



## **Delaware Supreme Court Finds Complaint Alleged Director Conflict Sufficient to Rebut Business Judgment Rule and Limits Application of Shareholder Ratification Doctrine**

*On January 27, 2009, the Delaware Supreme Court issued its opinion in Gantler v. Stephens, No. 132, 2008, 2009 WL 188828 (Del. 2009) reversing the Court of Chancery's dismissal of all claims brought by shareholders against corporate directors for their rejection of certain bids in favor of privatization. This decision (1) emphasizes that if a complaint sufficiently alleges that a board is conflicted with regard to a decision, the business judgment rule does not apply and a plaintiff may survive a Rule 12(b)(6) motion to dismiss; (2) holds that officers have the same fiduciary duties as directors; (3) explains why a disclosure regarding "careful deliberations" may be materially misleading at the motion to dismiss stage; and (4) clarifies that a decision by a conflicted board may be ratified by a subsequent shareholder vote if shareholder approval is not statutorily required and the shareholders are fully informed. For more information, please contact Cathy L. Reese, a principal in the Delaware office of Fish & Richardson P.C. and head of its Corporate and Chancery Litigation practice or Brian M. Rostocki or Charles B. Vincent, Associates in the Delaware office of Fish & Richardson P.C.*

The Delaware Supreme Court in *Gantler v. Stephens* reversed the Court of Chancery's dismissal of all claims for breach of fiduciary duty brought by certain shareholders of First Niles Financial, Inc. ("First Niles" or the "Company") against the Company's directors and officers related to their response to an unsolicited offer. In so doing, the Court emphasized the importance of full disclosure and reemphasized how the Court will apply the business judgment rule in light of the pleadings. The Court confirmed that *Unocal* only applies to actions in which it can reasonably be inferred that the defendants acted "defensively" and that rejection of an acquisition offer is not a defensive transaction. Examining the complaint itself, the Court held that plaintiffs had properly pled facts sufficient to establish disloyalty of a majority of the defendant directors and rebut the business judgment rule. The Court also held that the fiduciary duties of officers are the same as those of directors. The Court found that a disclosure regarding a board's "careful deliberations" could be found to be materially misleading where there are allegations that the board rejected an alternate transaction without serious consideration. Finally, the Court held that the common law doctrine of shareholder ratification is limited "to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve." *Gantler v. Stephens*, 2009 WL 188828, at \*13 (Del. 2009). Except for a claim that directors lacked the authority to take action that was later ratified, the Court held that "the 'cleansing' effect of a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether." *Id.*

The dispute in this case arose following the decision of the First Niles Board to sell the Company. Before the receipt of any bids, First Niles management proposed a privatization plan as an alternative to the sale of the company. Meanwhile, the Company received three offers from potential purchasers. The Board considered all three offers and the privatization proposal and authorized management to conduct due diligence in connection with two of the bidders. After due diligence, one bidder offered a revised bid that the Company's financial advisors opined was fair. At a special Board meeting, but "[w]ithout any discussion or deliberation," the Board voted 4 to 1 to reject this bid, and instead instructed the Company's legal counsel to investigate management's privatization plan. *Id.* at \*3.

A privatization plan proposing to reclassify shares of common stock into non-voting preferred stock with a higher dividend was developed and presented to the Board. Almost eight months later, after investigating issues related to this plan, the Board voted 3 to 1 to proceed with reclassification. Six months later, after interim changes in the Board's composition, the Board determined that the reclassification was fair and voted unanimously to amend the certificate of incorporation to effect the reclassification. The Board then submitted a preliminary proxy to the SEC, and later disseminated a revised proxy to shareholders. The reclassification proxy disclosed that the Company had received one firm merger offer and that "[a]fter careful deliberations, the board determined in its business judgment the proposal was not in the best interests of the Company or [its] shareholders and rejected the proposal." *Id.* at \*5. The shareholders approved the reclassification with a 57.3% vote. Of the disinterested shareholders, the proposal passed by a 50.28% vote.

In their amended complaint, Plaintiffs claimed that the defendant officers and directors violated their fiduciary duties by (1) rejecting a valuable opportunity to sell the Company and abandoning the sales process; (2) disseminating a misleading proxy in order to induce shareholder approval; and (3) implementing a reclassification plan of the Company's shares to benefit themselves. The Court of Chancery dismissed the complaint in its entirety, finding that it had failed to rebut the presumption of the business judgment rule in favor of the officers and directors, there were no material misrepresentations in the proxy, and that any taint in the decision to reclassify the stock was purged through ratification by a majority of the disinterested shareholders.

The Supreme Court reversed on all counts. The Court emphasized that in deciding a motion to dismiss, the complaint is to be viewed in the light most favorable to the non-moving party, and the court is to accept as true well-pled allegations and draw all reasonable inferences that logically flow from those allegations in the plaintiff's favor. *Id.* at \*5.

The Court agreed that with regard to Count I, the heightened standard of review under *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985) was inapplicable because there was no allegations of a "hostile takeover attempt or similar threatened external action from which it could reasonably be inferred that the defendants acted 'defensively.'" *Id.* at \*7. The Court noted that "[r]ejecting an acquisition offer, without more, is not a 'defensive action' under *Unocal*." *Id.* at \*7 n.23. Instead, the question was whether the complaint had alleged facts sufficient to rebut the business judgment presumption and trigger entire fairness because "[a] board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment

framework.” *Id.* at \*8. The Court also set forth a two-prong analysis required to determine whether a board decision merits the business judgment presumption (in this case, the Board’s decision to decline or terminate a merger): “First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly.” *Id.* The Court noted that to be entitled to the business judgment presumption, both questions have to be answered affirmatively.

The Court found that the complaint pled sufficient facts that the majority of the board was disloyal and reversed the dismissal of Count I as to the Director Defendants. The Court recognized that the decision to decline a merger is often rooted in “distinctively corporate concerns” of which a good faith pursuit will satisfy the first prong. *Id.* Noting that entrenchment is often a tautological argument in allegations over rejections of merger proposals, the Court reaffirmed that a plaintiff “must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.” *Id.*

The Court also found that the Court of Chancery erred in dismissing Count I as to the Officer Defendants. Here, the Court held explicitly that the “the fiduciary duties of officers are the same as those of directors.” *Id.* at \*9. The Court also noted that the consequences of a fiduciary breach of an officer as opposed to a director is not necessarily the same because Section 102(b)(7) of the Delaware General Corporate Law (“DGCL”) only exculpates its directors from liability for a breach of the duty of loyalty and there is no comparable statutory provision for officers. *Id.* at \*9 n.37. Examining the complaint, the Court found that it alleged sufficiently detailed acts that the officers also breached their fiduciary duty of loyalty. The Court reasoned that “[t]he complaint alleges that Safarek never responded to Cortland’s due diligence requests and that as a result, Cortland withdrew a competitive bid for First Niles. Those facts support a reasonable inference that Safarek and Stephens attempted to sabotage the Cortland and First Place due diligence process.” *Id.* at \*10. The Court reversed the dismissal of Count I as it applied to the officers of the Company.

The Court next reversed the Court of Chancery’s dismissal of Count II of the complaint after concluding that the proxy disclosures concerning the deliberations about one of the bids were material and materially misleading. Recognizing that “a corporate board is not obligated to disclose in a proxy statement the details of merger negotiations that have ‘gone south,’ the Court found that the disclosure of “careful deliberations” was misleading on the facts of this case. *Id.* at \*12. In particular, the allegation that the Board had voted to reject a merger without discussion supported a reasonable inference that there were no “careful deliberations” of the merits of that transaction. *Id.* The Court also rejected the Court of Chancery’s finding that had the phrase been omitted, it would have led to the same result. Moreover, the Court noted the factual argument presented by the defendants on this issue was not appropriate on a motion to dismiss.

Finally, the Court reversed the Court of Chancery’s dismissal of Count III of the complaint, which alleged that the defendants breached their duty of loyalty by recommending the reclassification proposal for purely self-interested reasons. The Court of Chancery found that the complaint had sufficiently alleged that a majority of the directors who approved the proposal lacked independence, but that a disinterested majority of shareholders had ratified the

reclassification by voting to approve it. *Id.* at \*12. The Supreme Court reversed this ruling on two grounds: (1) “because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to ratify the challenged conduct of the interested directors;” and (2) “the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.” *Id.* at \*13.

In reversing, the Court held that “the scope of the shareholder ratification doctrine must be limited to its so-called ‘classic’ form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve.” *Id.* at \*13; *see also id.* at \*14 n.55 (“This Opinion clarifies that ‘ratification’ legally describes only corporate action where stockholder approval is not statutorily required for its effectuation.”). The Court noted that “[t]he only species of claim that shareholder ratification can validly extinguish is a claim that the directors lacked the authority to take action that was later ratified.” *Id.* at \*13 n.54. This clarification only applies to the common law doctrine of shareholder ratification, not to the jurisprudence of Section 144 of the DGCL. *Id.* Applying this doctrine, the Court found that the Court of Chancery’s ruling was legal error because the “ratification doctrine does not apply to transactions where shareholder approval is statutorily required.” *Id.* at \*14. Because the Reclassification Proxy was determined to be materially misleading, it precluded a ruling that the approving shareholder vote ratified this conduct. *Id.*