

Delaware Supreme Court Limits Application And Cleansing Effect of Shareholder Ratification

The Delaware Supreme Court issued an important *en Banc* opinion on January 27, 2009 reversing the Court of Chancery's dismissal of a stockholder complaint challenging the conduct of officers and directors in rejecting a merger offer and instead implementing, with stockholder approval, a recap that allegedly benefited the insiders. *Gantler v. Stephens*, No. 132, 2008, 2009 WL 188828 (Del. Jan. 27, 2009) (Jacobs, J.). The complaint also alleged that approval of the recap was secured by means of a misleading proxy statement. The Supreme Court found that the complaint pleaded facts sufficient to overcome the business judgment presumption and to state viable breach of fiduciary duty and disclosure claims.

The decision is important doctrinally on a number of levels and no doubt will be subject to a blizzard of commentary by practitioners and scholars alike. In a nutshell, the principal holdings can be summarized as follows. First, allegations that the defendants sabotaged the merger offeror's due diligence, rejected the offer, and terminated negotiations in order to entrench and benefit themselves were, on the facts alleged here, to be measured by the entire fairness standard and not by the business judgment rule. Typically, a board's decision NOT to pursue a merger opportunity is normally reviewed within the traditional business judgment framework, deferring to the board's decision. The Supreme Court reaffirmed that the board's action is entitled to the business judgment presumption only if (1) the board reached its decision in the good faith pursuit of a legitimate corporate interest and (2) the board acted "advisedly" in making its determination. The board's pursuit of long term value objectives, according to the opinion, is an example of a legitimate concern satisfying the first prong of the analysis. The court declined to apply *Unocal's* enhanced scrutiny standard of review because the complaint, while alleging disloyal behavior, failed to assert defensive conduct by the board. Second, in an unsurprising holding, the Supreme Court expressly held for the first time that corporate officers "owe fiduciary duties of care and loyalty, and ... the fiduciary duties of officers are the same as those of directors." Third, the Supreme Court broke new ground in connection with the shareholder ratification doctrine. The Court of Chancery held that claims that defendants breached their duty of loyalty by recommending the recap for their own benefit were extinguished because a disinterested majority of shareholders had "ratified" the recap by voting in favor of it. The Supreme Court held that the Court of Chancery erred in dismissing the claim for two reasons: (1) because a shareholder vote was **REQUIRED** to amend the certificate of incorporation (and effect the recap), the "approving vote could not also operate to 'ratify' the challenged conduct of the interested directors;" and (2) the claim that the proxy contained a material misrepresentation eliminated an essential predicate for ratification--that the shareholder vote was fully informed.

The court further explained its clarification of the scope and effect of shareholder ratification. First, shareholder ratification is limited to circumstances where a fully informed shareholder vote approves board action that does NOT legally require shareholder approval in order to become legally effective (e.g., mergers under Section 251, certificate amendments under Section 242, sale of all or substantially all assets under Section 271, etc.). Second, ratification applies only to board conduct which the shareholders are **SPECIFICALLY** asked to approve. Third, the cleansing effect of a ratifying stockholder vote, with one exception, is to subject the

action to business judgment review and NOT to extinguish the claim altogether. Stockholder ratification extinguishes only claims that directors lacked authority to take certain actions.

Two concluding points. The Supreme Court expressly overruled that part of *Smith v. Van Gorkom*, 488 A.2d 858, 889-90 (Del. 1985) holding that ratification could have a more expansive effect in the merger context. ("Hence, the merger can be sustained, notwithstanding the infirmity of the Board's action, if its approval by majority vote of the shareholders is found to have been based on an informed electorate."). Finally, the court noted that its "doctrinal clarifications" respecting shareholder ratification are not intended to affect or alter Delaware jurisprudence governing the effect of a majority vote under Section 144 of the DGCL (removing, in described circumstances, the common law taint of voidness upon interested director transactions).

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