

February 2009

## Delaware Supreme Court Addresses M&A Process, Officers' Duties and Stockholder Ratification

On January 27, 2009, the Delaware Supreme Court reversed a lower court's ruling and denied a motion to dismiss where a stockholder-plaintiff challenged a board of directors' decision to abandon merger discussions and instead pursue a recapitalization. The decision is significant for several reasons. First, it confirms that a board's decision to abandon merger discussions will be reviewed under the business judgment rule as long as a majority of the directors are disinterested and independent. Second, the decision definitively establishes that officers of Delaware corporations owe the same fiduciary duties as do directors. Third, and perhaps most important, the decision significantly reduces the circumstances in which directors and officers can raise stockholder ratification as a defense to breach of fiduciary duty claims.

### Background

In *Gantler v. Stephens*, the board of directors of a Delaware corporation operating a federally chartered stock savings association (the "Company") retained an investment banker and solicited acquisition proposals in connection with a review of strategic alternatives. Although several bidders came forward, management abruptly terminated the due diligence process and the board subsequently decided to abandon all merger discussions. The board allegedly failed to engage in any deliberative process in reaching its decision. Five weeks later, the Company's

chairman and chief executive officer proposed a recapitalization pursuant to which holders of 300 or fewer shares of common stock would have their shares converted into a new issue of preferred stock. As a result, the Company would "go dark" and delist from NASDAQ. The board endorsed the recapitalization, which ultimately was approved by the Company's stockholders by a bare majority of the shares not affiliated with the directors or management.

### Stockholder Litigation

A stockholder and former director of the Company brought suit alleging the directors and officers breached their fiduciary duties by pursuing the recapitalization, forgoing the third-party merger opportunities, and making false and misleading statements in the proxy statement distributed in connection with the recapitalization. Although the Court of Chancery dismissed all of the plaintiffs' claims, its decision was reversed by the Delaware Supreme Court.

### The Decision Not to Merge

The *Gantler* decision is significant on several grounds. With respect to board decision-making processes, the court ruled that the termination of due diligence and the board's decision to abandon the merger discussions was not a defensive action triggering heightened judicial scrutiny under *Unocal*. The court made clear that *Unocal*, which requires directors' actions be reasonable

and proportionate to a perceived threat to the corporation, applies only when directors employ defensive measures. The decision to terminate merger discussions, by itself, was not "defensive."

The court then explained that:

A board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework. In that context the board is entitled to a strong presumption in its favor, because implicit in the board's statutory authority to propose a merger, is also the power to decline to do so.

However, the court found the plaintiff had pled adequate facts, on a motion to dismiss, to infer that a majority of the directors were interested for purposes of the merger discussions and the subsequent recapitalization. In support of that finding, the court determined that the Company's inside director was interested because he knew at least one of the prospective bidders intended to replace the incumbent board. The court also found that two outside directors were interested because they owned local businesses that allegedly provided significant services to the Company. Accordingly, a majority of the board was not disinterested and, therefore, its decisions were reviewable under the entire fairness standard.

## Corporate Officers Owe Fiduciary Duties

The *Gantler* court affirmed that officers of Delaware corporations owe fiduciary duties identical to those of directors. This is the first definitive statement from the Delaware Supreme Court on the issue, although practitioners and the Court of Chancery have long assumed it to be true. It is important to note that, unlike directors, officers are not protected by Delaware's exculpatory statute. Whether that distinction could have significant implications for directors who also serve as officers remains to be seen.

## Proxy Disclosures Deemed Misleading

The court held that the Company's proxy statement was misleading because it stated the board had "carefully deliberated" and given "careful consideration" to the third-party merger discussions. The court found that the plaintiff, who was a former director with knowledge of the board's discussions, had pled sufficient facts to call into question those disclosures. Moreover, the court rejected the defendants' argument that the disclosure was immaterial, concluding "a reasonable shareholder would likely find significant—indeed, reassuring—a representation by a conflicted Board that the Reclassification was superior to a potential merger which, after 'careful deliberations,' the Board ... rejected."

## Doctrine of Stockholder Ratification

Finally, *Gantler* held that stockholder ratification will not result in business judgment rule protection if the stockholder vote was otherwise required by law. In other words, stockholder ratification is a proper defense only in "circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to be legally effective." Moreover, the court stated that only the explicit action that stockholders are asked to approve will be considered

ratified, and not any related actions taken by directors or officers.

The court noted that its holding was not intended to alter the laws surrounding Delaware's interested-director transaction statute. Thus, approval by disinterested stockholders of an interested transaction should still prevent a court from voiding that transaction by reason of the conflict of interest.

## Conclusion

*Gantler* provides some comfort to directors, particularly in the present economic environment, by making clear that they can exercise their business judgment and reject significant transactions without fear of heightened judicial scrutiny as long as a majority of the board is disinterested and independent. The decision, however, also is a reminder both that board deliberations must be taken with care and be well documented and that the proxy statement must accurately describe those deliberations. The Delaware Supreme Court's decision accepted the allegations of the plaintiff, who was a former director, that the board had abandoned the merger negotiations without any discussion and that management terminated the due diligence process without board authority and without promptly informing the directors of its actions. These alleged failures supported not only fiduciary duty claims, but also challenges to the Company's proxy statement disclosures regarding the board's deliberative process.

*Gantler* also is important as an authoritative statement of Delaware law with respect to the duties of corporate officers. The Delaware Supreme Court made clear that officers owe fiduciary duties of care and loyalty that are the same as those owed by directors. Because fiduciary duty education historically has been focused on the board, corporations should now ensure that all of their officers understand the duties of care and loyalty and the laws governing conflict of interest transactions.

Perhaps the most significant aspect of *Gantler*, however, is its pronouncement on the doctrine of ratification. The court's holding precludes stockholder ratification as a defense whenever a stockholder vote is legally required. As a result, the decision largely forecloses the ability of directors and officers to assert stockholder ratification as a defense in fiduciary duty claims in a myriad of situations, including mergers, consolidations, significant asset sales, conversions and charter amendments, all of which require stockholder approval under the Delaware General Corporation Law.

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