INSIGHTS

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The Delaware Supreme Court Restores Equilibrium: Independent Directors Not Liable in *Ryan v. Lyondell Corp.*

In a decision that will be widely applauded by independent directors and their counsel, the Delaware Supreme Court in Lyondell *narrows the circumstances that trigger* Revlon *duties and substantially narrows the circumstances under which an independent director may be held liable for breach of the good faith component of the duty of loyalty.*

by Randall W. Bodner, Christopher G. Green, and Peter L. Welsh

On March 25, 2009, the Delaware Supreme Court issued a significant decision in *Ryan v. Lyondell Chemical Co.*,[1] reversing a controversial decision issued by the Chancery Court.[2] The Delaware Supreme Court effectively held that, absent egregious misconduct, independent directors will not be liable personally for breaches of their so-called *Revlon* fiduciary duties for approving a merger or other strategic transaction.

The precise significance of the decision will be debated for some time. Those practitioners and commentators who view the decision as changing the rules governing strategic transactions will focus on the Supreme Court's protection of directors from personal liability in spite of a CEO-orchestrated sales process coupled with minimal board oversight and activity. This view has merit. Unquestionably there were shortcomings in the Lyondell sales process: For nearly two months, the directors took no action to prepare for a potential sale of Lyondell following the filing of a Schedule 13D by the successful bidder that put the company "in play."[3] The directors largely were unaware of significant negotiations by Lyondell's CEO to sell the company. The directors did not conduct any pre-signing market check. They entered into a merger agreement after only a week of limited deliberations. They did not obtain a "go shop" post-signing market check and they agreed to deal protection measures that included a no-shop, a match right, and a 3.2 percent break-up fee.[4]

There will be other practitioners and commentators who will view the decision as restoring the equilibrium prior to the Chancery Court's decision in *Lyondell*. They will note that the allegations contained in the complaint amount to, at most, a textbook breach of the fiduciary duty of care for which most directors are exculpated from liability under Delaware law. Indeed, the facts and circumstances of *Lyondell* were in many ways remarkably similar to, and, in certain respects, less actionable than, those in the paradigmatic duty of care case, *Smithv. Van Gorkom*.[5] Although the Lyondell directors may have cut some corners in the deal process, 10 of the 11 Lyondell directors were fully independent and disinterested, the company was sold at what was by all indications, and, more importantly, what the directors were advised at the time was, a significant premium to the market price of Lyondell's shares, and the shareholders voting on the transaction voted nearly unanimously in favor of the merger. To impose personal liability on the directors in those circumstances would be highly unusual. Viewed in that light, the Supreme Court's decision merely affirms fundamental principles of Delaware law, particularly the principle that independent and disinterested directors making a difficult decision will not be held personally liable absent egregious circumstances and obviously deliberate or reckless dereliction of duty.

Whatever one's view may be of the significance of *Lyondell*, there are several key points to be taken

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away from the decision. First, the Supreme Court's decision clarifies the narrow circumstances under which directors' *Revlon* duties are triggered. Only a Board's own decision to sell a company, whether on its own or in response to an unsolicited offer, will trigger *Revlon* duties. Second, the decision limits the circumstances in which directors may be deemed to have violated the good faith component of the duty of loyalty. Only an "utter failure" to meet one's "known" duties may constitute a violation of the good faith component of the duty of loyalty. Third, following *Lyondell*, once a transaction closes, a plaintiff's likelihood of success to recover damages diminishes considerably. Particularly when considered with other recent decisions rejecting post-closing liability of directors in the transactional setting, as discussed below, the focus of transactional litigation will turn more sharply and directly on the pre-closing injunction remedy. In this regard, it is important to bear in mind that, even if post-closing director liability for a breach of the duty of care is not available, a breach of the duty of care nevertheless may well support issuance of an injunction, pre-closing. Finally, the Chancery Court's criticism of the deal process, particularly the Lyondell directors' failure to conduct an active sale process (pre- or post-signing) and their reliance on "customary" deal protections and the passage of a typical period of time between signing and closing, should not be ignored by transactional professionals.

The Lyondell Deal

Ryan v. Lyondell Chemical Co. involved a challenge to the $13 billion acquisition of Lyondell by Luxembourg-based manufacturer Basell AF (Basell) for $48 per share in cash, a 45 percent premium over the pre-announcement market price.[6] The potential for a sale of the company emerged in April of 2006, when the Chairman and President of Basell's parent corporation, Access Industries (Access), Leonard Blavatnik, approached Lyondell's Chairman and CEO, Dan F. Smith, and expressed an interest in a possible acquisition of Lyondell.[7] Access followed up with a written indication of interest in a possible transaction at a price between $26.50 and $28.50 per share. The Lyondell Board rejected Access's offer as inadequate and not in the best interests of the Lyondell stockholders.[8]

In May of 2007, Access resurfaced when it filed a Schedule 13D announcing that it had acquired a right to purchase approximately 8.3 percent of the outstanding equity of Lyondell in a private transaction with Occidental Petroleum, Lyondell's second-largest shareholder.[9] The Access/Occidental transaction was disclosed publicly on May 11, 2007, when Access filed a Schedule 13D disclosing the transaction. The filing of the Schedule 13D clearly signaled to the market that Lyondell was "in play."[10] Indeed, only three days later, on May 14, 2007, a private equity firm, Apollo Management, approached Smith to propose a possible acquisition of Lyondell by Apollo. Smith "rebuffed Apollo's solicitation, however, apparently because he and the other members of Lyondell management viewed such transactions as fraught with inherent conflicts of interest for both management and the Board."[11]

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In June of 2007, Smith met with Basell's CEO in London and suggested that Lyondell might be for sale at a price of $48 per share.[12] Smith arranged to meet with Blavatnik on July 9, 2007, to discuss further a possible transaction. The Lyondell Board was uninvolved in these discussions and was not directing Smith in his discussions with Blavatnik.

The Lyondell Board considered the Basell proposal during several relatively brief meetings.

During their July 9, 2007 meeting, Blavatnik indicated Basell's interest in pursuing a possible acquisition of Lyondell at a per share price of $40 per share. Smith rejected $40 per share as too low. During the same meeting, Blavatnik raised his offer to between $44 and $45 per share. Smith stated that he would convey Blavatnik's offer to the Lyondell Board but indicated that he was doubtful that the Lyondell Board would approve a transaction at that price. He urged Blavatnik to provide his "best" offer for Lyondell so that Smith and the Lyondell Board could have a productive discussion of Basell's interest. Blavatnik called Smith later the same day and stated that his "best" offer was $48 per share, provided that the Lyondell Board would sign a merger agreement by July 16, 2007, and agree to a $400 million break-up fee, which represented approximately 2 percent of Lyondell's total enterprise value and 3.2 percent of Lyondell's equity value in the deal. Blavatnik reported further that Basell would not require any financing contingency for the transaction. Smith agreed to take the proposal to the Lyondell Board.[13]

Over the ensuing seven days, the Lyondell Board considered the Basell proposal during several relatively brief meetings.[14] At a special meeting on July 10, 2007, Smith disclosed the Basell offer to the Board. The Board considered valuation materials that had been prepared for the regularly scheduled Board meeting to be held the following day. The Board discussed the Basell offer and the likelihood that another bidder might emerge. The Board also instructed Smith to obtain a written proposal from Basell and more details concerning Basell's financing for the deal. On July 11, the Board met again.[15] At this meeting, the Board met for less than an hour concerning the Basell proposal. The Board decided it was interested in pursuing a possible transaction with Basell. The Board authorized the retention of Deutche Bank as financial advisor to Lyondell. The Board also directed Smith to negotiate with Blavatnik. On July 12, the Board met again to discuss the Basell proposal. At this meeting, the Board directed Smith to attempt to negotiate better terms with Blavatnik, including a higher price, a "go-shop" provision, and a lower break fee. In response to Smith's attempt to negotiate further, Blavatnik was "incredulous." He had offered his best price, was eager to sign a deal quickly, and was now being asked to bid against himself. Blavatnik refused to raise the price and refused the request for a post-signing "go shop," but did agree to lower the break-up fee from $400 million to $385 million.

On July 16, the Lyondell Board met to consider the proposed transaction and draft merger agreement. The Board was advised by its legal counsel that although Basell did not agree to a post-signing "go shop," the proposed merger agreement contained a "fiduciary out" that allowed Lyondell to consider alternative bids post-signing. In addition, Lyondell's financial advisor, Deutsche Bank, presented its fairness analysis. Deutsche Bank reviewed with the Board valuation analyses based on "bullish" projections and more conservative projections. The price Basell was offering represented a 45 percent premium to Lyondell's undisturbed market price before the announcement. The Deutsche Bank analysis yielded valuation ranges that did not even reach the $48 per share price Basell was offering. Indeed, Deutsche Bank advised the Board that the price Basell was willing to pay for Lyondell was "an absolute home run." Deutsche Bank also advised the Board that it believed that no other bidder would top Basell's offer. After receiving this advice, the Board voted unanimously to approve the transaction and recommend it to the Lyondell shareholders.[16]

The transaction was approved by the 11-member Lyondell Board on the recommendation of the non-management directors, whom the Chancery Court held were "independent and not impermissibly motivated by self-interest." The transaction also "garnered the near unanimous support" of the Lyondell stockholders voting at a shareholder meeting

following disclosures in the merger proxy statement that the Court held were adequate.

The Chancery Court's Decision

A putative class of shareholders brought a class action in the Delaware Chancery Court challenging the $13 billion merger and alleging that the Lyondell directors breached their fiduciary duties of care, loyalty, and candor. Specifically, the complaint alleged that: (1) the merger price was grossly insufficient; (2) the directors were motivated to approve the merger for their own self-interest; (3) the process by which the merger was negotiated was flawed; (4) the directors agreed to unreasonable deal protection provisions; and (5) the preliminary proxy statement omitted numerous material facts. The Chancery Court rejected all claims except those challenging the process by which the directors sold the company and the deal protection provisions in the merger agreement.[17]

On July 29, 2008, Vice Chancellor Noble issued a decision denying a motion for summary judgment brought by the Lyondell directors on the process and deal protection claims. In its decision, the Court noted that the directors had not conducted adequate pre- or post-signing "market checks" to scout out higher offers, and inappropriately had agreed to "deal protection" terms that could impede topping bids. The Court refused to grant summary judgment in favor of the directors on the mere basis that the directors had accepted a "blow-out" offer made on "take-it-or-leave-it" terms. As a result, Vice-Chancellor Noble declined to dispose of the plaintiffs' "bad faith" claims, and held that a more developed record following either discovery or a trial would be required to determine whether the directors were personally liable for damages to the Lyondell public shareholders.

The "Sale Process" Claims

On the defendants' motion for summary judgment on plaintiff's "sale process" claims, the Court held that, when faced with an all cash offer, the directors of a Delaware corporation must either: (1) "engage in an active sale process" involving "auctioning the company to the highest bidder" or other efforts designed to secure the "best price" for the company; or (2) amass a "reliable body of evidence against which to judge the adequacy and fairness" of the single bidder's offer. "The corollary to this is clear: When [a board] does not possess reliable evidence of the market value of the entity as a whole, the lack of an active sales effort is strongly suggestive of a . . . breach." The Court held that the directors failed to show either an active sales effort by the Board or reliable evidence that the deal was so good that it could not be passed up without further negotiation or market checks.

Based on the record presented on summary judgment, the Court held first that "there [was] no evidence of a proactive sales process" by the Lyondell Board of Directors. The Board did not conduct either a pre-signing market check or a post-signing market check, because the buyer offered a "blow-out" price to Lyondell's CEO and threatened no offer if the Board sought to negotiate further. As a result, the Board instructed Deutsche Bank not to test the market before signing the merger agreement and the deal did not provide for a post-signing "go-shop" period or (at least according to the Chancery Court) an effective post-signing market check.

The Court also held that the Lyondell directors had failed to demonstrate that they had a "body of reliable evidence" concerning the value of Lyondell with which to evaluate the adequacy of Basell's offer. First, the deal "materialized very quickly. The entire deal was negotiated, considered and agreed to in less than seven days." "[T]he Board formally met to discuss the Basell Proposal for a total of no more than six or seven hours." Second, the Board "did not retain an investment banker or even ask management to prepare projections and valuations of the Company" until after the price of the deal had been negotiated by the CEO. Finally, "the Board did *nothing* (or virtually nothing, at least on this record) to study the market carefully or to prepare itself in anticipation of an offer for the Company."[18]

In short, the "Lyondell Board was largely out of the loop until the very end of the process when it. . . approved the deal [the CEO] had negotiated."[19]

The "Deal Protection Device" Claims

The Chancery Court also denied the directors' motion for summary judgment on the plaintiffs' claims that the "deal protection" provisions of the merger agreement, while customary, were inappropriate. The Court applied an "enhanced scrutiny" standard to the provisions, and held that, while the protections were typical and could even "be said to appear regularly, in one form or another in deals of this magnitude," the deal protections were nonetheless problematic in view of the directors' failure to shop the company. The Court faulted the existence of the "no-shop" provision (despite the "requisite fiduciary out"), particularly in view of the absence of pre-signing "market checks" or the Board's active engagement in any post-signing market check:

> [W]here there is lingering doubt as to the Board's efforts to ensure that it had secured the 'best' transaction available to the Lyondell shareholders before it endorsed the transaction, the Court should also be skeptical of the wisdom of the Board's decision to grant considerable deal protections, simply as a matter of course, that limited its ability to discharge proactively its fiduciary obligations after the fact.[20]

Potential Personal Liability of the Directors

In addition to faulting their handling of the sale process and the deal protections generally, the Court held that the Lyondell directors could face potential personal liability at a trial on the merits as a result of the shortcomings noted by the Court. Although it has all of the hallmarks of a classic "duty of care" case, the Chancery Court held that the summary judgment record permitted an inference of conduct that was not in "good faith," which would eliminate the protections of the Company's exculpatory charter provision:

> The Lyondell Defendants argue that even if the Court concludes, as it has, that for summary judgment purposes the Board's efforts under *Revlon* were insufficient, they nevertheless are entitled to summary judgment because those perceived shortcomings amounted to nothing more than a breach of the duty of care and Lyondell has adopted an exculpatory charter provision in accordance with 8 Del. Ch. § 102(b)(7) to preclude an award of damages for such a breach of duty. This may not be a case, however, where a board of directors simply botched the sale process in some careless or even grossly negligent manner; instead, this is a board of directors that appears never to have engaged fully in the process to begin with, despite *Revlon*'s mandate. Thus, the good faith aspect of the duty of loyalty may be implicated, which precludes a Section 102(b)(7) defense . . .[21]

With this holding, the Chancery Court's decision in *Lyondell* became remarkable and controversial.

What made the Chancery Court's decision in *Lyondell* remarkable and controversial is the widely-held perception that *Lyondell* was, at most, a classic duty of care case. Indeed, in many respects, the conduct alleged in *Lyondell* was no worse, or more worthy of director personal liability, than the textbook duty of care case: *Smithv. Van Gorkom*. In *Smithv. Van Gorkom*, the directors of Trans Union Corporation were sued for approving an acquisition of Trans Union by the Pritzker family pursuant to an allegedly flawed process. In that case, plaintiffs alleged that the Trans Union directors allowed the CEO to sell the company without any formal board involvement or any meaningful market check.[22] The CEO allegedly presented the transaction to the board of directors as a fully negotiated deal that needed to be signed in short order.[23] Unlike *Lyondell*, in which the Board deliberated during several meetings over the course of a week, the Trans Union board allegedly considered the Pritzker offer during a single, relatively short board meeting.[24] Unlike the Board in *Lyondell*, the Trans Union board also did not retain any financial advisor to assist in assessing the Pritzkers' offer for the corporation.[25] On these facts, the Delaware Supreme Court held that the directors had *not* breached their fiduciary duties of loyalty or good faith but that they had breached their fiduciary duty of care in approving the sale of Trans Union, and they could be held personally liable, as a consequence.[26] Indeed, Section 102(b)(7) was passed by the Delaware General Assembly precisely to remove for directors of Delaware corporations the specter of

personal liability that arose out of the *Van Gorkom* decision.[27]

In brief, what made the Chancery Court's decision in *Lyondell* so potentially problematic was that it was very difficult to see how the facts alleged in *Lyondell* were any worse than the facts alleged in the *Van Gorkom* case.[28]

The Supreme Court's Decision

The Supreme Court, per Justice Berger and sitting *en banc*, reversed. In a concise, 20-page opinion, the Supreme Court held that that the Court of Chancery had reviewed the record under a "mistaken view of the applicable law" in three ways:[29]

Revlon Duties Are Not Triggered When a Company Is Merely "in Play"

First, the Delaware Supreme Court held that the Court of Chancery improperly imposed *Revlon* duties on the Lyondell directors either before they had decided to sell the company, or before a sale of the company had become inevitable. The Chancery Court had determined that the directors' *Revlon* duties had been triggered when Basell filed a Schedule 13D, thereby signaling that the company was "in play." The Supreme Court held, however, that an effort by a shareholder or third-party to put the company "in play" was not sufficient to trigger *Revlon* duties.[30] The Supreme Court thus concluded that the directors' so-called wait-and-see approach—by which the directors took no action for two months in response to the Schedule 13D filing—was an "entirely appropriate exercise of the directors' business judgment."[31] The Supreme Court held that directors' *Revlon* duties are triggered only when a company "embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."[32] The Supreme Court held that the triggering date in Lyondell's case was July 10, 2007, when Lyondell's CEO informed the Board of Basell's offer and the Board, as a result, took steps in response.

Thus, the two months of director inactivity or, as the Chancery Court put it, "slothful indifference" by the Board, was irrelevant to the *Revlon* analysis. The Supreme Court noted that a proper *Revlon* inquiry would, in these circumstances, focus only on the one week during which the Lyondell Board considered Basell's offer. And, in that week, the directors met several times, they instructed the CEO to attempt to negotiate better terms, and they considered Lyondell's value and the prospects of getting a higher bid. The Supreme Court held that when viewed in that limited timeframe, the directors' efforts to obtain the best price available were not, as a matter of law, in bad faith.[33]

No "Known Duties" under *Revlon*

Second, the Supreme Court held that directors cannot be said to have "consciously disregard[ed] known duties" because there are no such specific, known duties or prescribed steps required to meet the *Revlon* obligation to obtain the best price reasonably available.[34] The Chancery Court read *Revlon* and the cases applying *Revlon* as collectively establishing that directors may meet their *Revlon* obligation to obtain the best available sale price in any one of three ways: (1) by conducting an auction; (2) by conducting an active market check; or (3) by demonstrating "an impeccable knowledge of the market."[35] The Chancery Court noted that the directors had conducted neither an auction nor an effective market check, and that the record was insufficient to hold that they had an "impeccable knowledge of the market." The Supreme Court rejected that reasoning, holding that "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[36] In other words, because there are no specifically prescribed duties or obligations under *Revlon*, one cannot consciously disregard those duties or obligations.

Bad Faith Requires "Utter Failure," Not Mere "Imperfection"

Finally, the Supreme Court held that the test to apply in determining whether the independent directors acted in bad faith is whether they "utterly failed to attempt to obtain the best sale price," not whether they did everything they should or could have done.[37] The Supreme Court held that viewing the record with

that (admittedly low) bar in mind permitted only one conclusion. The Board met several times, they knew the company and the market generally, they solicited and followed the advice of their financial and legal advisors, and they attempted to negotiate better terms even in the face of a "blowout" price. The Supreme Court assumed that the Board did nothing to prepare for the offer, and they did not even consider a market check. But given the steps they did take, the record clearly established that they did not "utterly fail to obtain the best price available."[38]

For the foregoing reasons, the Supreme Court entered judgment in favor of the directors.

Implications for Practitioners

Both the Chancery Court's initial decision and the Supreme Court's decision reversing it contain numerous important lessons.

Post Closing Liability of Independent Directors Is Highly Unlikely

Following *Lyondell*, it is difficult to imagine realistic circumstances in the transactional context in which a board populated by a majority of independent directors could be held personally liable, post-closing, for a claim challenging a transaction on the ground of so-called bad faith or a knowing disregard of one's duties. Such circumstances would presumably require the directors to have done even less than what was undertaken here (*e.g.*, fewer meetings, no attempt to negotiate better terms or no solicitation of financial advice), the deal terms would have to be less favorable to shareholders (*e.g.*, no premium), and the shareholder vote would have to be close or suspect. But even in those circumstances, the standard post-*Lyondell* is such that imposing personal liability on directors remains very difficult. "Utter failure" to obtain the best price available may require complete inaction, or nearly so, which, as a practical matter, will rarely (if ever) be the case.

The Stakes for Pre-Closing Injunction Litigation Have Increased

The Supreme Court's decision in *Lyondell*, particularly when coupled with the Chancery Court's recent decision in *In re Transkaryotic Therapies*, will force the plaintiffs' bar to focus its efforts more heavily on pre-closing injunction litigation, particularly in transactions approved by a majority of disinterested directors. In *Transkaryotic Therapies*, the Chancery Court held that, absent exceptional and highly unusual circumstances, directors could not be held personally liable for post-closing monetary damages for a breach of the fiduciary duty of candor. The Court held specifically that the appropriate remedy for fiduciary duty claims challenging disclosures in a merger proxy statement was an order by the Chancery Court requiring corrective or supplemental disclosures and that, once the shareholder vote had taken place and the transaction closed, the Court could not afford a meaningful remedy and the claim was effectively barred.[39] Taken together, *Lyondell* and *Transkaryotic Therapies* largely foreclose post-closing monetary damages of independent directors in the transactional context.

As a result, the stakes have been raised for pre-closing injunction litigation. In order to effectively challenge on *Revlon* grounds a merger transaction recommended by a majority of independent directors, the plaintiffs' bar must, absent highly unusual circumstances, obtain an injunction preventing the shareholder vote and/or the closing of the transaction. While motions for a preliminary injunction were always a staple of deal litigation, following *Lyondell* and *Transkaryotic Therapies*, the focus of transactional litigation almost will be entirely on the pre-closing motion for a preliminary injunction. Target directors of any significant deal can expect their process to be tested by a motion for a preliminary injunction by shareholder plaintiffs. In cases that do not settle or when an injunction does not issue, the claims may very well be abandoned given the absence of any realistic prospect of recovery of damages.

The Lyondell Deal Remains a Cautionary Tale for Directors

Although *Lyondell* and *Transkaryotic Therapies* largely foreclose a post-closing damages claim against independent directors, it is important not to lose sight of the fact that, post-*Lyondell*, the fiduciary duty of care remains very relevant. Although directors generally may not be held liable, post-closing,

for a breach of the duty of care, a transaction may still be enjoined, pre-closing, as a result of a breach of the duty of care. Neither *Lyondell* nor *Transkaryotic Therapies* affect that settled rule of law. For this reason, the Chancery Court's observations concerning the process followed by the Lyondell directors remain very relevant for deal practitioners. In particular:

- ***Deal protections should be tailored to the circumstances:*** Deal protections should not be adopted reflexively, but should be tailored to the circumstances. "Standard" no-shop provisions and "typical" 3 percent break-up fees may not be considered standard or typical depending on the circumstances. Any deal protections will need to be explained in the context of the deal as a whole and not by reference to "market" terms or general deal term precedents.
- ***The tradeoff between market checks and deal protections:*** Above all, absent a robust pre-signing market check, deal protections should be limited, and bidders can expect the Chancery Court, at least, to continue to scrutinize carefully stringent deal protections. The Chancery Court's decision in *Lyondell* appears designed to shift the cost-benefit calculus for aggressive bidders seeking bullet-proof deals, and the Chancery Court can be expected to hold the line on this front.
- ***"Go-Shop" provisions help:*** The Chancery Court tacitly endorsed the "go-shop" as an effective device for use in a post-signing market check and implicitly criticized the Lyondell Board for its failure to obtain a "go-shop." In *Lyondell*, even the passage of some four months between the public announcement of the proposed merger and the shareholder vote without the emergence of a competing bid, combined with a market 3 percent break-up fee, was not viewed by the court as a sufficient post-signing market check. The takeway: "go shops" help.

Narrowing of *Revlon*

Perhaps the most significant doctrinal takeaway from the Supreme Court's decision is the Court's narrowing of the circumstances under which a Board's *Revlon* duties will be triggered. Despite the fact that a company may clearly be "in play," *Revlon* duties are not triggered unless the company is in the market by the Board's own initiative or by steps taken by the Board in response to an unsolicited offer. This holding is critical, particularly in the face of increasing shareholder activism. Even when such activism rises to the level of a shareholder increasing its position in a company and publicly indicating a desire to buy the company, following *Lyondell*, directors have no immediate *Revlon* duties. Moreover, even when *Revlon* is triggered, *Lyondell* makes clear that there are no specific steps whatsoever that a Board must undertake to meet its duty to obtain the best price reasonably available. Underlying the Supreme Court's decision in each of these respects relative to *Revlon* is the fundamental deference in Delaware law to the business judgment of a majority of independent directors.

NOTES

1. *Ryan v. Lyondell Chemical Co.,* — A.2d.—, No. 401, 2008, 2009 WL 790477 (Del. Mar. 25, 2009) (hereinafter, *Lyondell II*).
2. *Ryan v. Lyondell Chem. Co.,* 2008 WL 2923427 (Del. Ch. July 29, 2008) (hereinafter, *Lyondell I*).
3. Lyondell I, at 1.
4. *Id.*
5. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).
6. Lyondell I, at 1.
7. *Id.* at 4.
8. Id.
9. *Id.* at 5.
10. *Id.*
11. *Id.*
12. *Id.* at 5.
13. *Id.* at 6.
14. *Id.*
15. *Id.* at 7.
16. *Id.* at 7–9.
17. Lyondell II, at 8–9
18. Lyondell I, at 14.
19. *Id.* at 15.
20. *Id.* at 17.
21. *Id.* at 18.
22. *Smith* at 874.
23. *Id.*
24. *Id.*
25. *Id.* at 876–877.
26. *Id.*
27. *See Malpeide* v. *Townson*, 780 A.2d 1075, 1095 (Del. 2001) ("Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following

a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*. The purpose of this statute was to permit stockholders to adopt a provision in the certificate of incorporation to free directors of personal liability in damages for due care violations, but not duty of loyalty violations, bad faith claims and certain other conduct.")

28. It is worth noting that the Chancery Court, both in its initial decision denying summary judgment, and in a later decision denying the Lyondell directors' motion for an order certifying an interlocutory appeal of the summary decision, observed that the record was relatively undeveloped for a summary judgment motion. Specifically, in a letter opinion denying the Lyondell directors' motion for an order certifying an interlocutory appeal, Vice Chancellor Noble made clear his view that the case had been too hastily submitted for summary judgment. The 26-page letter opinion is replete with references to the undeveloped nature of the record. In the letter opinion, the Vice Chancellor also specifically rebuked the Lyondell directors for seeking summary judgment on such an undeveloped record. *See, e.g.,Ryan v. Lyondell Chemical Co.*, CA No. 3176-VCN, slip op, at 2, n. 2 (Del. Ch. Aug. 29, 2008) ("Defendants made a tactical choice to seek summary judgment very early in this case and, consequently, they relied on a record developed in connection with related preliminary injunction litigation in Texas. Here, Ryan filed his Complaint on August 20, 2007; Defendants moved to dismiss and stay discovery on September 12, 2007; the Basell defendants then moved for summary judgment on September 27, 2007. The Defendants joined in Basell's motion for summary judgment on November 21, 2007, but they did not separately brief their arguments in defense of Ryan's allegations against them; instead, they relied on the Basell defendants' briefs, which focused primarily (at least in their opening brief) on addressing Ryan's aiding and abetting claims. The Court heard oral argument on the motions for summary judgment less than a week later."); *see also id*. at 17, n.38 ("Once again, the Court emphasizes that this is summary judgment and the record, as it presently stands, is nothing more than the record prepared for the preliminary injunction hearing in Texas. . . . In short, the predicament in which the directors presently find themselves is entirely of their own making and the result of their impatience with the litigation process.")

29. Lyondell II, at 4.

30. *Id.* at 4–6.

31. *Id.* at 6.

32. *Id.* at 6.

33. *Id.* at 7.

34. *Id.* at 7.

35. *Id.* at 6.

36. *Id.* at 7.

37. Id.

38. Id.

39. *Lyondell I*, at 21 n.128 (*citingIn re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 2008 Del. Ch. LEXIS 76, 2008 WL 2699442, at *8–10).

SECURITIES REGISTRATION

The Threat of Unsponsored ADR Programs

Foreign companies are being targeted by US depositary banks as a result of new rules that have relaxed the requirements on unsponsored American Depositary Receipt programs. Foreign companies need to be ready to guard against having new securities trading in the United States without their consent as depositary banks seek to register unsponsored ADRs on their shares.

by Michael L. Fitzgerald, Frank Vivero, and Pedro Reyes

Recently adopted amendments to Rule 12g3-2(b), which exempts foreign private issuers from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act), have limited the ability of foreign companies to control the establishment of unsponsored American Depositary Receipt (ADR) programs in their securities and have resulted in the explosive growth of these unsponsored programs. Significant concerns arise for foreign companies when unsponsored ADR programs are created in their securities.

Overview of ADR Programs

An ADR is a certificate that evidences American Depositary Shares (ADSs and, together with ADRs, ADRs), which represent one or more (or a fraction) of an underlying security (typically ordinary shares of non-US companies). The ADRs are issued by a US commercial bank, known as the depositary, through a depositary facility (also referred to as an ADR program). ADR programs permit investors to invest in securities of non-US companies through an instrument denominated in US dollars and with a three-day settlement; dividends also are paid in US dollars. If the securities underlying the ADRs are listed on a US national securities exchange or are the subject of a US public offering, the ADRs and the underlying securities must be registered with the Securities and Exchange Commission (SEC) under the Exchange Act. Registration under the Exchange Act subjects the issuer to annual and interim reporting and disclosure obligations, including requirements to reconcile financial statements to IFRS or US GAAP, as well as the provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).

Levels of ADR Programs

There are three levels of ADR programs.

Level I

In a Level I program, the ADRs are traded in the US over-the-counter market. While a Level I program does not involve an official stock exchange listing in the United States, it permits US residents and other investors to trade the securities of a foreign company in dollars in the US settlement system. Level I programs do not trigger Exchange Act reporting and disclosure obligations, including requirements under the Sarbanes-Oxley Act, provided the issuer qualifies for a Rule 12g3-2(b) exemption as described below. In addition, the ADR depositary must file a Form F-6 registration statement with the SEC. A Form F-6 registration statement contains limited information and includes no substantive information about the issuer or the underlying securities.

A Level I ADR program may be sponsored or unsponsored. A sponsored ADR program is created when the issuer of the deposited securities enters into a deposit agreement with a depositary that agrees to issue ADRs against the deposit of the issuer's shares in the issuer's home market. Under a sponsored ADR program, the issuer is able to exercise control regarding the terms and operation of the ADR program. Sponsored ADRs are issued by a single depositary and cannot be duplicated by another depositary.

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An unsponsored ADR program, on the other hand, is set up by a depositary without the participation or consent of the issuer. While the depositary may request a letter of non-objection from the issuer before establishing an unsponsored ADR program, there is no obligation or condition that the issuer's consent for the ADR program be obtained. Effectively, there is no limit on the number of unsponsored ADR programs that can be established. The most effective way for an issuer to prevent the establishment of an unsponsored ADR program is for the issuer to set up a sponsored ADR program.

The SEC staff has taken the position that an unsponsored program may not coexist with a sponsored program for the same securities because of the market disorder and confusion that could result.[1] Therefore, once an issuer establishes a sponsored ADR program, unsponsored ADR programs for the same underlying securities may not be established. If an issuer seeks to set up a sponsored program after one or more unsponsored programs have been created, the preexisting unsponsored programs must first be terminated and the underlying securities and accounts of ADR holders under such programs must be transferred to the new sponsored program. There may be fees associated with collapsing such unsponsored programs, which the issuer may be required to pay.

Level II

A Level II ADR program always is sponsored as it involves listing the ADRs and the underlying securities on a US stock exchange. A Level II ADR program is used by issuers that are not raising capital at the time of its establishment. Level II ADR issuers are required to file a Form 20-F registration statement and must comply with reporting and disclosure obligations under the Exchange Act, including, among others, requirements under the Sarbanes-Oxley Act, and a requirement to reconcile financial statements to IFRS or US GAAP.

Level III

Level III ADR programs always are sponsored and are used by issuers to list the ADRs and underlying securities on a US stock exchange and to conduct a public offering in the United States at the same time. Because these programs involve a registered offering of securities in the United States, Level III ADR issuers generally file a registration statement on Form F-1 under the Securities Act of 1933 (Securities Act). The depositary also is required to file a registration statement on Form F-6. A Level III ADR program subjects issuers to the same Exchange Act reporting and disclosure obligations as Level II ADR issuers, including the requirements under the Sarbanes-Oxley Act.

Legal Framework of Rule 12g3-2(b)

As mentioned above, whether an ADR program is sponsored or unsponsored, the ADR depositary must file a registration statement with the SEC on Form F-6 before the ADRs can be traded. A depositary only may file a Form F-6 and issue ADRs if the issuer is a reporting company under the Exchange Act or exempt from Exchange Act registration under Rule 12g3-2(a) or Rule 12g3-2(b).

Under Section 12(g) of the Exchange Act, an issuer must register within 120 days of the last day of its fiscal year, and be subject to the onerous reporting requirements of the Exchange Act, if the issuer has 500 or more recordholders of its equity securities, and its total assets exceed $10 million. However, an issuer will be exempt from registration under the Exchange Act: (1) under Rule 12g3-2(a) if fewer than 300 holders of its equity securities are resident in the United States as of each fiscal year end, or (2) by claiming the Rule 12g3-2(b) exemption.

In addition to allowing issuers to be eligible for Level I ADR programs, the Rule 12g3-2(b) exemption provides a number of benefits. For example, the exemption:

- Avoids the risk that the foreign private issuer inadvertently may be subject to the reporting requirements of the Exchange Act if it is discovered that the issuer has more than 500 holders of its equity securities;
- Ensures automatic compliance with the informational requirements of Rule 144A under the Securities Act, which requires the issuer to provide a buyer of such issuer's securities pursuant to Rule 144A, upon request, with a brief

statement of the nature of the issuer's business and of its products and services as well as certain financial information. Under Rule 144A(d)(4), issuers must make general information available to investors upon their request, including "the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation." These financial statements, which generally would be prepared in accordance with statutory (home-country) accounting principles, are required to be audited to the extent audited financial statements are "reasonably available;"
- Enables the issuer to qualify for an exemption from the securities laws of a number of US states; and
- Avoids any impediment to trading that may arise in the secondary market because of a potential failure of transmission of information required under Rule 144A(d)(4).

In general, to claim the exemption under 12g3-2(b), an issuer must not have any class of securities listed on a national securities exchange in the United States or otherwise be a reporting company under the Exchange Act, and the issuer must maintain a foreign listing. Additionally, the issuer must have published its material disclosure documents since the beginning of its most recent fiscal year, in English, on its Web site or through an electronic information delivery system generally available to the public in its "primary trading market." Prior to the recent amendments to Rule 12g3-2(b) effective October 10, 2008, an issuer was required to apply by written application to the SEC for a Rule 12g3-2(b) exemption and periodically provide information to the SEC on an ongoing basis in order to maintain the exemption. Therefore, an issuer could prevent a depositary from launching an unsponsored ADR program by not applying for the exemption.

Recent Amendments to Rule 12g3-2(b) and ADR Programs

Effective October 10, 2008, the SEC amended Rule 12g3-2(b) and Form F-6. The Rule 12g3-2(b) amendments eliminated the written application process formerly required for the 12g3-2(b) exemption, and provided for the automatic availability of the exemption as long as the required information is made available on the issuer's Web site.[2] Similarly, the amendments to Form F-6 now only require the depositary to state that, if the issuer of the securities is not an Exchange Act reporting company, the securities are exempt from registration by 12g3-2(b). Additionally, a depositary now may file a Form F-6 for an unsponsored ADR program if the depositary, after reasonable diligence, holds a "reasonable, good faith belief" that the issuer complies with the requirements. Finally, it should be noted that the SEC has declined to require that the depositary obtain the consent of the issuer of the underlying securities before registering ADRs on Form F-6.

Many depositaries have taken the position that the combination of the amendments to Rule 12g3-2(b) and the revisions to Form F-6 have made it easier to establish unsponsored ADR programs and these depositaries have therefore increased their activities in setting up unsponsored Level I ADR programs without the issuer's consent or knowledge. Before the amendments, an issuer could prevent an ADR depositary from establishing unsponsored ADRs by not formally applying for or meeting the requirements of the Rule 12g3-2(b) exemption. Accordingly, the automatic availability of the exemption for issuers and the reasonable belief standard for depositaries have facilitated the proliferation of unsponsored ADR programs.

Considering that ADR depositaries can generate substantial fees from investors for issuing and canceling ADRs, ADR depositaries have been active in unilaterally establishing unsponsored ADRs to meet purported demand for previously unlisted issuers' securities. According to statements made by several market observers and regulators, over 1,000 unsponsored ADR programs have been established by depositaries in the weeks following the adoption of the recent amendments to Rule 12g3-2(b). European companies have been the principal targets to date for the establishment of these unsponsored ADR programs.

Legal and Practical Implications to an Issuer of an Unsponsored ADR Program

Several legal and practical consequences may stem from the establishment of an unsponsored

ADR program for an issuer's securities. For example, the establishment of an ADR program may increase interest in the issuer's securities in the US market and result in an issuer having more than 300 holders of a class of its equity securities in the United States. This scenario would trigger the requirement that the issuer register the class of securities with the SEC under Section 12(g) of the Exchange Act unless it has qualified for and maintained a Rule 12g3-2(b) exemption.

In order to determine the appropriate course of action, an issuer should determine whether one or more ADR programs have been established on its behalf by checking the SEC Web site for a Form F-6 filed under the issuer's name. Additionally, an issuer should calculate (or hire an outside expert to calculate) the number of outstanding shareholders, considering that the SEC requires one to "look through" the holders of record to determine the identity of the actual beneficial holders.[3]

In addition, the issuer's lack of control over one or more unsponsored ADR programs may lead to market perception problems arising from an investor drawing negative conclusions in respect of the issuer's securities, particularly if the investor is unaware that an ADR program is unsponsored. In an unsponsored program, the issuer has very little control over the US trading price of the ADRs because the issuer does not participate in negotiating the share to ADR ratio. Accordingly, multiple depositaries could create confusion among investors by offering ADRs at different prices and ratios.

However, even if the depositary in question were to withdraw the unsponsored program, this does not foreclose other depositary banks from creating new unsponsored programs unless the issuer takes additional affirmative steps. Even if an issuer is successful in withdrawing its securities from an unsponsored program, investors may be displeased by the suspension or termination of ADRs trading in the US market, and downward selling pressure may result. An issuer that has successfully cancelled an unsponsored ADR program should be careful when limiting English disclosure on its Web site, or stating on the Web site that the information provided is not sufficient to satisfy Rule 12g3-2(b), as such issuer may be perceived as effectively opting for less disclosure to its existing shareholders.

Additionally, the issuer has no control over the fees charged to the ADR holders by the depositary. Finally, considering that multiple unsponsored programs may exist for the securities of a single issuer, depositaries may provide different services to their holders. For example, multiple depositaries may offer dividend payments to holders at different exchange rates, which may create confusion among holders. Therefore, one or more unsponsored depositary programs may cause a negative perception of the issuer in the US market.

Corporate governance problems also may arise from the creation of unsponsored ADR programs. Depositaries of unsponsored ADR programs typically do not provide voting rights to ADR holders for the underlying shares, distribute shareholder communications, or establish procedures for shareholder services such as rights offerings, stock splits, and corporate reorganizations, which may jeopardize investor relations. As the number of shareholders increases with the creation of a large unsponsored ADR program, an issuer's ability to obtain a quorum or pass shareholder resolutions may be impaired.

Options Available to an Issuer that Discovers an Unsponsored ADR Program

An issuer that finds its securities trading in an unsponsored ADR program should voice its strong objection to the depositary. While a depositary is not required to terminate an unsponsored program upon the issuer's request, a number of unsponsored ADR programs have been withdrawn shortly after their establishment, upon the issuer's request. Objecting to the program may be particularly effective if the issuer believes that it is ineligible to qualify for the 12g3-2(b) exemption because the issuer's stated non-compliance would make it unlikely that the depositary could reasonably believe the issuer is compliant. In this regard, care also should be exercised to determine that the existing unsponsored ADR program has not increased interest in the issuer's securities in the US market and resulted in the issuer having more than 300 holders of a class of its equity securities in the United States, as this scenario would trigger the requirement that

the issuer register the class of securities with the SEC under Section 12(g) of the Exchange Act unless it has qualified for and maintained a Rule 12g3-2(b) exemption. Issuers also may be required to pay termination fees in connection with the closing of an established unsponsored program, particularly when there are several unsponsored programs in place.

An issuer can foreclose the establishment of an unsponsored ADR program by setting up its own sponsored Level I ADR program. As noted, the SEC has stated that a sponsored program cannot coexist with an unsponsored program. Therefore, if an unsponsored program does not already exist, an issuer may establish a sponsored program. The benefits of a sponsored program over an unsponsored program are numerous. The issuer can negotiate the appropriate share to ADR ratio with the depositary and exercise more control over the voting, dividend payment and other provisions of the deposit agreement under a sponsored program, thereby avoiding many of the market perception and corporate governance problems discussed above. Further, the issuer can communicate directly with ADR holders, which should foster more positive investor relations.

Conclusion

An issuer faces a host of potential problems when a depositary establishes an unsponsored ADR program on behalf of an issuer without the issuer's consent or knowledge. Non-US companies without unsponsored ADR programs should consider foreclosing the establishment of unsponsored ADR programs in their securities by establishing a sponsored Level I ADR program. Alternatively, non-US companies in non-English speaking jurisdictions that wish to avoid the establishment of an unsponsored ADR program should consider limiting English disclosure on their Web site, including adding a note to the effect that the information provided is not sufficient to satisfy Rule 12g3-(2)(b) provided there is relatively little or no US market interest in their securities. Non-US companies with unsponsored ADR programs also should address the following issues:

- Whether the issuer qualifies for the 12g3-2(a) exemption and is exempt from registration under the Exchange Act;
- Whether the issuer is able to remain fully compliant with revised Rule 12g3-2(b) and remain exempt from registration under the Exchange Act, including the potential for technical noncompliance for failure to present fully-translated English language annual reports and other required documents;
- Whether the issuer risks US market perception and corporate governance problems due to the existence of an unsponsored ADR program;
- Whether terminating an existing unsponsored ADR program can be done without having a negative effect on investor relations and on demand for the issuer's securities; and
- Whether establishing a sponsored Level I ADR program would promote the issuer's interests.

NOTES

1. SEC Release No. 33-6894 (May 23, 1991).
2. SEC Release No. 34-58465 (September 5, 2008).
3. "Holders of Record" under Rule 12g3-2(a) is determined by Rule 12g5-1, which generally defines holders of record as "each person who is identified as the owner on records of security holders maintained by or on behalf of the issuer…" However, for purposes of 12g3-2(a), securities held of record by a broker, dealer, bank or nominee for the accounts of US residents are counted as held by the number of separate accounts for which the shares are held. The issuer may rely in good faith on information as to the number of such separate accounts supplied by the brokers, dealers, or banks or a nominee for any of them.

DIRECTOR LIABILITY

The Business Judgment Rule Controls in Delaware—Even in Times of Economic Crisis

A recent Delaware Court of Chancery decision involving Citigroup and its investments in subprime mortgage assets finds that Citigroup's directors are not personally liable for the losses. The business judgment rule is alive and well.

by J. Travis Laster and T. Brad Davey

On February 24, 2009, Chancellor William B. Chandler, III of the Court of Chancery of the State of Delaware issued his decision in *In re Citigroup Shareholder Derivative Litigation,*[1] the first opinion to address the fiduciary duties of directors under Delaware law in the context of the unprecedented credit crisis and attendant disruptions to the financial industry and markets. The Chancellor dismissed the bulk of a complaint brought against former officers and directors of Citigroup, Inc. In doing so, he confirmed the continuing vitality of the business judgment rule as the bedrock of Delaware jurisprudence.

Background

In *Citigroup,* stockholders sued derivatively and alleged that the company's officers and directors breached their fiduciary duties by failing to monitor the risks associated with the company's exposure to subprime mortgage assets, despite numerous "red flags" warning of the impending crisis. The plaintiffs further alleged that the defendants breached their fiduciary duties by failing to make adequate and accurate financial disclosures relating to the company's subprime mortgage assets and by committing waste.

Defendants moved to dismiss or stay the action in favor of a separate action pending in the Southern District of New York. Defendants also moved to dismiss pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim and Court of Chancery Rule 23.1 for failure to plead demand futility. Chancellor Chandler denied the motion to dismiss or stay in favor of the New York action, but dismissed the entire complaint, except a single claim for waste based on the severance compensation agreement with Citigroup's former CEO, for failure to plead demand futility.

Motion to Dismiss or Stay

Because the Delaware action was filed "only a few days" after the New York action, Chancellor Chandler deemed them to have been filed contemporaneously.[2] As such, Chancellor Chandler did not apply the ordinary deference that Delaware affords to prior-filed actions,[3] but instead considered the motion to stay or dismiss "'under the traditional *forum non conveniens* framework.'"[4] Defendants' argument in favor of a stay, according to Chancellor Chandler, was simply "that it would be more expedient and convenient to litigate in New York rather than Delaware."[5] "Such considerations … without more," Chancellor Chandler concluded, "are not sufficient to entitle defendants to a stay on *forum non conveniens grounds*."[6] The plaintiffs therefore were entitled to their choice of forum.

Demand Futility Analysis

Having denied the motion to dismiss or stay in favor of the New York action, Chancellor Chandler next considered defendants' motion to dismiss for failure to adequately plead demand futility as required by Court of Chancery Rule 23.1. Plaintiffs argued that demand was futile as to the claims for failure to monitor business risk and inadequate disclosures, because the directors faced "a substantial threat of personal liability" with respect to those claims and, therefore, could not "exercise disinterested business judgment in responding to a demand."[7] Plaintiffs

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argued that demand was futile as to the waste claims, because the director defendants' approval of the challenged transaction "did not constitute a valid exercise of business judgment."[8]

Failure to Monitor Business Risk

Because plaintiffs argued demand futility based on a "substantial threat of personal liability," Chancellor Chandler first had to consider the appropriate standard for establishing personal liability based on a failure to exercise oversight. Chancellor Chandler began his analysis by reviewing *In re Caremark* and *Stone v. Ritter,* the two leading Delaware decisions addressing oversight liability. In *Caremark*, then Chancellor William T. Allen held that "only a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[9] In *Stone,* the Delaware Supreme Court "approved the *Caremark* standard for director oversight liability and made clear that liability was based on a concept of good faith."[10] Chancellor Chandler, therefore, concludes that "a showing of bad faith is a *necessary condition* to director oversight liability."[11]

A director's obligation to exercise oversight "does not eviscerate the core protections of the business judgment rule."

Chancellor Chandler, however, noted that the stockholder claims in *Citigroup* presented "a bit of a twist on the traditional *Caremark* claim." While the typical *Caremark* claim involves allegations of failure to monitor financial fraud or criminal misconduct, the stockholders' claims were based on a failure to monitor and anticipate business risk. "When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."[12] Viewed in that light, the claims of the stockholder plaintiffs fell within a type routinely turned aside by the Delaware courts pursuant to the business judgment rule. Chancellor Chandler made clear that a director's obligation to exercise oversight "does not eviscerate the core protections of the business judgment rule"—protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn our poorly.[13]

Chancellor Chandler also noted that bad faith is required to establish director liability for a separate and independent reason: The Citigroup certificate of incorporation contained an exculpatory provision authorized by 8 *Del. C.* §102(b)(7) shielding directors from personal liability for breaches of the fiduciary duty of loyalty, including the duty of good faith.[14] As a result, the plaintiffs could only recover damages by pleading a non-exculpated claim against the directors, such as a violation of the duty of loyalty or bad faith conduct. Because the stockholder plaintiffs did not allege that the directors were interested, personal liability only could be established, if at all, based on a showing of bad faith. To plead bad faith based on a failure to exercise oversight, a plaintiff must "allege particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business."[15] As Chancellor Chandler concluded,

> [t]he presumption of the business judgment rule, the protection of an exculpatory §102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.[16]

While Chancellor Chandler held open the possibility that a plaintiff might meet that burden under some set of facts, he concluded that the Citigroup plaintiffs had failed to do so. At the outset, Chancellor Chandler emphasized that plaintiffs did not "contest that Citigroup had procedures and controls in place that were designed to monitor risk."[17] Chancellor

Chandler then addressed the contention that the director defendants must not have made "a good-faith effort to comply with established oversight procedures" due to the presence of numerous "red flags" that "should have put the director defendants on notice of the impending problems in the sub-prime mortgage market and Citigroup's exposure thereto."[18] The "red flags," according to Chancellor Chandler were not "evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions."[19] Simply put, the "red flags" identified by the plaintiffs were not an adequate basis for the "Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk."[20] The defendant directors, therefore, did not face a substantial likelihood of personal liability and demand was not excused.

The Disclosure Claims

Chancellor Chandler reached a similar conclusion with respect to the disclosure claims. Because of the exculpatory charter provision, the plaintiffs had to plead "particularized factual allegations that 'support the inference that the disclosure violation was made in bad faith, knowingly or intentionally,'" in order to establish a substantial likelihood of personal liability based on the disclosure claims.[21] Plaintiffs, however, failed to allege: (1) the misstatements or omissions that constituted a violation of the duty of disclosure; (2) board involvement in the preparation of the disclosure; and (3) knowledge, on the part of the directors, that the disclosures were false or misleading.[22] Chancellor Chandler therefore concluded that the plaintiffs had failed to allege demand futility with respect to the disclosure claims.[23]

Waste Claims

Finally, Chancellor Chandler considered plaintiffs allegations that several transactions entered into by the company amounted to waste. Chancellor Chandler's analysis focused on two transactions: (1) the directors' approval of a stock repurchase program, and (2) a letter agreement pursuant to which the company agreed to pay its former CEO $68 million, in addition to continuing certain employment benefits, upon the his departure from the company. The Chancellor noted that in order to excuse demand as to a waste claim, a plaintiff "must allege particularized facts that lead to a reasonable inference that the director defendants authorized an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[24]

Plaintiffs' allegations with respect to the directors' approval of the stock repurchase program did not satisfy the standard. The Chancellor rejected out-of-hand plaintiffs' contention that no ordinary or rational business person would believe the company obtained adequate consideration in its repurchase of shares at the market price. Indeed, the Chancellor observed that the market price of the stock reflected the price at which ordinary and rational business people were trading the stock.[25]

Plaintiffs' challenge to the letter agreement, however, fared better. While directors have discretion in setting executive compensation, that discretion is not unlimited. The "outer limit" is demarcated at that point where "a decision of the directors on executive compensation [may be] so disproportionately large as to be unconscionable and constitute waste."[26] Plaintiffs alleged that under the terms of the letter agreement Prince would receive $68 million plus other perquisites in exchange for a promise not to compete, a non-disparagement agreement, a non-solicitation agreement, and a release of all claims against the company.[27] Taking the allegations of the complaint as true, Chancellor Chandler concluded there was a reasonable doubt as to whether the letter agreement moved beyond the "outer limit" of the directors' discretion to set executive compensation.[28] That claim, therefore, was the only claim to survive defendants' motion to dismiss for failure to plead demand futility.[29]

Implication for Practitioners

The *Citigroup* opinion confirms the continuing vitality of the business judgment rule, something that should not come as a surprise to practitioners familiar with the Delaware courts. But while not surprising, there are several noteworthy aspects of the decision.

First, in considering the plaintiffs' claims that the directors failed to monitor the company's business risk, Chancellor Chandler squarely rejected the idea that directors with special expertise should be held to a higher standard under Delaware law: "Directors with special expertise are not held to a higher standard of care in the oversight context."[30] Similarly, directors who sit on committees with oversight responsibility are not exposed to a higher "standard of director liability under *Caremark* and its progeny."[31] These holdings are important, as plaintiffs frequently argue that Audit Committee members or directors with special accounting or business degrees or experience "should have known" about particularly activities in light of their committee service, education, or experience.[32]

After* Citigroup*, plaintiffs will have an even more difficult time pleading bad faith in connection with a failure to monitor business risk.

Second, although Chancellor Chandler drew a distinction between traditional *Caremark* claims based on a failure to monitor for financial fraud or criminal misconduct and claims based on a failure to monitor business risks, both claims likely will require particularized allegations of bad faith when considered on a motion to dismiss pursuant to Rule 23.1. This is particularly true when the directors are protected by a Section 102(b)(7) exculpation provision. In both settings, this is a high bar. Nonetheless, after *Citigroup*, plaintiffs will have an even more difficult time pleading bad faith in connection with a failure to monitor business risk due to the Court's traditional deference to the business decisions of directors. This deference also reflects the recognition that taking business risk, unlike fraud risk or criminal risk, is an acceptable, expected, and typically desirable, aspect of a profitable business enterprise. As Chancellor Chandler explained, "[t]he essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses … make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return."[33] Stockholders can best address this risk through diversification, rather than litigation. For those reasons, plaintiffs seeking to establish personal director liability for failure to monitor business risk likely will be required to plead facts similar to a waste claim, *i.e.* a scenario where no business person of ordinary, sound judgment would deem the business risk in question to be acceptable.

Third, for a long time, it has been understood that waste claims under Delaware law were not only difficult to prove, but difficult to plead. It is not clear whether Chancellor Chandler's denial of the motion to dismiss with respect to the letter agreement signals that the Delaware courts will now be more receptive to waste claims. As a result of this decision, it is safe to predict that large compensation packages, particularly severance packages, likely will be the target of increased scrutiny and litigation.

NOTES

1. *In re Citigroup Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009).
2. *Id.* at 116.
3. In *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Engineering Co.*, 263 A.2d 281, 283 (Del. 1970) (emphasis added), the Delaware Supreme Court held that the discretion of Delaware courts to stay an action "should be exercised freely in favor of the stay when there is a *prior action* pending elsewhere, in a court capable of doing prompt and complete justice, involving the same parties and the same issues."
4. *Citigroup*, 964 A.2d at 116 (*quotingThe Bear Sterns Cos. S'holder Litig.*, C.A. No. 3643-VCP, 2008 WL 959992, at *5 (Del. Ch. Apr. 9, 2008).
5. *Id.* at 119.
6. *Id.*
7. *Id.* at 121.
8. *Id.*
9. *Id.* at 122.
10. *Id.* at 122–123 (*citingStone v. Ritter*, 911 A.2d 370 (Del. 2006)).
11. *Id.* at 124.
12. *Id.* at 121.
13. *Id.* at 125.
14. *Id.* at 124–125.
15. *Id.* at 125.
16. *Id.* at 127.
17. *Id.*
18. *Id.*
19. *Id.* at 128.
20. *Id.* at 130.

21. *Id.* at 132 (*quotingO'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 915 (Del. Ch. 1999)).

22. *Id.* at 132–135.

23. *Id.* at 135.

24. *Id.* at 136 (*quotingBrehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

25. *Id.* at 137.

26. *Id.* at 138 (*quotingBrehm*, at 262, n.56).

27. *Id.* at 138.

28. *Id.*

29. Because the standard for pleading demand futility is higher than the standard for stating a claim, the waste claim also survived defendants' motion to dismiss pursuant to Court of Chancery Rule 12(b)(6).

30. *Id.* at 128, n.63.

31. *Id.*

32. These holdings stand in contrast to the decision in *In re Emerging Communications Shareholder Litigation*. C.A. No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004). In that case, then-Vice Chancellor Jacobs determined that a going private transaction led by the company's majority stockholder was not entirely fair. In assessing the liability of individual directors, the Court considered that one of the directors, as an investment banker, had "specialized financial expertise" and was, therefore, in a "unique position to know" that the transaction was unfair. *Id.* at *39.

33. *Citigroup*, 964 A.2d at 126.

STATE CORNER

Amendments to Delaware General Corporation Law

by Michael B. Tumas and John F. Grossbauer

In February, the Delaware State Bar Association approved proposed amendments to the General Corporation Law of the State of Delaware (General Corporation Law). The bill containing the amendments was approved by the Delaware legislature and was signed by the governor on April 10, 2009. The amendments become effective on August 1, 2009.

Consistent with Delaware's preference for enabling legislation and maintaining maximum flexibility, the amendments eschew mandates for corporate action. Specifically, the amendments create new Sections 112 and 113 that expressly permit Delaware corporations to adopt bylaws implementing proxy access and requiring reimbursement of stockholder proxy expenses in certain circumstances. Also included among the amendments are changes to Section 213 to permit Delaware corporations to provide separate record dates for determining stockholders entitled to notice of and to vote at stockholder meetings, a revision to Section 145(f) expressly providing that pre-existing indemnification and advancement rights provided in a corporation's governing documents cannot be impaired by later amendments to those documents, and a new provision permitting judicial removal of directors under specified circumstances.

Michael B. Tumas and John F. Grossbauer are partners at Potter Anderson & Corroon LLP, in Wilmington, DE. The views expressed are those of the authors and may not be representative of those of the firm or its clients. An earlier version of this article appeared in materials relating to the 21st Annual Corporate Law Institute at Tulane University Law School.

Shareholder Access to Proxy Solicitation Materials (New Section 112)

The amendments create a new section of the General Corporation Law expressly authorizing a Delaware corporation to adopt a bylaw that grants stockholders the right to include within the corporation's proxy solicitation materials stockholders' nominees for the election of directors, subject to any lawful conditions the bylaws may impose. The subject of "proxy access" has been a controversial matter, and it promises to continue to be so in the current environment. At issue is whether companies may be required to include in company proxy materials nominees for director proposed by stockholders in addition to nominees proposed by the company. Activist investor groups have long argued that stockholders should be permitted to nominate directors without having to mount a costly proxy battle.

The Securities and Exchange Commission (SEC) is expected to revisit the issue of proxy access this year, and it is possible that the SEC will reverse its long-standing policy of permitting companies to exclude from its proxy materials shareholder proposals seeking the adoption of proxy access rules.[1] If the SEC revises its present position on proxy access and permits stockholder proposals to be included on a company's proxy materials, Section 112 will facilitate the adoption and implementation of proxy access by Delaware corporations.

Section 112 removes any uncertainty regarding the ability of Delaware corporations to effect proxy access through adoption of a bylaw. In particular, the bylaws of a Delaware corporation may require that if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its proxy materials one or more nominees submitted by stockholders, subject to certain limitations and conditions. The amendment clarifies that corporations may impose reasonable restrictions on the stockholders' right to access company proxy materials and identifies a non-exclusive list of restrictions that are deemed to be reasonable.

One condition specified in Section 112 would permit the bylaws to establish minimum ownership requirements for stockholders to become eligible to include nominees in company proxy materials, measured both by amount and duration of ownership. The bylaws may establish this minimum ownership threshold by defining beneficial ownership to include ownership of options or other rights relating to stock, including derivative rights. Because Section 112 is intended to apply to stockholder nominations of short slates of directors and not as a vehicle for effecting changes of control through the corporation's own proxy materials, the new section also expressly permits the bylaws to condition eligibility for inclusion in the corporation's proxy materials to nominations for a limited number of seats that may be contested and to preclude entirely inclusion of nominations by persons who own or propose to acquire (such as through a tender offer) more than a specified percentage of the corporation's stock.

The bylaws also may require the nominating stockholder to submit specified information such as information concerning the ownership of the corporation's stock by the stockholder and the stockholder's nominees. In addition, the bylaws may condition eligibility to require inclusion of nominees in the corporation's proxy materials on the nominating stockholder's execution of an undertaking to indemnify the corporation for any loss resulting from any false or misleading information submitted by the stockholder and included in such proxy materials, or on "any other lawful condition."

The adoption of Section 112 thus provides a more certain path for corporations and stockholders desiring to implement proxy access to balance the often disruptive nature of proxy contests with the desire to provide significant stockholders an avenue for effecting changes to the composition of the board of directors.

Proxy Reimbursement Bylaws (New Section 113)

The other new election-related statute is Section 113, which effectively codifies the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan.*[2] In *CA, Inc.*, the Delaware Supreme Court answered certified questions of Delaware law from the SEC, as permitted under a recent amendment to the Constitution of the State of Delaware.[3] In an *en banc* opinion, the Delaware Supreme Court held that a proposed bylaw that would have required CA, Inc. to reimburse the reasonable expenses of stockholders that were successful in short-slate director election contests was a proper subject for stockholder action, but, as drafted, would violate Delaware common law by infringing on the directors' ability to fully discharge their fiduciary duties. In particular, the Court found that, notwithstanding the fact that the proposed bylaw specifically would require and direct the board to expend corporate funds, the context of the bylaw at issue was largely procedural in nature. The Court reasoned that stockholders of Delaware corporations have the right to participate in the nomination process and thus, "the shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election."[4]

Nevertheless, the Court ultimately determined that the proposed bylaw was inconsistent with Delaware law because, if adopted, the bylaw would require the board of directors to expend corporate funds without regard to their fiduciary obligations. Importantly, the Court noted that the bylaw was unenforceable as drafted "because the bylaw contain[ed] no language or provision that would reserve to CA Inc.'s directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."[5] Justice Jacobs, writing for the Court, suggested that under at least one set of circumstances, the board of directors could be obligated to reimburse proponents that were successful, even if the proxy contest in question was driven by interests that conflicted with those of the corporation.[6] Accordingly, the Court concluded that the fact that the proposed bylaw would require the board to expend corporate funds without regard to their fiduciary duties violated Delaware law and rendered the bylaw unenforceable as drafted.

Consistent with the Supreme Court's decision in *CA, Inc.*, new Section 113 would provide a statutory framework for the development of bylaw provisions

that mandate reimbursement of reasonable expenses incurred by stockholders who achieve a defined level of success in a proxy contest. Specifically, Section 113(a) permits Delaware corporations to adopt a bylaw providing for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaw may prescribe. Section 113 identifies a non-exclusive list of such conditions, including: (1) conditioning eligibility for reimbursement on the number or proportion of persons nominated by the stockholder; (2) conditioning eligibility on whether the stockholder previously sought reimbursement for similar expenses; (3) limiting the amount of reimbursement (which may be based on the proportion of votes cast in favor of such nominee or the amount expended by the corporation in soliciting proxies); (4) limiting elections of directors by cumulative voting; or (5) any other lawful condition. The restrictions thus permit corporations to limit the reimbursement to "short slate" contests, to define what level of "success" must be achieved in order to qualify for reimbursement, and otherwise to tailor their bylaws to their specific situation.

Section 113 does not, however, include an express requirement that any proxy reimbursement bylaw contain a fiduciary out. It remains to be seen whether, notwithstanding the express statutory authority for a proxy reimbursement bylaw provided by Section 113, Delaware courts will read a fiduciary out requirement into such a bylaw.

Record Date/Notice Amendments (Section 213(a))

Another issue addressed in the 2009 amendments has its origins in the concern over the effects of "empty voting." Empty voting most commonly occurs when a stockholder: (1) sells its shares during the period of time after the record date and prior to the date of a stockholder meeting; (2) acquires voting rights to a significant block of publicly traded stock without acquiring a comparable economic interest in the company; or (3) simultaneously takes a short position that offsets the stockholder's economic interest in the company. By divorcing voting power from economic interest, empty voting potentially disrupts the presumed tendency of stockholders to vote in a manner that maximizes their ownership interests in the company.

Hedge funds and other large stockholders that are successful in borrowing a significant number of shares and/or shorting the underlying stock may acquire enough voting power to swing a stockholder vote in their favor without having to take a comparable economic stake in the corporation. Under such circumstances, a significant number of shares could be voted in a manner that is inconsistent with the best interests of the corporation or its economic owners. For example, a hedge fund could borrow a large number of shares prior to the record date for the vote on a proposed merger, vote against the merger and sell the shares short, resulting in a profit derived from the knowledge that the proposed merger would be defeated.

One of the factors contributing to "empty voting" is the relatively long period of time between the record date and the date of a stockholder meeting. The amendments to Section 213(a) of the General Corporation Law, which outlines the process by which corporations may determine stockholders of record for purposes of stockholder meetings, provide a partial answer to this issue by permitting a board of directors to fix a record date for voting separate from the record date for notice of the stockholder meeting. In this way, a board may fix a record date that is closer to the meeting date, and presumably more reflective of the stockholder base, than a record date that is as many as 60 days prior to the meeting date.

The need to provide for notice well ahead of a meeting frequently occurs in the situation of votes to approve mergers and other similar matters requiring a longer solicitation period. This sometimes has led to difficulty in obtaining required majority votes in situations in which a large number of shares changes hands following a record date because the holders of sold shares often fail to vote, and purchases in the public markets do not automatically carry with them associated authority to direct the voting of shares acquired after the record date. Revised Section 213(a) provides no limit on how close the voting record date may be to the meeting date.

For public companies, this will need to be determined in consultation with non-Delaware participants such as transfer agents, stock exchanges, and proxy advisory services.

The amendments to Section 213(a) also add language applying the separation of notice and voting record dates to adjourned meetings. Other fundamental provisions of Section 213(a), including the requirement that the record date for notice and for voting be not more than 60 or less than 10 days before an upcoming meeting, remain unchanged.

The changes in Section 213 necessitate conforming changes to a number of other sections to include the concept of different record dates for determining entitlement to notice and to exercise voting rights. These include Sections 211, 219, 222, 228, 262, and 275.

Indemnification and Advancement Rights (Section 145(f))

The amendments amend Section 145(f) of the General Corporation Law to adopt a default rule that is contrary to that articulated by the Court of Chancery in *Schoon v. Troy Corp*.[7] In that case, the Court of Chancery held that a board of directors can amend a corporation's bylaws to eliminate indemnification or advancement rights for claims relating to actions taken prior to such amendment, provided that no claim has actually been made against the indemnitees before the amendment is adopted.

In *Schoon*, William J. Bohnen (Bohnen), a former director of Troy Corporation (Troy), pursued claims for advancement in connection with defending threatened and pending fiduciary duty claims asserted by Troy. Bohnen was the director-nominee of Steel Investment Company (Steel) from 1988 until February 2005, at which time Richard W. Schoon (Schoon) replaced Bohnen. In September 2005, Steel and Schoon sued Troy for access to certain books and records under Section 220 of the General Corporation Law. Shortly thereafter, in November 2005, Troy's board of directors amended the bylaws to remove the word "former" from its definition of the directors entitled to advancement.[8] In early 2006, Troy initiated fiduciary duty claims against Bohnen and Schoon, alleging that the former and current directors provided proprietary information to Steel in contravention of their fiduciary obligations to Troy.

While the proceedings were pending, Bohnen and Schoon formally demanded advancement of their fees and expenses in defending the fiduciary duty claims. The Court of Chancery determined that as a former director, Bohnen was not entitled to advancement under the amended bylaws. Bohnen argued that his rights in the pre-amendment bylaws, which granted former directors the right to advancement, vested before the adoption of the amendment.[9] The Court of Chancery rejected this argument and found that the right to advancement vests upon the triggering of the corporation's obligations. Thus, even though the alleged breaches occurred before the bylaw amendments, because Bohnen was not named as a defendant until *after* the Troy board amended the bylaws (nor was there any evidence that Troy was even contemplating claims against him prior to the amendments), his rights under the pre-amendment bylaws had not been triggered.[10]

After the Court's decision in *Schoon*, many corporations revised their governing documents or entered into indemnification agreements with indemnitees expressly negating the effects of the Court's opinion. The amendment to Section 145(f) adopts a statutory rule that eliminates these concerns. Specifically, pursuant to revised Section 145(f), a corporation cannot eliminate or impair an indemnitee's right to indemnification or advancement of expenses granted under a provision in the corporation's certificate of incorporation or bylaws through an amendment to such provision adopted after the occurrence of the act or omission to which the indemnification or advancement of expenses relates. Such an amendment eliminating indemnification or advancement rights may be permitted, however, if the provision in the certificate of incorporation or bylaw in effect at the time of the act or omission includes language expressly authorizing such elimination or limitation.

Judicial Removal of Directors (Section 225)

Section 225, which affords directors, stockholders, and corporations the right to a judicial

determination of entitlement to office or the outcome of a stockholder vote, has been amended to add a new subsection (c) authorizing the Court of Chancery to remove a director in certain narrow circumstances upon the application of a corporation or derivatively by a stockholder on behalf of a corporation. The new subsection (c) authorizes the Court of Chancery to remove a director who has been convicted of a felony or found by a court to have committed a breach of the duty of loyalty if the Court of Chancery determines that the director did not act in good faith in performing the acts underlying the conviction or judgment and that the removal of the director is necessary to avoid irreparable harm to the corporation. New Section 225(c) purposely is drafted very narrowly, and expressly requires that an action thereunder be brought "subsequent" to the one in which the underlying judgment is made. This amendment is similar to, though more circumscribed than, the judicial removal of directors provision in the Model Business Corporation Act,[11] which has been enacted by several states.

Conclusion

Sections 112 and 113 will provide useful guidance to Delaware corporations should they be required to (or choose to) implement proxy access or proxy reimbursement. In particular, the expressly approved conditions eliminate any uncertainty that may have existed concerning the ability of Delaware corporations to condition the exercise of such rights on minimum thresholds for ownership and maximum limits on the number of seats to be contested or amounts that may be reimbursed. In addition, directors should carefully consider the impact of the changes to Sections 213(a) and other statutes permitting a board of directors to fix a record date that is closer in time to a meeting date.

NOTES

1. SEC Chairman Mary L. Schapiro, "Address to the Council of Institutional Invstors," April 6, 2009, available at *www.sec.gov/news/speech/2009/spch040609mls.htm*.
2. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).
3. Del. Const. Art. IV, Sec 11(8) (amended 2007) (authorizing the Delaware Supreme Court to hear and determine questions of law certified to it by (in addition to the tribunals already specified therein) the SEC).
4. *CA, Inc*., at 237.
5. *Id*. at 240.
6. *Id*.
7. *Schoon v. Troy Corp.,* 948 A.2d 1157 (Del. Ch. 2008).
8. *Id*. at 1161.
9. *Id*. at 1165. In support of his argument, Bohnen cited *Salaman v. National Media Corp*., 1992 Del. Super. LEXIS 564 (Del. Super. Oct. 8, 1992), wherein the Superior Court granted advancement rights to a director for fees incurred in connection with defending a breach of fiduciary duty claim. In that case, after advancing the plaintiff a portion of his fees, the defendant corporation amended its bylaws to repeal the basis for the claimed right and then refused any further advancement. The Salaman Court rejected the corporation's argument that it could amend the bylaws to deny Salaman his preexisting right to advancement, holding that the corporation could not "unilaterally rescind a vested contract right upon which Salaman relied." *Id*. at *17. In the instant case, however, Bohnen "fail[ed] to acknowledge that the Court only upheld Salaman's right to advancement because he was named as a defendant before the bylaw was amended." *Schoon*, 948 A.2d at 1166 (emphasis added).
10. *Id*. at 1166.
11. Model Business Corporation Act, § 8.09.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested parties concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of any of the listed memoranda should contact the firms directly; some firms may charge a nominal fee for copying and mailing.

Akin Gump Strauss Hauer & Feld LLP
Washington, DC (202-887-4000)

New SEC Areas of Focus: Preferential Redemptions and Account Holdings Confirmation (March 24, 2009)

A discussion of announcements by the SEC and its Office of Compliance Inspections and Examinations concerning new focus areas related to hedge fund redemptions and advisers' statements to fund investors.

Alston & Bird LLP
Washington, DC (202-756-3300)

Update: NYSE Continues with Elimination of Broker Non-Votes (March 4, 2009)

A discussion of the New York Stock Exchange (NYSE) filing of a proposed amendment to Rule 452, which permits brokers to vote on "routine" proposals when the beneficial owner of the stock fails to provide specific voting instructions to the broker at least 10 days before a scheduled stockholder meeting. The proposed amendment would remove the election of directors from the list of "routine" items.

Arnold & Porter LLP
Washington, DC (202-942-5000)

Implications of Recent Developments in SEC Enforcement (March 2009)

A discussion of the steps recently taken by the SEC to focus on enforcement and to restore investor confidence in the financial markets, including ending the two-year pilot program requiring the SEC staff to obtain approval from the Commission before negotiating civil money penalties with public companies and permitting formal orders of investigation to be approved quickly. In addition, the focus on enforcement is being backed by proposed increases in SEC funding. The memorandum cautions companies to be vigilant in ensuring compliance with the federal securities laws and SEC inquiries.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

SEC Approves Chicago Mercantile Exchange Inc. as the Third Central Counterparty for the Clearance of Default Swaps (March 25, 2009)

A discussion of the SEC's approval of temporary and conditional exemptions that would allow the Chicago Mercantile Exchange Inc. to operate a central counterparty for the clearance of credit default swaps. This is the SEC's third approval of the operation of such a central counterparty since November 2008.

Dewey & LeBoeuf LLP
New York, NY (212-259-8000)

FASB Holds Roundtable Discussion on Disclosure of Certain Loss Contingencies (March 13, 2009)

A discussion of FASB roundtables held on March 6, 2009 concerning the disclosure of certain loss contingencies, following its proposal in June 2008 of amendments to Statement of Financial Accounting Standards No. 5, Accounting for Contingencies.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

"Going Dark": Voluntary Delisting and Deregistration under the Securities Exchange Act of 1934 (March 17, 2009)

A discussion of "going dark"—the process of voluntary delisting a public company's shares from a national securities exchange or inter-dealer quotation system and subsequently deregistering its shares under the Securities Exchange Act of 1934 (Exchange Act), thus suspending or terminating the public company's reporting obligation. However, delisting alone does not eliminate public reporting requirements as many non-listed companies also are reporting issuers.

Edwards Angell Palmer & Dodge LLP
Boston, MA (617-239-0100)

SEC Adopts Amendments to Rule 15c2-11 relating to Municipal Securities Disclosure (March 2009)

A discussion of amendments to SEC Rule 15c2-12 that will require brokers, dealers or municipal securities dealers acting as underwriters of a primary offering of municipal securities to reasonably determine that the issuer or obligated person has agreed to provide information to the Municipal Securities Rulemaking Board and to provide such information in an electronic format.

Foley & Lardner LLP
Milwaukee, MN (414-271-2400)

Shifting Landscape for D&O Insurance in the Economic Crisis (March 17, 2009)

A discussion of the director and officer liability insurance market in the current economic environment and the issues facing AIG. Some of the provisions likely to be tested are: (1) "order of payment"/"priority of payment" provisions; (2) the insured versus insured exclusion; and (3) the importance of Side A coverage generally.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-229-7870)

NYSE Clarifies Stockholder Approval Requirement in Convertible Debt Exchange Offers (March 5, 2009)

A discussion of guidance provided by the NYSE staff with respect to its Rule 312.03 requiring stockholder approval if the number of shares to be issued equals or exceeds 20 percent of the shares actually outstanding.

Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY (212373-3000)

SEC Adopts New Rules for Credit Rating Agencies (March 16, 2009)

A discussion of new SEC rules under the Credit Rating Agency Reform Act of 2006 that require: (1) enhanced disclosure of performance measurement statistics and ratings methodologies; (2) Web site disclosure of the rating histories of a sample of issuer-paid credit ratings; (3) additional record-keeping and annual reporting; and (4) adherence to additional restrictions designed to prevent conflicts of interest.

Wachtell, Lipton, Rosen & Katz
New York, NY (212-403-1000)

Moody's New Guidance on Ratings Implications of Exchange Offers and Restructurings (March 25, 2009)

A discussion of Moody's recently published updated guidance on the implications of debt exchange offers, tender offers and repurchases on credit ratings. *Moody's Approach to Evaluating Distressed Exchanges* (March 2009). The memorandum indicates that, like S&P, Moody's seeks to distinguish between "distressed" transactions, designed to avoid bankruptcy or default by the issuer, and opportunistic offers made by healthy issuers.

INSIDE THE SEC

SEC Considers NYSE Amendment to Eliminate Broker Discretionary Voting

by Susan Reilly

The Securities and Exchange Commission (SEC) recently published for comment a proposed amendment to New York Stock Exchange (NYSE) Rule 452, *Giving Proxies by Member Organizations*, that would limit the ability of brokers to cast discretionary votes in uncontested director elections. Because Rule 452 applies to brokers, the proposed amendment, if adopted, will impact not only companies listed on the NYSE, but also other companies.

The proposed amendment to Rule 452 must be approved by the SEC before it takes effect and is subject to a public comment period, which closed on March 27, 2009. If adopted by the SEC, the proposed amendment will be applicable to proxy voting for shareholder meetings held on or after January 1, 2010. However, if the proposed amendment is not approved by the SEC until after August 31, 2009, the effective date will be delayed until a date that is at least four months after the approval date and that does not fall within the first six months of the calendar year. In any case, the proposed amendment will not apply to a shareholder meeting that was originally scheduled to be held prior to the effective date but was properly adjourned to a date on or after the effective date.

Background and Proposed Amendment

Under current rules, brokers are required to deliver proxy materials to beneficial owners and request that the beneficial owners provide voting instructions. If brokers do not receive voting instructions by the 10th day preceding a company's scheduled shareholder meeting, Rule 452, allows brokers to exercise discretionary voting authority and thus vote on certain matters the NYSE considers "routine," including uncontested director elections. In contrast, brokers are not permitted to vote on "non-routine" matters without receiving instructions from the beneficial owners. Rule 452 currently lists 18 items that are considered "non-routine," including matters involving an election contest or any matter that may affect substantially the rights or privileges of shareholders. The proposed amendment to Rule 452 would make uncontested elections of directors a "non-routine" matter, meaning that brokers could not vote on such matters absent specific instructions from their clients. Thus, the amendment to Rule 452 would eliminate broker discretionary voting in uncontested director elections.

NYSE Proxy Working Group

In April 2005, the NYSE created a Proxy Working Group to review the NYSE rules governing the proxy voting process, with particular focus on Rule 452. The Working Group included representatives from a number of different constituencies, including companies, NYSE member organizations, the legal community, institutional investors, and individual investors. The Working Group issued its report and recommendations in June 2006.[1] Among the Working Group's recommendations was that the NYSE amend Rule 452 to make uncontested elections of directors a "non-routine" matter. The Working Group also recommended that the NYSE work with the SEC and companies to develop a "significant investor education effort" to inform investors about the proxy process and the importance of voting and that the NYSE support a review by the SEC of its shareholder communications rules to consider how to improve communications between companies and their beneficial owners.

Alternatives

Critics of Rule 452 object to the rule on the basis that it allows persons without an economic interest in a company to vote on corporate matters and, at least until recently, because brokers typically have voted uninstructed shares in accordance with the

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recommendations of an company's board of directors. However, in recent years, some brokers have implemented policies whereby they will not vote shares as to which they have not received voting instructions. In addition, a number of brokers have implemented proportional voting on "routine" matters, whereby the brokers will vote uninstructed shares in the same proportion as those shares for which they received voting instructions from their other retail shareholders. The NYSE Proxy Working Group considered the alternative of proportional voting and concluded at the time it issued its initial report that, although a proportional voting system was "somewhat attractive," it was not the "optimum result." In an addendum to the Working Group's report released in August 2007,[2] the Working Group stated that it planned to review the experiences of brokers who have implemented proportional voting to determine whether proportional voting is a viable alternative.

The addendum to the Working Group's report also discussed a new proposal developed by Working Group member Stephen Norman called Client Directed Voting. Under Client Directed Voting, when an investor opens a brokerage account, the investor would be allowed (but not required) to provide a "good until cancelled" instruction on matters to be voted on at companies in which they own stock. Investors would be permitted to elect whether to always: (1) vote in accordance with the board's recommendation; (2) vote against the board's recommendation; (3) abstain from voting; or (4) vote proportionally with the broker's retail clients' instructed votes on the same issue. At the time of any proxy solicitation, each investor would receive a notice from their broker reminding the investor of their standing instructions and how those instructions would be implemented with respect to the upcoming vote. Investors would then have the ability to override their standard instructions by providing specific voting instructions. The Working Group stated in the addendum that it would continue to evaluate the advantages and disadvantages of Client Directed Voting in light of its recommendation to amend Rule 452.

Comment Letters

The SEC received over 100 comment letters on the proposed amendment to NYSE Rule 452 from various groups, including companies, institutional investors, proxy advisory firms, law firms and others. Institutional investors generally encouraged the SEC to approve the proposed amendment to Rule 452 and in some cases, urged the SEC to consider an earlier implementation date. Many institutional investors emphasized that director elections should not be considered "routine," as electing directors is one of the most important decisions shareholders make. In addition, institutional investors noted that the elimination of broker discretionary voting in uncontested director elections would ensure that voting results in director elections are not "distorted" or "skewed" by broker votes.

On the other hand, companies generally did not support approval of the proposed amendment to Rule 452 at this time. They emphasized that any amendment to Rule 452 should not be considered in isolation, but instead should be considered in connection with a broader review of the proxy voting and shareholder communications system. Specifically, they noted that the SEC's current shareholder communication rules, which preclude direct communication between companies and many of their shareholders, present a significant obstacle to efficient communication. Companies also noted that eliminating broker discretionary voting in uncontested director elections without a corresponding investor education effort could impact adversely shareholders' exercise of their rights, as many shareholders may continue believing that even if they do not provide voting instructions, their brokers will vote on their behalf. Companies also noted that the interaction of the amendment to Rule 452 with a majority vote standard in uncontested director elections, which a growing number of companies have adopted, could raise substantial questions. Finally, companies noted that the elimination of broker discretionary voting in uncontested director elections could result in quorum problems at companies that do not have at least one routine item on their ballot.

Notably, the NYSE Proxy Working Group submitted a comment letter expressing its continued support of the amendment to Rule 452 to eliminate broker discretionary voting for the election of directors. However, the Working Group also noted its belief that the SEC should consider using the

opportunity created by the proposed amendment to Rule 452 to engage in a broader review of the current proxy system and "consider changes that take advantage of technical advances to increase efficiencies and reduce costs while protecting the varied interests of all participants in the proxy process . . . ."

SEC Chairman Announces Corporate Governance Agenda

In a speech to the Council of Institutional Investors on April 6, 2009, SEC Chairman Mary Schapiro announced an ambitious rulemaking agenda in the area of corporate governance and securities disclosure. She indicated that the issue of shareholder access to company proxy materials to nominate directors will once again be considered by the Commission in late May. This will be followed in June with proposals mandating additional disclosure concerning: (1) director nominee experience, qualification and skills; (2) a board's rationale for selecting its particular leadership structure (*e.g.*, independent chair, lead director, etc); (3) how a company—its board and management—addresses risk, generally and with specific focus on compensation; and (4) compensation, with respect to how the company's compensation structure drives an executive's risk taking and how it applies beyond executives. In response to a question, Schapiro indicated that later this summer, the Commission would consider the requests it had received for additional disclosure concerning environmental and social matters that might have a material impact.

In her speech, she also identified the regulation of market professionals and intermediaries as another area to which the SEC was devoting a great deal of attention. Among other things, she mentioned registration of hedge funds and their advisors, addressing the disparate regulation of broker-dealers and investment advisors, increasing the disclosure required of credit rating agencies and enhancing the standards applicable to money market funds.[3]

NOTES

1. Available at: *http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf*.
2. Available at: *http://www.nyse.com/pdfs/PWGAddendumfinal.pdf*.
3. Available at: *http://www.sec.gov/news/speech/2009/spch040609mls.htm*.

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