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Corporate Law and Litigation Bulletin

Delaware Court of Chancery Suggests a Reformulation of The Standard of Review in M&A Cases Where Director Action Implicates Stockholder Voting Issues

In *Mercier v. Inter-Tel (Delaware), Inc.,* 929 A.2d 786 (Del. Ch. 2007), Vice Chancellor Leo E. Strine of the Delaware Court of Chancery urges restraint and reformulation in the application of the exacting "compelling justification" standard of review announced in *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del Ch. 1988). According to the Vice Chancellor, the *Blasius* standard of review should not be applied unless director conduct affects an election of directors or a vote touching on matters of corporate control. Moreover, suggests the Vice Chancellor, the "compelling justification" standard should be reformulated in other cases to focus on the reasonableness of directors' actions directed to a corporate objective that impacts the stockholder voting process.

Mercier involved a motion by stockholders of Inter-Tel (Delaware), Inc. ("Inter-Tel" or the "Company") to enjoin the consummation of a merger ("Merger") with Mitel Networks Corporation ("Mitel"), which Merger was approved by a majority of the Company's stockholders. The transaction was an all-shares, all-cash acquisition by Mitel at $25.60 per share. The Merger vote was originally scheduled to take place at a special meeting of the Company's stockholders on June 29, 2007. As the meeting date drew near, Inter-Tel's directors became aware that the Merger would not be approved and that an additional ballot item–a proposal authorizing adjournment to solicit additional proxies in the event there were not sufficient votes to approve the Merger at the special meeting–also would not be approved.

On the morning of June 29, the special committee of Inter-Tel's board of directors ("Special Committee"), after a lengthy meeting the day before, decided to reschedule the Merger vote. Among the reasons for the rescheduling were (i) to allow stockholders more time to consider recent developments, including changes in the debt capital markets adversely affecting the availability and cost of financing for acquisitions; (ii) to provide stockholders with an update regarding Inter-Tel's sales results, which reflected lower than expected results; (iii) to advise stockholders of Mitel's recent announcement that it would not increase its bid; (iv) to afford stockholders the opportunity to consider definitive proxy materials filed by the Company's founder, who was proposing a recapitalization that included a Company buy-out of a significant portion of his holdings; and (v) an indication by the stockholder advisory group Institutional Shareholders Services that it would recommend a "no" vote on the Merger in the absence of a postponement of the special meeting. According to the Court, "Although the minutes do not put it this way, the Special Committee believed the stockholders were about to make a huge mistake."

The Special Committee changed the record date and set a new meeting date of August 2, 2007. Between the record dates for the June 29 and August 2 meetings, new holders who supported the Merger acquired Inter-Tel stock. Additionally, following the release of the Company's revised sales figures, ISS changed its recommendation and advised its clients to vote in favor of the Merger. Upon ISS's change of position, the Company's founder withdrew his competing recapitalization proposal. At the August 2 special meeting, an overwhelming majority of Inter-Tel's stockholders voted in favor of the Merger.

Specifically, the Court held that the board would bear the initial burden to identify a legitimate corporate objective served by its decision to postpone the vote. Then, the board was required to demonstrate that its actions in furtherance of such an objective were reasonable and did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way. Employing a reasonableness analysis, the Court ultimately concluded that there existed a "compelling justification" for the postponement of the Merger vote.

Plaintiff then moved to enjoin the consummation of the Merger. The crux of plaintiff's argument was that the last-minute rescheduling of the Merger vote, when it was clear that a majority of Inter-Tel's stockholders were about to vote it down, was an attempt by the Special Committee to thwart the will of the majority of the Company's stockholders by interfering with the stockholder franchise. That, according to plaintiff, should have triggered the "compelling justification" standard of review announced in *Blasius*. In a thoughtful analysis, the Vice Chancellor discussed the history of the *Blasius* standard of review and how, in his opinion, it is too often a label placed on an after-the-fact conclusion that the challenged board decision does not pass muster, as opposed to a useful tool for evaluating that conduct in the first instance. Indeed, the Vice Chancellor noted:

continued on next page

In this Issue

Reformulation *continued from cover*

> It would hardly be indiscreet for me to acknowledge yet again the widely known reality that our law has struggled to define with certainty the standard of review that this court should use to evaluate director action affecting the conduct of corporate elections. The results in the cases make sense, as the decisions do a good job of sorting between situations when directors have unfairly manipulated the electoral process to entrench themselves against insurgents and those when directors have properly used their authority over the election process for good faith reasons that do not compromise the integrity of the election process. The problem that remains though is that there is no certain prism through which judges are to view cases like this.

In particular, the Court's concern was how to tailor the applicable standard of review to cases involving electorally-directed action in the M&A context. In that context, the Court opined that it makes sense to look to the standard of review articulated in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), which requires directors to demonstrate the reasonableness of defensive action taken in response to reasonably perceived threats to corporate policy and effectiveness. Looking to relatively recent Delaware Supreme Court precedent, the Vice Chancellor opined that the "fit" test used in *Unocal* can be applied to cases like *Mercier* that arise in the M&A context, but also implicate the impact of director conduct on stockholder voting issues. To this end, the Vice Chancellor reasoned:

> One can read *Liquid Audio [MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003)] as suggesting that the heightened scrutiny that *Unocal's* fit test employs to assess defensive actions by directors, was to be ratcheted up to a form of strict scrutiny when the directors' actions affected the corporate franchise. Although it does not use those precise words, *Liquid Audio* can be viewed as requiring the directors to show that their actions were reasonably necessary to advance a compelling corporate interest.

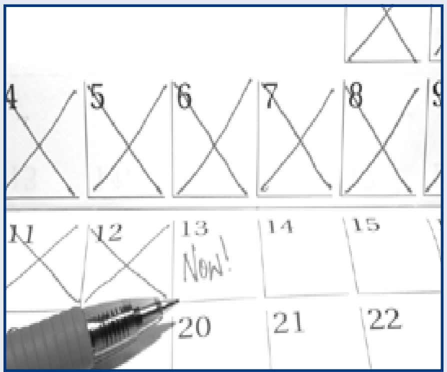
Based on this reasoning, the Court applied a reasonableness standard to judge the action taken by the Inter-Tel board of directors in connection with rescheduling the Merger vote. Specifically, the Court held that the board would bear the initial burden to identify a legitimate corporate objective served by its decision to postpone the vote. Then, the board was required to demonstrate that its actions in furtherance of such an objective were reasonable and did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way. Although the Vice Chancellor formulated the test he would apply as something akin to a *Unocal* analysis, he recognized that he was constrained by controlling precedent, referring to a "compelling justification" standard of review. Employing a reasonableness analysis, the Court ultimately concluded that there existed a "compelling justification" for the postponement of the Merger vote.

The Court denied plaintiff's request for an injunction and found that defendants had a compelling justification for a postponement of the Merger vote when the directors (i) were well-motivated and independent; (ii) believed the Merger was in the stockholders' best interests; (iii) knew the Merger would have been voted down at the June 29 meeting; (iv) reasonably feared that, if the Merger were rejected, Mitel would walk away and the Company's stock price would plummet; (v) wanted more time to communicate with and provide information to the stockholders before they voted and risked an irrevocable loss of Mitel's offer; and (vi) rescheduled the meeting within a reasonable time and did not preclude or coerce the stockholders from voting freely to accept or reject the Merger.

Delaware Court of Chancery Denies Rule 23.1 Motion to Dismiss Stock Option Backdating Complaint, but Grants Dismissal for Lack of Standing

In *Conrad v. Blank, et al.*, 2007 WL 2593540 (Del. Ch.), the Delaware Court of Chancery addressed another alleged stock option backdating scheme, this time involving Staples, Inc. ("Staples" or the "Company"). In November of 2006, in its third quarter Form 10-Q, Staples disclosed the results of an internal review by the Company and its audit committee of the Company's historic stock option granting practices from 1997 to the present and found "accounting errors due to the use of incorrect measurement dates." As a result of these errors, the Company recorded a $10.8 million expense in third quarter of 2006, but was not required to restate any historical financials. The Company's 10-Q reported that the use of incorrect measurement dates was not the result of intentional wrongdoing. The Company's filing, however, did not elaborate further and did not mention any effort by the Company to recover value from those who received improperly dated options and did not mention any effort to hold anyone accountable for the use of incorrect measurement dates.

Plaintiff, a Staples stockholder since 1998, commenced a derivative action in December 2006, challenging an alleged 10-year scheme by which the Company illegally backdated over 7.5 million stock options that were issued to members of senior management. The complaint alleged that from 1994 to 2003 there were 51 discretionary stock option grants, 12 of which appear to have been backdated. Plaintiff alleged that her backdating claim was supported by: (i) Staples' public filing, admitting the pricing of options at "incorrect measurement dates;" (ii) violations of the option plans, under which the options in question were granted and which required that the exercise price be equal to the fair market value of the underlying company stock on the date of the grant; and (iii) a statistical analysis showing the allegedly favorable timing of the challenged option grants.



Specifically, the Court stated, "[g]iven the finding of erroneous dating practices (by inference, backdating), the court questions how it is that the interests of the corporation are not, or at least do not appear to be, adverse to the interests of the individual defendants."

The individual defendants, all current or former members of the Staples board of directors, and the Company as nominal defendant, moved to dismiss plaintiff's derivative complaint on two grounds: (i) failure to plead demand futility under Court of Chancery Rule 23.1 ("Rule 23.1"); and (ii) lack of standing with respect to certain option grants. In denying the defendants' motion to dismiss for failure to plead demand futility, the Court held that demand was excused under the test announced in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). Of the 10 members of the board at the time the complaint was filed, five were either recipients of the allegedly backdated options or were members of the compensation committee charged with approving the grants. Because the complaint contained allegations sufficient to raise a reasonable doubt that at least half of the board could have exercised its independent and disinterested judgment in responding to plaintiff's demand, the Court held that demand would have been futile and plaintiff was free to bring her complaint on behalf of the Company. Interestingly, though, the Court noted that it was troubled by the fact that the same counsel represented the Company and the individual defendants alleged to have received and approved the challenged stock option grants. Specifically, the Court stated, "[g]iven the finding of erroneous dating practices (by inference, backdating), the court questions how it is that the interests of the corporation are not, or at least do not appear to be, adverse to the interests of the individual defendants."

In the course of denying the defendants' motion to dismiss based on failure to make demand, the Court had occasion to distinguish at least one aspect of another recent case dealing with allegations of stock option backdating, *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007). Relying on *Desimone*, defendants argued that plaintiff had to show that the compensation committee members *knew* of the alleged backdating in order for her complaint to survive a motion to dismiss under Rule 23.1. Unlike the stock option plans in *Desimone*, the stock option plans in *Staples* required that all grants be made at fair market value. Moreover, in *Staples*, the plaintiff identified 12 specific option grants by date and alleged that the compensation committee directly authorized them. From this, the Court could infer, at least at the plead-

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ings stage of the case, that it is fairly unlikely that that the compensation committee could have innocently or unknowingly authorized backdated options.

Although it rejected defendants' motion to dismiss under Rule 23.1, the Court conditionally granted the defendants' second basis for dismissal – lack of standing under 8 *Del. C.* § 327 as to certain option grants that pre-dated the plaintiff's stock ownership. Section 327 prohibits a plaintiff from bringing a derivative action to challenge a transaction that does not coincide with that plaintiff's stock ownership. The Court stated that it was constrained by recent decisions holding that the "continuing wrong" theory does not apply to a pattern of allegedly backdated stock option grants such that they can be characterized as an ongoing wrong that can be challenged by a plaintiff who purchased stock after the commencement of the pattern of allegedly backdated grants. Rather, each such grant must be viewed as an independent transaction. Accordingly, plaintiff was barred from challenging any instance of alleged backdating prior to 1998. Nevertheless, the Court did condition its dismissal on the parties submitting information to the Court as to whether another stockholder was willing to intervene to assert claims relating to alleged instances of backdating that pre-dated the plaintiff's ownership of Staples stock.

Delaware Court of Chancery Construes Charter to Approve Vote and Consummation of Merger Where Polls Were Closed Due to Misinformation From Transfer Agent and Later Re-Opened to Allow Management to Purchase More Stock That Was Then Voted in Favor of Merger

In *Kinley v. Healthcare Acquisition Corp.*, C.A. No. 3161-CC (Del. Ch.) (Transcript Ruling), plaintiff Matthew P. Kinley ("Petitioner" or "Kinley"), a stockholder of record and former President and former director of defendant Healthcare Acquisition Corp. ("HAQ," the "Company" or "Respondent") n/k/a PharmAthene, Inc. ("New PharmAthene"), a public company whose shares trade on the American Stock Exchange LLC ("AMEX"), filed an action against PharmAthene pursuant to Section 225(b) of the Delaware General Corporation Law ("DGCL"). Petitioner sought a determination or declaration on the validity of the vote by HAQ's stockholders at a Special Meeting on August 3, 2007, to approve a merger ("the Merger") between HAQ and the pre-Merger PharmAthene entity ("Old PharmAthene"), pursuant to which a wholly-owned subsidiary of HAQ merged with and into Old PharmAthene and Old PharmAthene became a wholly-owned subsidiary of HAQ. In connection with the Merger, HAQ's name was changed to "PharmAthene, Inc."

HAQ, a special purpose acquisition vehicle, was formed for the purpose of acquiring an operating business in the healthcare industry. To fund this acquisition objective, HAQ conducted an initial public offering. Nearly all of the funds generated thereby were to be held in trust and were to be released only upon the consummation of a future acquisition or liquidation. If an acquisition did not occur by a date certain, HAQ's organic documents required it to liquidate. The Merger was HAQ's last opportunity to effect an acquisition and avoid mandatory liquidation. An overwhelming majority of HAQ's stockholders approved the Merger.

Although the Merger was *approved* by sufficient votes pursuant to the Company's certificate of incorporation and the DGCL (*i.e.*, a majority), the certificate of incorporation provided that the Merger could not be *consummated* if more than 20% in interest of HAQ's stockholders voted against the Merger and contemporaneously demanded, as was their right, to have their shares converted into a pro rata portion of the funds held in trust. During the August 3, 2007, Special Meeting of stockholders to consider the Merger and related proposals, at which these votes were being tallied, the Company's transfer agent issued an official report that less than 20% of the Company's stockholders had voted against the Merger and demanded conversion. Thereafter, the Special Meeting was adjourned, and the polls were closed.

The Court then held that it did not have to rule on the issue of whether equity would extend mistake-of-fact contract principles to the anomalous events surrounding the vote because the Merger was validly approved and consummated on the First Vote. The Court concluded that majority approval had at all times been obtained and that the later withdrawal of conversion requests did not violate the terms of the Charter.

Later that same day, the Company learned that its transfer agent had mistakenly reported that less than 20% of the Company's stockholders had voted against the Merger and demanded conversion. In actuality, more than 20% of the Company's stockholders demanded conversion, with the result that the Merger, although validly approved, could not then be consummated. At that point, the meeting was re-opened, shares of Company stock were acquired from certain dissenters and those dissenters' conversion demands were withdrawn such that the percentage of stockholders requesting conversion fell below the 20% threshold, eliminating any obstacle to consummation of the Merger. The Merger was then consummated with the filing of a Certificate of Merger with the Secretary of State of the State of Delaware.

This Section 225(b) proceeding was necessitated by the fact that the Company agreed to release the IPO funds to those stockholders who requested conversion, but refused to release the remaining IPO funds (for the benefit of the Company and its current public stockholders) until the validity of the Merger has been established conclusively. The reason for the Company's refusal was that as a consequence of the anomalous events surrounding the Special Meeting, it was unable to obtain an unqualified opinion of counsel that the Merger was validly approved and consummated in accordance with Delaware law.

The first question before the Court of Chancery was whether the official stockholder vote was the one taken after the re-opening of the Special Meeting (the "Final Vote") or the one taken prior to the re-opening in reliance on misinformation provided by the transfer agent (the "First Vote"). Petitioner argued that the Final Vote was the official vote because the Special Meeting was adjourned and re-opened for no other reason than reliance on a mistake of fact officially reported by the Company's transfer agent, whose qualifications and independence were not at issue. Petitioner argued in the alternative that even if the Special Meeting had not been re-opened, sufficient votes for the approval of the Merger had already been obtained on the First Vote, and the events following the re-opening merely eliminated an obstacle to consummation of the Merger, but had no legal effect on the stockholder vote approving the Merger. The basis for the argument was that the Company's Charter distinguishes between the vote necessary for *approval*–*i.e.*, a simple majority, which was at all times obtained–and the conditions to *consummation* of a stockholder-approved merger, and thus, the events following the re-opening merely eliminated a prohibitory condition to consummation, but had no legal effect on the vote approving the Merger.

The Complaint was filed on August 13, 2007, and the Court promptly set a final hearing date of August 27, 2007. The Court then directed the Company to publicly disseminate notice of the proceedings to all of the Company's stockholders via a press release and the filing of a Form 8-K with the Securities and Exchange Commission. A hedge fund that purchased shares after the vote sought to intervene and also filed an objection to the relief sought by the Petitioner. The hedge fund alleged that the re-opening of the Special Meeting violated fundamental notice provisions of the DGCL and that management's stock purchases constituted a breach of fiduciary duty because management lacked a "compelling justification." The hedge fund also argued that because the Charter stated that demands for conversion must be made "contemporaneous" with the vote, they could not be withdrawn later.

The Court of Chancery first found that the hedge fund (i) lacked standing under Section 225(b) because it was not a stockholder as of the record date for Special Meeting or even as of the date of the vote

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and (ii) lacked standing to allege breach of fiduciary claims because it was not a stockholder at the time of the alleged harm and was attempting to buy a lawsuit.

The Court then held that, even assuming the hedge fund had standing, the challenge to the Merger lacked merit. The Court first observed that the stockholders, via a proposal listed on the agenda for the Special Meeting, had given pre-approval for management to adjourn the Special Meeting for the purpose of acquiring stock in order to reduce conversion requests and, but for the transfer agent's mistake, the polls would not have been closed. The Court then held that it did not have to rule on the issue of whether equity would extend mistake-of-fact contract principles to the anomalous events surrounding the vote because the Merger was validly approved and consummated on the First Vote. The Court concluded that majority approval had at all times been obtained and that the later withdrawal of conversion requests did not violate the terms of the Charter. The Court further noted that not only did the later withdrawal of conversion requests not affect the vote, but also that the word "contemporaneous" could be construed to mean around the time of and does not necessarily mean at the exact time of the vote.

Delaware Court of Chancery Dismisses Derivative Complaint Alleging Stock Option Manipulation

The Delaware Court of Chancery, in *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007), dismissed a stockholder derivative complaint alleging misconduct in the issuance of stock options by the board of directors of Sycamore Networks, Inc. ("Sycamore"). The Court dismissed the complaint because (i) plaintiff lacked standing to challenge options grants made prior to the time he acquired his shares and (ii) plaintiff failed to satisfy his burden of pleading demand futility. At the outset, the Court thoroughly distinguished the claims before it with those presented in the recent cases of *Ryan v. Gifford and In re Tyson Foods, Inc. Cons. S'holder Litig.* The Court also clarified the pleading standard required in derivative actions alleging stock option manipulation.

The Court rejected plaintiff's argument that he had standing because "the conduct alleged in the complaint involved a pattern of 'continuing wrongs' persisting into the time period when he was a stockholder." Thus, the Court concluded that plaintiff lacked standing to challenge any options grants made prior to plaintiff becoming a stockholder in February 2002.

The Court first addressed whether plaintiff lacked standing to challenge any stock options grants made prior to plaintiff acquiring his Sycamore stock in February 2002. All but two of the allegedly improper options grants were made before plaintiff became a stockholder. The only options grants that occurred after plaintiff acquired his stock were a set of officer grants in December 2003. The Court rejected plaintiff's argument that he had standing because "the conduct alleged in the complaint involved a pattern of 'continuing wrongs' persisting into the time period when he was a stockholder." Thus, the Court concluded that plaintiff lacked standing to challenge any options grants made prior to plaintiff becoming a stockholder in February 2002.

Next, even though the Court held that plaintiff lacked standing to challenge all but two officer options grants, the Court analyzed whether all the claims of stock option manipulation could be dismissed pursuant to Court of Chancery Rule 23.1. In analyzing the viability of options grants claims, the Court categorized the option grants according to the recipients: employees, outside directors, and officers.

With regard to the employee options grants, the Court found that because plaintiff failed to demonstrate that the Sycamore directors were aware that certain options grants to employees were backdated, there was "no basis to conclude that the board faced a substantial threat of liability from claims." Consequently, plaintiff could not show there was a reasonable doubt as to the board's ability to consider those claims. The Court also rejected plaintiff's oversight claim because plaintiff did not allege "any fact to suggest that Sycamore's internal controls were deficient, much less that the board, the Audit Committee, or Sycamore's auditors had any reason to suspect that they were or that backdating was occurring." As a result, plaintiff failed to plead an oversight claim against Sycamore's directors with particularity, and demand was not excused with respect to the employee options grants allegations.

With regard to the outside director options grants, the Court found that, although plaintiff satisfied his demand futility pleading requirements, plaintiff failed to state a claim under Court of Chancery Rule 12(b)(6) because the outside director options grants were issued in adherence with Sycamore's stockholder-approved stock option plan. Importantly, the Court noted that, where a stockholder-approved plan permits options to be priced below market, it would be within the board's exercise of business judgment to issue options at a low point in a trading period (as long as the directors satisfied its disclosure and other regulatory requirements).

With regard to the officer options grants, most of them involved allegedly backdated options, and the Court concluded that plaintiff had failed to allege that any member of the board had knowingly approved backdated options. Plaintiff also alleged, however, that defendants had timed an option grant to benefit from a recent stock price decrease and an expected stock price increase. The Court's analysis focused on whether, at the time of the issuance of the option grant, the board had material, non-public information. The Court concluded that issuing stock options after negative news is disclosed would not ordinarily state a claim because those options would have been issued "at fair market value reflecting negative information previously disclosed to the public markets." The same is not true, however, where options are spring loaded (*i.e.*, issued before a positive announcement). Notwithstanding, the Court distinguished the plaintiff's allegations of a single spring loaded grant from the allegations, made by the plaintiffs in *Tyson Foods*, of "multi-year pattern of large grants occurring at random times of year that preceded large, market moving announcements."

The Court concluded that the Sycamore board was not exposed to personal liability regarding plaintiff's claims. Therefore, because demand was not excused, plaintiff could not pursue such derivative claims.

Delaware Court of Chancery Finds Fraud and Breach of Contract and Awards Damages to Acquirer Because Seller Fraudulently Misrepresented Historic Cash Flow

The Court of Chancery, in *Cobalt Operating LLC v. James Crystal Enterprises*, LLC, 2007 WL 2142926 (Del. Ch. July 20, 2007), found that defendants committed fraud in the course of selling a radio station to plaintiff and, as a result, the Court awarded over $11 million in monetary damages to plaintiff (including the cancellation of a $5 million promissory note and the cancellation of defendants' $2 million equity interest in plaintiff). The damage figure represented the difference between the actual value of the radio station at the time of the sale and the $70 million purchase price. The Court also awarded pre-judgment interest on the monetary portion of the award, as well as awarded plaintiff's attorneys' fees and costs pursuant to the Asset Purchase Agreement.

The Court held that plaintiff "clearly satisfied the elements of its common law fraud claim, as it proved that [defendants] intentionally provided it with false financial information on which it reasonably relied in entering into the transaction and which cause it to overpay for WRMF." The Court noted that plaintiff also established the elements of equitable fraud, which requires similar proof except that scienter is not required.

In March 2002, plaintiff purchased a West Palm Beach, Florida, radio station – WRMF – from defendants for $70 million. Plaintiff's willingness to pay the $70 million purchase price was based on defendants' representation that WRMF's annual broadcast cash flow was $5 million (plaintiff was willing to pay 14 times cash flow). Plaintiff confirmed the accuracy of the $5 million figure through due diligence conducted in June 2002, and based on that confirmation the transaction closed. Approximately three months later, after WRMF's traffic manager had resigned, plaintiff noticed that it could not fit all of the commercials that it had sold into WRMF's daily on-air schedules, which struck plaintiff as odd because WRMF was not selling any more commercials than it had sold when defendants owned the station. When the problem persisted and plaintiff could not figure out what was causing the problem, it attributed the problem to defendants' fraud.

Plaintiff filed a lawsuit asserting claims for fraud and breach of contract. Plaintiff asserted that in the period leading up to the sale, defendants sold more pre-recorded commercial advertising to WRMF's customers than WRMF was able to air and then billed the advertisers (and collected) for ads that WRMF did not run. As a result, WRMF's cash flow was artificially inflated by approximately $1 million a year, which caused plaintiff to overpay for the station by $12 million. Defendants listed many reasons for the discrepancy and argued that because plaintiff did not come forward with any admission by one of defendants' former employees confessing that the fraud actually occurred, plaintiff did not sustain its burden of proof.

Based on one week's worth of trial testimony and thousands of pages of briefs and exhibits, the Court concluded that the ads in question did not run and that defendants offered no reasonable explanation for the bad billings to advertisers. The Court also concluded that defendants and several of their employees were motivated to defraud plaintiff so that they could obtain a higher price for WRMF. The Court held that plaintiff "clearly satisfied the elements of its common law fraud claim, as it proved that [defendants] intentionally provided it with false financial information on which it reasonably relied in entering into the transaction and which cause it to overpay for WRMF." The Court noted that plaintiff also established the elements of equitable fraud, which requires similar proof except that scienter is not required. The Court held that plaintiff also proved its breach of contract claim because defendants represented in the Asset Purchase Agreement that the financial statements (showing an annual cash flow of $5 million) provided to plaintiff were not materially misleading. Instead, "nearly 20% of that cash flow was attributable to the fraud perpetrated by [defendants] on its customers." Thus, the financial statements were materially misleading, and defendants breached their representation to the contrary.

The Court awarded plaintiff its expectation damages and, in rejecting defendants' contention that the Court must only rescind the Asset Purchase Agreement, stated, "when a contract or agreement is silent as to the remedy for a breach, the Court of Chancery has the discretion to award any form of legal or equitable relief and is not limited to awarding contract damages for breach of the agreement." The Court awarded the following relief for defendants' fraud and breach of contract: (i) $4 million in monetary damages, (ii) the cancellation of a $5 million promissory note, (iii) the cancellation of defendants' $2 million equity interest in plaintiff, (iv) indemnification in the amount of $180,745 in advertiser credits plaintiff provided to the defrauded advertisers of WRMF, (v) pre-judgment interest on the $4 million award, and (vi) attorneys' fees and costs. While the fee award was based on an indemnification provision contained in the Asset Purchase Agreement, the Court noted that it would have awarded substantial fees under the bad faith exception to the American rule, as a result of defendant's many baseless arguments.

Delaware Supreme Court Rules That Creditors of a Delaware Corporation Cannot Bring Direct Claims Against Directors for Breach of Fiduciary Duty – But Questions Remain

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 WL 1453705 (Del. May 18, 2007), the Delaware Supreme Court, in a case of first impression, provided some clarity on the controversial issue of whether and to what extent creditors have the ability to assert fiduciary duty claims against directors. The Supreme Court held, unequivocally, that "creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against [a] corporation's directors." Rather, the Court noted, creditors can protect their interests by asserting derivative fiduciary duty claims on behalf of an insolvent corporation or by asserting any applicable direct non-fiduciary duty-based claims. In the opinion, the Court pointed out that the plaintiff asserted only a direct claim for breach of fiduciary duty and waived any basis to pursue such a claim derivatively.

The Supreme Court held, unequivocally, that "creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against [a] corporation's directors."

While the *Gheewalla* decision put to rest the issue of a creditor's ability to pursue direct claims for breach of fiduciary duty, there remain unresolved questions about the "insolvency" standard and the rights and roles of creditors under Delaware's corporate law.

The Facts and Holding of *Gheewalla*

The Court's decision in *Gheewalla* affirmed the Court of Chancery's dismissal of a claim by plaintiff North American Catholic Educational Programming Foundation, Inc. ("NACEPF")—a putative creditor of Clearwire Holdings, Inc. ("Clearwire")—that directors of Clearwire, while the company was insolvent or in the "zone of insolvency," breached their fiduciary duties by:

> (1) not preserving the assets of Clearwire for its benefit and that of its creditors when it became

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Questions Remain *continued from page 5*

apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated and (2) holding on to NACEPF's ITFS license rights when Clearwire would not use them, solely to keep Goldman Sachs's investment "in play."

The director-defendants were directors of Clearwire (the "Defendants") serving at the behest of their employer, Goldman Sachs. NACEPF alleged that the Defendants effectively controlled Clearwire through the influence (financial and otherwise) that Goldman Sachs had over Clearwire.

NACEPF was a member of an alliance of FCC license holders, which included Hispanic Information and Telecommunications Network, Inc. ("HITN"), Instructional Telecommunications Foundation, Inc. ("ITF"), and various affiliates of ITF (collectively, the "Alliance"). The Alliance collectively owned a significant percentage of FCC-approved licenses for microwave signal transmissions ("spectrum") used for educational programs.

At some time between 2000 and 2001, Clearwire negotiated an agreement with the Alliance under which Clearwire was to acquire the licenses of the Alliance members when such licenses became available. In return, Clearwire was to pay the members of the Alliance more than $24.3 million. According to NACEPF's allegations, the Defendants represented that Clearwire's stated business purpose was to create a national system of wireless connections to the internet. NACEPF also alleged that the Defendants knew, but did not inform NACEPF, that Goldman Sachs did not intend to fund Clearwire, and, thus, Clearwire did not have the funds to pay to the Alliance, which included NACEPF, under the terms of the agreement.

A little over one year later, the market for wireless spectrum collapsed when WorldCom announced its accounting problems. Consequently, it appeared that a surplus of spectrum was to become available from WorldCom. Therefore, Clearwire began negotiation with the members of the Alliance to end Clearwire's obligations pursuant to the agreement. Ultimately, Clearwire paid over $2 million to HITN and ITF to settle their claims. The settlements left NACEPF as the sole remaining member of the Alliance. According to the complaint, by October 2003, Clearwire "had been unable to obtain any further financing and effectively went out of business."

As a result of Clearwire's rapid demise, NACEPF filed a complaint in the Court of Chancery, asserting three claims against the Defendants: (i) fraudulent inducement, (ii) breach of fiduciary duties, and (iii) tortious interference with prospective business opportunities. In response to the filing of the complaint, the Defendants filed a motion to dismiss based on lack of personal jurisdiction and failure to state a claim. NACEPF premised personal jurisdiction over the Defendants for the non-fiduciary duty-based claims on the Court of Chancery's first determining that the fiduciary duty claim was viable. The Delaware courts have personal jurisdiction over non-resident directors and officers of Delaware corporations pursuant to Title 10, Delaware Code § 3114. The statute provides that non-resident directors and officers of Delaware corporations are subject to personal jurisdiction in the Court of Chancery for claims relating to an individual's duty as a director or an officer of the corporation. The plaintiffs did not assert any other basis on which the Court of Chancery had jurisdiction over the director-defendants. The Court of Chancery proceeded on the basis that if it found that the fiduciary duty claim must be dismissed for failure to state a claim, then it would be without personal jurisdiction over other claims. The Court of Chancery then dismissed the complaint for failure to state a cognizable fiduciary duty claim.

> **"When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."**

On appeal, the Delaware Supreme Court concluded first that creditors of a Delaware corporation merely in the "zone of insolvency" at the time of an alleged breach of fiduciary duty may not bring direct breach of fiduciary duty claims against directors. The Court stated that, while directors owe fiduciary obligations to the corporation, generally they do not owe such duties to creditors. The Court reasoned that while stockholders rely on directors acting as fiduciaries to protect their interest, "creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."

The Court very pointedly and unequivocally held:

> [T]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

The Court further concluded that, although creditors of a Delaware corporation that is actually insolvent "take the place of shareholders as the residual beneficiaries" of the company and, therefore, "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties," they may not assert direct claims for breach of fiduciary duty. The Court stated that permitting a corporation's creditors to bring such claims would:

> …create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary duty claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

On the other hand, the Court noted that permitting a corporation's creditors to bring a derivative claim does not benefit them directly but seeks recovery of value belonging to the company as a whole. The Court also indicated that creditors could bring whatever non-fiduciary duty-based direct claims that are available and identified some of these claims as breach of contract, fraud, fraudulent conveyance, etc.

Potential Issues and Implications of the *Gheewalla* Decision

Notwithstanding the clarity in the Court's ultimate ruling in *Gheewalla* on the issue of direct claims, with regard to derivative claims there are some unresolved questions about when such fiduciary duty-based claims can be brought by creditors. Some practitioners and scholars have asked whether the "zone of insolvency" has any remaining significance under Delaware law and whether a creditor can assert a derivative claim against directors of a Delaware corporation operating in the "zone of insolvency."

While the Delaware Supreme Court did not expressly decide the issue, the answer would appear to be "no." In its discussion on the viability of fiduciary duty claims by creditors, the Delaware Supreme Court brushed aside the "zone of insolvency" analysis and limited its recognition of claims by creditors to actual insolvency: "Creditors may … protect their interest by bringing *derivative* claims on behalf of [an] *insolvent* corporation …." (Emphasis added). If this language restricts a creditor's ability to pursue derivative claims outside the context of insolvency, the "zone of insolvency" would have no remaining practical application in the world of fiduciary duty claims by creditors. The more significant questions relate to application and to practicality: When can creditors derivatively assert fiduciary duty claims?

What is the "Insolvency" Standard?

"Insolvency" for purposes of pursuing a derivative claim under Delaware's corporate law may be different from "insolvency" as generally understood by most practitioners. Historically, there have been two principle tests for insolvency: (i) inability to pay debts as they come due and (ii) liabilities exceed the fair market value of assets. These are also the tests set forth in Delaware's Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b). Although the Delaware Supreme Court clearly stated that "[c]reditors may…protect their interest by bringing *derivative* claims on behalf of [an] *insolvent* corporation…." (emphasis added), the standard articulated in *Gheewalla* appears to have added something to the historical insolvency test. The Court articulated the second test as follows: "A deficiency of assets below liabilities *with no reasonable prospect that the business can be successfully continued in the face thereof.*" (Emphasis added). The additional language was adopted from the Court of Chancery's decision below as well as the Court of Chancery's prior decision in *Production Resources Corp. v. NCT Group, Inc.* 863 A.2d 772, 782 (Del. Ch. 2004). This additional language makes the standard somewhat different from *some* earlier Delaware precedent and U.S. Supreme Court precedent, which follow the balance sheet approach. For example, in *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992), the Delaware Court of Chancery explained that a corporation is insolvent if "it has liabilities in excess of a reasonable market value of assets held." Similarly, in *McDonald v. Williams*, 174 U.S. 397, 403 (1899), the U.S. Supreme Court defined an insolvent corporation as an entity with assets valued at less than its debts. In *Production Resources*, the Court was addressing a request for appointment of a receiver under Section 291 of the Delaware General Corporation Law, which may explain the additional language focusing on continuation of the business. Moreover, according to the *Gheewalla* opinion, Clearwire was insolvent *and*, while not in bankruptcy, was "out of business" at the time of the litigation, which may explain why the *Gheewalla* Court followed the Court of Chancery's expansive definition of insolvency. However, one could argue that regardless of whether a company is out of business or operating, *Gheewalla* has announced a rule of law that imposes an additional burden on creditors before they can pursue derivative claims.

The "insolvency" test employed has implications. Many companies, including many public companies with significant market caps and much long-term promise (in the view of their management), operate as viable entities even though a creditor could argue they are technically "insolvent" under a balance sheet test because of the inability to include future prospects as an intangible asset. Notably, the cost of litigation between management and creditors over what insolvency test applies and whether it has been satisfied could be just enough to ensure that a company on the fence will go out of business. That possibility, and the leverage to creditors that comes with that possibility, is at least one obvious consequence of creditors having standing to at least litigate the issue of a company's "reasonable prospect" of continuing the business at the same time the company is nonetheless attempting to operate while being balance sheet insolvent.

Is There Dual Standing?

If a company is paying its debts as they come due, is viable and somewhat promising (in management's view), notwithstanding a balance sheet analysis, and if creditors can bring a derivative fiduciary claim under such circumstances, then is there dual standing so that stockholders have a simultaneous right to bring a claim? If the answer is "yes," then can stockholders take a position contrary to that of the creditors in the litigation, or do stockholders lose standing to sue derivatively if the company is insolvent? No Delaware decision states that stockholders lose standing, and what would be the basis to deprive stockholders of standing when they remain invested with a possibility (though maybe remote) of a return on their investment over time. Nonetheless, it is noteworthy that the Court's opinion stated that the "creditors *take the place of* shareholders as the residual beneficiaries of any increase in value" resulting from a derivative claim. (Emphasis added). "Replacement" of an interest is inconsistent with dual standing. Furthermore, to take this a step further, what if the derivative claim exceeds the amount of the solvency deficiency so that the stockholders have a residual interest after the creditors? Do the creditors bring the claim for both or do both the creditors and stockholders have the right to bring the claims as their interests may appear?

As all of this plays out in future cases, arguments on both ends of the spectrum may emerge. Directors and corporations may seize upon the language in *Gheewalla* to argue for a rule that provides more clarity. For example, they may argue that until equity is wiped out (i.e., out of the money) and the company is in bankruptcy, dissolution, or at least "out of business" and stockholders no longer have an interest in pursuing fiduciary duty claims, when it comes to the issue of compliance with their fiduciary duties, management should only answer to stockholders (the constituency who elected them to act as fiduciaries). Later, when creditors "take the place of" stockholders, creditors can bring derivative fiduciary duty claims that were available to the stockholders, but only as the residual beneficiaries of those claims — i.e., claims that the company itself was harmed by a breach of fiduciary duty. On the other side, creditors may argue that dual standing is workable, and, if the goal is to determine whether the company has been harmed by a breach of fiduciary duty, a court can simply hear from both stockholders and creditors (as it does when stockholders make competing arguments) and decide which constituency, if either, is correct. In any event, future cases may show that this is a small or non-issue and that stockholders and creditors are aligned most of the time.

Impact on Director Decision-Making

Importantly, the Delaware courts have made it clear that directors, in the exercise of their business judgment, are free to engage in entrepreneurial risk-taking. Thus, when fiduciary duty claims are asserted in the context of insolvency, such claims are likely to focus, to various degrees, on (i) whether a board's decision was outside the bounds of reasonable business judgment and placed too much risk on creditors or (ii) whether the directors disregarded the stockholders' interests by foregoing business strategies, opting instead to preserve assets for creditors. The central question may well be whether the directors' fiduciary duties rest primarily (or exclusively) with the corporation *and its stockholders* or whether, when the company is insolvent, the directors' fiduciary duties rest *only* with the corporation (whatever the courts ultimately determine that to mean) and the directors cannot favor the interests of one corporate constituency (*e.g.*, stockholders) over another corporate constituency (*e.g.*, creditors).

While legal analyses are nice, directors want to avoid potential liability for their decision making. This is an even greater concern if the breach of fiduciary duty claim is being pursued in a bankruptcy proceeding, where advancement of defense costs from the bankrupt company may not be available, leaving directors to rely on a fast-depleting directors' & officers' insurance policy. Clearly, a stockholder or creditor asserting a derivative claim will have to demonstrate that the directors breached either their duty of care or their duty of loyalty (as a consequence of a conflict of interest or bad faith action); but the analysis is not crystal clear. Cases where a board of a wholly-owned subsidiary harms the company (creditors and/or stockholders) by transferring assets to the parent or guaranteeing the debt of the parent for inadequate consideration may prove easy; but, consider a scenario where the company has never turned a profit and has used $35 million of a $50 million line of credit, and the board is faced with the following choice: cease doing business now with the bank trying to recover just $35 million or pursue another strategy with a very low probability of success (but a probability nevertheless) and utilize the remaining $15 million. When the company ultimately fails, imagine being a former director facing claims by creditors who have obtained leave from the bankruptcy court to bring the action in a non-Delaware court with a right to a jury trial and who are arguing that not enough weight was given to preserving assets (for the creditors) and that the low probability of success of the plan pursued (for the stockholders) was so low that it was not a valid business judgment or amounted to bad faith. When does a business plan get so risky (if ever) that the duty of the board shifts to preserving assets? Add to the aforementioned facts a board dominated by a private equity firm with preferred stock and a liquidation preference and, therefore, a greater incentive to forego risk so as to benefit from the preference rather than having to line up with the unsecured creditors in bankruptcy if a last-ditch business strategy fails. Although the language of the rule of law may be clear that directors owe their fiduciary duties to the corporate enterprise, and there is a deference to business judgment absent disabling conflicts of interest, weighing the interests of stockholders and creditors may not be easy for directors sitting on the boards of distressed companies.

Conclusion

In the end, although it remains to be seen how the Delaware courts will deal with the foregoing issues, directors can take some comfort in the fact that the Delaware Supreme Court held that while in the "zone of insolvency" the company is to be managed for the benefit of stockholders (by negative implication, not creditors). Indeed, the precise language employed by the Court was quite clear: "[W]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its stockholder owners."

Delaware Court of Chancery Holds that Beneficial Holder of Stock Purchased After Record Date Can Seek Appraisal if Record Holder Possessed and Perfected Appraisal Rights Pursuant to Section 262 of the Delaware General Corporation Law

In *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007) the Delaware Court of Chancery held that a stockholder of record who holds shares on behalf of many beneficial owners may perfect appraisal rights under § 262 of the Delaware General Corporation Law–Delaware's stockholder appraisal or "dissenters' rights" statute–without establishing that the particular shares for which appraisal is sought were not voted in favor of the merger, provided the total number of shares held by the record stockholder and not voted in favor of the merger exceeds the number of shares for which that record stockholder seeks appraisal. The Court reasoned that "based on the literal terms of the statutory text and under longstanding Delaware Supreme Court precedent, only a record holder…may claim and perfect appraisal rights. Thus, it necessarily follows that the record holder's actions determine perfection of the right to seek appraisal."

The Court reasoned that "based on the literal terms of the statutory text and under longstanding Delaware Supreme Court precedent, only a record holder…may claim and perfect appraisal rights. Thus, it necessarily follows that the record holder's actions determine perfection of the right to seek appraisal."

This action originated from a merger of Transkaryotic Therapies, Inc. ("TKT") with and into a wholly owned subsidiary of Shire Pharmaceuticals Group plc ("Shire"). On April 21, 2005, TKT announced a definitive merger agreement with Shire under which Shire would acquire TKT for $37 per share in cash. The TKT board of directors set June 10, 2005, as the record date for determining which stockholders were entitled to vote on the proposed merger. On July 27, 2005, a special meeting of the TKT stockholders was held to vote on the proposed merger. At the meeting, approximately 52% of the TKT shares entitled to vote were voted in favor of the merger. The merger was consummated shortly thereafter.

As of the record date, the nominal petitioner, Cede & Co. ("Cede"), was the record holder of approximately 29.7 million shares of TKT. Cede voted approximately 12.9 million shares in favor of the merger, approximately 9.9 million shares against it, and abstained or did not vote approximately 6.9 million shares in connection with the merger. On the record date, petitioners were beneficial owners of approximately 2.9 million of the approximately 11 million shares for which petitioners sought appraisal. Petitioners purchased the remaining approximately 8

continued on next page

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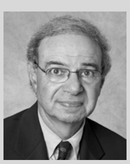

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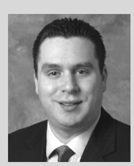

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million shares after the record date, but before the effective date of the merger.

TKT moved for partial summary judgment seeking a ruling that petitioners were not entitled to appraisal of the approximately 8 million TKT shares that petitioners purchased after the record date. TKT argued that an appraisal petitioner bears the burden of proving compliance with § 262; and, where a petitioner cannot demonstrate compliance, the court shall disqualify that petitioner's shares from the appraisal proceeding. TKT's argument relied on its interpretation of the statutory text of § 262. TKT argued that § 262 necessitates stockholders seeking appraisal to satisfy the first three requirements of § 262(a) as to the same shares. TKT argued that § 262(a) requires the stockholders to hold "shares of stock" on the date of making demand, to make a demand for appraisal "with respect to such shares," and to hold "such shares" continuously through the effective date of the merger. The statute's final requirement, however, states that the "stockholder" must refrain from voting in favor of the merger. Accordingly, TKT argued that a stockholder seeking to establish compliance with § 262 must demonstrate that the particular shares as to which demand was made were not voted in favor of the merger.

TKT argued that petitioners could not establish that the disputed shares were not voted in favor of the merger. TKT also argued that petitioners could not rely on Cede's negative votes because there was no proof that those shares were the shares that petitioners held. There were approximately 16.8 million TKT shares owned by Cede that could be considered "no votes" and, therefore, "eligible" for an appraisal demand (9.9 million "no votes" together with 6.9 million abstentions). Thus, according to TKT, petitioners were not entitled to appraisal of the disputed shares as a matter of law.

Petitioners argued that the necessary inquiry is determining what shares the record holder, not the beneficial owner, holds at the time of the record date. Petitioners stressed that the term "stockholder," under § 262, refers only to the record holder. The Court adopted petitioner's position and also cited to precedents prohibiting inquiry into the relationships between Cede as record holder and the beneficial owners. Thus, the Court held that only Cede's actions were relevant and that, because the number of shares Cede held and did not vote in favor of the merger exceeded the number of shares for which Cede demanded appraisal, Cede was entitled to appraisal for all shares as to which demand had been made.

The Court noted that any policy concerns implicated by its ruling (*i.e.*, that the goals of § 262 will be distorted "by allowing it to be used as an investment tool for arbitrageurs as opposed to a statutory safety net for objecting stockholders"), to the extent such concerns are valid, should be addressed by the legislature, because as currently drafted, § 262 dictates the Court's conclusion.

Go-Shop Provisions: The Delaware Court of Chancery Offers Guidance on Directors' *Revlon* Duties

In two recent decisions, both penned by Vice Chancellor Strine, the Delaware Court of Chancery offers some practical guidance on how directors can satisfy their duty to maximize stockholder value under the teaching of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), where a merger agreement is not subject to a pre-signing public auction. It is well recognized that when a board of directors determines to sell control of a Delaware corporation, the board's duty shifts from that of a protector of corporate policy and effectiveness to that of a facilitator of a process to maximize value for the stockholders who will be "cashed out." While the phrase "*Revlon* duties" is often used as shorthand for a duty to shop or auction the company prior to recommending stockholder approval of a merger, *Revlon* itself imposes no such duty. Indeed, *Revlon* does not require any particular process, or even an auction at all. Regardless of what process is followed, however, directors must satisfy themselves that the transaction at issue is in the stockholders' best interests and, in light of other alternatives, offers the best value reasonably obtainable at the time. In this context, "go-shop" provisions become relevant because they provide a mechanism by which a board, in compliance with *Revlon*, can execute a binding merger agreement without having conducted a pre-signing auction. Instead, the board shops the company during a reasonable period of time after signing the merger agreement. Of course, the presence or absence of a go-shop provision, in and of itself, is not dispositive of whether a deal not subject to a pre-signing auction will satisfy the directors' fiduciary duties. The analysis remains fact and context specific. That said, the two cases discussed below offer some insight into the utility and limitations of go-shop provisions.

The Court opined that Eisner's match rights were not preclusive of a topping bid and indeed were typical of match rights that have been overcome in other deals. Although the court thought the post-go-shop termination fee of approximately 4.3% of total deal value was a bit high, it was justifiable in light of the comparatively small size of the deal with Eisner and because the fee was inflated by an expense reimbursement component.

In re The Topps Co. S'holder Litig.

In *In re The Topps Co. S'holder Litig.*, 926 A.2d 58 (Del. Ch. 2007), Michael Eisner ("Eisner") proposed to acquire The Topps Company, Inc. ("Topps" or the "Company") in a going private transaction through a private equity firm he controls, The Tornante Group, LLC, in conjunction with another private equity firm, Madison Dearborn Capital Partners, LLC. The merger negotiations were set against the backdrop of a recent threat of a corporate control contest. To avoid that contingency, the Company agreed to explore the auction of one of its divisions. No serious buyer surfaced. The next year, 2006, insurgents surfaced again and were on the verge of guaranteeing the election of their slate of directors when Arthur Shorin ("Shorin"), the Company's Chairman and CEO, brokered a compromise. The board was expanded, and Shorin was re-elected along with all of the insurgent nominees. The incumbent and insurgent directors disagreed over whether and how the Company should be sold. In particular, the insurgent directors equivocated as to whether a sale was advisable, but insisted that if a sale did occur, any such sale should be preceded by a public auction process.

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Revlon *continued from page 9*

After an *ad hoc* committee comprised two incumbent directors and two insurgent directors deadlocked as to whether the Company should negotiate with Eisner, one of the other incumbent directors, who was independent, negotiated the terms of a deal with Eisner. The material terms of the merger were as follows. Eisner would acquire Topps for $9.75 per share, which yielded a total deal price of approximately $385 million. While Eisner was not willing to do a deal that required a pre-signing auction, he was agreeable to a go-shop. The "open" go-shop provision authorized Topps to solicit alternative bids and discuss a potential transaction with any buyer during an initial 40-day period. After this initial "Go-Shop Period," Topps was required to cease all talks with potential bidders unless a bidder had already submitted a "Superior Proposal" or the board determined that the bidder was an "Excluded Party." A Superior Proposal was defined as one to acquire at least 60% of the Company on terms that would provide more value to Topps' stockholders than the deal with Eisner. An Excluded Party was defined as a potential bidder that the board considered reasonably likely to make a Superior Proposal. Topps was permitted to continue talks after the close of the Go-Shop Period with a bidder that submitted a Superior Proposal or a bidder that the board determined to be an Excluded Party. Topps was permitted to consider unsolicited bids after the Go-Shop Period if such bids were Superior Proposals or reasonably likely to lead to one. Topps could terminate the agreement with Eisner to accept a Superior Proposal; however, such termination was subject to Eisner's matching rights. The reciprocal termination fee provision of the merger agreement provided that a termination by either party during the Go-Shop Period would trigger an $8 million termination fee (plus an expense reimbursement) approximating 3.0% of the transaction value. A termination by either party after the Go-Shop Period would trigger a $12 million termination fee (plus an expense reimbursement) approximating 4.3% of the deal value.

Shortly before the merger agreement was approved by the board, Topps' chief competitor, The Upper Deck Company ("Upper Deck"), expressed its willingness to make a bid for Topps. Indeed, Upper Deck had been interested in a friendly deal with Topps since 1999. The Company signed the merger agreement without responding to Upper Deck. After the merger agreement was signed, the Company's banker commenced the go-shop process, contacting more than 100 financial and strategic buyers. The only serious bidder to emerge was Upper Deck, which proposed a friendly merger at $10.75 per share, subject to additional due diligence. Because the offer was made prior to the close of the Go-Shop Period, the Company was free to continue negotiations after the close of the period upon a finding that Upper Deck's bid was reasonably likely to lead to a Superior Proposal. The board voted against such a finding, and the Go-Shop Period closed. Undeterred, Upper Deck made a second, unsolicited offer at $10.75 per share and no financing contingency. Upper Deck also committed to resolve any antitrust issues, issues that, realistically, were not an impediment to closing. For its own protection, Upper Deck insisted on a $12 million reverse break-up fee, the same amount that Eisner had negotiated for himself. Topps refused to find that Upper Deck had presented a Superior Proposal.

Despite its rejection of plaintiffs' *Revlon* arguments, the Court did grant a limited injunction based on plaintiffs' disclosure arguments. According to plaintiffs, the Company's proxy materials omitted a material fact by not disclosing that Rossiter–the lead negotiator of the proposed merger with Icahn–had an interest in a going private transaction as a means by which his deferred compensation benefits could be accelerated while he was still employed. The stockholder vote was postponed to allow for supplemental disclosures.

As a condition to receiving due diligence materials, Upper Deck signed a Standstill Agreement, which included provisions prohibiting Upper Deck from making (i) any public disclosure with respect to a proposed deal with Topps and (ii) open market purchases of Topps' stock, launching a tender offer, soliciting proxies, or otherwise seeking control of Topps for a period of two years without Topps' consent. After Upper Deck's bid, Topps made public disclosures that distorted Upper Deck's expression of interest and called into question the seriousness of Upper Deck's commitment to a potential deal. Due to the Standstill Agreement, Upper Deck was contractually bound not to respond. Prior to the stockholder vote on the merger with Eisner, Upper Deck requested Topps' consent for relief from the Standstill Agreement so that Upper Deck could launch a tender offer. Topps refused. Subsequently, but before the date of the stockholder meeting, Upper Deck and a group of Topps' stockholders moved for a preliminary injunction to enjoin the merger vote. The crux of the plaintiffs' application for a preliminary injunction was threefold. They alleged that (i) Topps failed to disclose material facts about the merger negotiation process in its proxy materials; (ii) Topps' directors breached their fiduciary duties by failing to release Upper Deck from the Standstill Agreement's restrictions against responding to Topps' characterizations of the deal process and against launching a tender offer; and (iii) Topps denied its stockholders the opportunity to decide for themselves whether to accept the merger with Eisner's group or to possibly secure a higher-priced deal with Upper Deck. Having found that plaintiffs demonstrated a likelihood of success on the merits of their claims, the court entered an injunction. Pursuant to the injunction, the vote on the Eisner merger was enjoined until Topps' disclosed material facts omitted from its proxy materials and Upper Deck was released from the Standstill Agreement so that it could comment publicly on its negotiations with Topps and so it could launch a non-coercive tender offer for Topps on terms as least as favorable as those already offered by the Eisner group.

In accordance with the terms of the injunction, Upper Deck commenced a tender offer on June 25, 2007. Contemporaneously, Topps stockholders initiated a proxy contest to unseat certain Topps board members and to oppose the merger. Although the tender offer, which was originally scheduled to close on July 24, 2007, was extended until August 29, 2007, Upper Deck withdrew its offer on August 21 after it came to an impasse with Topps regarding Upper Deck's allegations that Topps refused to negotiate in good faith, thus foreclosing the possibility that certain conditions precedent to a deal could be met. As of the date of these materials, the special meeting of Topps stockholders entitled to vote on the merger with Eisner's group is scheduled for September 19, 2007. A proxy context is ongoing.

In course of rendering its decision on the injunction, the Court of Chancery made a few comments regarding the deal structure that merit mention. While the cornerstone of the deal protection package was an open go-shop provision that allowed Topps to shop the company for a 40-day period, the Court commented on Eisner's match rights and the transaction fee. The Court opined that Eisner's match rights were not preclusive of a topping bid and indeed were typical of match rights that have been overcome in other deals. Although the court thought the post-go-shop termination fee of approximately 4.3% of to-

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tal deal value was a bit high, it was justifiable in light of the comparatively small size of the deal with Eisner and because the fee was inflated by an expense reimbursement component.

In re Lear Corp. S'holder Litig.

In *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007), Lear Corporation ("Lear" or the "Company"), one of the world's leading suppliers of automotive interior systems, has suffered along with the American automobile industry over the past several years. To deal with this financial adversity, Lear initiated a restructuring. In the midst of that restructuring, Carl Icahn ("Icahn") began amassing a substantial interest in Lear through open market purchases. In October 2006, Icahn increased his holdings to 24% as part of a secondary offering. In connection with that offering, the Company agreed to waive the provisions of Delaware's anti-takeover statute, 8 *Del. C.* § 203, and Icahn, in turn, agreed to cap his position in the Company at 24%. Prior to this time, in December 2004, the Company had allowed its stockholder rights plan to expire and had adopted corporate governance policies prohibiting the re-institution of its poison pill absent a stockholder vote or the approval of a majority of independent directors.

During the time that Icahn was increasing his holdings, the Company's CEO, Robert E. Rossiter ("Rossiter"), was exploring his options for accelerating the receipt of deferred compensation benefits to which he would otherwise be entitled only upon retirement. Ultimately, Rossiter decided against any acceleration of retirement benefits, arguably to avoid the negative publicity of a senior executive pulling money out of an already ailing company that had been flirting with the prospect of bankruptcy in its not too distant past. Fortuitously, he would not have to confront that issue again as Icahn, in January 2007, expressed his interest in taking Lear private in a transaction that would retain existing management. Following this expression of interest, the Lear board of directors, a majority of whom were independent, created a special committee to negotiate with Icahn. The special committee, however, ceded control of the negotiations to Rossiter.

The material terms of the proposed merger called for Icahn to pay $36 per share for Lear's stock. Icahn was amenable to a post-signing go-shop, but indicated that he would pull his offer if the board elected to auction the company pre-signing. A 45-day "closed" go-shop was conditioned on the Company's agreement to a termination fee. The parties eventually agreed on a two-tiered reciprocal termination fee proving that (i) a termination followed by a competing agreement within the go-shop period would trigger a fee of 2.79% of the equity value of the transaction (or 1.9% of the enterprise value); and (ii) a termination followed by a competing agreement after the close of the go-shop period would trigger a fee of 3.52% of equity value (or 2.4% of the enterprise value). In the event of a superior proposal, Icahn had a match right. If, however, he did not exercise his match right, he was obligated to vote his entire 24% interest in the Company in favor of the competing superior proposal.

Stockholder plaintiffs moved to enjoin the stockholder vote on the merger, arguing that the Lear directors breached their Revlon duties and failed to disclose material facts necessary for the Company's stockholder to cast an informed vote. The court was not persuaded by plaintiffs' Revlon claim.

Stockholder plaintiffs moved to enjoin the stockholder vote on the merger, arguing that the Lear directors breached their *Revlon* duties and failed to disclose material facts necessary for the Company's stockholder to cast an informed vote. The court was not persuaded by plaintiffs' *Revlon* claim. First, the decision to forego an auction was found reasonable in light of a limited pre-signing market check that yielded no serious bids. Additionally, the court was unprepared to disturb the board's conclusion that, on balance, it was preferable to forego an auction rather than run the risk of disrupting the Company's business and losing the value of Icahn's premium bid. Second, the court noted that the highest termination fee, 3.52%, was within a range of reasonableness and would not be likely to deter a meaningful topping bid. Also in connection with the termination fee, the court opined that, when considering the preclusive effect of a termination fee on a competing bidder, it is often more significant to look at enterprise value (*i.e.*, debt plus equity) because typically the competing bidder must not only pay for the company's equity, but also must refinance its debt. Third, the court was influenced positively by Icahn's agreement to vote his 24% interest in favor of a Superior Proposal that he was not willing to match.

Although the Court of Chancery concluded that plaintiffs failed to establish a reasonable likelihood of success on their *Revlon* claim, the Court was not overly impressed with the 45-day go-shop provision. Unlike the go-shop in *Topps*, the go-shop in *Lear* was "closed." In other words, in order to obtain the advantage of the lower termination fee under the two-tiered structure, a definitive agreement had to be executed within the go-shop period. In the Court's view, it was unlikely that any such deal could be accomplished given the terms of the merger agreement with Icahn, as well as certain practical considerations. For example, a rival bidder would need time for adequate due diligence. Then, such bidder would need to submit a superior proposal to the Company along with a near definitive merger agreement. For the deal to progress, the Lear board would have to declare the competing bid a superior proposal and then allow Icahn 10 days to match. If Icahn did not match, then the board would be free to accept the Superior Proposal and negotiate the final deal documents.

Despite its rejection of plaintiffs' *Revlon* arguments, the Court did grant a limited injunction based on plaintiffs' disclosure arguments. According to plaintiffs, the Company's proxy materials omitted a material fact by not disclosing that Rossiter–the lead negotiator of the proposed merger with Icahn–had an interest in a going private transaction as a means by which his deferred compensation benefits could be accelerated while he was still employed. The stockholder vote was postponed to allow for supplemental disclosures. The vote was taken at Lear's annual meeting on July 16, 2007. The proposed merger with Icahn did not receive approval from the holders of the requisite majority in interest of Lear's stock, and the merger agreement terminated by its own terms.

Inadequate Disclosure of Bankers' Contingent Fee Arrangement and Failure to Characterize "Special Dividend" as Merger Consideration Subject to Appraisal Rights Resulted in Preliminary Injunction of Stockholder Vote

Caremark Rx, Inc. ("Caremark"), a Delaware corporation best known for its role in the 1996 Delaware Court of Chancery decision which formulated the standard for directors' oversight duties [*In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)], was involved in another recent decision of note: *Louisiana Municipal Police Employees' Retirement System v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007) ("*LAMPERS*"). *LAMPERS* involved a vertical merger between Caremark, a pharmaceutical benefits management company, and CVS Corp. ("CVS"), the largest U.S. retail pharmacy. Caremark and CVS entered into a merger agreement on November 1, 2006. The parties characterized the transaction as a "merger of equals," whereby Caremark stockholders would exchange each share of Caremark stock they held for 1.67 shares of CVS stock. The merger resulted in the former Caremark stockholders owning approximately 45% of CVS. The merger agreement included several deal protection devices implemented to mitigate risk of the deal not closing. These devices included: (i) a $675 million reciprocal termination fee, equal to approximately 3% of the transaction value, which would be triggered if, for almost any reason, either board withdrew or changed its recommendation of the merger; (ii) a "force the vote" provision that contractually bound the board of each company to submit the merger to a stockholder vote; (iii) a "no shop" provision under which neither board could speak with a competing bidder unless the competing offer is deemed a "Superior Proposal" as defined in the merger agreement; and (iv) a "last look" provision that obligated either board to disclose a Superior Proposal and allow the counterparty a five-day window in which to match the unsolicited bid.

These deal protection measures were implicated shortly after execution of the merger agreement when Express Scripts, Inc. ("Express Scripts"), announced an unsolicited bid for Caremark. Express Scripts offered cash and stock representing more than $3 billion (or 22%) over CVS's offer, which was valued at $26 billion. While CVS's offer provided a premium for Caremark stockholders, the Delaware Court of Chancery noted that the deal also provided substantial benefits to certain Caremark insiders by, among other things, accelerating the vesting of their options. After review, Caremark's board publicly announced its conclusion that Express Scripts' bid did not constitute a Superior Proposal and, thus, did not trigger a release from the "no shop" provision.

Rather, opined the Court, the evaluation of a termination fee requires consideration of multiple factors, including, without limitation: (i) size of the fee and its percentage value; (ii) the benefit to stockholders (including a premium) that the directors seek to protect; (iii) the absolute size of the transaction; (iv) the relative size of the merger parties; (v) the degree to which a counterparty determined the deal protection devices to be crucial, keeping in mind discrepancies in bargaining power; and (vi) the preclusive or coercive effect of all deal protection devices taken as a whole.

The board cited several reasons. First, as a matter of corporate policy, Caremark had determined to effect a vertical as opposed to horizontal merger, and Express Scripts was, like Caremark, a pharmaceutical benefits management company. Second, certain Caremark clients were purportedly reluctant to work with Express Scripts. Third, the merged entity would be highly leveraged. Fourth, Caremark's board suspected that Express Scripts' offer was a defensive ploy to disrupt the Caremark/CVS merger.

Following Express Scripts' unsolicited bid, CVS enhanced its offer to Caremark. CVS agreed to waive certain provisions in the merger agreement in order to allow Caremark to declare a special $2.00 dividend to its stockholders that was contingent on stockholder approval of the merger. The dividend would be declared prior to the date of the special meeting at which Caremark's stockholders would vote at the meeting, but the dividend would be payable only on or after the effective date of the Caremark/CVS merger. CVS also proposed to initiate an accelerated share repurchase program pursuant to which the merged Caremark/CVS entity would retire approximately 150 million shares of common stock after the merger. The Caremark board approved these revisions to the merger agreement.

Within one day of the Caremark board's approval of CVS's increased offer, Express Scripts commenced an exchange offer for all outstanding shares of Caremark common stock on the same terms as its unsolicited bid. The Caremark board recommended its stockholders reject Express Scripts' exchange offer. A proxy contest ensued. On February 12, 2007, Caremark issued an 8-K in which it provided stockholders with additional information. The next day, CVS agreed to allow an increase in the conditional special dividend from $2.00 to $6.00 per share (the special dividend was later increased to $7.50 per share). In order to provide stockholders with additional time to digest the February 12 disclosures, the Delaware Court of Chancery enjoined Caremark's special meeting, scheduled for February 20, 2007, until at least March 9, 2007. Prior to the March 9, 2007, meeting date, minority stockholders of Caremark and Express Scripts brought actions to preliminarily enjoin the meeting yet again, alleging that the individual defendants (members of Caremark's board) breached their fiduciary duties by: (i) agreeing to deal protection devices that were inconsistent with their fiduciary duties; (ii) failing to investigate and consider other merger opportunities, including Express Scripts' offer; and (iii) failing to disclose to stockholders information material to their determination of which, if either, offer to accept. Plaintiffs also contended that CVS aided and abetted the individual defendants in the foregoing breaches of fiduciary duty.

The Court of Chancery did not consider substantively the likelihood of success of plaintiffs' challenges to the deal protection devices employed by Caremark and CVS, but instead enjoined the special meeting on other grounds and concluded that stockholders would suffer no irreparable harm if given the opportunity to exercise a fully informed vote. However, some of the Court's comments regarding deal protection, though *dicta*, merit mention. Defendants argued that the deal protection devices in the merger agreement were customary and not worthy of the scrutiny urged by plaintiffs. The Court was unconvinced by defendants' "argument by custom," particularly in regard to the termination fee. After acknowledging that termination fees in the range of 3% of overall transaction value have been upheld by Delaware courts on prior occasions, the Court refused to "presume that all business cir-

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cumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal." Rather, opined the Court, the evaluation of a termination fee requires consideration of multiple factors, including, without limitation: (i) size of the fee and its percentage value; (ii) the benefit to stockholders (including a premium) that the directors seek to protect; (iii) the absolute size of the transaction; (iv) the relative size of the merger parties; (v) the degree to which a counterparty determined the deal protection devices to be crucial, keeping in mind discrepancies in bargaining power; and (vi) the preclusive or coercive effect of all deal protection devices taken as a whole.

Although the Court concluded that most of plaintiffs' disclosure claims were insufficient to warrant an injunction, it was persuaded by one of them: defendants' failure to disclose properly the structure of the investment bankers' compensation. Each banker received a $1.5 million fee for the rendering of an opinion as to the advisability of the merger, regardless of the conclusion reached. The second prong of the bankers' compensation was a $17.5 million fee payable upon the consummation of the Caremark/CVS merger, or, alternatively, a merger with a third party within a specified period of time. In Caremark's February 12, 2007, supplemental disclosures, the company informed stockholders that the consummation of the merger would yield a combined $35 million payment to the two bankers. Caremark also disclosed that if Caremark entered into an agreement with a third party other than CVS within a specified period of time, then the bankers would be entitled to the same $35 million fee payable in connection with a Caremark/CVS merger. By the time of this disclosure, however, the initial requirements for payment to the bankers had already been met (*i.e.*, public announcement and approval of the merger). Thus, the bankers were already entitled to $35 million in fees upon the occurrence of any Transaction (as defined in the bankers' engagement letters) with any party within a specified period of time, which, by the time of the court's opinion, was nine months.

The Court held that defendants' disclosure of the bankers' fee arrangement was technically true, but nevertheless misleading because it omitted to disclose the initial requirements the bankers had to meet to be entitled to their respective $17.5 million fees. Recognizing that the contingent nature of bankers' fees is material because it can impact the weight a stockholder ascribes to a banker's opinion, the Court held:

> Where a public announcement of a contemplated transaction is a prerequisite for receipt of fees, those fees are naturally contingent upon initial approval of the transaction. It follows then that where a significant portion of bankers' fees rests upon initial approval of a particular transaction, that condition must be specifically disclosed to the shareholder. Knowledge of such financial incentives is material to shareholder deliberations.

"It follows then that where a significant portion of bankers' fees rests upon initial approval of a particular transaction, that condition must be specifically disclosed to the shareholder. Knowledge of such financial incentives is material to shareholder deliberations."

Regarding the $6.00 per share "special dividend," the parties took competing views as to its proper characterization. Plaintiffs contended that the dividend was merger consideration subject to appraisal rights. Under Delaware's appraisal statute [Section 262 of the Delaware General Corporation Law ("DGCL")], a stockholder who dissents from a merger is entitled to petition the Delaware Court of Chancery for an independent determination of the "fair value" of that stockholder's *pro rata* portion of the to-be-merged entity on a going concern basis. Defendants countered that the dividend was declared and payable by Caremark and, therefore, had independent legal significance such that it should not be included in the merger consideration. The doctrine of independent legal significance provides that action taken pursuant to the authority of one section of the DGCL constitutes an act of independent legal significance, the validity of which is not dependent on other sections of the DGCL. Ostensibly, then, defendants' argument is that the declaration of a dividend under Section 170 of the DGCL is an act of independent legal significance and thus not contingent on, or subject to, a stockholder's appraisal rights under Section 262 of the DGCL. The Court resolved the dispute in favor of plaintiffs, holding that the "'special dividend,' although issued by the Caremark board, is fundamentally cash consideration paid to Caremark shareholders on behalf of CVS." The Court premised this holding on the facts that the dividend was contingent on stockholder approval of the merger, was payable *after* the effective date of the merger, and that CVS controlled the value of the dividend (*i.e.*, by its power to waive provisions of the merger agreement that would otherwise prohibit the dividend). That the "special dividend" was contingent on stockholder approval of the merger and only payable after the effective date weighs against a finding of independent legal significance. In sum, the Court stated:

> So long as payment of the special dividend remained conditioned upon shareholder approval of the merger, Caremark shareholders should not be denied their appraisal rights simply because their directors are willing to collude with a favored bidder to "launder" a cash payment. As Caremark failed to inform shareholders of their appraisal rights, the meeting must be enjoined for at least the statutorily required notice period of twenty days.

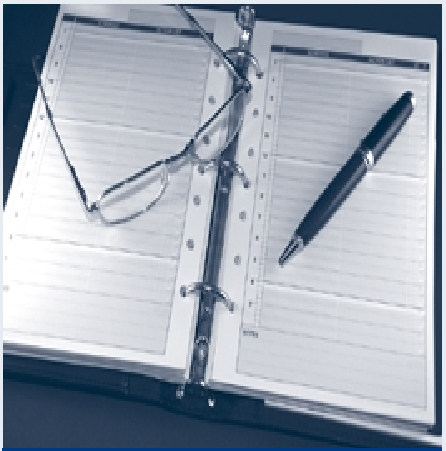
Based on the improper disclosure of the bankers' fee structure, as well as defendants' failure to recognize the "special dividend" as merger consideration and provide the requisite notice, the Court enjoined the meeting of Caremark's stockholders for at least twenty days following the notice required under the appraisal statute. Section 262 of the DGCL provides that if a merger is to be submitted for approval at a stockholder meeting, then notice of appraisal rights must be given stockholders at least 20 days in advance of such meeting. The Court also ordered Caremark to disclose the structure of the bankers' fees prior to any stockholder vote. Although the Court expressed concerns about the process surrounding the negotiations culminating in the Caremark/CVS merger agreement, it declined to enter a broader injunction because the combination of a fully informed stockholder vote and appraisal rights adequately protected Caremark's stockholders. This ruling underscores the importance of full disclosure of all material facts when a corporation requests stockholder action and the corresponding deference that Delaware courts will then afford stockholders when they exercise their franchise and vote on a merger or other significant transaction. Finally, it is important to note that all preliminary injunction applications are decided on incomplete factual records. Preliminary injunctions operate only to preclude imminent irreparable harm to the applicant. As such, the Court's decision in *LAMPERS* to issue only a limited injunction does not preclude litigation on the merits of plaintiffs' fiduciary duty claims. Subsequent to the issuance of the Court's opinion on plaintiffs' preliminary injunction application, the CVS and Caremark stockholders voted to approve the merger on March 15 and 16, 2007, respectively. It remains to be seen what, if any, litigation will proceed regarding this transaction.

Delaware Court of Chancery Tackles Issue of First Impression and Rules That Stock Option Backdating Violates a Director's Fiduciary Duty of Loyalty

In *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007), the Delaware Court of Chancery addressed a novel issue of Delaware law: Whether backdating stock option grants violates one or more fiduciary duties. From 1998 through mid-2002, the board of directors of Maxim Integrated Products, Inc. ("Maxim" or the "Company"), and, in particular, the Company's Compensation Committee, granted options for the purchase of millions of shares to the Company's founder, chairman and CEO John F. Gifford ("Gifford"). Those options were granted pursuant to stockholder approved stock option plans filed with the U.S. Securities and Exchange Commission ("SEC"). According to the stock option plans, the exercise price of options granted thereunder had to be no less than the fair market value of the Company's common stock measured by the publicly traded closing price for Maxim stock on the date of the grant.

Plaintiff, Walter E. Ryan ("Plaintiff"), continuously held shares of Maxim since April 11, 2001, when his shares of Dallas Semiconductor were converted to Maxim shares in connection with Maxim's acquisition of Dallas Semiconductor. The alleged option backdating commenced as early as 1998; however, because Plaintiff did not become a Maxim stockholder until April 11, 2001, the Court of Chancery held that he lacked standing to challenge instances of backdating prior to that date. The impetus for Plaintiff's action, and numerous other stockholder challenges to option dating and timing at various companies throughout the country, was a March 2006 report issued by Merrill Lynch. In the report, Merrill Lynch conducted a statistical analysis of the timing of stock option grants during the period 1997-2002 by the companies that comprise the Philadelphia Semiconductor Index. The report found a substantial divergence between stock price performance subsequent to options pricing events versus stock price performance over a longer period of time. As to Maxim, in particular, "Merrill Lynch found the twenty-day return on option grants to management averaged 14% over the five-year period, an annualized return of 243%, or almost ten times higher than the 29% annualized market returns in the same period." Although the Merrill report did not conclude any actual backdating, it noted that if backdating did not occur, then Company management must have had an uncanny ability to time options pricing events.

Less than three months following the Merrill Lynch report, Plaintiff filed a derivative action alleging breach of fiduciary duty against six current and former members of the Company's board of directors: Gifford; three other directors who comprised the Company's compensation committee at all times relevant to the action, Bergman, Hagopian, and Wazzan; Karros, a director from 2000-2002; and Sampels, a director from 2001-2002 (collectively, "Defendants"). Maxim was named a nominal defendant. Plaintiff alleged that nine specific stock option grants were backdated between 1998 and 2002 because they seemed too fortuitously timed to be coincidence. Each of the grants corresponded with low (or the lowest) trading days of the years in question, or on days immediately preceding precipitous increases in the Company's stock price.



"Backdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"

Before turning to the central issue, it is important to note that Defendants sought to dismiss the complaint based on the fact that similar actions were first filed in other jurisdictions. The court declined to exercise its broad discretion to dismiss Plaintiff's complaint in favor of the first filed actions, in part because the Court of Chancery was presented with a novel question of Delaware corporate law that is best resolved by a Delaware court. Defendants also argued that Plaintiff's complaint was subject to dismissal because the applicable three-year statute of limitations had run. The Court also rejected this affirmative defense, holding that the directors' failure to disclose the backdating, in light of the affirmative representations to the contrary in the option plans, amounted to fraudulent concealment sufficient to toll the statute of limitations. The Court refused to hold Plaintiff to the burden of conducting a statistical analysis based on publicly available information in order to uncover the alleged backdating.

The critical defenses asserted by the Defendants was that Plaintiff failed to make demand or demonstrate demand futility. When a stockholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that stockholder to first make demand on the board of directors. The purpose of the demand requirement is to afford the directors an opportunity to examine the stockholder's grievance and the related facts and determine whether pursuing the action is in the best interest of the corporation. This process allows the directors to determine whether the company should maintain control of the derivative litigation, the very purpose of which is to obtain a recovery for the benefit of the company, as opposed to a direct recovery for the benefit of the stockholder plaintiff. The demand requirement is, however, excused if a plaintiff can raise a reason to doubt that: (i) a majority of the board is disinterested and independent or (ii) the challenged acts were the product of the board's valid exercise of business judgment. This test for demand excusal, referred to as the *Aronson* test [derived from the 1984 case of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)] applies when the challenged decision is a decision of the board in place at the time the complaint is filed.

As a threshold matter, the Court had to determine whether it was appropriate to apply the *Aronson* test. Maxim's board consisted of six members at all relevant times. Three of those members, Bergman, Hagopian, and Wazzan, constituted the compensation committee. Thus, three of the board's six members approved each challenged option grant. When at least one half or more of the board in place at the time the complaint is filed is also in place at the time the underlying transactions being challenged were approved, the *Aronson* test applies.

For purposes of the demand futility test, three out of six directors (*i.e.*, the compensation committee) constitutes a majority. Based on this, Plaintiff argued that their approval of the challenged option grants, under the circumstances alleged in the complaint, called into question whether such acts were valid exercises of business judgment under the second prong of *Aronson*. The Court agreed:

> Specifically, plaintiff states that the terms of the stock option plans *required* that "[t]he exercise price of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted." The board had no discretion to contravene the terms of the stock option

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plans. Altering the actual date of the grant so as to affect the exercise price contravenes the plan. Thus, knowing and intentional violations of the stock option plans, according to the plaintiff, cannot be an exercise of business judgment. I conclude that the unusual facts alleged raise a reason to doubt that the challenged transactions resulted from a valid exercise of business judgment. (Emphasis in original).

The Court noted that Plaintiff's position was bolstered by empirical evidence suggesting that backdating occurred. According to the Merrill Lynch report, Maxim's average annualized return of 243% on option grants to management was almost ten times higher than the 29% annualized market returns in the same period. This "aggressiveness" in the timing of option grants militates in favor of a finding of backdating because, according to the Court, it "seems too fortuitous to be mere coincidence. The appearance of impropriety grows even more when one considers the fact that the board granted options, not at set or designated times, but by a sporadic method."

As a final comment on its demand futility analysis, the Court stated that even if the actions of the compensation committee could not be imputed to the entire board, thus implicating the *Aronson* test, stockholder demand still would have been futile under the alternate *Rales* test [derived from the 1993 case of *Rales v. Blasband*, 634 A.2d 927 (Del. 1993)]. This alternate test applies when the challenged transaction is not the result of a business decision made by the board in place at the time a derivative complaint is filed. Where the board has not made a decision, demand is excused when the complaint contains particularized facts creating a reason to doubt that a majority of the directors would have been independent and disinterested when considering the demand. Directors who are sued have a disabling conflict of interest for pre-suit demand purposes when "the potential for liability is not a mere threat but instead may rise to a substantial likelihood." The Court reasoned that a director who approves backdating of options faces a substantial likelihood of liability because the grant of options that contravenes the terms of a stockholder approved option plan is a lie to stockholders that is difficult, if not impossible, to reconcile with that director's duty of loyalty:

> Backdating options qualifies as one of those "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." Plaintiff alleges that three members of a board *approved* backdated options, and another board member accepted them. These are sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering demand. (Emphasis in original).

Defendants next argued that Plaintiff's complaint was subject to dismissal for failure to state a claim pursuant to Court of Chancery Rule 12(b)(6) because the complaint did not (i) contain allegations sufficient to rebut the presumptions of the business judgment rule (*i.e.*, that the directors acted on a reasonably informed basis and in the best interests of the corporation) or (ii) allege waste. The Court disagreed, holding instead that the same facts that establish demand futility under the second prong of *Aronson*–the directors' purposeful failure to honor the pricing requirement in the stock option plan–also rebut the business judgment rule for a motion to dismiss. This is because the pleading requirement for alleging demand futility is more stringent than the one for surviving a motion to dismiss. Because Plaintiff alleged particularized facts sufficient to demonstrate demand futility, *a fortiori* Plaintiff also rebutted the business judgment rule.

"I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary."

Even if this were not the case, the Court noted that the complaint alleged acts taken in bad faith. Such acts constitute a breach of loyalty and thus rebut the business judgment rule. According to the complaint, those acts were (i) the affirmative representation to stockholders that the exercise price of option grants would be not less than the fair market value of Maxim's stock on the date of the grant; (ii) in reliance on this representation, Maxim's stockholders approved the option plans; (iii) Maxim's directors subsequently attempted to circumvent their duty to price options in accordance with the options plans by surreptitiously changing the dates on which the options were granted; and (iv) the directors failed to disclose this conduct to the stockholders, instead making false representations about option dates in public disclosures. Accepting as true these allegations and all reasonable inferences drawn therefrom, as it must on a motion to dismiss, the Court concluded:

> I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary.

The burden on a stockholder plaintiff to plead demand futility is an onerous one. Although Plaintiff in this case met that burden, one cannot assume that other stockholder plaintiffs will be as successful in different derivative actions involving the dating and/or timing of stock option grants. Here, as noted repeatedly by the Court, Maxim's stock option plans provided that "the exercise price of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted." The stock option plans of many companies, by contract, expressly permit discounted options or use less stringent language. In such cases, stockholder plaintiffs would not have the same basis as Plaintiff in this case to allege reason to doubt that the option grant at issue was the product of a valid exercise of the directors' business judgment. Moreover, if options are granted by compensation committees or other directors constituting less than a majority of the board, there may well be a majority of disinterested and independent directors in place to consider demand on the date a complaint is filed.

Finally, it is significant to keep in mind the procedural posture of the case at the time the Court rendered its decision in *Ryan v. Gifford.* The motions at issue were based on the pleadings. At this stage of the litigation, Plaintiff is entitled to certain presumptions and inferences regarding the verity of his allegations. Should the case go to trial, however, it will be incumbent on Plaintiff actually to prove by a preponderance of the evidence: (i) specific instances of backdating; (ii) violations of stockholder approved option plans; and (iii) fraudulent disclosures regarding compliance with such plans. Regardless of the outcome of this particular case, the Court of Chancery has signaled that on the appropriate set of facts the intentional backdating of stock options will violate the fiduciary duties of directors of a Delaware corporation.

Delaware Speaks on Timing of Stock Option Grants and Refuses to Dismiss Derivative Complaint Alleging "Spring Loading"

Issued on the same day as *Ryan v. Gifford*, the Delaware Court of Chancery handed down its decision in *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, 919 A.2d 563 (Del. Ch. 2007). Whereas *Ryan v. Gifford* dealt with the backdating of stock option grants, the *Tyson* decision dealt with the similar but somewhat different issue of alleged "spring loading" of stock option grants. "Spring loading" is the practice of issuing stock option grants shortly prior to the release of information likely to drive up the price of the issuer's stock. As a result, the optionee receives options that are almost instantly "in the money." Although this case did not include claims of "bullet dodging," the practice of granting options after the release of materially damaging information so that employees receive lower-priced options, the Court indicated that its comments would be equally applicable in such cases.

In *Tyson*, stockholders of Tyson Foods, Inc. ("Tyson" or the "Company") brought derivative and class actions against the Company, its controlling stockholder, and current and former directors and officers to recover for breach of fiduciary duties by (i) approving consulting contracts, awards of other compensation, "spring loaded" options, and related-party transactions; (ii) failure to investigate self-dealing payments; (iii) failure to comply with terms of previously settled stockholder litigation involving similar claims; and (iv) misrepresentations in proxy statements. One of the plaintiffs, an individual stockholder, was spurred to litigate after becoming aware of an SEC investigation regarding the proper classification of perquisites to Tyson executives. Another lawsuit was the result of an investigation commenced prior to the SEC's by another Tyson stockholder, Amalgamated Bank ("Amalgamated"). Amalgamated's action included both class and derivative claims alleging breaches of fiduciary duty and proxy disclosure violations. These stockholder actions were consolidated. Defendants moved to dismiss, primarily on the basis that the statute of limitations had run and/or that plaintiffs had failed to state claims upon which relief could be granted.

The acts challenged in plaintiffs' complaint were complex and spanned a ten-year period. For the most part, they implicated members of the Tyson family, who controlled the Company, and other insiders. For present purposes, only the granting of "spring loaded" options is discussed. Tyson's capital structure included Class A and Class B common stock, which were low-vote and high-vote shares, respectively. In 2001, Tyson adopted a Stock Incentive Plan ("Plan") granting the board permission to award options to purchase Class A shares of the Company's capital stock. Tyson vested in its Compensation Committee and Compensation Subcommittee complete discretion as to when and to whom they would distribute such options. Although plaintiffs alleged that Plan required the price of the options to be no lower than the fair market value of the Company's stock on the date of the grant, the Company's 2004 Proxy Statement ("Proxy") suggests that plaintiffs were only partially correct.

"It is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at 'market rate' and simultaneously withhold that both the fiduciary and the recipient *knew* at the time that those options would quickly be worth much more."

Indeed, the Proxy differentiates between incentive stock options and nonqualified options. As to the former, "the exercise price…may not be less than the fair market value of the Class A Common Stock on the date of the grant…." Nonqualified stock options, on the other hand, "may be made exercisable at a price equal to, less than, or more than the fair market value of the Class A Common Stock on the date that the option is granted." The Compensation Committee's discretion to set an option price is thus determined by whether the option at issue is an incentive or nonqualified option. For purposes of defendants' motion to dismiss, this distinction is not particularly relevant because plaintiffs alleged that defendants "spring loaded" options, while representing in public disclosures that such options were granted at market prices. The Court of Chancery accepted these allegations as true, which it must on a motion to dismiss, but noted that it is conceivable that a director might show that stockholders expressly empowered a board, or committee thereof, to use "spring loading," "bullet dodging," or backdating as part of an employee compensation plan. Plaintiffs identified four specific instances on which the Compensation Committee granted options to key employees, which grant was followed shortly by the release of information that drove up Tyson's stock price. The subsequent release of information in two instances was the day after the grants in question, both of which were in 2001. In another case, the release of information came within two weeks of the grant, again in 2001. As to the final grant in question, the material information was released four days later. This final option grant was in 2003.

Defendants offered two principal challenges to plaintiffs' "spring loading" claim. First, defendants argued that plaintiffs were in possession of all the information they needed to bring their claims on the dates of certain of the option grants (*i.e.*, the options granted in 2001). Accordingly, argued defendants, the applicable statute of limitations had run by the time plaintiffs filed the complaint. Second, defendants argued that plaintiffs did not allege facts sufficient to rebut the presumption that the members of the Compensation Committee acted loyally. These challenges, both of which were rejected by the court, will be addressed in turn.

The Court held that the statute of limitations that applied to the option grants prior to 2003 was tolled because plaintiffs alleged that defendants knowingly "spring loaded" options to key employees while publicly disclosing that those same options were granted at market value. According to the Court, "[s]uch partial, selective disclosure–if not itself a lie, certainly exceptional parsimony with the truth–constitutes an act of 'actual artifice' that satisfies the requirements of the doctrine of fraudulent concealment." An alternative ba-

continued on next page

sis for tolling the statute of limitations is the doctrine of equitable tolling, which according to the Court, entitled plaintiffs to rely on the good faith of their fiduciaries in making disclosures:

> It is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at "market rate" and simultaneously withhold that both the fiduciary and the recipient *knew* at the time that those options would quickly be worth much more. Certainly at this stage of the litigation, plaintiffs are entitled to the reasonable inference of conduct inconsistent with a fiduciary duty. (Emphasis in original.)

Defendants' final effort to shield themselves with the statute of limitations fared no better. Defendants posited that plaintiffs were on inquiry notice of the alleged "spring loading" by virtue of the public disclosure of the date and price of the option grants. That, however, would have required the plaintiffs to "sift through a proxy statement" to find the relevant pricing and timing data and compare that to a "year's worth of press clippings and other filings" in order to discern a correlation between the prices at which options were granted and the subsequent releases of favorable news that propelled the underlying stock price upward. Plaintiffs cannot be held to that burden, noted the Court, particularly when the pattern for which they must search was concealed by those charged with the duty of protecting the interests of the Company's investors.

Regarding defendants' substantive challenge to the "spring loading" claim, plaintiffs conceded that the Compensation Committee had sole authority to grant options, but nevertheless argued that the whole board could be sued on this count because the Compensation Committee was required, under the terms of the Plan, to consider recommendations by Tyson's chairman and CEO, each of whom were option recipients. The Court disagreed, holding instead that it was irrelevant that the committee was required to seek recommendations from the chairman and CEO. The Compensation Committee retained independent authority and discretion to grant options under the Plan. As such, only the members of that committee were proper defendants on the "spring loading" claim. Like a board of directors, an independent committee thereof enjoys the presumption that its decisions are protected by the business judgment rule. In the *Tyson* case, plaintiffs failed to plead facts sufficient to rebut the independence of the Compensation Committee. Plaintiffs' claim nevertheless survived defendants' motion to dismiss because plaintiffs demonstrated that the granting of "spring loaded" options was not within the bounds of the Compensation Committee's business judgment because those acts, under the circumstances alleged, could not have been in good faith. The Court observed that "[w]here a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in *good faith* to meet their duty." (Emphasis in original)

"A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary."

At the outset, it is important to recognize that the option-timing issue in *Tyson* is somewhat different than the backdating issue in *Ryan v. Gifford*. Backdating, according to the Court, always involves a lie to stockholders because the directors who approve the grant misrepresent the date on which the option was actually granted. Charges of "spring loading," on the other hand, "implicate a much more subtle deception." The deception is subtle because it is indirect. A board of directors that receives stockholder approval for a stock option incentive plan but then distributes shares in accordance with that plan in a way that undermines the purpose of the plan cannot be said to act in good faith:

> The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he *knows* those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary. (Emphasis in original)

In order to establish a director's disloyalty and bad faith in connection with the granting of "spring loaded" options, the Court delineated three elements that a plaintiff must plead: (i) options were issued pursuant to a stockholder-approved employee compensation plan; (ii) directors approved "spring loaded" or "bullet dodging" options while in possession of material non-public information soon to be released; and (iii) directors issued the options with the intent to circumvent stockholder-approved restrictions on the exercise price of the options. As in the *Ryan v. Gifford* case, the Court's opinion in the *Tyson* case was on a motion to dismiss. Accordingly, the Court must accept as true all of plaintiffs' well-pleaded allegations and draw reasonable inferences therefrom in favor of plaintiffs. Should the case proceed through discovery and ultimately go to trial, plaintiffs will bear the burden to prove each of the elements delineated by the court, including *scienter*. While it remains to be seen what plaintiffs will be able to prove in this case, as a general matter, *scienter* can be a difficult element to prove for any plaintiff. To satisfy the *scienter* element, a plaintiff must demonstrate that a director knew or had reason to know, at the time of the grant, that the shares were worth more than the exercise price. Thus, a plaintiff must plead not only that a director was in possession of material inside information about to be released, but also that the director knew or had reason to know that such information, upon its release, would increase the market value of the underlying stock. Without demonstrating this *scienter* element, a plaintiff cannot adequately allege that a director authorized an option with a market-value strike price at a time when he or she knew the underlying shares were worth more than the exercise price of the option.

Subsequent to the Court's denial of Defendants' motion to dismiss, the outside director defendants moved for judgment on the pleadings regarding Plaintiffs' allegations of "spring loading." The Court denied that motion on August 15, 2007. *In re Tyson Foods, Inc.*, 2007 WL 2351071 (Del. Ch.).

2007 Amendments to the Delaware General Corporation Law

The following amendments to the Delaware Constitution and Delaware General Corporation Law became effective August 1, 2007:

Delaware Constitution–Certification of Questions to Delaware Supreme Court

Art. IV, Sec. 11, Para. 8

Article IV, Section 11, Paragraph 8 of the Delaware Constitution of 1897 was amended to allow the U.S. Securities and Exchange Commission to certify questions of Delaware law to the Delaware Supreme Court.

Directors and Officers

§ 141

Section 141(d) was amended to permit a certificate of incorporation to confer upon one or more directors voting power greater than or lesser than that of any other directors, regardless of whether the director or directors were separately elected by the holders of any class or series of stock.

Stock Transfers

§ 203

Section 203(b)(4) was amended to eliminate an exception to Delaware's Anti-Takeover statute. Section 203 prohibits a corporation from engaging in any business combination with any interested stockholder for a period of three years following the time that the stockholder became an interested stockholder unless certain requirements are met. One exception was if the corporation did not have a class of voting stock that was authorized for quotation on the NASDAQ Stock Market. The Amendment eliminated this exception.

Meetings, Elections, Voting and Notice

§ 216

Section 216(4) was amended to clarify that, unless otherwise provided in the certificate of incorporation or the bylaws, a plurality vote (and not a majority of the quorum) is the vote required to elect directors where one or more classes or series of stock votes as a separate class or series for the election of directors.

Merger, Consolidation or Conversion

§§ 251 and 255

Sections 251 and 255 were amended to eliminate the requirement that an agreement of merger or consolidation includes a certification by the secretary or assistant secretary of the corporation that the agreement has been adopted by the requisite vote of the stockholders or members, as applicable, or otherwise has been approved in accordance with Section 251 without a vote of the stockholders, if a certificate of merger or consolidation is filed *in lieu* of filing the agreement. Because of incorporations by reference, the amendments to Sections 251 and 255 also eliminated the certification requirement from Sections 252, 254, 256, 258, 263 and 264.

§ 258

Section 258(b) was amended to clarify that the agreement of merger or consolidation also must be certified by each of the constituent foreign corporations in accordance with the laws under which each was formed.

§ 262

Section 262(b) was amended to eliminate an exclusion to appraisal rights. The amendment deleted the phrase "designated as a national market system security on an interdealer quotation system by the National Association for Securities Dealers, Inc."

Sections 262(e) and (k) were amended to clarify the right of a stockholder to withdraw an appraisal demand and receive the merger consideration at any time within 60 days after the effective date of the merger, even if a petition for appraisal has been filed, as long as that stockholder has not filed such a petition or otherwise joined the proceeding as a named party. Section 262(e) was further amended to enable beneficial holders of shares of stock held in street name to file petitions for appraisal and to request a statement of shares with respect to which demands for appraisals have been received in their own name rather than in the name of the stockholder of record.

Sections 262(h) and (i) were amended to establish a presumption that interest is to be awarded for the period from the effective date of the merger until the date of payment of judgment, compounded quarterly and accruing at the rate of 5% over the Federal Reserve discount rate, giving effect to any variation in that rate during that period. The Court of Chancery may depart from this presumptive approach for good cause in order to avoid an inequitable result. Section 262(h) was further amended to clarify that the Court of Chancery in appraisal proceedings does not determine the fair value of shares on its own initiative and that appraisal proceedings are adversary proceedings to be litigated in accordance with generally applicable rules of the Court of Chancery. [The amendments to Section 262 are effective only with respect to transactions consummated pursuant to agreements entered into after August 1, 2007, (or, in the case of short-form merger pursuant to Section 253 of the DGCL, consummated pursuant to resolutions of the board of directors adopted after August 1, 2007) and appraisal proceedings arising out of such transactions.]

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