Corporate and Securities Alert:

Delaware Supreme Court Confirms Officers' Fiduciary Duties and Refines the Application of the Common Law Doctrine of Shareholder Ratification

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The Delaware Supreme Court's recent decision in *Gantler vs. Stephens* (Del. January 27, 2009) – where the Court issued a rare reversal of a Court of Chancery decision – contains several noteworthy holdings on core corporate governance principles, including "entire fairness" review of a breach of fiduciary duty claim, the fiduciary duties of corporate officers, and the applicability of the common law doctrine of shareholder ratification to corporate transactions. The case arose from a complaint challenging the decision of the board of directors of First Niles Financial, Inc. ("First Niles") to reject a merger proposal.

Key Determinations:

- A board decision not to pursue a merger opportunity is normally reviewed under the standard of the business judgment rule. However, where a plaintiff pleads sufficient facts to support a claim of director self-interest, then the decision could be reviewed under the more rigorous entire fairness standard.
- Corporate officers owe fiduciary duties to the corporation and its stockholders that are identical to those owed by corporate directors.
- Where stockholder approval of a transaction is statutorily required, this stockholder approval will not operate to also ratify the challenged conduct of interested directors in connection with that transaction.

Factual Background

Plaintiffs' allegations are summarized as follows. The board of directors of First Niles began exploring a potential sale of First Niles in 2004. At the same time, the CEO and Chairman of the company was advocating an alternative proposal to "privatize" the company. The board received bids from three potential buyers and the company's financial advisor opined that all three bids were within an acceptable range. The board did not pursue one of the bids that made it clear that the First Niles board would not be retained. The management team was either unresponsive, or slow, in providing requested due diligence materials to the other bidders and one bidder then withdrew its bid. Following diligence, the final remaining bidder submitted an improved offer to the board. At a special meeting, a majority of the Board, without any discussion or deliberation, voted to reject that offer and the sales process was terminated.

Management and a special committee of the Board then proceeded to develop a plan for the privatization of the company. They ultimately approved an amendment to First Nile's certificate of incorporation to reclassify shares of holders of 300 or fewer of First Niles shares into a new series of preferred stock with very limited voting rights, enabling First Niles to delist its shares. The reclassification was approved by holders of 57.3% of the company's outstanding shares; however, of the shares held by persons other than directors and officers, the proposal was only approved by a 50.28% majority vote.

The plaintiff stockholders of First Niles brought a breach of fiduciary duty action against the defendant directors and officers of First Niles, claiming they had breached their duties of care and loyalty by improperly abandoning the sales process and effecting the share reclassification. Specifically, the plaintiffs alleged that the defendants improperly sabotaged the due diligence aspect of the sales process, terminated the sales process, and effected the reclassification, all for the purpose of retaining the benefits of continued incumbency and serving other self-interests.

The Delaware Court of Chancery dismissed the complaint for failure to state a claim, based on findings that the board's decision not to pursue a sale of the company was entitled to protection under the business judgment rule and that a disinterested majority of the stockholders had ratified the Board's actions in connection with the share reclassification by voting to approve it. On appeal, the Supreme Court reversed the Court of Chancery's decision on all counts.

Breach of Duty of Loyalty; Entire Fairness Standard

The Delaware Supreme Court noted that the decision of a board of directors not to pursue a merger opportunity is normally reviewed under the traditional framework of the business judgment rule. Under the business judgment rule, a court presumes 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 corporation. Where the business judgment rule applies, a court will not substitute its judgment for that of the board if the decision can be 'attributed to any rational business purpose'. However, the plaintiff can rebut the business judgment presumption, thereby subjecting the claim to heightened 'entire fairness' review, by pleading facts sufficient to support a reasonable inference that in making the challenged business decision, the board of directors breached either its duty of loyalty or its duty of care.

In this case, the Supreme Court found that the plaintiffs had pled facts creating a reasonable inference that the CEO's actions, in hindering the due diligence process, were motivated by his personal financial interest in not losing his long held positions with First Niles, and that other directors had also disloyally voted to abandon the sale process to preserve lucrative existing business relationships with the company. As such, the court found that the plaintiffs had pled sufficient facts to state a cognizable claim that a majority of the directors had breached their duty of loyalty and, therefore, the Court of Chancery had erred in dismissing the complaint under the deferential standard of the business judgment rule.

The Supreme Court agreed, however, with the ruling of the Court of Chancery that the actions of the First Niles board were not subject to enhanced judicial scrutiny under *Unocal*. "Enhanced judicial scrutiny under Unocal applies 'whenever the record reflects that a board of directors took defensive measures in response to a perceived threat to corporate policy and effectiveness which touches on issues of control.'"

In this case, there was no hostile takeover attempt or other similar threatened external action from which it could be reasonable inferred that the defendant directors acted "defensively". Their rejection of the acquisition offer, without more, did not constitute improper defensive conduct under Unocal.

Fiduciary Duties of Officers

The Supreme Court also explicitly held that the officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty to the corporation and its shareholders, and that the fiduciary duties of officers are the same as those of directors. Courts have long implied that officers and directors of Delaware corporations have identical fiduciary duties and the Gantler decision now expressly confirms this.

It is important to note that under Delaware law, a corporation is permitted to eliminate the personal liability of directors, **but not officers**, for claims by the corporation or its shareholders for breaches of the duty of care. (This is the so-called "raincoat" or "exculpatory" provision.) As a result, an officer who breached his duty of care to the corporation or its shareholders might be at greater risk of personal liability than a director who engaged in the same violation.

In light of the Gantler decision, companies may want to review corporate officer indemnification provisions within charter documents and indemnification agreements, and directors' and officers' insurance coverage, to ensure adequate protection for corporate officers against breach of fiduciary duty claims. While director and officer insurance policies generally cover direct shareholder suits against directors and officers for alleged breaches of the duty of care, coverage language can differ significantly among policies. In sum, companies may want to take steps to confirm that the Delaware Supreme Court's express endorsement of the fiduciary duties of corporate officers does not have unexpected implications.

Shareholder Ratification

The plaintiffs had further alleged that the defendants breached their duty of loyalty by recommending the share reclassification proposal for self-interested reasons, *i.e.* to enlarge their ability to engage in stock buybacks and to trigger put and appraisal rights under the First Niles employee stock option plan. The Court of Chancery dismissed this claim on the ground that a disinterested majority of the stockholders had "ratified" the reclassification by voting to approve it.

Seeking to clarify the scope and effect of the common law doctrine of shareholder ratification, the Supreme Court held that it should be limited to circumstances where a fully informed stockholder vote approves a director action that does not legally require stockholder approval to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the stockholders are specifically asked to approve. The Court concluded that because a stockholder vote was required to amend the First Niles certificate of incorporation to effect the reclassification, that vote could not also operate to ratify the challenged conduct of the interested directors of First Niles.

This clarification of the shareholder ratification doctrine may have implications for the corporate approval process regarding merger transactions to provide protection for directors and officers from claims of breach of fiduciary duty. Shareholder ratification has often been advanced by defendants in merger litigation to defend against such claims, and it remains unclear to what extent the Gantler decision will impact the viability of this defense in future matters involving Delaware corporations.

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