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ANNUAL REPORT 2007

The Year in Governance

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Governance 2006 headline makers: Hewlett-Packard Chairman **Patricia Dunn** and Home Depot Chairman and CEO **Robert Nardelli**

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Corporate governance litigation: 2006 review

Directors navigated in a highly charged atmosphere of rulings on 'good faith' standards, rights of controlling shareholders, propriety of defense costs, and the state of deepening insolvency — as well as an incipient storm of backdated-options suits. **By John L. Reed**

Although not a year of Enrons or WorldComs, 2006 was an extremely active year on the securities and corporate governance fronts, and directors of publicly traded corporations faced a variety of significant challenges. Highlighted by the wide-ranging stock option backdating scandal and a host of legal, accounting, and tax issues, an unprecedented number of companies found themselves in the unwelcome spotlight of the national media, government enforcers — both civil and criminal — and an energized plaintiffs' bar purporting to represent stockholders. At the same time, governance reforms introduced by the Sarbanes-Oxley Act moved to the fore as record numbers of directors were required to perform their oversight function on behalf of shareholders.

In this highly charged atmosphere, important court decisions provided guidance to boards and management in navigating this treacherous and often unfamiliar terrain. Several of those 2006 decisions, along with a preview of 2007, are highlighted below.

Oversight standards and the duty of 'Good Faith'

In *Stone v. Ritter, et al.*, 2006 WL 3169168 (Del. Nov. 6, 2006), the Delaware Supreme Court affirmed the Delaware Court of Chancery's dismissal of a derivative action against certain current and former directors of AmSouth Bancorporation, which paid approximately $50 million dollars in fines and penalties in order to resolve investigations for alleged violations of the federal Bank Secrecy Act and federal anti-money laundering regulations.

The stockholder-plaintiffs pled an oversight claim alleging that AmSouth's board faced a substantial likelihood of liability arising from its "sustained or systematic failure … to exercise oversight – [i.e.] an utter failure [by directors] to attempt to assure a reasonable information and reporting system exists" regarding compliance with applicable banking laws and regulations.

While recognizing that the compliance system instituted by AmSouth proved inadequate to assure compliance with federal law, the Court of Chancery held that plaintiffs' complaint was not viable because it failed to adequately plead "facts showing that the board was ever aware that AmSouth's internal controls were inadequate … and that the board chose to do nothing about problems it allegedly knew existed." The failure to plead particularized facts establishing that the director-defendants knew the company's controls were inadequate meant there was no actionable "bad faith," and therefore, no breach of fiduciary duty.

The court record included a report by KPMG Forensic Services which noted that AmSouth had an officer who was responsible for Bank Secrecy Act and anti-money laundering matters, for training staff, and for reporting and presenting proposed policy changes to the board. The officer was assisted by a compliance department with 19 staff members. In addition, the company had a corporate security department, headed by a former U.S. Secret Service agent, and a suspi-

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cious activity oversight committee, which had responsibilities supplementing those of the compliance department. Moreover, the board's audit committee reviewed these compliance programs on a quarterly basis. Finally, AmSouth's compliance assurance programs predated AmSouth's becoming aware that it was the target of any government investigation.

In light of this, the Delaware Supreme Court held that the directors acted in good faith and there was no utter lack of oversight, even though the company's compliance safeguards ultimately failed. The case is noteworthy for the Delaware Supreme Court's articulation of the necessary conditions predicate for director oversight liability. The court held that a plaintiff must plead facts showing that:

- "the directors utterly failed to implement any reporting or information system or controls," or
- "having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."

The court noted that, "in either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." Further, the case demonstrates that long-standing compliance programs that are administered by credible employees and regularly monitored by an active board will likely defeat an oversight claim. In this regard, the court stated:

> In the absence of red flags, good faith and the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.

Finally, the decision is also significant for the definitive stance taken by the Delaware Supreme Court on the role of "good faith" in the fiduciary framework of corporate governance. The court held that the duty of good faith is not an independent fiduciary duty, but rather a component of the duty of loyalty, noting that "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."

Business judgment rule protection for certain controlling-stockholder transactions

Negotiated mergers, going private deals, or other transactions involving controlling stockholders are, as a general matter, subject to heightened judicial review if challenged. Under such circumstances, the burden is on the board to prove that the transaction was entirely fair to the stockholders. Even if the transaction is approved by an independent special committee, a board comprised of a majority of independent directors, or a vote of a majority of the minority stockholders, business judgment rule protection is not available. Such procedural safeguards only shift the burden back to a stockholder-plaintiff to prove that the transaction was unfair, which means the substance of the transaction will be evaluated by a court. This is very different from transactions potentially eligible for business judgment rule protection where the court merely evaluates whether a board was fully informed (duty of care) and whether a majority of the board was independent (duty of loyalty).

This framework has now been modified by a Delaware Court of Chancery decision. In *In re PNB Holding Co. Shareholders Litigation,* 2006 WL 2403999 (Del. Ch. Aug. 18, 2006), the Delaware Court of Chancery held that a controlling-stockholder transaction, otherwise subject to entire fairness review, would be entitled to business judgment rule protection if ratified by a stockholder vote of the "majority-of-the-minority outstanding."

To effectuate its decision to reorganize itself as a sub-chapter S corporation, and to comply with S-corporation regulations, PNB Holding Company reduced the number of its stockholders from over 300 to less than 75 through a cash-out merger. It was anticipated that following the merger, only 68 stockholders would

Delaware as the 'Corporate Capital'

Most of the cases discussed here were issued by Delaware courts. Why the focus on Delaware? The answers are well known within financial and corporate America.

First, Delaware is the state of incorporation for more than 60 percent of the Fortune 500 and more than half of all companies whose securities trade on the New York Stock Exchange, the Nasdaq, and other large exchanges.

Second, the Delaware Court of Chancery, which has statutory jurisdiction over directors and certain officers of Delaware corporations as well as the governance of business entities formed under the laws of Delaware, has become the forum of choice in the United States for resolving corporate disputes. The Delaware Court of Chancery and the Delaware Supreme Court are nationally and internationally renowned, and both courts issue nationally significant corporate law decisions concerning challenges to the decisions of boards of directors, claims for breach of fiduciary duty, mergers and acquisitions litigation, issues of individual director and officer liability, and other issues arising under the corporate and business entity laws of the State of Delaware.

Third, Delaware's judicial system is consistently ranked No. 1 among the 50 states in an annual assessment conducted by the United States Chamber of Commerce, which notes the fairness, reasonableness, competency, and impartiality of the Delaware judiciary as well as its timeliness in resolving disputes.

It is for these reasons that Delaware has come to be known as the "Corporate Capital of the World."

— John L. Reed

remain in PNB. Of the stockholders who were cashed out, certain of them exercised dissenters' rights and petitioned for an appraisal of their shares, while others accepted the merger consideration and then claimed that the merger was unfair and that PNB's directors breached their fiduciary duties.

The Court of Chancery determined that the merger was subject to entire fairness review because PNB's board of directors was comprised of 10 directors, nine of whom, along with 27 of their relatives, remained as stockholders of PNB following the merger. Although there was no single "controlling stockholder," the court found that a majority of the directors were financially interested in the merger such that the entire fairness standard should apply. However, the court held that, where there is an interested transaction but no single "controlling stockholder," such a transaction would be entitled to business judgment rule protection if approved by a vote of the "majority-of-the-minority outstanding," as opposed to a "majority-of-the-minority voting."

(Note: Because a majority of the outstanding PNB shares cashed out in the merger did not vote in favor of the merger, the court found that the merger was not ratified by stockholder approval and remained subject to entire fairness review.)

The debate about when — or even whether — directors owe fiduciary duties to creditors is an evolving area of the law.

Landmark *Disney* ruling applying the duty of 'Good Faith'

The lengthy and high-profile litigation involving the Walt Disney Co. and its 1995 hiring and subsequent 1996 firing of Michael Ovitz as Disney's president came to an end last year with a ruling from the Delaware Supreme Court. In *In re Walt Disney Company Derivative Litigation,* 906 A.2d 27 (Del. 2006), the court affirmed the Delaware Court of Chancery's post-trial opinion in which the trial court found that members of the board of directors of Disney did not breach any of their fiduciary duties and did not act in bad faith in connection.

In January 1997, several Disney shareholders brought derivative actions in the Court of Chancery on behalf of Disney against Ovitz and the members of Disney's board of directors. Plaintiffs claimed that after only 14 months of employment, a $130 million termination payout based on the terms of Ovitz's employment contract was (i) the product of fiduciary duty and contractual breaches by Ovitz, (ii) breaches of fiduciary duty by the Disney directors, and (iii) a waste of the company's assets. After trial, the Court of Chancery entered judgment in favor of all defendants and dismissed all of the plaintiffs' claims.

In determining whether any directors acted with gross negligence (*i.e.*, breached their duty of care) in the selection and firing of Ovitz or the approval of his employment agreement, the Delaware Supreme Court held that the board was not required to approve the agreement as it had appropriately delegated decisions relating to employment and compensation of company officers to its compensation committee, and nothing in the Delaware General Corporation Law mandates that such decisions cannot be delegated. The court further concluded that the evidence supported a finding that discussions regarding payout scenarios and total compensation under the employment agreement had occurred and had been analyzed among all of the compensation committee members. The court held that under Section 141(e) of the Delaware General Corporation Law, committee members were entitled to rely on their fellow committee members to inform them of the status of the contract, just as the committee as a whole was entitled to rely on their executive compensation expert.

In analyzing whether the Disney board acted in "good faith," the Delaware Supreme Court first discussed the law and noted that there is an obvious lack of good faith if a transaction is motivated by an actual intent to harm. In addition, the court noted that behavior motivated by an "intentional dereliction of duty, a conscious disregard for one's responsibilities" is the type of bad faith that would rebut the presumptions of the business judgment rule and that such conduct also falls outside the boundaries of conduct that is exculpable under Section 102(b)(7) of the Delaware General Corporation Law or indemnifiable under Section 145 of the Delaware General Corporation Law.

Using these guidelines, the Delaware Supreme Court found that the directors did not breach their duty to act in good faith in connection with Ovitz's termination because there was sufficient ambiguity in the company's organic documents for the court to conclude that the board and Eisner as chief executive officer had concurrent authority to fire Ovitz. Because Eisner already had undertaken the responsibility to fire Ovitz, the board did not have to do so — i.e., the members of the board did not disregard their duties and the board was also allowed to rely on Eisner's determination.

The Delaware Supreme Court's decision regarding the hiring and firing of Ovitz demonstrates the continuing application of the bedrock business judgment rule to boards of directors of Delaware corporations. Although the defendants in the Disney case fell well short of meeting what the Delaware Supreme Court described as guidelines of so-called "best practices," their failure to do so did not result in a finding of liability. Of course, the events and transactions at issue took place approximately 10 years ago and it is worth querying whether the conduct of the Disney board would pass muster in today's arena of corporate governance.

Limiting claims by creditors against directors

The debate about when — or even whether — directors owe fiduciary duties to creditors is an evolving area of the law. In *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006), the Delaware Court of Chancery definitively weighed in on the issue when it dismissed a tort claim that has become known by the popular name "deepening insolvency."

The claim was brought by a litigation trust to recover money for the benefit of the creditors of a bankrupt corporation. Although the issue had been touched upon previously by the federal courts, which had predicted that Delaware state courts would recognize the claim, the *Trenwick* decision was the first Delaware state court decision to address and then reject the tort. In the decision, the court also took a closer look at whether additional duties are owed by directors to creditors when a company is in the "zone of insolvency" and determined that the proper exercise of the directors' business judgment is all that is required.

This case involved a public global insurance holding company (Trenwick) executing a business plan in which it acquired three additional insurance companies in quick succession. After the acquisitions, the businesses reorganized themselves so that one of Trenwick's U.S. subsidiaries (Trenwick America) became the intermediate parent to all of the holding companies of the U.S. operations. Trenwick America also became the guarantor of the overall debt of its parent, Trenwick. As guarantor, Trenwick America was the primary guarantor of

Preview: Some stock option backdating cases survive early dismissal

In two early 2007 decisions, the Delaware Court of Chancery tackled for the first time issues related to the dating and timing of stock option grants. In *Ryan v. Gifford*, C.A. No. 2213-N (Del. Ch. Feb. 6, 2007) and *In re Tyson Foods, Inc. Consol. S'holder Litig.*, C.A. No. 1106-N (Del. Ch. Feb. 6, 2007), the court denied the directors' motions to dismiss the derivative lawsuits brought by shareholders, signaling a reluctance at the pleading stage to apply the business judgment rule to dismiss actions alleging director involvement in the granting of inaccurately dated options.

In *Ryan v. Gifford,* the plaintiff sued members of the compensation committee and other directors of Maxim Integrated Products Inc., alleging that they had breached their fiduciary duties by approving backdated options that violated shareholder-approved stock option plans. The plaintiff alleged that the plans specifically provided that the exercise price of all options would be no less than the fair market value of Maxim's common stock on the day the options were granted. The complaint also referenced a statistical analysis by Merrill Lynch which indicated that the 20-day return on options granted to Maxim's management averaged 14 percent over the five-year period between 1997 and 2002, resulting in an annualized return 10 times higher than the annualized market return for the same period. The court found that the plaintiff's claims were sufficient to survive a motion to dismiss, notwithstanding defendants' arguments, *inter alia,* that (1) plaintiff had neither made a demand on the board requesting the company bring the lawsuit itself nor adequately alleged that making such a demand would have been futile; and (2) the challenged conduct was protected by the business judgment rule.

Accepting the pleaded facts as true for purposes of the motion to dismiss, the court concluded that a demand on the board was excused because the stock option plans did "not grant the board discretion to alter the exercise price by falsifying the date on which options were granted. Thus, the alleged facts suggest that the director defendants violated an express provision of two option plans and exceeded the shareholders' grant of express authority." As an alternative ground for excusing demand, the court also found that there was sufficient reason to doubt that the board could be independent and disinterested when all three of the committee members who approved the challenged grants remained on the six-member board at the time the complaint was filed. The court noted that a "director who approves the backdating of options faces at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders … and yet satisfy his duty of loyalty." The court added that "[b]ackdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment. …' " Because half of the current board members served on the compensation committee that granted the allegedly backdated options, the court concluded that plaintiff had adequately alleged violation of an express provision of the stock option plans and, if proven, that such conduct could not be viewed as a valid exercise of business judgment.

Issued on the same day as the *Ryan* decision, the *Tyson Foods* opinion addressed the alleged "spring loading" of stock options. Spring-loaded options are granted just before the release of news that would cause the stock price to go up. While noting that it was unclear whether spring loading constituted a form of insider trading, the court stated that a "director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary." The court concluded that plaintiffs' averments that the directors of Tyson Foods Inc. approved grants while in possession of material nonpublic information and with the intent to circumvent the shareholder-approved restrictions upon the pricing of options were sufficient to survive a motion to dismiss. The court found, however, that the spring-loading claim was alleged properly only as against the directors who were members of the compensation committee that had approved the options, and not against the entire board. The court also found that the pre-suit demand for relief upon Tyson's board was excused. Finding that the plaintiffs had alleged a "conspiracy-style theory" of transactions that benefited the directors, the court concluded that the allegations "raise a reason to doubt the disinterestedness and independence of the board, justifying excusal of demand."

Although a complaint alleging spring loading

$260 million of a $490 million line of credit for Trenwick, the secondary guarantor of the remaining debt on the line of credit, and it assumed responsibility for approximately $190 million in debt securities of Trenwick. Trenwick and its subsidiary, Trenwick America, later filed for bankruptcy.

The plan of reorganization approved by the bankruptcy court created a litigation trust with the right to prosecute claims belonging to the bankrupt estate of Trenwick America. The litigation trust filed a complaint on behalf of the creditors of Trenwick America against the former directors of Trenwick, the former directors of Trenwick America, and various former professional advisors of Trenwick alleging that Trenwick employed a bad business strategy when it acquired insurance companies that were in poor financial condition due to underestimation of insurance claims and that such bad business strategy caused Trenwick and its Trenwick America subsidiary to become insolvent, resulting in financial harm to Trenwick America's creditors.

At the core of "deepening insolvency" is the issue of insolvency itself. In many states, the fiduciary duties of officers and directors have been held to extend solely to the company's shareholders unless the company is actually insolvent. However, courts in some states have ruled that fiduciary duties to creditors arise prior to actual insolvency, at the point at which a company moves into the so-called zone of insolvency.

The debate was picked up by the Court of Chancery and fleshed out in *Trenwick*. The court noted that the use of the words "insolvency, or more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure." As the court further stated:

> The general rule embraced by Delaware is the sound one. So long as directors are respectful of the corporation's obligations to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests have become the firm's principal objective.

For the past several years, litigation targets for "deepening insolvency" claims have included directors and officers, lenders, financial advisors, turnaround consultants, accountants, and attorneys. Such claims typically allege that a company, while actually insolvent or within the zone of insolvency incurred, or was caused to incur, additional debt, and/or its corporate life was prolonged by artificially maintaining liquidity and concealing its true financial condition, causing damage to the company, its shareholders, and its creditors.

State law determines whether a claim based on "deepening insolvency" may be brought against likely targets, and Trenwick is a very significant decision for companies incorporated in Delaware. The Court of Chancery held unequivocally that "Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept."

may survive a motion to dismiss, proving breach of the duty of loyalty may be difficult under *Tyson Foods*. The court set forth the required showing as follows: A plaintiff must show that (1) the options were issued pursuant to a shareholder-approved plan; (2) the directors who approved the options possessed material nonpublic information; and (3) the directors issued the options with the intent to circumvent the restrictions on exercise price set forth in the approved plan. The scienter showing suggested in *Tyson Foods* may prove an insurmountable hurdle for many plaintiffs.

While the tone and approach adopted in the *Ryan* and *Tyson Foods* opinions suggest that plaintiffs may avoid pre-suit demand requirements, it is important to note the unique facts on which the court relied:

- In *Ryan,* the court expressly relied on the language of the stock option plan which provided that "the exercise price of each option shall be not less than one hundred percent (100 percent) of the fair market value of the stock subject to the option on the date option is granted." The stock option plans of many companies either explicitly permit the issuance of discounted options or use less stringent language. For example, in *Tyson,* the court noted that the stock option plan permitted the issuance of nonqualified stock options at a price "equal to, less than or more than" the fair market value on the date of the grant. Thus, where a stock option plan may be read to authorize discounted options, demand should not be excused and the business judgment rule should remain available.
- As noted above, Maxim's three-person compensation committee, which had approved the allegedly backdated options, comprised half of the total board and continued to serve on the board at the time of the complaint. Although the court concluded that demand would be futile under those circumstances, the same conclusion would not necessarily apply where the compensation committee comprised less than half the board or where the board membership had changed, thus leaving a majority of disinterested and independent directors free to consider the demand.

Additionally, a federal court recently held that plaintiffs asserting claims based on alleged option backdating bear the same burden as any other derivative plaintiff to plead particularized facts to overcome the presumption of good faith and to create a reasonable doubt that a majority of the directors are disinterested or independent. See *In re Linear Tech. Corp. Deriv. Litig.,* C-06-3290-MMC (N.D. Cal. Dec. 7, 2006) (applying the traditional standards of demand futility and application of the business judgment rule and dismissing complaint).

The *Ryan* and *Tyson Foods* opinions represent strong pronouncements by the Delaware Court of Chancery that intentional backdating or spring loading of stock options, if proven, constitute violations of a director's duty of loyalty. Given the prominence of the Delaware courts in matters of corporate law, these holdings will be influential in future cases involving challenges to the dating of stock option grants, even in cases governed by the corporation statutes of other states.

— John L. Reed

In making its point, the court further stated:

> Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.

With respect to whether fiduciary duties are owed to creditors, the court held that:

> If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

(Note: This case is currently on appeal before the Delaware Supreme Court. On May 18, 2007, the Delaware Supreme Court, in another case (*North American Catholic Educational Programming Foundation, Inc., v. Gheewalla, et al.*, No. 521, 2006), ruled that creditors cannot pursue direct claims for breach of fiduciary duty regardless of whether the company is in the "zone of insolvency" or even "insolvent.")

Many companies bowed to prosecutorial pressure and stopped advancing legal fees.

Controlling stockholder can have direct liability for harm that is also derivative

In *Gentile v. Rossette,* 906 A.2d 91 (Del. 2006), plaintiffs, former stockholders of SinglePoint Financial Inc., brought a claim for breach of fiduciary duty against SinglePoint's former directors and its former chief executive officer, Pasquale David Rossette, who also was SinglePoint's controlling stockholder. Plaintiffs challenged an alleged self-dealing transaction in which Rossette forgave the corporation's $3 million debt to him in exchange for stock of SinglePoint, which had a value that exceeded the value of the forgiven debt. The transaction reduced the cash value and the voting power of the public stockholders' minority interest in SinglePoint and increased the value and voting power of Rossette's majority interest correspondingly. After the debt was forgiven and the stock was issued, SinglePoint was acquired by another company (Cofiniti) in a merger. Shortly after the merger, Cofiniti filed for bankruptcy and was liquidated.

Plaintiffs filed an action in the Delaware Court of Chancery seeking to recover the value that plaintiffs claimed to have been wrongfully deprived in connection with the forgiveness of debt and the issuance of stock to Rossette. The court dismissed the action on the basis that the harm flowing from the claim was suffered only by the company, and therefore, the claim was derivative. As a result of the merger with Cofiniti, plaintiffs lost standing to assert the claim on behalf of SinglePoint.

On appeal, the Delaware Supreme Court recognized that the issue presented by plaintiffs was "one purely of law: can SinglePoint's former minority stockholders bring a direct claim against the fiduciaries responsible for the debt conversion transaction complained of, or is such a claim exclusively derivative?" After initially acknowledging that "[n]ormally, claims of corporate overpayment are treated as causing harm solely to the corporation and, thus, are regarded as derivative," the court then stated:

> There is, however, at least one transactional paradigm — a species of corporate overpayment claim — that Delaware case law recognizes as being both derivative and direct in character. A breach of fiduciary duty claim having this dual character arises where: (1) a stockholder having majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.

Such a transaction, the Delaware Supreme Court noted, (i) harms the corporation because of the "overpayment (or 'over-issuance') of shares" and the corporation "has a claim to compel the restoration of the value of the overpayment," and (ii) harms the minority stockholders because the shares that represent the "overpayment" embody both economic value and voting power being transferred improperly "from the public shareholders to the majority or controlling stockholder" and the minority stockholders have a claim "to recover the value represented by that overpayment."

Advancing defense costs does not evidence a lack of cooperation with the government

It is no secret that, in the last few years, the United States government has made corporate misconduct one of its top prosecutorial priorities. The government has not shied away from investigating and, at times, indicting business organizations for fraud and other wrongdoing. Companies are facing ever-increasing pressure from the Securities and Exchange Commission, Department of Justice, U.S. Attorneys Offices, and other agencies to cooperate with investigators in order to avoid the potentially fatal consequences of a criminal case.

Many companies understand that full cooperation with the government is the best, and perhaps only, way to avoid an indictment of the company. In this context, a company's advancement of legal defense fees for employees and directors charged or investigated as a result of doing their jobs — a regular practice among many corporations — has come under close government scrutiny. Fearful that any advancement of legal fees would be construed by the government as evidencing a lack of cooperation, many companies bowed to prosecutorial pressure and stopped advancing legal fees, leaving officers and directors with substantial legal bills to pay on their own or, more likely, forcing them to forego a full defense or plead guilty because the defense costs were beyond their means.

"The government," the court stated in a stinging rebuke, "has violated the Constitution it is sworn to defend."

This predicament was a recent phenomenon. Many states permit a corporation to obligate itself to advance its officers' and directors' legal defense costs during a government investigation. Recent decisions in Delaware, for example, have strictly enforced a corporation's duty to advance legal fees to executives as provided by Section 145 of the Delaware General Corporation Law. These legal obligations and longstanding corporate practices, however, were at odds with a memorandum issued by then-Deputy Attorney General Larry D. Thompson on January 20, 2003 (known as the "Thompson Memorandum," available at www.usdoj.gov/dag/cftf/corporate_guidelines.htm). In the memorandum, the Justice Department set guidelines for the prosecution of business organizations. Notably, the department advised that "a corporation's promise of support to culpable employees and agents … through the advancing of attorneys fees … may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation." The term "culpable" was not defined, thereby affording

Miscellaneous Cases

Interpreting Merger Agreements: In *Energy Partners Ltd. v. Stone Energy Corporation,* 2006 WL 2947483 (Del. Ch. Oct. 11, 2006), the Delaware Court of Chancery interpreted a "no shop" provision in a merger agreement and concluded that the provision at issue did not restrict the acquiring corporation from negotiating with a third party bidder. In reaching its decision, the court reaffirmed that settled contract interpretation principles apply to merger agreements, but noted that merger agreements must also be construed in accordance with fiduciary duty principles with which the parties are familiar during the negotiation process.

Federal versus State Law Obligations: In 2005, the Delaware Court of Chancery found that a corporation's inability to issue an annual report or to solicit proxies under the federal securities laws did not excuse a Delaware corporation from holding an annual meeting to elect directors each year as required by Section 211 of the Delaware General Corporation Law (*New Castle Partners, L.P. v. Vesta Insurance Group, Inc.,* 887 A.2d 975 (Del. Ch. 2005), *aff'd,* 906 A.2d 807 (Del. 2005)). In *Esopus Creek Value L.P. v. Hauf,* 2006 WL 3499526 (Del. Ch. Nov. 29, 2006), the Court of Chancery extended the reasoning of that decision to asset sale transactions requiring a stockholder vote pursuant to Section 271 of the Delaware General Corporation Law.

Hedge Fund Litigation: In recent years, hedge funds have become dominant players in corporate America. In addition to investing extraordinary amounts of capital, hedge funds have not shied away from direct confrontation with corporate boards when the hedge funds question the board's competence or business plans. Consistent with this aggressive approach, hedge funds increasingly have turned to the courts for redress for their concerns.

In *Highland Select Equity Fund, L.P. v. Motient Corporation,* 906 A.2d 156 (Del. Ch. 2006), a hedge fund made a demand for books and records pursuant to Section 220 of the Delaware General Corporation Law during a proxy contest. The hedge fund's demand letter, in which it set forth its so-called "proper purpose" to review the records, was 25 pages and contained 47 separate paragraphs of substantive demands. This overly broad demand, along with other actions, led the Delaware Court of Chancery to conclude that "[t]hese facts described a remarkable confluence of events that amount to an abuse of the Section 220 process, designed for some purpose other than to exercise Highland Select's legitimate rights as a stockholder." The Court denied the hedge fund access to any corporate records, and the decision was recently affirmed by the Delaware Supreme Court.

In *Accipiter Life Sciences Fund, L.P. v. Helfer,* 905 A.2d 115 (Del. Ch. 2006), the Delaware Court of Chancery considered a claim by a hedge fund that a corporation "buried" the announcement of an annual meeting in a press release reporting the corporation's earnings and, as a result, caused the hedge fund to miss the deadline for nominating an opposing slate of directors. The court denied the hedge fund's claims, putting hedge funds on notice that the court is unlikely to find that a sophisticated hedge fund is entitled to equitable relief for its own failure to properly monitor a corporation's public disclosures.

— *John L. Reed*

government attorneys broad discretion in determining when a corporation is cooperating and when, in the government's view, it is not. The Thompson Memorandum created perverse incentives that pit a corporation against its own executives and directors suspected of wrongdoing.

The perils and predicaments that companies and their executives face as a result of the Thompson Memorandum were highlighted in the U.S. government's prosecution of former KPMG LLP employees accused of selling fraudulent tax shelters. In that case, the defendants contended that the government strong-armed KPMG to limit, or threaten to withhold, legal fees from partners or employees who were subjects during the investigation and defendants in the pending criminal action.

In a stinging rebuke to federal prosecutors and the Thompson Memorandum, the United States District Court for the Southern District of New York (*United States of America v. Stein,* 435 F. Supp. 2d 230 (S.D.N.Y. 2006)) concluded that the Thompson Memorandum was unconstitutional and violated the KPMG defendants' substantive due process rights and their constitutional right to counsel. "The government," the court stated, "has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend." Concluding that "KPMG refused to pay [its employees' defense fees] because the government held the proverbial gun to its head," the court offered two remedies for the defendants: either KPMG could advance defense costs, or the defendants could obtain, in a separate proceeding, a court order mandating advancement.

The KPMG decision should influence prosecutors to back off from implementation of the Thompson Memorandum, at least temporarily, which is good news for criminal defendants and investigative targets.

Until there is greater clarity and finality on the limits of governmental actions in these investigations and prosecutions, however, corporations and their employees and directors should:

• Review their state's laws on the obligations of corporations to pay legal fees for employees who are the subject of prosecutions and government investigations.

• Review and reevaluate the company's bylaws, articles of incorporation, and any employment contracts and agreements regarding the terms and scope of the company's obligations to pay an executive or director's legal defense costs.

• Discuss the implications of funding executives' or directors' defense costs with counsel and, if possible, secure the assurance of government attorneys that such actions would not be deemed a failure to cooperate with the government.

• Review the company's D&O policies to assess their applicability and investigate other insurance products that offer coverage for employees' legal expenses incurred in connection with investigations by prosecutors and regulators, not just those legal expenses incurred after the onset of adversarial proceedings. Many government investigations do not result in an indictment or a formal proceeding, but an individual officer or director can nevertheless incur substantial legal fees without being charged civilly or criminally.

A director cannot bring a derivative action

In *Schoon v. Smith*, C.A. No. 1753-N (Del. Ch. Sept. 7, 2006), the Delaware Court of Chancery rejected an attempt by a director to pursue, in his capacity as such, a derivative action on behalf of the corporation he served. The substantive portion of the two-page letter opinion stated, in its entirety, as follows:

> Delaware law does not recognize the right of a director, acting in that capacity, to sue on behalf of the corporation he or she serves or on behalf of its stockholders. Moreover, I decline the plaintiff's invitation to revisit this issue. There are powerful policy interests embodied in both Section 372 of the Delaware General Corporation Law and Court of Chancery Rule 23.1 that militate against recognizing the standing of an individual director to bring such litigation. Any decision to alter those arrangements is properly left to the collective judgment of the General Assembly.

Clauses limiting liability in acquisition agreements are enforceable

In *Abry Partners V, L.P., v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), plaintiffs, a group of Delaware entities affiliated with a private equity firm, Abry Partners, sought to rescind a stock purchase agreement (SPA) pursuant to which they bought a portfolio company, F&W Publications Inc. from an entity owned by another private equity firm, Providence Equity Partners.

The SPA expressly stated the buyer's promise that it was not relying on any representations and warranties not contained within the SPA and that the seller made no representations to the buyer except those delineated in the SPA. The SPA also purported to limit the liability of the seller for any misrepresentation of fact contained within the SPA to damages not to exceed the amount of a contractually established indemnity fund. The SPA made that indemnity fund the exclusive remedy of the buyer for misrepresentation; thus, the seller sought to dismiss the buyer's complaint by arguing, among other things, that the SPA barred the rescission remedy sought by the buyer. According to the buyer's complaint, after closing, the buyer discovered that the company's financial statements contained material misrepresentations and did not accurately portray the company's fi-

> **"Directors are expected to seek profit for stockholders, even at risk of failure."**

nancial condition. The buyer claimed it paid $500 million for a business that was worth approximately $400 million and that it was fraudulently induced to enter the SPA.

The Court of Chancery considered whether Delaware's public policy permitted the enforcement of those SPA provisions limiting the buyer's possible remedy to the $20 million in the indemnity fund established by the SPA. When it comes to commercial parties bargaining at arms-length, the court held that non-reliance provisions should be enforced in the absence of fraud, which necessarily involves knowing misrepresentations. The court reasoned as follows:

> To fail to enforce non-reliance clauses is not to promote a public policy against lying. Rather, it is to excuse a lie made by one contracting party in writing — the lie that it was relying only on contractual representations and that no other representations had been made — to enable it to prove that another party lied orally or in a writing outside the contract's four corners.

The court also noted the economic benefits that are thought to result from the enforcement of the terms agreed to by sophisticated parties, such as the avoidance of erroneous litigation outcomes.

Of course, the Delaware Court of Chancery had to place its general observations and policy rationales within the context of this particular case, which deals not with claims of extra-contractual misrepresentations, but rather addresses the enforceability of contract terms (here, the exclusive remedy of a claim for damages in arbitration) when the contract itself was allegedly induced by fraudulent statements within that document itself. As stated by the court:

> This case, however, raises a related, but more difficult, question: to what extent may a contract exculpate a contracting party from a rescission or damages claim based on a false representation of fact made within the contract itself? Many parties premise a contract on defined representations but promise in advance to accept a less-than-adequate remedy if one of them had been induced by lies about one of those material facts?

To answer this question, the court had to balance its respect for freedom of contract against its abhorrence of fraud. While recognizing that Delaware courts are loathe to immunize fraud, the vice chancellor also pointed out the commercial reality that sophisticated businesses, such as the buyer and seller in this case, are in a better position than the courts to make judgments about their relative risk tolerance and the amount of due diligence they elect to undertake.

Accordingly, the court concluded that the buyer could avoid the SPA's contractual limitations on remedies only by showing that the seller made knowing misrepresentations in the SPA. Thus, Delaware's public policy will not countenance the seller's attempt to insulate itself from the remedy of recission if the buyer can show at trial that the seller knew the company's representations and warranties were false or that the seller itself lied to the Buyer about a contractual representation and warranty. The court noted that to establish such a lie or knowing misrepresentation, the buyer must show that the seller "acted with an illicit state of mind" in the sense that it knew the representation or warranty at issue was false. Anything less than a knowing misrepresentation will be insufficient, as the "buyer knowingly accepted the risk that the seller would act with inadequate information."

Sarbanes-Oxley does not prohibit advancement of indemnifiable expenses

In *Envirokare Tech, Inc. v. Pappas*, 420 F. Supp. 2d 291 (S.D.N.Y. 2006), the United States District Court for the Southern District of New York held that Section 402 of the Sarbanes-Oxley Act of 2002, which prohibits a publicly reporting company from making personal loans to its executive officers and directors, does not prohibit a company from advancing defense costs to its directors or officers as those costs are incurred in even though the advances are repayable if indemnification were ultimately held to be unavailable.

The Thompson Memorandum created perverse incentives that pit a corporation against its own executives and directors.

This case involved a claim by Envirokare Tech Inc., a Nevada corporation, against its former chief executive officer for a breach of fiduciary duty. As permitted by state law, the company's bylaws entitled officers and directors to be reimbursed for expenses incurred in defending a civil or criminal action arising out of their service with the company, upon receipt by the company's board of directors of a satisfactory undertaking to repay the company if a court ultimately decided that indemnification was not permitted. This provision is very common. State corporation statutes generally permit the advancement of expenses to defend indemnifiable claims. Delaware is typical in permitting companies to indemnify directors and officers. Section 145(e) of the Delaware General Corporation Law provides that "[e]xpenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action … upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section."

Under Section 402 of Sarbanes-Oxley, it is "unlawful" for a public company "directly or indirectly" … to extend or maintain credit … in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that [company]." Because its former chief executive officer would be required to repay any amounts that were advanced to him if a court decided he were not entitled to indemnification, Envirokare claimed that the advances amounted to an extension of credit, and that it was therefore prohibited from advancing his defense expenses as incurred.

Section 402 was effective immediately upon adoption of Sarbanes-Oxley and, in contrast to much of that statute, is not subject to SEC rulemaking. The Section 402 provisions are instead a part of the U.S. Criminal Code, and the SEC has declined to offer interpretive guidance in that area. From the earliest days of Sarbanes-Oxley, practitioners posed the question of whether the advancement of indemnification expenses would be prohibited under the statute.

The court in *Envirokare* did not attempt to define comprehensively what a "personal loan" under Section 402 means, but it held that the advancement of defense costs in this context do not fall within that term. The court reasoned that nothing in the legislative history of Sarbanes-Oxley indicated that the advancement of indemnifiable defense costs under state law was one of the abuses Congress intended to address, observing instead some of the multimillion-dollar personal loans to executives that received extensive press attention at the time. The court stated that if Congress intended to prohibit a practice that is explicitly permitted by the laws of every state in the United States, it would have made its purpose more explicit. ■

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