Delaware Court Holds that Required Shareholder Vote Cannot Ratify a Challenged Board Decision; Officers Owe Same Fiduciary Duties as Directors

In a decision that could subject challenged corporate decisions to greater review, and that makes explicit officers' duties, the Delaware Supreme Court recently clarified two important corporate governance principles in its unanimous, *en banc* opinion in *Gantler v. Stephens*. The court established a significant limitation on the doctrine of shareholder ratification, ruling that a shareholder vote required by law cannot serve to ratify a challenged decision of a board of directors. Further, the Court explicitly confirmed that officers of Delaware corporations owe shareholders the same fiduciary duties of care and loyalty as those of corporate directors.

Gantler involved a Nasdaq-listed bank holding company, First Niles Financial, Inc. The First Niles Board sought to put the company up for sale, and received three competing bids. First Niles' financial advisor deemed each of the bids favorable, and the board directed company management to conduct due diligence with two of the suitors. One potential offer fell through after management failed to provide due diligence materials. The second offer was rejected by the board, with no discussion or deliberation. Over the course of the failed sales process, management simultaneously advocated pursuing the privatization of the company.

Based on favorable recommendations from management and outside counsel, the board eventually approved the privatization transaction, through which First Niles's shares were de-listed from Nasdaq, and the shares of shareholders with 30 or fewer shares were reclassified into a preferred series of stock with no voting rights except on a proposed sale of the company. After dissemination of a proxy regarding the reclassification, the privatization transaction was approved by holders of a majority of the company's outstanding shares.

Plaintiff shareholders raised three breach of fiduciary duty claims against the defendant officers and directors, based on the defendants' (i) rejection of the merger offer and abandonment of the sales process, (ii) dissemination of a false and misleading proxy statement, and (iii) approval of the reclassification. Taken together, the plaintiffs characterized this course of conduct as "sabotage" of the sales process by management and inside directors to pursue the reclassification for their own benefit. The Delaware Chancery Court dismissed all three claims raised in the complaint. It deferred to the board's decision to abandon the sales process under the business judgment rule, finding that the plaintiffs had failed to rebut the presumption that the decision was made in good faith. The Chancery Court also deemed any potentially misleading disclosures in the proxy statements to be immaterial. Finally, the Chancery Court reasoned that while the plaintiffs alleged that a majority of the board voting on the reclassification lacked independence, the subsequent approval vote of the disinterested shareholders ratified this decision, entitling it to the protection of the business judgment rule.

On appeal, the Delaware Supreme Court reversed all three rulings by the Chancery Court. In analyzing the claims related to the board's decision to abandon the sales process, the Supreme Court disagreed with the Chancery Court's application of the business judgment standard ruling that the plaintiffs adequately alleged disqualifying conflicts of interest by a majority of the directors sufficient to rebut the business judgment presumption. (Among the five directors, one was First Niles's President and CEO, a second owned a heating and air-conditioning company that serviced Company buildings, and the third was a principal in a law firm that represented the company.) The Supreme Court separately determined that the breach of fiduciary duty claims were properly raised against two officers who were alleged to have delayed First Niles' response to due diligence requests. As part of this analysis, the court explicitly held "that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors."

The court further agreed with plaintiffs that the proxy statement did indeed contain false statements. While the proxy statement did reveal that all the directors and officers of First Niles had a conflict of interest in the reclassification vote because each stood to benefit from the privatization, it also stated that "after careful deliberations, the board determined in its business judgment the [merger] proposal was not in the best interest of the Company or our shareholders." Despite the proxy's forthcoming disclosure about the directors and officers' conflicts of interest, the court accepted the plaintiffs' allegations challenging the "careful deliberations" language, which may have reassured shareholders about the transaction, and, as a partial disclosure regarding the decision, may have required a more complete characterization of events related to the board's decisions.

Finally, and perhaps most significantly, the court rejected the defendants' argument that the approval of the reclassification by a majority of disinterested shareholders separately entitled the decision to deference under the business judgment rule. In so ruling, the court articulated an important distinction regarding shareholder ratification, limiting the doctrine to its "classic" form, "where shareholders approve board action that, legally speaking, could be accomplished without any shareholder approval." By contrast, the court held that decisions that legally require shareholder approval, like the reclassification in this case, cannot serve to ratify a challenged board decision.

The ruling in *Gantler* may provide clarity to corporations weighing the previously uncertain consequences of legally required shareholder approvals of board decisions. In so doing, however, it creates a substantial barrier to corporate actions pursued by boards of directors who are inadequately disinterested in a given transaction, subjecting such transactions to heightened court scrutiny, even should a majority of disinterested shareholders separately deem the transaction to be in the corporation's best interest. In this context, the *Gantler* decision expands the ability of courts to review corporate decisions, and may allow more shareholder plaintiffs to survive motions to dismiss when challenging such decisions.

For further information concerning the decision, please contact your usual Ropes & Gray attorney.