. Ch. Apr. 29, 1993); *Henshaw v. Am. Cement Corp.*, 252 A.2d 125 (Del Ch. 1969).

¹⁶ E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761 (2008).

¹⁷ E. Norman Veasey, *The Persuasive Counselor—Shaping Client Conduct on Compliance, Risk Management, and a Culture of Integrity*, Keynote Address to the 2008 Corporate Counsel Forum (Oct. 1, 2008) (available upon email request to e.normanveasey@weil.com).

Recent Cases

In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,¹⁸ the Delaware Court of Chancery recently adjudicated, after trial, the application of a “material adverse effect” (MAE) clause. In that case, Hexion and Huntsman entered into a merger agreement in July 2007 in which Huntsman agreed to buy 100% of Huntsman’s stock for \$28 per share. In June 2008, Hexion and related entities sought to terminate the agreement, arguing among other things that Huntsman had suffered a material adverse effect under the merger agreement. Huntsman argued among other things that Hexion knowingly and intentionally breached the merger agreement. The court found that Huntsman had not suffered a material adverse effect and that Hexion committed a knowing and intentional breach of its obligations under the merger agreement by not using reasonable best efforts to consummate financing for the transaction and to discuss its concerns over the combined entity’s solvency with Huntsman management, instead of hiring counsel and developing an insolvency analysis and delivering that analysis to its banks. Although the court ordered specific performance against Hexion, it noted that the merger agreement specifically exempted Hexion from being obligated to close the transaction. Thus, it did not order consummation of the merger, stating that if Hexion’s failure to close resulted in a breach of contract, Hexion would be liable to Huntsman for damages.

In *McPadden v. Sidhu*,¹⁹ the Delaware Court of Chancery dismissed claims against the outside directors of i2 Corporation for allegedly selling TSC, a significant i2 subsidiary, in bad faith. The directors approved the sale of TSC to a management team led by then-TSC vice president Anthony Dubreville for \$3 million. At the time of the sale, a competitor had expressed interest in buying TSC for \$25 million. Six months after the sale, Dubreville received a third party offer for TSC for \$18.5 million; two years later, Dubreville sold TSC for \$25 million. Despite knowing that Dubreville was interested in purchasing TSC, the board tasked him with the sale process and did not hire an investment banker or business broker. The court held that demand was excused because the plaintiff had pleaded a duty of care violation that created a reason to doubt that the transaction was the product of a valid exercise of business judgment. The court determined that the directors were grossly negligent in assigning Dubreville to lead the sale process when they knew he was interested in buying TSC, and then in engaging in little or no oversight of the sale process. But the court dismissed the claims against the outside directors, as exculpated by i2’s § 102(b)(7) provision. The court held that the outside directors’ grossly negligent conduct, even if reckless, did not rise to the level of bad faith, which conduct is not exculpated by the statutory protection. Lack of good faith requires an “intentional dereliction of duty or the conscious disregard for one’s responsibilities.” Because the directors’ conduct constituted a breach of the duty of care and not bad faith, the exculpation provision required dismissal of the claims against the outside directors. The court denied the motion to dismiss with respect to Dubreville (who

¹⁸ C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008).

¹⁹ 2008 Del. Ch. LEXIS 123 (Del. Ch. Aug. 29, 2008).

was not a director), however, holding that the complaint stated a claim for breach of fiduciary duty against Dubreville as an officer. That breach of the duty of loyalty was not exculpated by the § 102(b)(7) provision, which does not apply to officers.

In *Ryan v. Lyondell Chemical Co.*,²⁰ plaintiff challenged a cash sale of Lyondell Chemical Company, a healthy, non-distressed company, to a strategic acquirer at a 45% premium. The board consisted of ten independent directors and the CEO. The board had not placed the company up for sale or engaged in a sale or valuation process. The CEO engaged in negotiations with the acquirer and established many of the terms of the transaction—including the buyer’s price expectation—before informing the board of the buyer’s interest and seeking board approval and a fairness opinion. Because of the poor optics resulting from the CEO’s control of the process before informing the board and the board’s brief and seemingly lackluster involvement, the Court of Chancery held that there were issues of fact and refused to grant summary judgment for the defendants on plaintiff’s *Revlon* claims. The Court of Chancery refused to certify an interlocutory appeal, but the Delaware Supreme Court accepted the appeal, apparently on the basis that the appeal raises a substantial question and the Court of Chancery’s decision may conflict with other decisions of the Court of Chancery. The appeal is currently in the briefing stage.

In *Schoon v. Troy Corp.*,²¹ the Delaware Court of Chancery decided that a former director was not entitled to advancement in litigation alleging that the former director had breached his fiduciary duties. When the director served as a director, the company’s bylaws had provided advancement for current and former directors. After his resignation, the board amended the bylaws to eliminate advancement for former directors. The former director had no contract providing for advancement, and contended that the amendment could not terminate his rights to advancement because they vested when he took office. The court held that the right to advancement vests when proceedings are initiated, not when the director takes office. Because the former director’s rights had not yet vested when the bylaw was amended, the corporation could unilaterally eliminate the right to advancement provided in the bylaws. In light of *Schoon*, rather than relying on advancement provisions in the bylaws, directors may wish to obtain contractual rights to advancement, which cannot be unilaterally terminated by the corporation.

In *National American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,²² creditors brought a direct claim for breach of fiduciary duty against directors of a Delaware corporation operating in the zone of insolvency. The Delaware

²⁰ 2008 Del. Ch. LEXIS 105 (Del. Ch. July 29, 2008).

²¹ 948 A.2d 1157 (Del. Ch. 2008).

²² 930 A.2d 92 (Del. 2007). For a discussion of *Gheewalla* and other “vicinity of insolvency” cases, see E. Norman Veasey, *Counseling the Board of Directors of a Delaware Corporation in Distress*, AM. BANKR. INST. J., June 2008, at 1.

Supreme Court held that: (a) creditors may not assert *direct* claims for breach of fiduciary duty against directors of a solvent corporation, whether or not it is operating in the “zone of insolvency;” and (b) creditors may not assert *direct* claims for breach of fiduciary duty against directors of an insolvent corporation. *Gheewalla* also states (in dicta, because the plaintiff did not raise any derivative claim) that creditors of an insolvent corporation have standing to assert derivative claims on behalf of the corporation for breach of fiduciary duty. The Court does not address, even in dicta, whether creditors of a solvent corporation in the “zone of insolvency” may assert derivative claims. Moreover, the Court in *Gheewalla* also declined to set forth a precise definition of “zone of insolvency.”