SIMPSON THACHER

DIRECTORS' AND OFFICERS' LIABILITY

DELAWARE UPDATE

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Delaware courts recently issued decisions of interest to directors and officers, including a Supreme Court opinion reaffirming the safe harbor against director liability for transactions where a majority of fully informed shareholders ratify the actions of even interested directors, and two Court of Chancery decisions solidifying the recent Delaware trend analyzed in this column last year to hold companies to bylaw provisions or agreements that grant broad advancement rights to directors and officers, regardless of how deeply the individuals seeking advancement have fallen out of favor with their company. On the subject of advancement, a tension is growing between the courts' rigorous enforcement of broad advancement provisions and the desire of companies, seeking to receive credit under the Thompson Memorandum and the *Seaboard* Report for cooperation with criminal and regulatory investigations, to avoid funding the defense of an indemnitee believed to have acted improperly.

Effects of Shareholder Ratification

In re General Motors (Hughes) Sh. Litig.[1] involved a challenge by holders of GM's Class H Common Stock -- a "tracking stock" representing an interest in the assets of GM but which paid a dividend based solely on the earnings of Hughes Electronics Corp., a wholly owned subsidiary of GM -- to a series of transactions by which The News Corp. Ltd. acquired a significant interest in Hughes. As part of an effort to divest itself of non-core businesses, the GM and Hughes management teams jointly undertook to negotiate a split-off of Hughes to News. GM management ultimately negotiated a series of transactions under which it disposed of its entire interest in Hughes. Hughes became a publicly traded company, 34% of which is owned by a subsidiary of News. GM's Class H stockholders, who previously owned approximately 80% of Hughes, received Hughes common stock and News stock worth approximately $14.00 per share in exchange for their shares, constituting total consideration of approximately $18.3 billion.

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GM mailed a combined Consent Solicitation and Prospectus seeking approval of the transactions by GM shareholders. The Consent Solicitation stated that the GM board of directors had approved the transactions and unanimously recommended that shareholders vote to approve the six proposals set forth in the Consent Solicitation, which set forth in detail the background and terms of the proposed transactions, including 70 pages of disclosure regarding the process for negotiating the transactions, the boards' consideration and approval of the transactions, and the analysis and fairness opinions of four separate financial advisors. More than 95% of the shares voted approved the various proposals.

Class H stockholders sued GM and its board alleging various breaches of the duty of loyalty, including failure to deal fairly with the GM H shareholders and compensate them fairly in the transactions, and for manipulating the shareholder vote by, among other things, usurping the voting rights of Class H stockholders by contributing 149.2 million shares of newly issued Class H stock to GM's employee-benefit plans. The pension contribution increased the number of Class H shares outstanding and reduced GM's retained economic interest in Hughes from approximately 30.7% to 19.8%, which enabled GM's ability to engage in certain types of strategic transactions involving a tax-free split-off of Hughes. Plaintiffs also challenged the adequacy of the disclosures to GM's stockholders in the Consent Solicitation.

Chancellor William B. Chandler III granted the motion to dismiss of GM and its directors after taking judicial notice of “publicly available facts that show that both classes of GM stockholders voted to approve the Hughes Transactions,” and evaluating the contents of the Consent Solicitation alleged to be materially misleading. The publicly available facts considered were GM's statements in a Form 10-Q filed with the SEC, disclosing what GM asserted were the results of the vote.[2]

The Delaware Supreme Court last month affirmed the dismissal, agreeing that the trial court on a motion to dismiss could take judicial notice of the approving shareholder vote, even if it is presented in hearsay form in SEC filings. Because no reason existed to doubt that the condition set forth in the Consent Solicitation - majority approval by holders of each class of GM stock - was satisfied, “the effect of shareholder ratification was to maintain the business judgment rule's presumptions.” The court’s affirmance strengthens the Delaware principle, noted by Vice Chancellor Strine in his denial of a preliminary injunction in *Toys “R” Us* last summer,[3] that where a majority of fully informed stockholders ratifies action of even interested directors, “an attack on the ratified transaction normally must fail.”[4] Delaware courts have approached the effect of shareholder ratification on duty of care claims differently from its effect on duty of loyalty claims. As to duty of care claims, an informed and uncoerced shareholder vote ratifying a board’s decision automatically extinguishes any claim for breach of the duty of care. Accordingly, claims that directors acted unreasonably or were not adequately informed and other similar allegations sounding in due care are eliminated by an approving vote from stockholders (or made moot by a disapproving vote).

Shareholder ratification does not automatically extinguish duty of loyalty claims. However, in the absence of a controlling shareholder who can dictate the result of the vote,

shareholder approval of a transaction invokes the protections of the business judgment rule unless the plaintiff pleads a claim for waste or that the transaction is irrational.[5] As proved the case in *Hughes*, this is a tall order for plaintiffs because to establish a claim of waste, plaintiffs must prove that no person of ordinary sound business judgment could view the benefits received in the transaction as a fair exchange.[6]

The Supreme Court also affirmed the dismissal of claims based on the adequacy of disclosures to GM's shareholders. A board of directors is not required to disclose all available information. Delaware law imposes a fiduciary duty to disclose only material information that would have a "significant effect upon a stockholder vote."[7] A fact is material if "there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote," and it would have "significantly altered the total mix of information made available."[8] To survive a motion to dismiss claims alleging a material omission, shareholders must demonstrate "that facts are missing from the [information] statement, identify those facts, state why they meet the materiality standard and how the omission caused injury."[9] *Hughes* emphatically rejected the notion that a court evaluating challenges to disclosure documents must limit itself to the portions alleged to be materially misleading. Rather, "the Court of Chancery properly considered the entire contents of the Consent Solicitation in determining whether the allegations in the Complaint stated a claim that the document was materially misleading. The Court of Chancery was not obligated to accept as true allegations that misstated or mischaracterized the entire Consent Solicitation." The Court of Chancery's meticulous review of the content of the disclosures amply demonstrated that defendants provided clear, accurate descriptions of such vital matters as the meaning and effect of the transactions and the investment bankers' analyses and opinions.

The Supreme Court also affirmed the Chancellor Chandler's rejection of the claim that the directors breached the duty of loyalty by manipulating the shareholder vote. Under *Blasius Indus., Inc. v. Atlas Corp.*,[10] Delaware courts employ a two-part analysis for vote manipulation claims under which (1) if plaintiff establishes that the board acted "for the primary purpose of thwarting the exercise of a shareholder vote," (2) then the board has the burden of demonstrating it has a "compelling justification" for its actions. The standard is rarely met, particularly when the vote does not involve election of directors or similar matters of directorial control over the company. In *Hughes*, plaintiffs principally argued that the GM board authorized the issuance Class H stock to GM's employee-benefit plans in order to thwart a fair shareholder vote, asking the court to infer that directors' primary purpose was to frustrate the shareholder franchise because the directors knew that the GM pension plans would vote their shares in favor of the Hughes transaction. The allegation failed, however, because an independent trustee had the sole authority to vote all shares contributed to the pension plans, and the franchise was not frustrated because the percentage of shares held by the pension plans was not material in determining the outcome of the vote.

Enforcement of Advancement Rights

Interim advancement of litigation expenses and corporate indemnification serve two objectives: securing able corporate officials and encouraging them to resist claims perceived to be meritless. Together with D&O insurance and DGCL § 102(b)(7) (authorizing a provision in the certificate of incorporation eliminating or limiting the liability of directors for damages for non-intentional, non-bad faith breaches of duty), corporate indemnification is a cornerstone of the effort to reduce the risk of personal liability arising out of board conduct.

Section 145 of the DGCL sets forth Delaware's statutory basis for indemnification and advancement. As in New York, the Delaware statute distinguishes between indemnification for third-party actions and derivative actions. For non-derivative actions, § 145(a) permits (but does not require) a corporation to indemnify directors and officers made or threatened to be made a party to an action for attorneys' fees actually and necessarily incurred, as well as judgments or amounts paid in settlement in civil, criminal, administrative or investigative proceedings. The indemnitee must have acted in good faith and for a purpose that he or she reasonably believed to be in the corporation's best interests. The statute expressly provides that the termination of a case by judgment or settlement does not, by itself, create a presumption that the standard of conduct has not been satisfied.

The statutory authorization for indemnification in derivative actions is narrower. In the derivative context, the corporation may indemnify directors and officers only for "expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action."[11] The statute does not authorize reimbursement of settlements paid or judgments in derivative actions.[12] The distinction reflects that in a derivative action the director or officer has allegedly breached a duty to the corporation, while in a third- party suit, the director or officer presumably acted in the best interests of the corporation when he purportedly damaged a third party, making it reasonable to expect broad corporate reimbursement. Section 145(g), however, authorizes corporations to purchase insurance covering such non-indemnifiable amounts. The same standard of conduct applies for reimbursement in derivative lawsuits as in third-party actions. Indemnification (including legal fees) becomes mandatory when the director or officer "has been successful on the merits or otherwise in defense" of any proceeding described in §145.[13]

Indemnification is never self-executing; a decisionmaker always must determine whether the proposed indemnitee acted in an indemnifiable capacity and meets the applicable standard of conduct. Section 145(d) provides that the determinations may be made by (a) a majority vote of directors who are not parties to the pertinent proceeding, even if less than a quorum; (b) by a committee of such non-defendant directors designated by majority vote of such directors, even if less than a quorum, or (c) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (d) by the stockholders.

"Advancement" is payment by the corporation during the pendency of a proceeding of expenses (principally attorneys' fees) that would be indemnifiable at the conclusion of the

proceeding. Section 145(e) authorizes advancement before final disposition of underlying litigation upon receipt of an undertaking by or on behalf of the indemnitee to repay such amount if it is ultimately determined that indemnification is not appropriate. The undertaking to repay does not have to be secured. A corporate official's entitlement under the corporation's advancement provisions to potentially indemnifiable litigation expenses during the pendency of an underlying proceeding is a separate question from whether the corporation must ultimately indemnify the official for expenses or liability covered by Section 145(a) or (b). Accordingly, issues regarding the official's alleged conduct in the underlying litigation ordinarily have no bearing on advancement. Although Delaware law does not require corporations to advance legal expenses, many corporations include mandatory advancement provisions in the corporate bylaws.

In *Brady v. i2 Technologies Inc.*,[14] Chancellor Chandler addressed the effect of a severance agreement and its indemnification provision on advancement rights granted in an earlier agreement between i2 and a now-former director. In 1996, the director had signed an indemnification and advancement agreement with i2, the obligations under which expressly survived termination of the director's employment. The director resigned in 2002 in the midst of an internal investigation into revenue recognition and financial reporting, at which time he signed a severance agreement which, among other things, obligated the Company to indemnify the director against any proceeding arising by reason of his employment at the Company. Significantly, the 2002 agreement contained an integration clause "with respect to the subject matter" of the 2002 agreement. In 2003, the director signed another agreement, under which the Company agreed to advance his reasonable attorney's fees and expenses, subject to the Company's ability to discontinue such payments at will. The director's lawyer, unfamiliar with the prior agreements with i2, negotiated a savings clause in the 2003 agreement that protected from any diminishment the rights granted in the 2002 Agreement "or that otherwise might exist."

Subsequently, the director became embroiled in various litigation related to his i2 employment and requested advancement. The Company declined payment, contending that the integration clause in the 2002 agreement abrogated the advancement rights in the 1996 agreement. The court disagreed, ruling that advancement and indemnification are "distinct concepts" and their inclusion "together in the same contracts (including the 1996 Agreement) d[id] not make them of the same subject matter." Advancement, the court stated, "is an option to borrow, triggered upon the initiation of a lawsuit or proceeding; its value lies in the cheap (usually free) access to capital required to maintain a rigorous defense," and "can exist even if indemnification is eventually determined not to apply (in which case the advanced fees would have to be repaid to the company)." Indemnification, in contrast, is paid only "upon the realization of" monetary liability. Accordingly, "the clear distinction between advancement and indemnification make them different subjects, leaving the advancement provision of the 1996 Agreement unaffected by the 2002 Agreement's integration clause." The court also awarded the director "fees on fees," *i.e.*, his legal fees incurred in vindicating his advancement rights under section 145, which are available under Delaware law (unlike New York law) where a corporation fails to tailor its indemnification bylaws to exclude "fees on fees."

In another recent advancement decision, *Radiancy, Inc. v. Azar*,[15] Vice Chancellor Stephen B. Lamb forcefully reiterated the lesson from the series of decisions addressing the extended advancement dispute between Homestore, Inc. and Peter Tafeen, a former officer. The court "emphasize[d] the unambiguous fact that corporations that voluntarily extend to their officers and directors the right to indemnification and advancement under 8 Del. C. § 145 have a duty to fulfill their obligations under such provisions with good faith and dispatch. It is no answer to an advancement action, as either a legal or logical matter, to say that the corporation now believes the fiduciary to have been unfaithful." Indeed, Vice Chancellor Lamb wrote, "it is in those very cases that the right to advancement attaches most strongly."

Radiancy involved a demand for advancement by three former directors and officers of the company in the face of (i) a Delaware lawsuit by the company and (ii) a counterclaim by the company in a case pending in Israel, both alleging that the individuals breached their fiduciary duties to the plaintiff, and committed fraud and waste in the course of their employment. Although the court concluded that the company's discretionary advancement bylaw provision for agents and employees who are not directors or officers relieved the company of any advancement obligation to one of the three individuals for the period before he became an officer and director, it enforced the mandatory advancement bylaw provision applicable to directors and officers as to most of the claims in both Delaware and Israel for which expenses were sought. Consistent with decisions in the *Homestore* litigation, the court broadly rejected the company's arguments that advancement was not required because the alleged misconduct at issue did not meet the familiar "by reason of service to the company" requirement for advancement and indemnification. *Radiancy* makes clear that conduct of directors and officers in their capacities as such, even if alleged to be illegal and have victimized the company, gives rise to "paradigmatically the kinds of claims that are subject to advancement. Indeed, to hold otherwise would be to allow companies to convert fiduciary duty claims subject to advancement into personal claims for which no payment is due simply by clever labeling." The court underscored its ruling by awarding the former directors "fees on fees," to discourage "the very kind of reflexive challenges to advancement claims that have proliferated in such number before this court recently."

Advancement obligations can thrust hard choices on companies involved in criminal or regulatory investigations. It is widely recognized that under the Thompson Memorandum and the Seaboard Report, cooperation with government agencies can avoid or mitigate both criminal and civil sanctions for business organizations under investigation. The emphasis of prosecutors and regulators on the completeness of a company's cooperation and remedial actions may create difficult choices for companies with broad advancement provisions. When evaluating cooperation with an investigation, prosecutors and regulators may take the position that funding defense costs of an individual the company believes has acted improperly, even in the face of broad advancement obligations, is inconsistent with a genuine corporate desire to hold culpable individuals accountable. On the other hand, the Delaware courts have consistently rejected attempts by companies with broad advancement provisions to discontinue payments, even as to individuals whose misconduct is established by a plea of criminal guilt, and awarded "fees on fees" against some companies that have tried.[16] What to do?

At a minimum, bring the fact and effect of the advancement provisions promptly to the attention of investigating authorities, hopefully eliminating any misperception about the motivation for existing or contemplated advancements to controversial present or former directors or officers. Depending on the circumstances, however, the company and current management may need to decide whether their fiduciary duties to shareholders counsel making the hard decision of denying advancement and putting potential indemnitees to their proof when the company in good faith believes they are not entitled to advancement – much less indemnification.

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1 2006 WL 722198 (Del. Mar. 20, 2006).

2 *In re General Motors Sh. Litig.*, 2005 WL 1089021 (Del. Ch. May 4, 2005).

3 *In re Toys "R" Us, Inc. Sh. Litig.*, 877 A.2d 975, 1023 (Del. Ch. 2005) (noting that shareholder vote "will have ratification effect, foreclosing as a practical matter, all claims of breach of fiduciary duty about the process leading to the merger.").

4 *In re Wheelabrator Tech., Inc. Sh. Litig.*, 663 A.2d 1194, 1201 (Del. Ch. 1995).

5 *See Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987); *Solomon v. Armstrong*, 747 A.2d 1098, 1115 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *Harbor Finance Partners v. Huizenga*, 751 A.2d 879, 890 (Del. Ch. 1999).

6 *Huizenga*, 751 A.2d at 892.

7 *Stroud v. Grace*, 606 A.2d 75, 85 (Del. 1992).

8 *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997).

9 *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1173 (Del. 2000).

10 564 A.2d 651, 660-61 (Del. Ch. 1988).

11 8 Del. C. § 145(b).

12 *TLC Beatrice Intern. Holdings, Inc. v. CIGNA Ins. Co.*, 1999 WL 33454 (S.D.N.Y. 1999).

13 8 Del. C. § 145(c).

14 2005 WL 3691286 (Del. Ch. Dec. 14, 2005).

15 2006 WL 224059 (Del. Ch. Jan. 23, 2006).

[16] *See Bergonzi v. Rite Aid Corp.*, 2003 WL 22407303, at *1 (Del. Ch. Oct. 20, 2003).