

THE STEWART LAW FIRM

Delaware Corporate and Alternative Entity Law Update

Special points of interest:

- Advancement of Expenses
- Fiduciary Standards
- Short-form Merger
- Material Adverse Effects
- Liquidation Preferences
- Duty of Good Faith
- Legislative Updates

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No Threat of Litigation, No Advancement of Expenses. No Kidding.

In *Duthie v. CorSolutions Medical, Inc.*, 2009 WL 1743650 (Del. Ch. June 16, 2009), the Chancery Court held that a provision in a corporation’s certificate of incorporation requiring advancement of expenses in defense of litigation no longer applied after no further threat of litigation against the officers existed. This case arose out of Matria Healthcare’s 2005 acquisition of CorSolutions. Following the acquisition, Matria sued the former CEO and COO of CorSolutions (both of whom were also directors) for fraud and breach of contract, alleging failure to disclose a CorSolutions cus-

tomers’ intention to undertake a clinical and financial audit of CorSolutions’ disease management programs. As part of a defensive strategy, the CEO and COO asserted affirmative claims for defamation, tortious interference with economic advantage, and ERISA. CorSolutions’ certificate of incorporation required the advancement of expenses incurred by its officers and directors in defense of litigation, and the Chancery Court had held in a 2008 decision that the officers were entitled to mandatory advancement of litigation expenses in asserting their affirmative claims. Following the 2008 decision, the fraud

claims were resolved in arbitration, and Matria represented to the Chancery Court that it had no intentions of pursuing further claims against the officers. Because the officers’ claims against Matria were no longer “a direct response to, or negation of, any claims against them,” the Chancery Court held that the claims were solely offensive and were therefore not eligible for advancement.



Link to Court Opinion:

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Accused of Breaching Fiduciary Duty, Law Firm Receives Advancement of Expenses from Accuser

In *Jackson Walker L.L.P. v. Spira Footwear, Inc.*, 2008 WL 2487256 (Del. Ch. June 23, 2008), the Chancery Court held that outside litigation counsel was an “agent” eligible for advancement of expenses under 8 *Del.C.* §145 and the company’s certificate of incorporation and bylaws. A law firm had acted as outside litigation counsel for Spira Footwear in a Texas action arising out of a stockholder contest for control of Spira. The competing stock-

holders reached an agreement that resulted in a change of control of Spira. Afterwards, new management terminated the law firm and filed an action against the firm for breach of fiduciary duties and negligence. Spira’s certificate of incorporation and bylaws both provided for mandatory advancement of attorney’s fees and expenses for Spira’s “directors, officers, employees and agents.” The Chancery Court held that because the law firm had the power to act

on behalf of Spira in relations with third parties, it was an “agent” and was entitled to advancement of its litigation expenses. The court distinguished *Fasciana v. Electronic Data Systems Corp.*, 829 A.2d 160 (Del. Ch. 2003), which held that counsel engaged in corporate advisory work was not an agent.



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Officers and Directors Held to the Same Fiduciary Standard



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Gantler v. Stephens, 965 A.2d 695 (Del. 2009) involved allegations that the directors and officers of First Niles Financial breached their fiduciary duties by rejecting an opportunity to sell First Niles in favor of a reclassification of the company's shares. First Niles had received three bids to purchase the company, and certain officers had failed to inform the board of directors of failures by the company to comply with certain due diligence requests, which failure ultimately resulted in a withdrawal of a bid. The Delaware Supreme Court reversed Chancery Court's dismissal of the shareholder's breach of

fiduciary duty claims against the officers. The Supreme Court directly held, apparently for the first time, that officers of Delaware corporations owe the same fiduciary duties of care and loyalty as directors owe. In so doing, the Supreme Court noted that 6 *Del.C.* § 102(b)(7) does not authorize a provision in the certificate of incorporation exculpating officers from monetary liability for a breach of their duty of care. The Court also held that statements in proxy materials concerning the board's "careful" consideration and deliberation of a third-party offer, when in fact the board had voted to reject

the proposal without discussion, were material, stating that without such representation, a shareholder might have evaluated the reclassification of shares more skeptically. Finally, the Court rejected the defense of stockholder ratification of the reclassification of shares, holding that ratification is limited to (i) circumstances whereas a fully informed vote approves action that does *not* require stockholder approval to become effective, and (ii) director actions and conduct that the stockholders are specifically asked to approve.

Minority Shareholders Involuntarily Cashed Out in Merger



Link to Court Opinion:

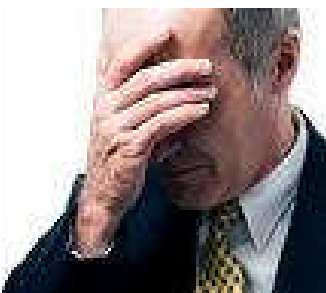
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Berger v. Pubco Corp., 976 A.2d 132 (Del. 2009) involved minority stockholders involuntarily cashed out in a short-form merger. The case involved a short-form merger where the notice of merger (i) provided no significant detail of the plans, prospects or operations of the company, and (ii) was accompanied by an outdated version of Section 262 of the Delaware General

Corporation Law governing stockholder appraisal rights. In a class action by minority stockholders, the Chancery Court held that such stockholders were entitled to a quasi-appraisal proceeding, including supplemental disclosures and requirements that the minority stockholders both opt into the class and escrow a portion of the merger proceeds. While agreeing with

the lower court's findings of breach of the fiduciary duty of disclosure, the Delaware Supreme Court held that the Chancery Court had erred in fashioning a remedy that included "opt-in" and escrow requirements. The Court reasoned that the "opt-out" approach is less burdensome to the stockholders and benefits the stockholders by reducing the risk of forfeiture.

A Serious Case of Buyer's Remorse



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In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008) the Delaware Chancery Court specifically enforced a \$10.4 billion merger agreement, holding that the acquiring company had intentionally breached numerous covenants under the contract. In 2007, Hexion had agreed to stringent terms for the purchase of

Huntsman. There was no "financing out" provision, as is often typical. After the deal no longer seemed attractive to Hexion, it concluded that the combined entity after the acquisition would be insolvent and, that as a consequence, financing would be unavailable and that a Material Adverse Effect ("MAE") had therefore occurred, effectively excusing

Hexion's performance. The Court held that Hexion had breached the agreement by scuttling its own financing and by not acting in good faith. The *Hexion* decision contains a detailed discussion of MAEs.

Divergent Stockholder Interests Lead to Class Action

In re: Trados Incorporated Shareholder Litigation, 2009 WL 2225958 (Del. Ch. July 24, 2009) was a class action suit brought by a former shareholder of Trados. The complaint alleged breaches of fiduciary duties arising out of a \$60 million purchase by merger of Trados by SDL, plc. Of the purchase price, preferred stockholders received \$52 million, executive officers received \$8 million pursuant to a recently adopted compensation plan, and common stockholders received nothing. A majority of the directors were designees of the preferred stockholders, and the board had earlier determined the fair market value of the common stock was 10

cents per share. In denying a motion to dismiss, the Delaware Chancery Court held that the interests of the preferred and common shareholders diverged with respect to the decision of whether to pursue the merger, and that plaintiffs had pled sufficient facts to permit an inference that a majority of the board had improperly favored the interests of the preferred shareholders. The Court also held that although generally the board's duty is to prefer the interests of the common stockholders, directors owe fiduciary duties to both the preferred and common stockholders where the right claimed by the preferred is not a preference as against the common but one shared

equally with the common. The Court remarked that the common stockholders would have been no worse off had merger not occurred, but noted that it would not necessarily be a breach of fiduciary duty "for a board to approve a transaction that, as a result of liquidation preferences, does not provide any consideration to the common stockholders." Finally, the Court noted that "[w]hile it is true that an individual stockholder that is not a controlling stockholder can generally vote in its individual interest, the same cannot be said of directors designated to the board by such a stockholder."



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Breach of Good Faith

Following up on the *Caremark*, *Disney*, and *Stone v. Ritter* cases, the Delaware Supreme Court continued to flesh out the contours of the duty of good faith in *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009) in the context of a sale of the company. The plaintiffs in *Lyondell* alleged that the board of director's passive approach to

a potential bid was a breach of the directors' duty of good faith. Distinguishing a breach of the duty of care from a lack of good faith, the Delaware Supreme Court held that lack of good faith sufficient to sustain a claim of the breach of the duty of loyalty may be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demon-

strating a conscious disregard for his duties." According to the Supreme Court, the appropriate question is not whether the directors should have done everything in their power to obtain the best price for the company, but rather whether those directors "utterly failed to attempt to obtain the best sale price."



Link to Court Opinion:

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Click on the highlighted text to be directed to the affected Section of the DE GCL

Changes to the Delaware General Corporation Law

[Section 145\(f\)](#) was amended to prohibit elimination or impairment of rights to indemnification or advancement of expenses by amending the certificate of incorporation or the bylaws, as the case may be, after the occurrence of the act or omission to which the expenses are related.

[Section 213\(a\)](#) was amended to permit the board of directors to fix separate record dates for

stockholders entitled to vote at a meeting and stockholders entitled to notice of the meeting.

[Section 225\(c\)](#) was added to grant the Chancery Court power to remove directors under certain circumstances; namely:

- application for removal by the corporation or by a stockholder derivatively in

the right of the corporation

- a conviction of a felony or a judgment of a breach of the duty of loyalty, in either case in connection with the duties of the director to the corporation
- a failure by the director to act in good faith, and
- a finding by the Court that judicial removal is necessary to avoid irreparable harm



Click on the highlighted text to be directed to the affected Sections of the DE LLCA, UPA and ULPA

Changes to Delaware Alternative Entity Law

[Section 18-1101](#) of the Limited Liability Company Act was amended to clarify that the doctrine of independent legal significance, as developed in Delaware corporate law, applies to limited liability companies.

Similarly, [Section 15-1201](#) of the Delaware Revised Uniform Partnership Act and [Section 17-1101](#) of the Delaware Revised Uniform Limited Partnership Act were amended to clarify that the doctrine of independent legal significance

applies to partnerships and limited partnerships, respectively.

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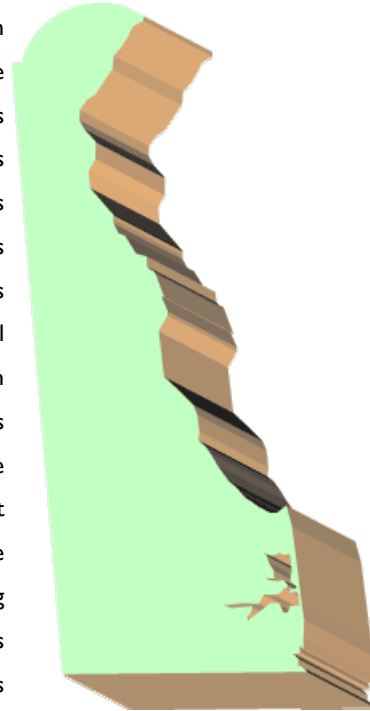
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With locations in Wilmington, Delaware and Las Vegas, Nevada, The Stewart Law Firm has risen to national prominence as a respected and valued resource for in-house counsel, out-of-state law firms, and accounting firms in matters related to the use and maintenance of alternative entities as well as general corporate and commercial law matters.

Entity Formation / Dissolution
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