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NEWSLETTER OF THE MERGERS & ACQUISITIONS PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

Delaware Supreme Court Rules on the Scope of the Business Judgment Rule, Confirms the Existence of Fiduciary Duties Owed by Officers, and Limits the Doctrine of Shareholder Ratification

David Grinberg and Matthew O'Loughlin

The recent Delaware Supreme Court decision in *Gantler v. Stephens* has provided new guidance on a number of issues impacting companies engaging in transaction activity. As expanded below, the *Gantler* decision contains further insights on standards of review applicable to actions by a board, confirmation that fiduciary duties are owed by officers under Delaware law, and clarification of the scope of shareholder ratification. Specifically, the Delaware court ruled that:

- Absent conflicts of interest, the decision by a board of directors to terminate merger discussions and abandon a sale process is protected by the business judgment rule;
- The enhanced scrutiny standard under *Unocal* is applicable only where defensive actions are taken by a board beyond merely rejecting an acquisition proposal;
- Officers of Delaware corporations owe the same fiduciary duties of care and loyalty to shareholders as directors owe to shareholders; and
- Shareholder votes cannot serve to ratify a challenged decision of a board of directors where the shareholder vote was itself required by law to approve a particular action.

Background to the Litigation

In August 2004 the board of directors of First Niles Financial, Inc., a Nasdaq-listed savings and loan holding company, authorized a process to sell the company and retained financial and legal advisors to assist with this process. Out of the six prospective bidders contacted, three submitted bids, of

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which two were actively pursued by the board. Cortland Bancorp offered $18 per share in a mix of cash and stock, which represented a 3.4% premium, and First Place Financial Corp. offered $18 to $18.50 per share in a stock-for-stock transaction, representing a 3.4% to 6.3% premium.

Cortland withdrew its bid due to the alleged failure of First Niles' management to provide due diligence materials on a timely basis, while First Place, after conducting diligence, raised its offer to a price representing an 11% premium. Despite this increase, the First Niles board rejected First Place's offer and abandoned the sale process altogether.

The board instead elected to pursue a reclassification transaction to privatize the company. Under the proposal, holders of 300 or fewer shares of common stock would have their shares converted into a newly issued series of preferred stock with no voting rights (other than in connection with a proposed sale of the company), would be entitled to dividends, and would have the same liquidation rights as common stock. After unanimous approval by the board, 57.3% of the company's outstanding shares ultimately approved the transaction, including a close majority of shares held by non-affiliates.

Several breach of fiduciary duty claims were brought against the officers and directors of First Niles based on their rejection of the offer of First Place, allegations that they disseminated a materially false and misleading proxy statement, and claims based on the officers and directors effecting the recapitalization transaction. The Delaware Chancery Court had dismissed all claims raised in the complaint. In so doing, the court deferred to the board's decision to abandon the sales process under the business judgment rule and concluded that even though a majority of the board voting on the recapitalization lacked independence, the subsequent approval vote of the disinterested shareholders ratified its decision, entitling it to the protection of the business judgment rule. However, on appeal, while the Delaware Supreme Court agreed with the Chancery Court's view that the business judgment rule would typically apply to review the actions of a board, it determined that in this case the stricter entire fairness standard would apply. In making this determination, the Delaware Supreme Court reversed the lower court's decision and provided some significant developments and clarifications in Delaware law.

More Insight on Standards of Review in the Sale Context

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The court concluded that the decision by a board of directors to cease due diligence, reject a merger offer, and abandon a sale process is normally reviewed under the business judgment rule (which gives deference to the decisions of a board which acted on an informed basis and in good faith). This is because implicit in the board's authority to propose a merger is also the power to decline to engage in such a transaction. In circumstances where the business judgment rule applies, boards are able to "just say no" to merger and other similar transaction offers if the board acts within the bounds of the duties of loyalty and care.

However, with respect to the facts in this case, the court determined that the application of the business judgment rule was not appropriate. In this case, the Court determined that the plaintiff had adequately alleged facts, for purposes of surviving a motion to dismiss, of disqualifying conflicts of interest by a majority of the directors sufficient to rebut the business judgment presumption. Specifically, the plaintiffs alleged that certain directors were acting based on preserving their positions with the company and preserving valuable business opportunities, and therefore were self-interested in maintaining the status-quo. As a result of the allegations of disloyalty, the court determined that the decisions of the board of directors should be reviewed under the entire fairness standard rather than under the less stringent business judgment rule.

The court did agree with the lower court that the enhanced scrutiny standard under *Unocal* (relating to the appropriateness of defensive measures in response to perceived threats touching on control) did not apply to this case. Specifically, the court rebuffed the notion that merely rejecting an acquisition offer and ending merger discussions was by itself a defensive action triggering the enhanced scrutiny standard (which requires directors' actions be reasonable and proportionate to a perceived threat).

Boards should be cognizant that where directors have interests different to that of shareholders, the higher standard of entire fairness may apply to their deliberations rather than the business judgment rule. In addition, the case reminds directors that, prior to abandoning merger discussions, the board should actively discuss such decisions and ensure that they are well informed. Furthermore, management should terminate the due diligence process only after obtaining board authority to do so.

Officers of Delaware Corporations Owe the Same Fiduciary Duties as Directors

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As part of its analysis, the court stated for the first time that officers of Delaware corporations owe fiduciary duties of care and loyalty in the same manner as directors. Although this is the first explicit statement from the Delaware Supreme Court on the existence of officer fiduciary duties, the court noted that it has implied this position in the past and practitioners have operated under the presumption that officers owed fiduciary duties similar to those owed by directors.

The court did note – highlighting likely legislative action in the future – that while the Delaware General Corporation Law currently provides that a corporation may adopt a provision in its certificate of incorporation exculpating its directors from monetary liability for an adjudicated breach of their duty of care, no such protection is available in the statute to exculpate officers.

In the case at issue, the claims that the officers had breached their fiduciary duties arose from alleged delaying tactics by the officers to slow-down the due diligence process with prospective bidders. The plaintiff alleged that the officers had taken such action without advising the board. With the court's explicit ruling that officers owe the same duties as directors, companies should ensure that robust policies have been instituted and communicated to ensure that officers are apprised of their fiduciary duties and to minimize the potential for successful claims against officers. Companies should review the officer indemnification provisions in their bylaws, in individual indemnification agreements with their officers and the coverage provided in their directors' and officers' insurance policies.

The Doctrine of Shareholder Ratification Has Significant Limits

Finally, the court rejected an argument that the approval of the recapitalization transaction by a majority of disinterested shareholders acted as a defense to cleanse the board's decision. The court noted that the scope of the doctrine of shareholder ratification prior to this decision was unclear, and it took this opportunity to clarify the doctrine. Specifically, the court ruled that shareholder approval serves to ratify a challenged board decision only in circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to be effective. In other words, the court chose to confirm that the doctrine applies only in its "classic" sense where a board seeks shareholder ratification of a board action and not where shareholder approval is otherwise required as part of validly approving an action.

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The court also clarified that shareholder ratification does not validly extinguish a challenge to board action but instead subjects the challenged action of the board to a business judgment rule level of review. The one type of claim that is validly extinguished is a challenge to a board's authority to take action if that action was later ratified by shareholders. The court also noted that its determination should not be viewed as altering the laws in connection with Delaware's interested-director statute. As a result, approval by disinterested shareholders of an interested transaction would still prevent a court from voiding the transaction by reason of the conflict of interest.

This decision of the court serves to significantly limit the scope of shareholder ratification as a defense to board action. The court was clear that, to the extent ratification is available, such ratification covers only director action or conduct that the shareholders are specifically asked to approve and does not cleanse related acts or conduct. Consequently, boards should consider carefully the limits of shareholder ratification and, if sought, the specificity of such ratification with respect to actions and conduct of the board.

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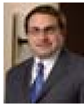
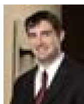


David Grinberg Mr. Grinberg's practice focuses on mergers and acquisitions, including tender offers, proxy contests, hostile takeovers and special committee representation, and underwritten securities offerings, including initial public offerings and public and private offerings of equity and debt.



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