Directors' and Officers' Liability:

Corporate Governance Developments

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FEBRUARY 10, 2011

Last month, Delaware courts and a federal district court issued several decisions of interest to corporate practitioners: (i) a Delaware Supreme Court reversal of a Court of Chancery decision that had established a bright-line rule barring a stockholder plaintiff from bringing a corporate books and records action if the plaintiff previously filed a putative derivative suit; (ii) a post-trial Court of Chancery ruling providing practical guidance to boards of corporations with a controlling stockholder in conducting a process for a third-party transaction that will pass both business judgment and entire fairness review; and (iii) in a case of first impression, a California federal district court's guidance on the steps a board may and may not take to pre-determine the forum for putative stockholder derivative actions brought on behalf of the company.

Books and Records Inspections

Section 220 of the Delaware General Corporation Law, titled 'Inspection of Books and Records,' grants any stockholder who makes a written demand on the company the right to inspect books and records 'for any proper purpose,' and defines a 'proper purpose' as 'a purpose reasonably related to such person's interest as a stockholder.' Despite its prosaic-sounding title, §220 codifies an important incident of stock ownership and generates a steady stream of decisions primarily addressing, frequently after the trial of a summary proceeding, (a) whether a stockholder has demonstrated a proper purpose for an inspection of the corporate books and records, and (b) the scope of any relief that should be granted.

Where the stockholder seeks to inspect the corporation's books and records other

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than the stock ledger or stock list, the burden of proof is on the stockholder, who must establish first (1) that he has complied with the provisions of §220 respecting the form and manner of making demand for inspection of such documents; and (2) that the inspection is for a proper purpose. There is no exhaustive list of proper purposes, but the most commonly recognized proper purposes are to: (a) investigate suspected corporate mismanagement, (b) determine the value of the corporation's stock, particularly in connection with a potential exercise of a right to put those shares to the corporation, (c) communicate with other stockholders on matters pertaining to the investment, and (d) solicit the participation of other stockholders in legitimate non-derivative litigation against the defendant corporation.

Delaware courts have urged stockholders intending to file a derivative action to avail themselves both of public sources and the summary procedure embodied in 8 Del. C. §220 to inspect and copy the corporate stock ledger, stockholder list and other corporate books and records of corporations in which they have an ownership interest--calling it the 'tools at hand'--in order to prepare derivative complaints with the requirements of factual particularity required by Rule 23.1 and Delaware substantive law. For example, Delaware courts have repeatedly held that a books and records action is an appropriate vehicle to enable a stockholder to determine if its pre-suit demand on the board to take action was wrongfully refused, or if facts exist that will excuse demand.

In *King v. VeriFone Holdings, Inc.*,[1] the Delaware Supreme Court on Jan. 28 reversed the Court of Chancery's adoption of a bright-line rule that the filing by a stockholder of a putative derivative action is an 'election' that bars the stockholder from pursuing a subsequent books and records action on the subject of the derivative litigation. The case arose out of multiple putative class actions and purported derivative actions filed in California federal court shortly after Verifone announced a restatement of certain revenue. Plaintiff Charles King made no pre-suit demand on VeriFone's board of directors. The federal district court dismissed Mr. King's derivative suit for failure to demonstrate that pre-suit demand would have been futile, giving him leave to amend his complaint, if possible, with facts to support his claims of demand futility and suggested that a §220 books and records inspection might be available if Mr. King could show a proper purpose.

Mr. King then demanded inspection of VeriFone's books and records for the purpose of determining whether pre-suit demand on the VeriFone board would

have been futile, and received some but not all of the documents demanded. He filed a books and records action in Delaware, and the Court of Chancery dismissed, stating: '[S]tockholders who seek books and records in order to determine whether to bring a derivative suit should do so before filing the derivative suit. Once a plaintiff has chosen to file a derivative suit, it has chosen its course and may not reverse course and burden the corporation (and its other stockholders) with yet another lawsuit to obtain information it cannot get in discovery in the derivative suit.'

The Delaware Supreme Court reversed, determining that the Court of Chancery's bright-line rule did 'not comport with existing Delaware law or with sound policy.' The Supreme Court reaffirmed 'longstanding Delaware precedent which recognizes that it is a proper purpose under §220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, where the earlier-filed plenary complaint was dismissed on demand futility related grounds without prejudice and with leave to amend.'

The court emphasized it was not endorsing the often 'imprudent and cost-ineffective' strategic choice to file a putative derivative suit alleging demand futility without first using a books and records inspection to try to build demand futility allegations. It suggested several ways that trial courts can discourage precipitous derivative suit filings, including denying the plaintiff who brings such a suit 'lead plaintiff' status in the case. Another more severe remedy against a derivative complaint brought without adequate pre-suit investigation of facts to support demand futility allegations would be dismissal of the derivative complaint with prejudice and without leave to amend as to the named plaintiff. A third available remedy would be for the court supervising the derivative suit to grant leave to amend once, conditioned on the plaintiff paying the defendants' attorney's fees incurred on the initial motion to dismiss.

Entire Fairness

In *In re John Q. Hammons Hotels Inc. S'holders Litig.*,[2] after observing that the use of adequate procedural protections for minority stockholders could have resulted in application of the business judgment standard of review to the board's approval of an acquisition of a public company with a controlling stockholder by an unaffiliated third party, Chancellor William B. Chandler III ultimately upheld the merger under entire fairness review. By statute, a Delaware corporation's sale by merger must be

approved by a majority of the board and a majority of the corporation's outstanding voting shares. Where a shareholder with a controlling stake seeks to acquire the minority remainder of the company's shares in a negotiated merger, the controlling shareholder 'stands on both sides' of the proposed merger as both buyer and seller and bears the burden of proving the entire fairness of the proposed transaction.[3]

The initial burden of establishing entire fairness in the 'interested negotiated merger' context rests with the controlling shareholder, who must demonstrate fair dealing and fair price. However, approval of the transaction by an independent committee of directors or an informed majority of minority stockholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging stockholder-plaintiff. 'Fair price' examines the substantive terms of the transaction, and 'fair dealing' encompasses the disinterest and independence of the corporate fiduciaries, and their conduct in the transaction, including how the purchase was initiated, negotiated and structured, and the manner in which director approval was obtained. The test is not bifurcated; the court considers all aspects of the transaction before making a unitary determination.

Whether entire fairness review should apply to a transaction in which a controlling stockholder does not stand on both sides of the transaction, but its control stake (and veto power over transactions) enables it to participate in negotiations with an unaffiliated third-party acquiror has not been definitively settled. John Q. Hammons was the controlling stockholder of John Q. Hammons Hotels (JQH), and in 2004 he informed the board that he had begun discussions with unaffiliated third parties regarding a potential sale of JQH or his interest in JQH. The JQH board established a special committee of independent and disinterested directors to evaluate and negotiate proposed transactions with potential buyers on behalf of the JQH minority stockholders and to make a recommendation to the board. Ultimately, the special committee obtained a $24-pershare offer from an unaffiliated buyer for the JQH Class A common stockholders.

Mr. Hammons received the same consideration for his Class A holdings. However, Mr. Hammons also held all of JQH's Class B supervoting stock and negotiated independently with the potential buyer regarding the Class B stock and his interest in a limited partnership controlled by JQH, ultimately entering into a series of agreements entitling him to additional consideration for his Class B stock and limited partnership interest. Plaintiffs alleged that Mr. Hammons breached his fiduciary duties as a controlling stockholder by negotiating benefits for himself that

were not shared with the minority stockholders, and that the JQH board breached its fiduciary duties by allowing the merger to be negotiated through a deficient process.

In denying summary judgment motions in 2009, the Court of Chancery held that where the controlling stockholder is not on both sides of the transaction, i.e., is not making an offer to the minority stockholders, the entire fairness standard of review will not necessarily apply.[4] The court determined that although 'the use of sufficient procedural protections for the minority stockholders could have resulted in application of the business judgment standard of review,' entire fairness applied ab initio because Mr. Hammons was 'in a sense 'competing' for portions of the consideration [buyer] was willing to pay to acquire JQH' and the court perceived inadequacies in the protections of the minority stockholders' interests.

Business judgment review would have applied if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.' The vote of the minority stockholders approving the merger by itself was insufficient for two reasons: (i) the vote could have been waived by the special committee, and (ii) the vote only required approval of a majority of the minority stockholders voting on the matter, rather than a majority of all the minority stockholders.

The court reasoned that the minority's vote backstops the special committee. 'An effective special committee, unlike disaggregate stockholders who face a collective action problem, has bargaining power to extract the highest price available for the minority stockholders. The majority of the minority vote, however, provides the stockholders an important opportunity to approve or disapprove of the work of the special committee and to stop a transaction they believe is not in their best interests.' Consequently, the court determined that the majority of the minority vote must be nonwaivable, even by the special committee.

After trial, the court determined the transaction was entirely fair because (i) the special committee that negotiated and approved the transaction was independent and disinterested; (ii) its members were highly qualified and had extensive experience in the hotel industry; (iii) the members understood their authority and duty to reject any offer that was not fair to the minority stockholders as evidenced by their rejection of another bidder's offer; and (iv) the record established that the

committee was thorough, deliberate and negotiated at arm's length with two bidders over a nine-month period to achieve the best available deal for the minority stockholders. The court rejected the argument that the committee was coerced into approving the merger 'to avoid ' worse outcomes' that the minority stockholders might face,' ruling that a claim of coercion cannot be premised on the threat of simply maintaining the status quo.

As to price, the court ruled that the $24 price, representing a 300 percent premium to the unaffected stock price, was fair in relation to the fair value of the company at the time of the merger. In addition, the court stated that overwhelming support of the transaction by the minority Class A stockholders further supported the fairness of the price. Although plaintiffs tried to neutralize the effect of the minority stockholder approval by arguing it was not fully informed owing to omissions in the Proxy Statement, the court ruled that each of the alleged non-disclosure claims involved circumstances immaterial to the stockholders' decision to vote on the merger and therefore were not required to be disclosed.

Forum Selection Clauses

Delaware law authorizes a corporation's board to amend the bylaws if the corporation's certificate of incorporation grants that authority to the board. Consistent with this authority, Oracle's certificate of incorporation empowers its board to amend the bylaws, and in 2006 Oracle's board adopted a resolution amending the bylaws to adopt a forum-selection clause specifying the Delaware Court of Chancery as the 'sole and exclusive forum' for any putative derivative lawsuit brought on behalf of Oracle.

The adoption of the forum provision was announced in a Form 8-K filed with the Securities and Exchange Commission, and the bylaws also were publicly available on Oracle's website since 2006. When an Oracle stockholder filed a putative derivative action on behalf of Oracle in the U.S. District for the Northern District of California, Oracle moved to dismiss under Rule 12(b)(3) for improper venue.

Plaintiffs argued that the forum selection clause was invalid under contract principles because the stockholders did not consent to be bound by it, and any such clause belongs in the certificate of incorporation, not the bylaws. In *Galaviz v. Berg*,[5] Judge Richard Seeborg agreed, stating that while the law favors enforcement of contractual venue clauses, the essential element of mutual consent was lacking from

a forum selection clause contained in these bylaws. That is, 'the venue provision was unilaterally adopted by the directors who are defendants in this action, after the majority of the purported wrongdoing is alleged to have occurred, and without the consent of existing stockholders who acquired their shares when no such bylaw was in effect.'

Significantly, the court stated in dictum that '[c]ertainly were a majority of shareholders to approve' a forum selection clause through a charter amendment, 'the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment.' Arguably, Galaviz may be confined to instances combining one or more of: the stockholder plaintiffs purchased their shares before the amendment to the bylaws, most of the alleged wrongdoing occurred prior to the bylaw amendment, and the same directors who adopted the forum selection bylaw were named as defendants in the putative derivative action. Nevertheless, companies wishing to pre-determine the forum for any shareholder derivative litigation can maximize the likelihood of enforcement of such a provision by proposing an appropriate charter amendment.

Endnotes:

[1] 2011 WL 284966 (Del. Jan. 28, 2011).

[2] 2011 WL 227634 (Del. Ch. Jan. 14, 2011).

[3] Kahn v. Lynch Commc'n Sys. Inc., 638 A.2d 1110 (Del. 1994).

[4] 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

[5] 2011 WL 135215 (N.D. Cal. Jan. 3, 2011).