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Directors' Actions Scrutinized in *Sample v. Morgan*

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Special to the DLW

In *Sample v. Morgan, et al.*, 2007 WL 177856 (Del. Ch., Jan. 23, 2007), the Court of Chancery addressed the risk of liability resulting from a committee of the board of directors not acting in a truly and "obviously" independent manner.

This opinion comes on the heels of a very recent opinion in *ATR-Kim Eng Financial Corporation v. Araneta*, 2006 WL 3783520, (Del. Ch., Dec. 21, 2006), where the Chancery Court chided directors for being mere "stooges" of the majority shareholder. In this case the two members of the compensation committee were non-employee directors described as being, at best: "unwitting and uninformed accomplices in this pre-conceived plan" to allegedly entrench the majority of directors.

The *Sample* decision is a reminder that in order to be treated as actually independent, committees of the board must have independent advisers, must be fully informed and must not be seen as merely doing the bidding of the interested directors, if they seek to avoid calling into question their duty of loyalty and their duty of care.

This case involved a very small publicly held company with annual sales of about \$10 million. It was not very profitable and the contested actions of the directors made it lose even more money.

The factual background involves an effort by the five member board of directors to seek approval from the stockholders for a certificate amendment and a management stock incentive plan that reduced the par value of the stock and also authorized the issuance of 200,000 new shares in order to "attract and retain" key employees.

The 200,000 shares represented a 46 percent increase in the number of shares that were issued and outstanding compared to the 431,680 shares as of the time the board approved the certificate amendment and the incentive plan. The stockholders were told that a committee made up of non-employee directors would determine which employees would receive the shares and under what terms and conditions they would be distributed.

The same day that barely a majority of the stockholders voted to approve the plan, a compensation committee was formed to implement the incentive plan. The first meeting lasted 25 minutes during which the two-member committee considered a

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proposal by the company's outside counsel to grant all 200,000 shares to only three employees — the CEO, the CFO and the vice president of manufacturing — all of whom were directors and who comprised the majority of the five member board.

About 10 days later, the second meeting of the committee, lasting 20 minutes, approved in substantially similar form, the proposal made by the company's outside counsel. The committee only required the recipients of the shares (which were the majority of the directors) to pay one-tenth of one penny for the shares which were valued at \$5.60 per piece.

The committee also caused the company to borrow approximately \$700,000 to cover the taxes owed by the recipients of the shares. The year that these transactions

occurred was 2004 and during that year the company lost \$1.7 million before taxes. Throughout the process, the only adviser to the committee was the company's outside counsel, the same counsel who made the proposal to grant all 200,000 shares to the three directors constituting the majority of the board.

In their proxy to the shareholders, the directors did not disclose that the company's outside counsel originally proposed that all 200,000 shares be issued only to the three inside directors. Nor was it disclosed that at the same time the board approved the incentive plan, they also approved the terms for the sale of the largest bloc of stock that restricted the board from issuing any new shares for five years. Nor was it disclosed that the company's outside counsel had proposed the incentive plan in the context of efforts by the majority of the board to maintain control.

Procedurally, the court was reviewing a motion to dismiss under Rule 12(b)(6), which motion the court referred to as frivolous. Moreover, the court had earlier denied a motion to stay discovery pending the motion to dismiss. Importantly, the

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court, during discovery, compelled the production of the memos by the company attorney to the inside directors, rejecting claims that the memos were protected by privilege.

The court rejected the argument that the board was insulated by stockholder approval of the plan for two reasons.

Initially, the doctrine of ratification is not a blank check. The authority given by stockholders to directors is broad but is tempered by the requirement that the authority be exercised consistently with equitable principles of fiduciary duty. Footnote 54 has a few "money quotes." The court cites to law review articles and Delaware cases for this important principle of broad application:

Every corporate action must be twice-tested: First, by the technical rules having to do with the existence and the proper exercise of power; second, by equitable rules

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applicable to fiduciaries.

The next reason that the directors' argument of ratification failed is due to their

inability to demonstrate that they disclosed all material facts to the stockholders in connection with their efforts to obtain stockholder approval for their actions.

In order to gain entry into the safe harbor of ratification, one must meet the burden of demonstrating full and fair disclosure. The court discusses the requirements of materiality and why they were not met in this case. Among the important facts not disclosed to shareholders was the memo by the company's outside counsel that contemplated all the shares going to the three employee-directors. The plan was advertised as designed to attract employees, but who was the plan designed to attract if all the shares went to existing directors?

The court *refused* to accept the argument that simply because the non-employee directors may not have been "beholden" to the majority employee-directors, the claims

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against them should be dismissed. This is so for two reasons.

First, if evidence at trial shows that the compensation committee knew of the scheme to entrench the other directors, questions about their duty of loyalty are raised, at a minimum.

Second, if the compensation committee did not inform themselves enough to find out relevant details about the scheme, then issues arise regarding whether they satisfied their duty of care.

Moreover (and this is especially noteworthy from my perspective), the court suggested the possibility of fraud by the company's outside counsel (who was the only adviser to the committee) if he did not disclose the material facts of the plan to the committee. If it was not disclosed, the other directors who were the recipients of the outside counsel's memo (regarding entrenchment) may also implicitly, according to the court, be involved in the same potential fraud on the committee.

Thus, the court could not give business judgment rule protection to a committee whose magnanimous actions (to put it charitably) in approving the issuance of shares, and payment of taxes on those shares, by the company might have been due to a poorly informed analysis based on conflicted advice from a lawyer subservient to management.

The concept of corporate waste was also discussed and though it is usually subsumed by the duty of loyalty, based on the extreme facts of this case, the court said it could not rule out that waste occurred — even with the very high threshold that must be met for that claim.

Importantly, the court also discussed the concept of "abdication" of a board's authority and examined what type of contract a board of directors can sign without abdicating its authority pursuant to Section 141(a) of the DGCL (See footnotes 75 to 78). The court viewed certain contracts limiting a board's exercise of power as consistent with exercising its authority. The court reasoned that as it relates to the agreement in this case, there was nothing untoward about a board restricting its future ability to issue shares and that it was perfectly reasonable for a buyer of shares to protect its investment from being diluted.

The court distinguished in Footnote 79 several Delaware Supreme Court cases that address agreements that restrict a board's future actions, such as *Quickturn Design Systems Inc. v. Shapiro*, 721 A.2d 1281 (Del.

1998) and *Omnicare Inc. v. NCS Healthcare Inc.*, 818 A.2d 914 (Del. 2003).

The court distinguished those cases in several ways. For example, the actions in those cases were in the context of mergers and acquisitions and may have involved

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both illegal and inequitable matters. Footnote 79 also contains a money quote with wide application:

The Delaware General Corporation Law does not contain provisions that prevent directors from entering into contracts with third-parties for legitimate reasons simply because those contracts necessarily impinge on the directors' future freedom to act. If the judiciary invented such a per se rule, directors would be rendered unable to man-

age, because they would not have the requisite authority to cause the corporation to enter into credible commitments with other actors in commerce.

So too, the court recognized the principle that: If a contract with a third-party is premised upon a breach of fiduciary duty, the contract may be unenforceable on equitable grounds, and it may be unenforceable as a matter of public policy, but such inquiries are fact-intensive and do not lend themselves to a bright-line test. (See Footnote 81.)

Procedurally, the court rejected an argument under Chancery Court Rule 19(b) that certain claims could not proceed due to the absence of allegedly indispensable parties in connection with the stock restriction agreement.

Lastly, the court noted that each director's motivations and actions must be scrutinized individually before any findings of liability can be made. Thus, it was curious that the directors were all represented by the same counsel — and according to the court, the company's outside counsel whose memo was so inextricably intertwined in the allegations, was apparently the one who was "driving the litigation train" in this case. Much more could be written about this case, but in the space allotted, this short summary should whet your appetite. •