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Commentary

REVIEW OF SELECTED 2005 DELAWARE CHANCERY COURT AND SUPREME COURT CASES

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This is an outline of a very brief overview of recent Delaware corporate and commercial decisions during 2005 that I selected based on those that I have summarized on my blog at www.delawarelitigation.com.

Note that I have not included cases that you likely may have seen reviewed elsewhere, such as the Disney decision. In re Walt Disney Co. Derivative Litigation, No. 15452, 2005 WL 205665 (Del. Ch. Aug. 9, 2005). In addition, this is not an overview of all the key Delaware cases from 2005. Full copies of each of the decisions cited below can be easily downloaded by using the search function of my blog to find the name of the case as it appears in my blog. There, you will find a hyperlink that will allow you to download the full decision.

In New Castle Partners L.P. v. Vesta Insurance Group Inc., No. 1485-N, 2005 WL 3148078 (Del. Ch. Nov. 16, 2005), the Chancery Court ruled very recently that the Delaware General Corporation Law requirement that a company hold an annual shareholders' meeting was neither in conflict with nor preempted by a Securities and Exchange Commission requirement that audited financial statements be made available prior to the meeting (in light of the company's claim that those statements would not be available for the meeting). The Delaware Supreme Court affirmed the Chancery Court's ruling within hours of the decision being appealed.

Beware of the scope of a broad, binding arbitration clause. There are no exceptions to arbitrability that allow the parties to seek injunctive relief or other judicial relief available in statutory proceedings. Such a clause barred the court from conducting statutory proceedings for the dissolution of a limited liability company, at least until after the arbitrator decided the request for dissolution, in the recent case of Terex Corp. v. STV USA Inc., No. 1614-N, 2005 WL 2810717 (Del. Ch. Oct. 20, 2005).

One of the few decisions to directly interpret the Delaware Limited Liability Company Act's statutory provision, allowing for involuntary judicial dissolution of an LLC, is the Chancery Court opinion in In re Silver Leaf LLC, No. 20611, 2005 WL 2045641 (Del. Ch. Aug.18, 2005). Though dissolution was granted, the court refused to appoint a receiver to oversee the dissolution. The court also prohibited the parties from pursuing further litigation without prior approval of the court. More importantly, at pages 27 and 28, the court explains the statutory phrase "not reasonably practicable to carry on business," which is a key statutory basis to dissolve judicially an LLC.

In Homestore Inc. v. Tafeen, No. 23-2005, 2005 WL 3091887 (Del. Nov. 17, 2005), the Delaware Supreme Court placed another nail (perhaps the final nail?) in the coffin of defenses that a corporation might have to a claim for advancement of fees incurred by an officer or director in defending lawsuits or investigations regarding actions

allegedly taken as an officer or a board member.

The court rejected defenses of laches, unclean hands, undue financial hardship and several others in light of the company's belief that the officer seeking advancement of fees to defend himself in lawsuits hid assets (to make it unlikely he could ever repay the company if required to do so). The company also argued unsuccessfully that the actions for which the former officer was sued were not done in his "official capacity" because he was allegedly enriching himself personally through the behavior for which he was being sued.

Bottom line: when based on express bylaws or other mandatory advancement provisions, a company may have no defense to a claim for advancement. Under the DGCL, this is a separate and summary proceeding with limited, if any, discovery, and is not subject to the same possible defenses or other considerations as a claim for indemnification would be -- after the underlying proceedings are final.

The Delaware Supreme Court recently affirmed the Chancery Court's ruling on advancement of litigation expenses for a former officer in another case, but in Kaung v. Cole National Corp., No. 163-N, 2005 WL 3462250 (Del. Ch. Dec. 13, 2005), the court remanded in part and again emphasized that the nature of a summary proceeding for advancement is too limited to address the related but distinct issues of indemnification or recoupment of amounts voluntarily advanced by the corporation.

Near the end of 2005, Chancellor William Chandler decided the very important case of UniSuper Ltd. v. News Corp., No. 1699, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005), a case in which he addresses the tension between shareholder and director power, and he concluded that shareholders can restrict the power of directors notwithstanding the general rule in DGCL Section 141(a) that directors manage the corporation.

The court denied a motion to dismiss, allowing a claim to proceed that the board breached an oral agreement not to institute a poison pill without first obtaining shareholder approval, which would not otherwise be required under Delaware law. This case has already generated substantial commentary among corporate scholars, many of whom have already posted extensive writings that are linked in my blog.

The Delaware Supreme Court recently ruled that the holder of preferred shares has no absolute right to dividends, in Shintom Co. Ltd. v. Audiovox Corp., No. 214-2005, 2005 WL 2871955 (Del. Oct. 31, 2005).

Seinfeld v. Verizon Communications Inc., No. 1100-N, 2005 WL 3272365 (Del. Ch. Nov. 23, 2005), is a good example of why demanding books and records in a suit filed under Section 220 is not always a simple or inexpensive matter. In this case, the Chancery Court ruled that a shareholder had not demonstrated the requirement, under Section 220 of the DGCL, that there was a "credible basis" for its claims of mismanagement and excessive compensation and, therefore, did not carry the burden to establish a "proper purpose" for its demand for books and records. The court reasoned as follows:

While it is well established that an investigation into corporate waste and mismanagement is a proper purpose for books and records inspection under Section 220, a mere suspicion of wrongdoing, such as the claim the plaintiff is making in this action, is insufficient. The statute places the burden of proving a proper purpose on the stockholder who seeks inspection of the company's books and records. This burden is not insubstantial and "mere curiosity or a desire for a fishing expedition will not suffice." The stockholder must "present some credible basis from which the court can infer that waste or mismanagement may have occurred." Although the plaintiff does not have to prove actual wrongdoing, "a mere statement of a purpose to investigate possible general mismanagement, without more, will not entitle a shareholder to broad Section 220 inspection relief."

Remember that even if one prevails, after the substantial cost and time of a trial in a Section 220 case, the only thing one wins is the right to inspect a limited scope of documents. Discovery during a Section 220 proceeding is generally limited to whether the statutory prerequisites have been satisfied.

The case of In re LNR Property Corp. Shareholders Litigation, No. 674-N, 2005 WL 3037034 (Del. Ch. Nov. 4, 2005), is a purported class action against a Delaware corporation, its former directors and its former controlling shareholder, alleging breach of fiduciary duty in connection with a cash-out merger pursuant to which the controlling stockholder and other members of management exercise the right to purchase a 25 percent equity stake

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in the surviving entity. Specifically, the complaint alleged that the directors breached their fiduciary duties when they allowed the controlling shareholder to negotiate (and later vote to authorize) the merger on terms that were inadequate and unfair to the public stockholders.

The principal issue addressed by the court in a motion to dismiss by the defendant directors was the proper standard of the court's review in examining the complaint. The defendants argued that the deferential standard of the business-judgment rule should apply, as opposed to the more intrusive close scrutiny of the entire-fairness standard. The court found that there was a reasonable inference that the controlling stockholder had a disabling conflict and, in essence, stood on both sides of the transaction, and therefore the entire-fairness standard would likely apply, shifting the burden to the defendants to prove the entire fairness of the transaction.

The court noted that the business-judgment rule does not protect the board's decision to approve a merger, even where a majority of the directors are independent and disinterested -- where a controlling shareholder has a conflicting self-interest. Instead, Delaware law imposes an entire-fairness burden when the fiduciary charged with protecting a minority and the sale of the company does not have an undivided interest to extract the highest value for the shareholders. The court distinguished Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002), as a recent decision where the mere fact that a controlling shareholder has or may be acquiring some interest in the buyer does not automatically trigger entire-fairness review.

The case of In re Toys R Us Shareholder Litigation, No. 1212-N, 877 A.2d 975 (Del. Ch. June 22, 2005), provides a thorough analysis of Revlon board duties in connection with the sale of a company. In denying Revlon claims that a separate auction for the whole company was required when the board initially entertained bids for only part of the company, the court reasoned: "Capitalists are not typically timid, and any buyer who seriously wanted to buy the whole company could have sent a bear hug letter at any time, if it wanted to be genteel about expressing an interest. In all reasonable likelihood, the board's sales process for Global Toys provided the most credible and likely buyers of the whole company with information that would have gotten their acquisitorial salivary glands going."

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