

Review of Corporate Decisions by Delaware Courts from 2006

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This is a brief overview of selected Delaware corporate and commercial decisions from the Delaware Supreme Court and the Delaware Chancery Court during the calendar year 2006 that I have selected for this short article based on those that I have summarized on my blog at www.delawarelitigation.com.¹

I have not included cases that have already been extensively discussed in mainstream and specialty publications such as the Delaware Supreme Court case of *In Re: The Walt Disney Company Derivative Litigation*. In addition, some cases fall into a category that could more appropriately be the focus of a separate article.²

The recent Delaware Supreme Court decision in *Stone v. Ritter*, is an important case with which to begin this overview. In this opinion, the court made clear that the fiduciary duty that each member of the board of directors of a corporation must adhere to, is made up of the twin duties of loyalty and care. The court held that the failure to act in good faith may also result in liability because it is a subsidiary element of the fundamental duty of loyalty.³

In another decision that should be of interest to business executives who jealously protect their confidential information and who must guard against employees taking that information to help competitors, the Supreme Court in *Empire Financial Services, Inc. v. The Bank of New York*, ruled that a credit agency had a cause of action against an employee who conspired with someone from The Bank of New York to transfer business from The Bank of New York to a new credit agency with whom the employee was seeking a job. The plan was for the employee to take confidential and proprietary information to his new employer based on an informal arrangement with his counterpart at The Bank of New York to transfer business to the new credit agency. The court determined that even if the agreement between the “old” credit agency and the bank was terminable at will, there was still a cause of action for wrongful interference with a prospective contractual relationship against The Bank of New York.

For business executives who sign agreements with arbitration clauses, one should be aware of the Delaware Supreme Court decision in the case of *James & Jackson, LLC v. Willie Gary, LLC*. In this case, the court determined that if the arbitration clause refers to the rules of the American Arbitration Association (AAA), without further explanation, a court will not have jurisdiction to grant emergency expedited relief in the event that, for example, a temporary restraining order is sought against an ex-employee. My experience is that obtaining emergency

¹ I have summarized about 170 Chancery Court cases and about 30 Delaware Supreme Court cases on my blog during 2006 and, therefore, in the short space allotted in this article I must of necessity leave out many key decisions. For my review of selected decisions from 2005, see 15 *Andrews Del. Corp. Litig. Rep.* 12 (Jan. 30, 2006).

² For example, I have written articles summarizing recent Delaware cases on specific topics such as the right of a shareholder to demand books and records under Section 220 of the Delaware General Corporation Law. See “Shareholder Request Denied for Books, Records under Section 220,” *Delaware Law Weekly* at 3 (Dec. 13, 2006).

³ Full copies of each of the decisions cited in this article can be easily downloaded by using the search function of my blog at www.delawarelitigation.com to find the name of the case as it appears. Where the case appears on my blog, you will find a hyperlink that will allow you to download the full decision.

injunctive relief from the AAA is next to impossible, especially when compared, for example, with the Delaware Chancery Court where emergency expedited relief can be granted within 24 hours in appropriate circumstances.

In the case of *In Re: J.P. Morgan Chase & Co. Shareholder Litigation*, the Delaware Supreme Court clarified that where directors have breached their disclosure duties in a corporate transaction that has in turn caused impairment to the economic or voting rights of stockholders, there must at least be an award of nominal damages. This clarified prior case law to confirm liability even when monetary damages are not clear.

In the Chancery Court, the recent decision of *Oliver v. Boston University* is notable as an example of how the Delaware Courts jealously protect the rights of minority shareholders. In denying a motion for reargument of a prior 105-page opinion, the court ruled that Boston University (BU), stood on both sides of a transaction, thus it bore the burden of demonstrating the entire fairness of the allocation to minority shareholders of merger proceeds. BU failed to satisfy its duty to the minority shareholders due to “an almost flippant disregard for their interests.” For example, the court noted that: (i) there was no independent committee formed; (ii) there were no independent legal or financial advisors retained to assess the fairness of the allocation of the merger proceeds; and, (iii) the president of BU testified that he did not think that the minority shareholders needed separate representation for their interests. The court was not moved by the argument that but for the merger proceeds, the minority shareholders of the failing company would not have received any consideration at all.

In another case that champions the rights of minority shareholders, the Chancery Court in an opinion on December 21, 2006 excoriated directors of a company who were found liable for being what the court described as “mere stooges” of the majority shareholder. In *ATR-KIM ENG Financial Corporation v. Araneta*, the court blasted the directors for standing idly by while the majority shareholder looted the company.⁴

In *Esopus Creek Value LP v. Hauf*, the court extended the reasoning of a decision last year which in essence allowed Delaware law to prevail over a conflicting federal law to the extent that the federal law interfered with the rights of shareholders to approve the sale of substantially all of the corporation’s assets. In particular, the court found that the failure to file an annual report, which according to SEC obligations barred an annual meeting, would not prevent the shareholders - - under Delaware law - - from enforcing their right to approve the sale of the company. Thus, the company’s plan to file bankruptcy and seek Bankruptcy Court approval without the consent of the shareholders was derailed.

In *Allied Capital Corp. v. GC-Sun Holdings, L.P.*, the court rejected the argument that entities with common equity ownership can never conspire illegally with one another. The court distinguished this issue from the separate question of whether corporate managers can be held civilly liable for conspiring among themselves and with their own corporation.

The case of *In Re: Primedia, Inc. Derivative Litigation* provides a veritable guidebook of bedrock principles of Delaware law on matters such as the duties of controlling shareholders in

⁴ See footnote 129 of the decision for a good sample of the court’s reasoning.

an interested transaction. This case is an example of the importance that the Chancery Court places on a director's duty of loyalty, and that duty is so important that even if it is not easy to quantify damages caused by the breach, the court will be flexible in awarding a remedy for the breach. For example, the court quoted other Delaware precedent for the following principle in that regard:

“The . . . duty of loyalty does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for purposes of removing all temptation, extinguishes all possibility of profit flowing from the breach of confidence imposed by the fiduciary relation.”

In the case of *B.F. Rich Co., Inc. v. Gray, et al.*, the Delaware Chancery Court reiterated the limited focus of a summary proceeding under Section 225 of the Delaware General Corporation Law. The court noted that such an action is: “narrowly limited to the validity of the election or vote and the right to hold office [of a director].” Thus, the court refused to consider a “parade of horrors” regarding a prior finding of breach of fiduciary duty in other proceedings that were not relevant to the question of whether the written consents in lieu of a meeting were valid to appoint directors in this particular proceeding.

In *Bakerman v. Sidney Frank Importing Co., Inc.*, the court determined that a claim could go to trial on the issue of whether a release was signed under duress. The case involved an in-house lawyer who was threatened with termination of his employment if he did not sign a consent within 30 minutes. The court found that even for an at-will employee, an argument could be made at trial that the release was signed under economic duress or other coercive conduct.

Delaware courts enforce contract provisions choosing Delaware courts as a forum. In *Cornerstone Brands, Inc. v. O'Steen*, the court allowed a claim to proceed for attorney's fees based on the breach of a forum selection clause. This opinion give teeth to the enforceability in Delaware of forum selection clauses.

The case of *Superior Vision Service, Inc. v. ReliaStar Life Insurance Company*, reiterated that the implied duty of good faith and fair dealing that is imposed on every Delaware contract, is not a sufficient basis to force a party to waive a provision in a contract that the party bargained for, and on which that party is entitled to rely. Do not expect Delaware courts to provide terms that are not in the agreement.

The court in *Trenwick America Litigation Trust v. Ernst & Young, LLP*, clearly established that “deepening insolvency” is no more a cause of action in Delaware than “shallowing profitability” is. This should be of comfort to business executives whose business decisions are alleged to cause a failing company to slip into bankruptcy.

In *Elite Cleaning Company Inc. v. Capel*, the Chancery Court endorsed the concept of enforcing a covenant-not-to-compete to protect the role of the middleman. Although the court was doubtful that there was a legitimate interest of the employer in enforcing a covenant against

an unskilled janitor, if the employee was skilled and had trade secrets, there was a protectable interest to avoid disintermediation, or eliminating the middleman.

One case emphasizes the importance of details such as correct addresses. In *Gildor v. Optical Solutions Inc.*, the Chancery Court ruled that before a shareholder could be deemed to have waived his preemptive rights that were based on a contract, the corporation had an obligation to send notice to a current address that it had in its records for the holder of those rights, when the address in the contract itself was obviously wrong.

In appraisal actions, Delaware courts may do their own valuation of a company. In *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, the court addressed the principles that apply to both appraisal claims under the appraisal statute, and entire fairness claims in connection with a squeeze-out merger of a closely held private company made up of radiologists. The 85-page opinion can be used as a reference manual for the analysis of fair price claims by minority shareholders and valuation of a closely held business. As happens on occasion, the court disagreed with the testimony of both valuation experts and made its own valuation of the company based on different parts it adopted from the competing experts' reports, as well as reliance on standard treatises that are widely recognized as authoritative on business valuation methods.

There are limits to what contract provisions the court will enforce. In *Abry Partners V, L.P. v. F&W Acquisition LLC*, the court addressed the issue of whether a court should enforce a contract that "permits lying." This opinion has a good analysis of integration clauses and how they interface with claims of fraud, as well as a need for a clear "anti-reliance clause." After a careful analysis, the court determined that for public policy reasons, it would not enforce a contract that expressly allows for misrepresentation - - although the court generally is not sympathetic to someone who signs a clause confirming no reliance on any statements outside the agreement but then seeks to make a claim for fraud.

If a company provides advancement rights, it must not try to evade that duty. In *Radiancy, Inc. v. Azar*, the Chancery Court once again emphasized that "advancement means advancement" and when by contract or otherwise an officer or director has a right to advancement of legal fees incurred in connection with the defense of an action or investigation, there are virtually no defenses to non-payment by the corporation. In addition, the court reiterated that attorney's fees for bringing advancement claims are also payable by the corporation.

Further clarification was given regarding the rights of shareholders to books and records. In *Shamrock Activist Value Fund, L.P. v. iPass Inc.*, the Chancery Court addressed whether there was a credible basis of mismanagement sufficient to satisfy the "proper purpose" requirement of the Delaware General Corporation Law's Section 220 (which enables a stockholder to demand books and records of a corporation). The issue was presented in the context of a Motion to Dismiss under Chancery Court Rule 12(b)(6). The stockholder's main complaint was that management either failed to implement a merger competently or that its projections about the merger were made irresponsibly.

In what will be music to the ears of company executives, the court reasoned that even though claims of mismanagement can be a “proper purpose” under Section 220:

“[c]redible evidence of mismanagement ... requires more than a divergence between forward-looking statements and subsequent results.” (citing *Trenwick Am. Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168, 193 (Del. Ch. 2006)(noting that the business judgment rule's utility would be “denuded” if the mere fact that a strategy turned out poorly was in itself sufficient to establish a breach of fiduciary duties).

However, the court found that in the context of a Rule 12(b)(6) motion, the allegation that the board failed to adopt an integration plan for the merger in a timely and comprehensive fashion that would address the complexity of the merger, was sufficient to “give the plaintiff the benefit of the doubt” (my words) in this procedural setting, and provided a sufficient “basis for an inference that mismanagement occurred” (court’s words). This is so, because in the context of a motion to dismiss, the court is “constrained to honor any reasonable inference that could be drawn in favor of Shamrock from the facts alleged.” The court observed in a footnote that the “credible basis” standard is the lowest possible burden of proof.

The flip side of the analysis is that, in the context of this motion to dismiss, because the court could **not** conclude with “reasonable certainty that there is *no* set of facts which could be proven by Shamrock to support this action” the motion to dismiss had to be denied. In footnote 18 the court observed that it was not possible in the setting of a motion to dismiss to address the claim by the company about whether Section 220 was being used in this case as “an effective and troubling tool for harassment and mischief.”

Although there are many other important cases from Delaware in 2006, I selected the foregoing cases based on what I predict to be of the greatest interest to most of the business executives and corporate counsel reading this short summary.

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