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Corporate Law in the Mid-Nineties

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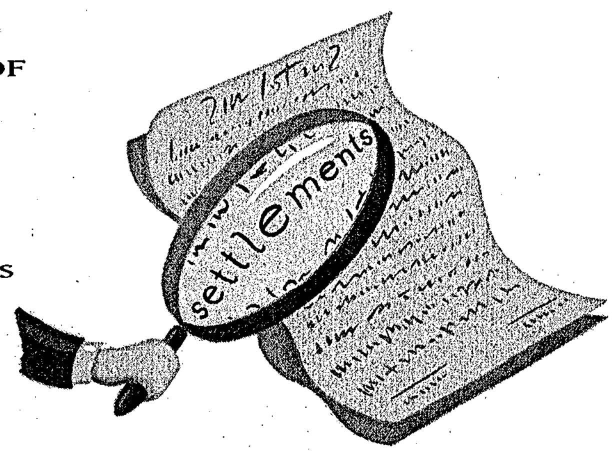

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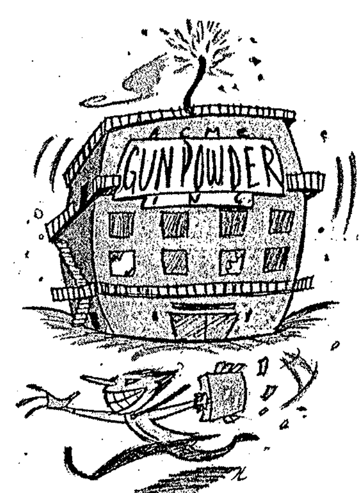

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EDITOR'S PAGE

From time to time, the Editors of DELAWARE LAWYER devote an entire issue to a specialized area of the law, even though it is an area in which only a small fraction of the Delaware Bar practices. Some legal specialty areas are so significant to our State and its citizens that all members of our Bar should be exposed to them. With that in mind, earlier issues of DELAWARE LAWYER have been devoted to subjects as diverse as environmental law, family law, and intellectual property law — to name a few.

The focus of this issue — developments in Delaware corporation and business law — is not new to this magazine. Indeed, in 1990 we presented a similar sampling to our readership. Unlike geology and astronomy, where four years is like the blink of an eye, in a field that is evolving as rapidly as corporation and business law, four years is a lifetime. Indeed, many of the topics in our Summer 1990 Issue now seem curiously dated. Since then totally new forms of doing business (and one new statutory method for going out of business) have come into being, the law of corporate takeovers has undergone another important evolution, and changes have occurred in other important corporate and business law areas as well.

Corporation law is, of course, important both to Delaware lawyers and to lawyers nationally. In preparing the articles that follow, our authors have attempted to write them in a style responsive not only to the "big firm" corporate practitioners but also to those practitioners from smaller firms, who (in terms of sheer numbers) represent by far the majority of clients engaged in business transactions. Whether we have succeeded in that goal only you, our readers, can decide.

My special thanks go to each contributor to this issue. They are all busy lawyers who took time out of their schedules to enlighten the rest of us. Also, I am greatly appreciative of the invaluable assistance provided by David Drexler and Helen Richards, without whose help this issue would not have been possible.

Jack B. Jacobs

This issue of Delaware Lawyer represents an unhappy first. It is the first issue in the twelve-year life of the publication not to bear in some form the editorial input of William E. Wiggin. Bill Wiggin was a principal founder of the magazine and his deft editorial hand has held it together ever since, even during the brief period when circumstances compelled him to relinquish its chairmanship. His love of thought-provoking ideas, his delight in the vagaries of the English language, and above all, his arch and perceptive wit have been sources of inspiration to the volunteer authors and editors who worked with him to produce Delaware Lawyer over the years. We wish him well in his retirement.

David A. Drexler
Interim Editor-In-Chief

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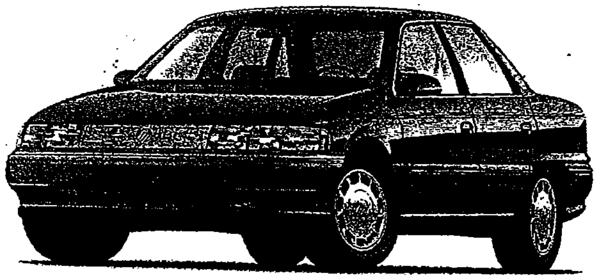

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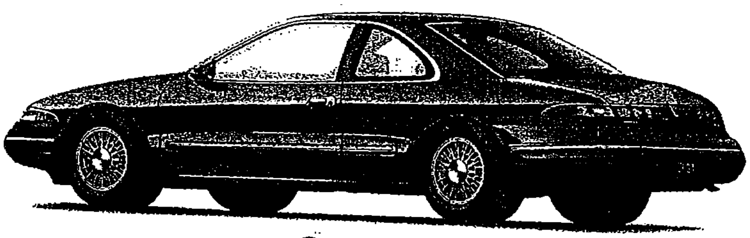

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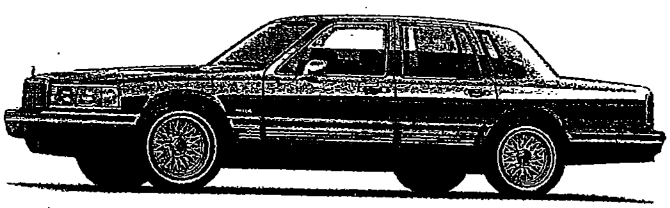

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PARAMOUNT AND QVC —

AN ENCORE FOR MERGERS AND ACQUISITIONS

by David C. McBride, Esquire

It had been more than four years since a titanic merger and acquisition struggle disrupted the courthouse on Rodney Square. The last time, Paramount Communications Inc. was making a hostile bid for Time Inc. while Time sought a "strategic merger" with Warner Communications. This time, Paramount again was in the courtroom, but the legal shoe was on the other foot — Paramount's "strategic merger" with Viacom Inc. was being challenged by a hostile bid from QVC Network Inc.

Courtroom 301 was filled with spectators, newspaper and television reporters, and the armies of lawyers and paralegals marshalled by the parties. There was national television coverage of the argument before the Delaware Supreme Court, and there were audiovisual aids for the hearing before the Court of Chancery. And, in the center of this crowd, there was, at first, Vice Chancellor Jacobs of the Court of Chancery and, then, Chief Justice Veasey and Justices Moore and Holland of the Delaware Supreme Court, each of whom was being subjected to the same searching scrutiny that they were being asked to apply to the Paramount directors. Every judicial word, comment, question, smile, frown or grimace was mined for its predictive significance — how would they rule?

In simplest and narrowest terms, the issue before the Court of Chancery and the Delaware Supreme Court was whether the Paramount directors would be permitted to force the shareholders of Paramount to sell their shares and control of Paramount to Viacom when QVC was offering to pay more for those same shares and control. By the time the television lights were extinguished, both the Court of Chancery and the Supreme Court had ruled that Paramount's transaction with Viacom could not proceed on its then-existing terms, each decision turning in large part on the fact that the transaction involved a change-of-control.[1]

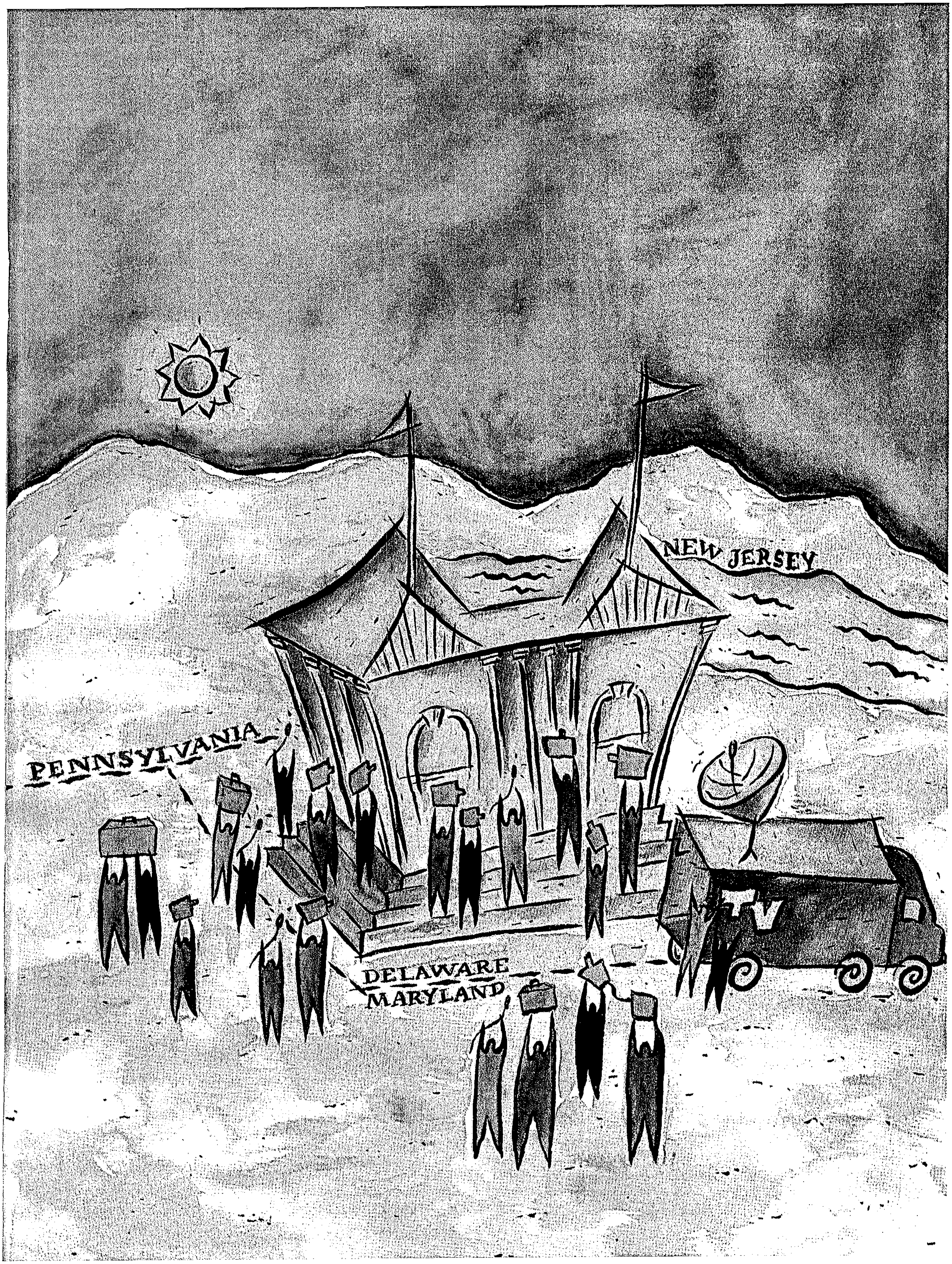
The Common Sense Of Takeover Law And Litigation

From a distance, and through the prism of the popular press, corporate takeovers appear to be a melodramatic power struggle between rich and powerful combatants fought on the unlikely battlefield of the abstract, intellectually complex area of corporate law mined for the unwary with obtuse financial concepts. This intoxicating brew has lead to a veritable plethora of legal and financial tactics employed by the various "combatants," and a host of relatively new legal theories or concepts applicable to resolve the legal issues raised by these tactics. There are two-tiered offers, white knights, poison pills, recaps, golden parachutes, bust-up fees, lock-up options, as well as the doctrines of enhanced judicial scrutiny, change-of-control, Revlon triggers and discriminatory conduct.

Despite the complexity and variety of tactics and applicable legal doctrines, most takeover litigation involves one basic factual situation (albeit with innumerable variations) that gives rise to two, simply stated issues. The basic factual scenario is that a "hostile" or unsolicited bid has been made for a company. The bid has an immediate market value potentially exceeding the immediate value of an alternative transaction or course of action preferred by the board of directors, but the bid cannot be accepted by the shareholders because of board action or inaction. While there are innumerable and material variations from case to case, almost every case shares this factual core.

From this scenario, two fundamental issues emerge. First, who sells the company - directors, shareholders

Illustration by Susan Gross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or both? In essence, what is the division of authority between directors and shareholders when an unsolicited offer is made to acquire the corporation? Second, in exercising whatever authority is available to directors, when may directors not pursue the alternative with the highest immediate value? Despite all the litigation, neither of these questions has been completely answered, either in the QVC decisions or in any prior case. Given the innumerable, material factual variations on the basic theme, it is unlikely that a complete answer can ever be given. The QVC decisions did add a few pieces to the puzzle (or, as Paramount might view it, rearranged a few pieces).

Corporate Takeovers are a melodramatic power struggle between rich and powerful combatants fought on the unlikely battlefield of the abstract.

Who Sells The Company — Directors, Shareholders Or Both?

Typically, a corporation may be acquired by one of two means (or a combination of the two): tender offer or merger. In the case of a merger, the powers of the directors and shareholders are explicitly established by statute. Subject to some limited exceptions, a merger cannot be accomplished unless two things occur: the directors must recommend the merger and the shareholders must freely and voluntarily approve it.[2] From this statutory arrangement, two policy choices are implicit. First, the statutory drafters obviously intended that directors have the power to determine whether or not a merger proposal will be submitted to the shareholders. The shareholders have no statutory right to receive and vote upon a merger proposal unless and until the directors are prepared to recommend it. The directors must comply with their fiduciary duties of care and loyalty in determining when to submit a merger proposal to the shareholders and what proposals to submit. But the statute also gives the directors the power not to recommend a merger.

Second, the directors do not have the power to coerce the shareholders into accepting a merger proposal. The shareholders have the right to accept or reject the proposal based upon a fully-informed, uncoerced vote; and, presumably, the directors cannot take action designed to hinder the shareholders' free exercise of their voting rights. Except in limited circumstances, the directors do not have the statutory power to cause a merger to occur over the opposition of shareholders.

In the case of tender offers, the respective powers and rights of the directors and stockholders are not expressly established by statute. Structurally, a tender offer is addressed directly to the shareholders and is simply an offer to purchase their shares. When tenders offers first were utilized as acquisition techniques, the directors had no statutory role in determining whether the shareholders should or could accept the offer. However, over the years, a number of "defensive techniques" were developed by which boards of directors could indirectly and, then, directly affect the shareholders' ability to accept or reject a tender offer. The ultimate of these devices, created for the express purpose of providing directors with the power to exercise some control over tender offers, was and is the "shareholder rights plan," otherwise known as the "poison pill." In addition, Section 203 of the Delaware General Corporation Law was adopted in 1988, and that section expressly recognized a role for directors in approving tender offers, although that role is indirect, not direct, and is subject to various provisions allowing stockholders to override the directors' judgment.

In QVC, the Paramount board was using a rights plan to preclude the QVC tender offer, but had lifted the rights plan so that the Viacom tender offer could proceed, notwithstanding that QVC's offer was higher. Because Viacom's tender offer was two-tiered, it was coercive. Allowing the Viacom offer to proceed and precluding QVC's offer meant that Paramount's directors were coercing the Paramount shareholders into accepting Viacom's offer and transferring control of Paramount to Viacom at potentially less than the highest price available. The Paramount directors attempted to justify this conduct by arguing (i) that the transaction with Viacom was a strategic acquisition not involving a "breakup" of Paramount and, therefore, not requiring the directors to obtain the highest price reasonably available, and (ii) that the long-term value of the combination with Viacom was greater than the long-term value of a combination with QVC.

In ruling against the Paramount directors, the Court of Chancery and the Supreme Court concluded that (i) the Paramount directors could not ignore the comparative values of the QVC and Viacom tender offers because the Viacom offer resulted in a change of control of Paramount and (ii) the Paramount board did not have a reasoned basis for concluding that a combination with Viacom had a higher, long-term or short-term value than a combination with QVC. Given these conclusions, neither the Court of Chancery nor the Supreme Court was required to decide whether the Paramount directors could use the rights plan to preclude shareholders from accepting the QVC offer and coerce the shareholders into accepting the Viacom offer if the directors reasonably believed that the Viacom offer had a higher "value," either long-term or short-term.

After the Supreme Court decision, the Paramount directors determined to auction Paramount in a process designed to give the shareholders the freedom to choose between the competing offers. But what if the Paramount directors had pursued a different course of action? If the Paramount directors had conducted an auction in which the directors, not the shareholders, decided which of the bidders offered "greater value," would the Delaware courts have permitted the directors to use the rights plan to preclude the shareholders from accepting the other offer? Further, would the courts have allowed the favored, tender offer to proceed if it were coercive, thereby forcing the shareholders to sell control based upon the directors' determination of "value" without permitting any exercise of free choice on the part of the shareholders?

When Is A Lesser Bid Acceptable?

The classic takeover confrontation concerns whether and when directors may prefer a bid with a lower, immediate market value over a bid with a higher, immediate market value, assuming both bids are equally available within the same time frame, and take action which effectively precludes shareholders from accepting the higher bid. There are three general justifications which have been offered for allowing directors to favor the bid with the lower immediate market value. It has been argued that accepting the lower bid could be justified as being in the best interests of the corporate enterprise, as distinct from the shareholders, or in the best interests of corporate "constituencies" other than the shareholders. Under this argument, the value of the bids to the shareholders, whether long-term or short-term, is not the sole criterion for the directors' decision. It has also been argued that the lower bid may be justified as having a higher "long-term value," despite its lower "present value." Finally, it has been argued that market value is not always the best reflection of the real or "intrinsic value," whether long- or short-term. The decisions in QVC impact each of these proffered justifications.

Enterprise And Other Interests

The proposition that directors, facing alternative transactions, may take into account interests other than the interests of the shareholders is a controversial proposition that has been advanced in various academic circles and expressly sanctioned in the corporate statutes of some states. Delaware has never adopted a statute either permitting or requiring directors to consider "other constituencies" when evaluating corporate action. However, there is language in both Revlon and, more pointedly, in Paramount which could be loosely interpreted as positing a corporate interest distinct from the shareholders.

In Revlon, the Supreme Court concluded that the directors of Revlon had impermissibly favored a lower, all shares, all cash bid over a higher, all shares, all cash bid. However, the Supreme Court noted that under either bid the corporate enterprise was to be "broken up."[3] In Paramount, the Supreme Court, when articulating its rationale for concluding that Revlon was inapplicable to the facts of that case, seemed to suggest that Revlon applied principally when a breakup or dissolution of the corporate enterprise had become inevitable. The language in both cases seemed to suggest the possibility of rejecting a higher bid and favoring a lower bid if the lower bid, unlike the higher bid, allowed for the preservation of the corporate enterprise, that is, did not "break up" the corporation. As a policy matter, those who were concerned that the takeover mania of the 1980s was disabling American business favored this view. On the other hand, proponents of free capital markets who believed that takeover activity, on the whole and in the long run, was healthy were highly critical of such a view.

By its decision in QVC, the Delaware Supreme Court appears to have implicitly rejected consideration of corporate enterprise interests or other constituency interests in change-of-control transactions unless such considerations reasonably can be related back to shareholder value. For example, where the shareholders receive securities of the surviving corporation, the enterprise or other constituency interests may affect the value of those securities, at least in the long-term. However, in a change of control transaction in which all shares are being acquired for all cash, these enterprise and other interests would seem to play no part. In QVC, the Supreme Court expressly rejected the contention that a "breakup" of the company was necessary to trigger Revlon and expressly held that in a change of control the directors' objective must be to obtain the highest value reasonably attainable for shareholders. These holdings appear to preclude director action in a change-of-control situation posited upon some interest other than the shareholders' interest in obtaining the highest value for their shares.

Long-Term Versus Short-Term

Prior to QVC, the issue of whether the directors must maximize immediate, short-term value was typically framed as whether Revlon had been "triggered" or whether a company was "in play." However, framing the issue in these terms tended to obscure the fundamental issue at stake. Simply stated, the fundamental issue is whether there is a reasoned, or even logical, justification for directors rejecting greater immediate value for potentially greater "long-term value." While some economists argue that there is no real distinction between long- and short-term value (because the immediate value of a security reflects its expected long-term value), the Delaware courts have accepted the proposition that directors may reasonably believe there is such a distinction and act based upon that distinction. Nonetheless, there are circumstances in which a posited long-term value cannot reasonably be said to justify rejecting greater immediate value. Based upon the cases to date, and the common sense reflected in those cases, there are three circumstances in which courts have found it difficult, if not impossible, to justify rejecting the higher immediate value.

The unsettled issues arise in cases that are somewhere between the polar extremes of Revlon and Paramount.

The first circumstance is reflected in Revlon — competing all cash offers for all shares. When the directors recommend a transaction in which shareholders are selling their entire equity interest in a corporation to a non-public company for cash, there is no "long-term" value for those shareholders. Thus, in Revlon, there could be no justification for "locking up" one cash bid for all shares when the directors knew, or had reason to know, that another higher cash bid for all shares was reasonably available within the same time period.

The second circumstance is reflected in QVC — where the shareholders' entire equity is not being converted into cash, but a change of control will result from the transaction. In such a circumstance, the shareholders' remaining equity is subject to being "cashed out" at any time and the shareholders, even if not "cashed out," lose control over their equity investment. In that situation, *it is illogical for directors to* compel shareholders to surrender immediate gain for a long-term value represented by an equity interest which could be extinguished at any time. Absent some mechanism which assures that the shareholders cannot be "cashed out," it is not reasonable for directors to compel or coerce shareholders to forego immediate value in favor of a long-term payoff which may be taken from them at any time.

The third circumstance is suggested in dictum in Revlon, Paramount and QVC — a "breakup" of the corporation. If a substantial part of the assets of the corporation are being liquidated (for example, in a restructuring with the proceeds dividended to shareholders) and the shareholders retain a "stub" equity in the remaining assets, it may be difficult to favor a lower-valued restructuring over a higher-valued tender offer. In such a case, the long-term value of the corporation (represented by its assets) is being substantially liquidated in the restructuring. In QVC, the Supreme Court did not reject a "breakup" as the trigger for Revlon duties. Rather, the Supreme Court merely recognized that a "breakup" is not the sole or necessary prerequisite to those duties.

Consider, on the other hand, the situation where none of the shareholders' equity is being extinguished (as is the case in a stock swap), no change of control is occurring and the corporation's business is not being liquidated to any significant extent. That situation is represented by the facts of Paramount and the unreported decision in Arnold v. Society for Savings Bancorp Inc.[4] In Paramount, the Supreme Court concluded that the directors of Time Inc. were not obligated to abandon Time's tender offer for Warner in order to permit the Time shareholders to receive Paramount's offer for Time. In Arnold, the Court of Chancery concluded that the directors could pursue a stock-for-stock merger not involving a change of control without first assuring themselves that the merger represented the highest, immediate value reasonably available to the shareholders.

The unsettled issues arise in cases

that are somewhere between the polar extremes of Revlon and Paramount. In QVC, both the Court of Chancery and the Supreme Court rightly suggested that the directors' decisions must be evaluated on a case-by-case basis and carefully limited their decisions to the particular facts of that case. When might a change in the facts make a difference? For example, if the Viacom offer had not involved a change of control, but was an offer of cash and stock in which most of the Paramount shareholders' equity was being converted into cash, could the directors reasonably justify compelling or coercing shareholders to forego a substantial immediate gain on most of their equity for a predicted, but inherently uncertain long-term gain on a small portion of their equity? Would it make a difference if the directors were providing a noncoercive alternative as opposed to pursuing a course of action which denied the shareholders any real ability to accept or reject the directors' favored alternative? Alternatively, does every arguable change in control require the directors to attempt to maximize immediate value? For example, if the directors propose to raise needed financing by selling equity to an existing shareholder who thereby might have sufficient shares to exercise practical or absolute control, would the directors be obligated to first attempt to sell the company for the highest value immediately attainable? Since the "rules" being articulated by the Delaware courts are inherently fact specific, the question whether a preference for long-term value can reasonably be justified will be answered in the context of a specific transaction.

Market Versus Other Valuations

The last justification typically advanced for preferring a bid with a lower market value to a bid with a higher market value is that the market value is not the best indicator of "real value." Again, economists may argue that there is no value other than market value (because the value of an asset can only be realized when the asset is liquidated in a public or private market) or economists may argue that market value is the best indication of value. However, the Delaware courts have recognized that directors may reasonably act on the belief that the company has an intrinsic value which differs from the market value, at least the present public market value.

In QVC, the Supreme Court again

recognized that market value is not controlling. In a significant passage and accompanying footnote, the Supreme Court stated:

> Where stock or other non-cash consideration is involved, the Board should try to quantify its value, if feasible, to achieve an objective comparison of alternatives. When assessing the value of non-cash consideration, a board should focus on its value as of the date it will be received by the stockholders. Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation.[5]

By this passage, the Supreme Court is making two observations. First, the market value of the non-cash consideration being offered is not controlling. As in the case of appraisals, generally accepted methods of valuation may be utilized by the directors. Second, valuation should be "as of the date [the non-cash consideration] will be received by the stockholders." This passage reflects that in a change of control (with no constraints on shareholders being cashed out) the predicted future value of equity securities is not relevant.

* * *

The decisions in QVC add to the legal mosaic on mergers and acquisitions. Still, the answers to very basic issues posed in takeover litigation remain incomplete. For those seeking bright line rules, QVC offers one: in a change-of-control situation directors may not take action designed to coerce shareholders to sell control to one bidder and preclude them from choosing the other bidder when the directors lack a reasonable basis for concluding that the present value of the preferred bid is greater than the present value of the precluded bid. If the transaction is not a change of control, or if the directors' action does not coerce shareholders, or if the directors have a reasonable basis for believing the preferred bid has a higher value, the answers become incomplete, but stay tuned.

FOOTNOTES

1 See QVC Network Inc. v. Paramount Communications Inc., Del. Ch., 635 A.2d 1245 (1993) and Paramount Communications Inc. v. QVC Network Inc., Del. Supr., 637 A.2d 34 (1993) (collectively, "QVC").

2. See, e.g., 8 Del. §. X 251.

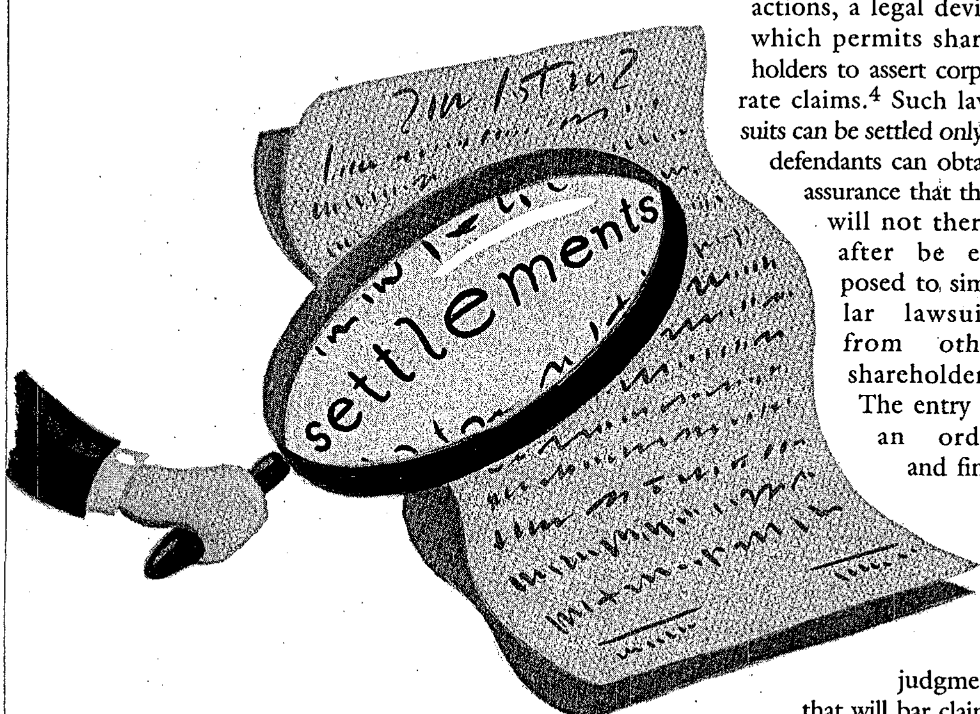
3. Paramount Communications Inc. v. Time Inc., Del. Supr., 571 A.2d 1140 (1990).

4. Del. Ch., C.A. No. 12883, Chandler, V.C. (December 15, 1993).

5. 637 A.2d at 44 n.14. ◆

NORMAN M. MONHAIT AND PAMELA S. TIKELLIS

Through the Magnifying Glass: The Courts Take a Closer Look at Settlements



Insuring fairness without transforming settlement hearings into full-blown trials.

Shareholder lawsuits in Delaware are brought in the Court of Chancery quite often as class actions, which assert personal claims common to a large group of shareholders,[2] or as derivative actions, a legal device which permits shareholders to assert corporate claims.[4] Such lawsuits can be settled only if defendants can obtain assurance that they will not thereafter be exposed to similar lawsuits from other shareholders. The entry of an order and final judgment that will bar claims of shareholders who are not named parties to the litigation is, therefore, a necessity.

To protect the interests of such non-litigant shareholders, the Court of Chancery has a dual role in the settlement process. Procedurally, the Court must assure that affected stockholders receive notice of the proposed settlement and an opportunity to be heard at a settlement hearing. Substantively, the Court must review the merits of the proposed settlement and make what the cases characterize as a business judgment as to its fairness, taking into account all of the factors conventionally affecting a litigant's decision to compromise claims.[4]

The Court of Chancery has never been a passive participant in the settlement process.[5] In recent years, however, the Court of Chancery and the Supreme Court have increasingly required plaintiffs and defendants to demonstrate with greater care the procedural and substantive fairness of settlements submitted for approval. This article focuses on some recent decisions that illustrate the heightened scrutiny Delaware courts have brought to proposed settlements of shareholder litigation.

Limiting Discovery

When one of the initial plaintiffs disagrees with other plaintiffs about the desirability of a proposed settlement, the Court will closely examine the merits of the settlement. In In re Amsted Indus. Inc. Litig., Mr. Barkan, the objector-plaintiff, had participated in the litigation from the commencement of the suit but had not participated in settlement negotiations. Barkan opposed the settlement and sought extensive discovery in connection with his opposition. Seeking to strike a balance that would preserve the efficiencies of the settlement process but afford a reasonable opportunity to expose a settlement's possible weaknesses, the Chancellor held that an objector is entitled to appropriately limited discovery into the good faith and competence of representation provided by plaintiff's counsel but, generally, not to the extensive and detailed discovery to which a litigant preparing for trial might be entitled.[6] Ultimately, in a lengthy opinion, the Court thoroughly reviewed the claims and defenses and approved the settlement. The

Illustration by Dan Yaccarino

Court, however, commended the objector for his substantial participation in the litigation and conditioned its approval of the fee application on the parties' agreement to allocate 25 percent of the fee to Barkan's counsel.

Granting Conditional Approval

Another case where an original plaintiff objected to a settlement negotiated by co-plaintiffs resulted in the Court's conditioning approval on a change in the settlement's terms. In re Mobile Communications Corp. of America, Inc. Cons. Litig. was a series of lawsuits challenging a merger initiated in early 1988 in which all of the stock of Mobile Communications Corporation of America ("MCCA") was acquired by a wholly-owned subsidiary of BellSouth Corporation ("BellSouth") in exchange for BellSouth stock worth approximately $710 million. The Court of Chancery denied a motion to enjoin the merger preliminarily, and the Supreme Court refused to certify an appeal.

The parties subsequently agreed on a proposed settlement which provided, inter alia, for: 1) an equity contribution of $18.3 million by MCCA to Mtel, a subsidiary which was spun-off to MCCA shareholders on the date of the merger; 2) MCCA's additional capital contribution to Mtel of $4.7 million following final judicial approval of the settlement; and, 3) BellSouth's delivery of up to 222,854 additional shares of BellSouth common stock to an exchange agent for distribution, pro rata, to those persons or entities who received shares of BellSouth common stock in the merger.

Non-settling plaintiffs objected to the settlement, arguing that the settlement was inadequate because the $18.3 million cash payment to Mtel at the time of the spin-off would have happened anyway and the $4.7 million payment was not being distributed directly to the class.

At the hearing on the proposed settlement, the Court scrutinized the terms of the settlement and the bases for the objections, and requested supplemental briefing on the probability of success of plaintiffs' misrepresentation claim,[7] as well as affidavits regarding the valuation of the BellSouth stock as of the date of the settlement hearing.[8]

In a detailed opinion, the Court examined plaintiffs' claims in light of the discovery record and found them rather weak.[9] In reviewing the adequacy of the settlement consideration, the Court determined that the $18.3 million payment to Mtel, which was followed immediately by the spin-off, was in fact part of the settlement consideration. The Court held that the possibility that some of the members of the class might have sold off their stock prior to the payment and spin-off, and thus would not participate in all elements of the consideration, did not disqualify the proposed settlement from approval.[10] The Court conditioned its approval of the settlement, however, on MCCA's $4.7 million payment being made directly to class members, rather than to Mtel, so that class members would benefit directly from the settlement consideration.

The parties then had the option of either abandoning the settlement or accepting the Court's modification. They chose the latter course, and the Supreme Court affirmed the Court of Chancery's approval.[11]

Questioning the Settlement Process Itself

While opponents of a settlement usually focus their energies on a settlement hearing, on occasion they have sought to persuade the Court not to invoke the settlement process at all. The Court encountered one such early challenge to a proposed settlement when the plaintiff in a prior-filed action sought a preliminary injunction against presentation of a proposed settlement.

In seeking the preliminary injunction, the plaintiff in the prior-filed action (the "Kahn Action")[12] charged that counsel in the settling action (the "Sullivan Action")[13] acted incompetently and in bad faith in reaching the agreement in principle to settle. The asserted evidence of bad faith was that defendants had negotiated solely with the Sullivan Action plaintiff's counsel. Indeed, counsel in the Kahn Action were informed of the agreement in principle only after a Memorandum of Understanding had been executed.[14]

The Court was sufficiently troubled by this procedure to permit the unusual preliminary injunction proceeding. Noting that it had "a special historical mandate to prevent unconscionable conduct on the part of any litigant or his counsel" in the settlement process, the Court granted Kahn expedited discovery limited to the issue of how the settlement was negotiated.[15]

Even though defendants' counsel had no satisfactory reason for conducting negotiations solely with Sullivan's counsel, the Court denied the preliminary injunction motion. The Court concluded that Kahn, "as a stockholder of Occidental, will have the opportunity to appear and object" at the settlement hearing, and therefore would suffer no irreparable harm if the Court permitted the settlement process to proceed.[16] The Court noted, however, that several aspects of the proposed settlement were troubling and would have to be addressed at the settlement hearing.[17] Apparently in response, the Sullivan Action parties revised the agreement in principle.[18]

After the settlement hearing, the Court noted in its written opinion that the revision to the agreement "left much to be desired."[19] After examining the circumstances of the settlement in their entirety, however, the Court determined that the settlement consideration, while "speculative," was adequate to support the compromise of generally weak claims which were vulnerable to dismissal.[20] The Court therefore approved the settlement.

Assessing the Fairness of the Settlement

The Court took a different approach when faced with an early challenge to the fairness of a settlement agreement in Stepak v. Tracinda Corporation.[21] The case involved claims that the majority stockholder of Tracinda had created a complex "strawman" transaction in order to increase unfairly the majority stockholder's share of Tracinda's MGM/UA assets at the expense of the minority stockholders. At the same time that the Delaware plaintiff moved the Court to approve the proposed form of notice to the class of the settlement of these claims, the plaintiffs in a related California action sought to intervene in and to stay the Delaware action.

The California plaintiffs contended that the settlement of the Delaware action was a "sell-out" of the class claims and was so lacking in merit that the mailing of notices and a hearing would not be justified.[22] The Court noted that its usual practice in the settlement approval process would be to allow notice to go out to the class and to defer consideration of the merits of the settlement until after the hearing. The California plaintiffs' charges of bad faith, however, coupled with the lack of prosecution of the Delaware action and the extraordinary terms of the settlement (videotapes and a small amount of cash) convinced the Court that it should preliminarily examine the settlement to determine if it met the "truly minimum standards [of fair-

ness] sufficient to invoke the mechanism [of notice and a hearing] required by Rule 23(e)."[23]

The Court weighed the strength of plaintiffs' theory of liability against the overall value of the settlement consideration. Despite the fact that payment by the "strawman" of an exorbitant sum for the MGM/UA assets would necessitate an application of the Delaware law of fiduciary duty to novel circumstances, the theory that the majority stockholder designed the transaction to deprive the minority stockholders of their share of the MGM/UA assets unfairly was sound. Given the millions of minority shares eligible to be members of the class, the potential damages were tremendous.[24] By comparison, the per share value of the cash component of the settlement consideration was a mere 4 to 5 cents when relatively munificent counsel fees and costs were netted out. The Court found the other component of the consideration, a movie videotape to each shareholder on a non pro rata basis, to be virtually worthless.[25]

On balance, the Court concluded that the record was not so clearly in defendants' favor to demonstrate that such a de minimus settlement comported with the "truly minimum standards of fairness." In considering the California plaintiffs' stay motion, the Court applied the traditional factors of a forum non conveniens analysis and contrasted the activity level in both litigations. Although it was filed after the Delaware case, the California action was vigorously prosecuted from its inception, while the Delaware case languished for two years before process was served on the defendants. This relative lack of activity added to the Court's concern about the aura of impropriety surrounding the proposed settlement. The Court refused to schedule a hearing and granted the California plaintiffs' motion to stay the Delaware proceedings.[26]

Reviewing the Adequacy of Representation

A case involving competing litigations in two different fora recently received the attention of the Delaware Supreme Court. De Angelis v. Salton/Maxim[27] was an asserted class action alleging common law fraud claims. The objectors to the settlement were among the named plaintiffs in an earlier-filed Illinois federal action. The objectors invited the Court of Chancery to scrutinize closely the motives of the named plaintiffs and their counsel, and plaintiffs' adequacy as class representatives.

The Court found several aspects of the settlement process disturbing. In light of the previously-filed Illinois action, the Court concluded that De Angelis could not have expected to try this case in Delaware and must, therefore, have filed the action solely for the purpose of settlement.[28]

The Court was skeptical of the defendants' decision not to move to dismiss or to oppose class certification as they had done in Illinois. It appeared that the defendants preferred De Angelis as an opponent and therefore chose to cooperate with his counsel. An additional disturbing factor was that the De Angelis complaint as originally filed asserted only common law fraud claims, which are not litigable on behalf of a class.[29]

Notwithstanding its concerns, the Court of Chancery approved the settlement because it found the settlement to be in the best interests of the class members. The Court found that establishing both liability and damages would, at best, require time-consuming and expensive litigation with a minimal possibility of ultimate success. If the plaintiffs were to succeed in achieving a higher award of damages than the amounts to be gained through the settlement, they might not be able to collect on the judgment. Finally, relatively few shareholders objected or opted out of the settlement, notwithstanding that the notice of the settlement hearing had included a statement prepared by the Illinois plaintiffs outlining their objections.

On appeal, the Supreme Court reversed. The Court noted that in class actions the requirement of adequacy of representation derives not simply from Rule 23, but has a constitutional dimension as well. Noting that the Court of Chancery had not found the Delaware plaintiffs to be adequate representatives (and, indeed, the parties had conceded that the Vice Chancellor made findings from which it could be inferred that De Angelis was an inadequate representative), the Court concluded that the Court of Chancery had erred in even considering the merits of the settlement. Augmenting the Court of Chancery's role in reviewing settlement proposals, the Supreme Court required the Court of Chancery to evaluate the adequacy of the representative plaintiffs "in every class action settlement" and to make an explicit determination on the record of the propriety of class certification according to the requisites of Rules 23(a) and (b).[30]

Looking to the Completeness of the Record

While the Court of Chancery will not engage in a fact-finding exercise when examining the merits of a proposed settlement, a recent case demonstrates that it will look to the completeness of the record as a yardstick by which to measure the fairness of a settlement.

The primary focus of Lewis v. Hirsch, as originally filed, was waste of corporate assets caused by allegedly excessive compensation paid to officers and directors of United States Surgical Corporation ("U.S. Surgical"). The operative amended complaint at the time of the settlement hearing also included claims that certain of the individual defendants had breached fiduciary duties owed to U.S. Surgical by engaging in insider trading on material, non-public information.[31] The Court concluded this claim could not be evaluated on the record submitted to it.

At the outset, the Court examined the waste claims and determined that the settlement consideration offered — a reduction in the number of years during which the directors could be granted stock options — was fair and reasonable compensation for the release of those claims. The Court noted that claims of excessive compensation are difficult to litigate successfully because decisions regarding executive remuneration are ordinarily governed by the business judgment rule. Moreover, the compensation levels challenged were recommended by a committee of disinterested outside directors which received advice from independent experts. In short, there was sufficient evidence in the record to satisfy the Court that the compensation claims were weak and the settlement consideration was significant in light of that weakness.[32]

As for the insider trading claims, plaintiff argued that they were "unsupported by the evidence." Objectors to the settlement, including a former director of U.S. Surgical who had brought his own suit against the company in Federal court, contended that plaintiff had not sufficiently investigated the circumstances surrounding the alleged insider trading activity to reach such a conclusion. Plaintiff countered that he had conducted such an investigation and pointed to a number of external factors as the explanation for the director-defendants' seemingly fortuitous stock trades.[33]

While the Court recognized the defenses which might be raised at trial in response to the insider trading claims, it found that the plaintiff had missed the point in focusing his discovery related to those claims.[34] According to the Court, the plaintiff should have taken discovery on certain key issues: 1) when defendants knew of certain factors which would negatively impact on the stock price; 2) whether defendants delayed advising other stockholders of the adverse information; and 3) whether defendants sold their stock based on that information before the public was informed. The Court concluded that approval of the settlement had to be withheld since the Court was "unable to evaluate the overall reasonableness of the proposed settlement at the present time because [plaintiff] has not shown that he adequately investigated the insider trading claims."[35] The Court permitted plaintiff to engage in further discovery to determine whether the settlement should be resubmitted.

Conclusion

As these cases demonstrate, the Court of Chancery brings to bear its own business judgment to assess the fairness of a proposed settlement. The Court's role is one of guardian to ensure protection for absent stockholders. Although the Court is not required to, and should not hold a trial on the merits, the Court has an elevated duty to stand in the shoes of the absent stockholder and make a business judgment concerning all of the factors affecting a litigant's decision to compromise claims.[36]

The recent decisions by the Supreme Court and the Court of Chancery indicate a continuing trend of heightened scrutiny of both the procedural and substantive aspects of proposed settlements. The Court of Chancery, in particular, employs such heightened scrutiny from the moment a stipulation of settlement is filed through the final hearing on the fairness of the settlement to assure, as it must, that stockholders' interests are protected and advanced in the settlement process.

* * *

Constraints of space make it impossible to include the author's extensive footnotes, but the numbers to these footnotes appear. The full footnotes will be available upon request to the offices of this magazine.

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The authors gratefully acknowledge the assistance of Carmella P. Keener, Esquire and Cynthia A. Calder, Esquire, without whom this piece would not have been timely completed. ◆

BY JESSE A. FINKELSTEIN

Independent Committees in Interested Transactions

Should an independent committee of outside directors be established to negotiate affiliate transactions on behalf of minority public stockholders?

He's one of your best business clients. He has built what was a small family retail business into a small empire, comprising majority ownership interests in several affiliated public companies. Your client comes to you with the proverbial "simple question that will take just a minute of your time." This brief question relates to an all too familiar proposal — he wants to (indeed "needs to") merge one of his controlled entities with one of the public companies. Of course there is a business rationale behind this. However, as an influential director of both companies, he is the quintessential embodiment of what you were taught constitutes "standing on both sides of the transaction."

As you hear the plan unfold, you still recall what you told your client at that champagne takeover celebration of years ago: "Yes, controlling a public company is great. In fact, controlling two or three is even better. But remember, as someone once said, multiple directorships leave 'no room for divided loyalties.'"

Now, however, is the time to deliver unpopular news. While not required, your client should seriously consider establishing an independent committee of outside directors to negotiate the transaction on behalf of the public company minority. In order to explain why you suggest a special committee of independent directors in corporate transactions, it may be helpful to your client to place these institutions in their proper historical perspective. At common law, transactions by a corporation with an "interested" party were held by some courts to be void for that reason alone, irrespective of the fairness of the underlying transaction.[1] Similarly, much to your client's surprise, a holder of a single share of stock could veto a corporate merger under prior law.[2] Both rules were modified by provisions of the General Corporation Law of the State of Delaware.[3]

For several decades, you explain, our law has been forced to address a world in which heretofore impossible affiliate transactions have become commonplace. Following the suggestion of the Delaware Supreme Court in Weinberger v. UOP, Inc.,[4] that negotiation by a committee of independent directors would constitute strong evidence of a merger's fairness and, if it had been employed, might have led to an "entirely different" view of the fairness of a challenged merger,[5] it is not surprising that many of your clients have increasingly examined independent committees. Of course, you caution, the "mere existence" of an independent committee will not necessarily alter a court's review of a transaction.[6] Rather, courts will examine the composition of the committee as well as how the committee functions.

Your client responds that he has doubts about whether to go with a committee, but if he does, he has just the directors for this assignment. None are employees. Why do you have to look beyond that? You remind him that the special committee must be composed of directors who are truly independent.[7] The courts have repeatedly reminded us that this is "a fact-dominated question, the answer to which will necessarily vary from case to case."[8] While his directors will not be disqualified by their receipt of directors' fees alone,[9] other factors may be worthy of consideration.

You appropriately point out that all committee members — no matter how truly independent — will be subject to careful scrutiny if litigation arises.

Now intrigued by the idea of a special committee, your client tells you that he knows just how to do it. His controlled company will make a proposal at a fixed price and the committee will decide whether to approve. After all, he points out, didn't you just say that he had a fiduciary duty to the shareholders of both corporations?

This gives you an opening to explain that the independence expected of a special committee will be subject to question if the committee is limited to a review of a "take it or leave it" price. An independent committee must also understand its function and be fully informed. To make the point more succinctly, you show your client Chancellor Allen's oft-quoted statement in In re Trans World Airlines, Inc. Shareholders Litig.:[10]

> [T]he special committee [here] did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary.... [T]he burden shifting effect will not occur where the special committee did not adequately understand its function — to aggressively seek to promote and protect minority interests — or was not adequately informed about the fair value of the firm and the minority shares in it.

Furthermore, an independent committee must have the power to reject an unfavorable transaction. To illustrate, you provide your client with your copy of Chancellor Allen's explanation in In re First Boston, Inc. Shareholder Litig.:[12]

> [The special committee must retain] . . . the critical power: the power to say no. It is that power and the recognition of the responsibility it implies by committees of disinterested directors, that gives utility to the device of special board committees in change of control transactions.
>
> * * *
>
> The only leverage that a special committee may have where a fiduciary's position precludes alternatives ... is the power to say no and, thus, to force the fiduciary to choose among the options of implementing a frank self-dealing transaction at a price that knowledgeable directors have disapproved, to improve the terms of the transaction or to abandon the transaction.[13]

Perhaps most importantly, Delaware courts have emphasized the need for independent committees to be able to negotiate at arm's length. Accordingly, you caution your client that restrictions preventing a committee from selecting from alternatives available to a fully independent board, or which effectively "hem in" their ability to act with true independence — will place at risk the burden-shifting benefit of using a committee in the first place.[14]

On the other hand, it is possible to obtain the benefit of a shift in the burden of proof to the shareholder challenging the fairness of the merger where the process by which the merger terms are set include "procedural protections that tended to assure a fair result..."[15] and evidence a negotiation "at arm's-length" by "a committee of directors totally independent of [the affiliated company]."[16]

A properly functioning committee of truly independent directors is significant to courts reviewing affiliate transactions.

The latest rearticulation of the burden-shifting effect of an independent committee was provided by the Delaware Supreme Court in Kahn v. Lynch Communications Sys., Inc.[17] Kahn illustrates a subset of the "interested" transaction, namely, a parent-subsidiary merger, in which a special committee of non-affiliated directors was utilized. While holding that the proper standard of review in an interested merger transaction remains the test of "entire fairness," the Court confirmed that approval by an independent committee of directors shifts the burden of proof on the issues of fairness to the plaintiff.[18] Referring to its affirmance in Rabkin v. Olin Corp., the Court cited two essential elements to be considered in determining the appropriateness of burden shifting: (1) the majority shareholder must not dictate the terms of the merger; and (2) the special committee must have real bargaining power that it can exercise with the majority shareholder on an arm's-length basis.[19]

After hearing about the advantages and disadvantages of the special committee process, your client asks you to summarize the most important lessons gleaned from the recent judicial review of other special committees. While everyone will draw his or his own conclusions, you ought to consider passing along the following observations:

What Power Should An Independent Committee Be Given

As the opinion of Chancellor Allen in First Boston made clear, it is critical that an independent committee has the power to say "no" to a controlling shareholder presenting a fixed transaction proposal. Standing alone, however, the power to say "no" is not enough. Kahn focuses on the independent committee's bargaining power throughout the negotiations. Indeed, Kahn suggests that even the actions of committees with previously proven independence will be closely scrutinized.

Substantial Stockholders Need To Be Wary of Exerting What Might Be Deemed Virtual Control

Obviously, a 50.1 percent holder — like your client here — will be treated by the courts as such. The more difficult situations involve substantial non-majority holders. Kahn suggests that it is important for a substantial holder to communicate any "final offer" in terms which do not suggest that an alternative transaction of lesser value will be forced through in the event the "final offer" is rejected. Anything that suggests inevitability of a transactional result, and certainly anything that might be construed as a threat or coercive ultimatum, places the benefits of an independent committee at risk.

The Hallmarks of True Independence Continue to Play an Important Role

Committees of directors are quickly compromised by facts which demonstrate self-interest. While most inherent and structural bias arguments (i.e., a director is "interested" if he knows the chairman socially before becoming a director) have been rejected, anything suggesting directorial reliance upon the controlling entities or individuals may be problematic.

Indeed, many truly disinterested and

independent directors should not be considered for committee membership if their independence will require substantial proof or explanation. As the cases illustrate, significant impediments may arise even with a truly disinterested committee.

* * *

So what message do you leave with your thoughtful (and perhaps somewhat confused) client? In the end, the fundamental lesson drawn from the early independent committee cases still holds true today. Any mechanism which places certain directors in the role of acting as the exclusive guardian for minority shareholder interests will necessarily subject those directors to careful scrutiny. The cases make clear that it would be better for affiliated companies to proceed without the use of an independent committee than to try to gain the benefit of an independent committee while maintaining unacceptable attributes of control over the process. As Chancellor Allen has observed:

> When a special committee's process is perceived as reflecting a good faith, informed attempt to approximate aggressive, arm's-length bargaining, it will be accorded substantial importance by the court. When, on the other hand, it appears as artifice, ruse or charade, or when the board unduly limits the committee or when the committee fails to correctly perceive its mission — then one can expect that its decision will be accorded no respect.[20]

Still, since a properly functioning committee of truly independent directors is significant to courts reviewing affiliate transactions, the use of such a committee should be considered before an affiliate transaction is undertaken.

So much for simple questions.

Jesse A. Finkelstein is a member of Richards, Layton & Finger. Mr. Finkelstein wished to acknowledge the valuable assistance of Matthew J. Ferretti, an associate of Richards, Layton & Finger, in the preparation of this article. Other Richards, Layton & Finger attorneys represent or have represented parties in certain of the cases discussed herein. This article does not necessarily reflect the views of Richards, Layton & Finger or its clients.

FOOTNOTES

1. See, e.g., David S. Ruder, Duty of Loyalty — A Law Professor's Status Report, 40 Bus. Law. 1383, 1387-88 (1985) (quoting Harold Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 35, 36 (1966)).
2. Chicago Corp. v. Munds, Del. Ch., 172 A. 452, 455 (1934).
3. See 8 Del. C. §§ 144, 251, 252, 253, 262.
4. Del. Supr., 457 A.2d 701 (1983).
5. Id. at 709-10 n.7.
6. Rabkin v. Olin Corp., Del. Ch., C.A. No. 7547, slip op. at 14 (Apr. 17, 1990), aff'd, Del. Supr., 586 A.2d 1202 (1990).
7. See, e.g., Rabkin v. Olin Corp., slip op. at 14-15; In re Trans World Airlines, Inc. Shareholders Litig., Del. Ch., Cons. C.A. No. 9844, slip op. at 16 (Oct. 21, 1988).
8. Cede & Co. v. Technicolor, Inc., Del. Supr., 634 A.2d 345, 364 (1993).
9. Grobow v. Perot, Del. Supr., 539 A.2d 180, 188 (1988).
10. Del. Ch., Cons. C.A. No. 9844 (Oct. 21, 1988).
11. Id., slip op. at 18.
12. Del. Ch., Cons. C.A. No. 10338 (June 7, 1990).
13. Id., slip op. at 15-16.
14. Freedman v. Restaurant Assoc. Indus., Inc., Del. Ch., C.A. No. 9212 (Sept. 19, 1990, revised Sept. 21, 1990).
15. Citron v. E.I. du Pont de Nemours & Co., Del. Ch., 584 A.2d 490, 504 (1990).
16. Id. at 504-05.
17. Del. Supr., 638-A.2d 1110 (1994).
18. Id., slip op at 1117.
19. Id.
20. William T. Allen, Independent Directors in MBO Transactions: Are They Fact or Fantasy?, 45 Bus. Law. 2055, 2060 (1990). ◆

LAWRENCE A. HAMERMESH & DONALD J. WOLFE

The Delaware Dissolution Statutes: A Case Study

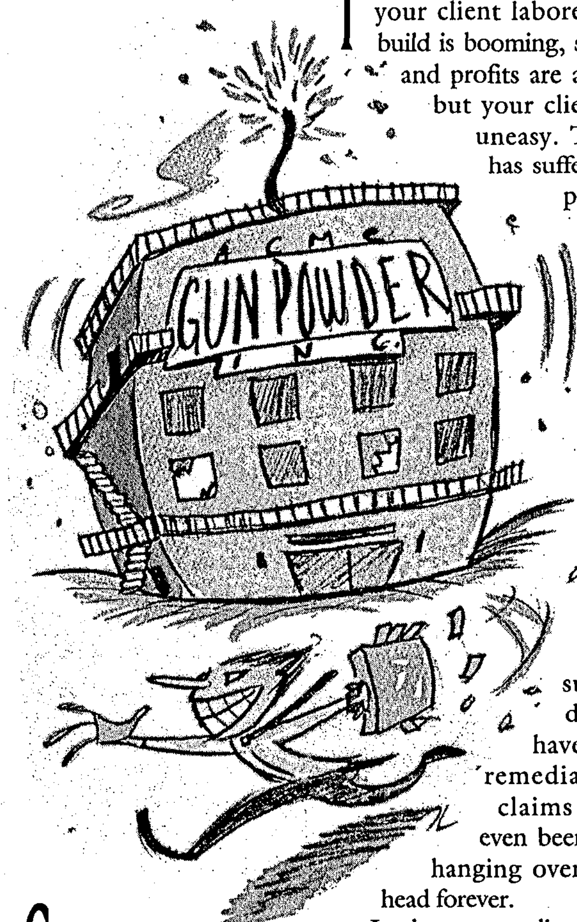

Illustration by Tom LaBaff

The recreational gunpowder business your client labored all his life to build is booming, so to speak. Sales and profits are at all-time highs, but your client is aging and uneasy. The corporation has suffered some recent product liability setbacks in court and continues to fight a pesky $2 million personal injury claim. Your client doesn't want to see the company's assets go up in smoke due to personal injury claims that haven't yet surfaced; he also doesn't want to have environmental remediation claims — claims which haven't even been asserted yet — hanging over the company's head forever.

Can a corporation ever call it quits in a hazardous and litigious world?

In short, your client, as a substantial stockholder, wants to dissolve the corporation, liquidate its assets, and, along with all the other stockholders, take his share of the company's net assets and retire to where the only powder he has to think about is on the slopes. The corporation's assets can be sold (free of all liabilities) for $10 million; the corporation has only $2 million in trade and bank debts, and the $8 million balance is stockholder equity on the balance sheet.

Your client is no fool, though, and sees that the $8 million equity can't simply be distributed to stockholders. After all, he is painfully aware that the pending $2 million lawsuit is an explosive situation, and even though no reserve has been set aside on the balance sheet, he has no confidence that the corporation's numerous defenses will carry the day in court. Moreover, an actuarial study he commissioned last year indicates that over the next ten years other personal injury claims are likely to be made yielding recoveries having a present value of about $4 million. Finally, he has commissioned an environmental engineering report indicating that payments with a present value of $1.5 million will be required to deal with environmental remediation claims likely to occur over the next ten years.

Your client asks you what he can do in this situation. He wants to dissolve the company and call it quits, but he and the other directors would like some reassurance that there is a basis to wind up the corporate affairs without the threat of "long-fuse" lawsuits against them and the stockholders reaching indefinitely into the future. Fortunately, as a student of the Delaware General Corporation Law, including the innovative provisions of Sections 280-282 originally adopted in 1987, you are able to give your client and his fellow directors some helpful advice. Here it is.

Upon the required director and stockholder approvals, the corporation can be dissolved. Dissolution starts numerous clocks ticking, including a three-year period (subject to extension by court order) in which the corporation continues to exist — and can sue and be sued — in order to wind up its affairs. Dissolution may proceed in either of two ways. The corporation can (1) adopt a plan of liquidation and implement it without court intervention or approval, or (2) proceed with a plan of liquidation under the auspices of the Delaware Court of Chancery.

The first approach enjoys the advantage of less litigation expense, at least at the outset. If the plan of liquidation satisfies statutory standards (as discussed below), directors are absolved from personal liability to claimants of the dissolved corporation;[2] stockholders who receive assets distributed in the plan of liquidation may still be held liable for later claims against the corporation, but only for the lesser of the amount of their distribution or their pro rata share of the claim.[3]

This approach, obviously, might still require your client to come in off the slopes once in a while. After all, the statutory requirements for an extrajudicial plan of liquidation are hardly bright lines, and afford a variety of eminently litigable issues. Paying trade and bank debts is straightforward enough, now that the 1994 statutory amendments have clarified that current claims can be paid in full, and that directors are no longer obligated to prorate such claims along with unasserted future claims.[4] The statute, however, requires the corporation to "pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured contractual claims known to the corporation, and to "make such provision as will be reasonably likely to be sufficient to provide compensation for any claim against the corporation which is the subject of a pending action, suit or proceeding to which the corporation is a party."[5] As far as the pending product liability suit is concerned, is anything less than the full $2 million claimed "reasonably likely to be sufficient"? Providing less than $2 million as security for the pending claim would leave the directors and stockholders subject to litigating a claim that they did not comply with the statutory standard and should be personally liable for any shortfall.

Similarly, the plan of liquidation must "make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not arisen but that, based on facts known to the corporation ..., are likely to arise or to become known ... within 10 years after the date of dissolution."[6] Your client's actuarial study and environmental engineering report may be good faith efforts to prognosticate, but they can always be criticized in hindsight. If the security set aside for payment of personal injury and environmental claims not yet asserted proves inadequate to meet the claims that arise over the ten years following dissolution, the claimants may seek to recover the shortfall from directors and stockholders on the theory that the security was not "reasonably likely to be sufficient to provide compensation" for future claims "likely to arise or become known ... within 10 years after the date of dissolution."

You could try to console your client with the observation that until amended this year, the statute (and its counterpart *for judicially supervised dissolutions)* required security for claims likely to arise "prior to the expiration of applicable statutes of limitation." Given the availability of tolling doctrines, that "limitation" was often no real limit at all. The ten-year absolute limitation enacted this year is arbitrary to a degree, of course, but strikes a balance between providing security for future claimants and tying up assets to provide for some distant future obligation that is difficult to quantify, actuarially difficult to compute, and may never arise in any event.

Acknowledging that the ten-year limit is an improvement, your client nonetheless worries that the directors who approve a plan of liquidation could be held liable if the security they put aside for future claims proves insufficient. Here, you offer some real comfort. You tell him about the ruling of the Court of Chancery that "[w]hen directors of a dissolved Delaware corporation are, during the course of winding-up corporate affairs, required to make decisions affecting various classes of interest holders, they are protected from liability in doing so, so long as they act disinterestedly, with due care and in good faith."[7] Under analogous standards, the claimants would bear the burden of disproving due care and good faith on the part of the directors in approving the plan of liquidation.[8]

The stockholders' situation, on the other hand, may be different. Unless the statutory limitation applies, venerable doctrine holds that corporate claimants may impress a constructive trust in their favor on assets received by stockholders from the corporation which after the statutory three-year winding-up period no longer can honor valid claims.[9] Although there is some contrary authority, even claimants whose claims are not brought until after the statutory winding-up period is over may be allowed to satisfy their claims by imposing a constructive trust on assets distributed to stockholders.[10]

All this advice about extrajudicial liquidation leaves your client a little nervous. He asks what additional protection the Court of Chancery can provide under the dissolution statutes, and what it would cost to achieve such incremental comfort. Here's what you say.

The statute governing court-sanctioned liquidation and distribution of assets is still fairly new and evolving, but it offers some real benefits. Like the extrajudicial approach, compliance with *the court-approved procedure insulates* the directors from personal liability. Better yet, the directors find out up front, in the proceedings themselves, whether their plan comports with the statutory requirements. Perhaps even more attractive, a court-approved liquidation insulates stockholders from any further liability for claims not brought within the three-year winding-up period following dissolution.[11]

Imagining a peaceful and financially secure retirement, your client visibly relaxes on hearing this, but warily asks how much this result will cost. You tell him about the costs of notice that must be mailed to known claimants and published in a national newspaper;[12] you tell him about the cost of having his actuarial and environmental experts testify in court; you tell him about the possibility that a guardian ad litem will be appointed, who in turn will hire experts, all at the corporation's expense, to represent the interests of unknown future claimants;[13] and last but not least, you tell him about what you and your litigators are likely to cost.

Now that you have fully engaged your client's attention, he wants to hear more precisely how and whether these costs will achieve the statutory protections for the directors and stockholders participating in the liquidation. Part of the answer is now easy: the 1994 amendments to the statute make clear that present claimants (other than those involved in pending litigation) who receive actual notice of the dissolution procedure will be barred if they do not present their claim within 60 days of the notice, or if they fail to bring suit within 120 days *after their initial claim is duly* rejected by the corporation.[14] For better or worse, the judicially supervised dissolution procedure forces the hand of persons with matured, unconditional claims known to the corporation at the time of dissolution.

The elective judicial procedure also requires the Court to "determine the amount and form of security that will be reasonably likely to be sufficient to provide compensation" for the pending litigation claims against the corporation.[15] Does this mean, your client asks, that the Court of Chancery will tell that crazy judge or jury in Dry Gulch that the $2 million product liability case against the corporation is worth only $100,000 at most, as the corporation contends? A good question, you say, and one not yet authoritatively addressed by the courts. *You don't give your client much encour*agement, though; the Court of Chancery is sensitive to comity and the risks of duplicative litigation.[16] The Court will probably not encourage full-blown litigation, for security determination purposes only, of claims that were already pending in another jurisdiction and will be tried there later in any event. The "likely to be sufficient" standard suggests that security for pending litigation claims will ordinarily be the full amount of the claim, absent a finding (probably on a basis similar to summary judgment, and not binding in the other forum in any event) that judgment will not exceed some lower amount. After all, you tell your client, the judicial dissolution procedure isn't designed to resolve all the corporation's litigation worries in the dissolution proceeding itself; if the wheels of Dry Gulch justice move slowly but yield a verdict of only $500,000, the extra $1.5 million security fixed by the Court of Chancery will not have disappeared. It will be available to satisfy other claimants whose security may prove insufficient or to permit a further distribution to stockholders. Also, putting aside $2 million in security for the pending lawsuit should never be understood in the other forum as a concession that liability exists at all, let alone in the amount set aside.

Resigned to putting $2 million on ice for several years, your client then asks how the Court will require security for claims against the corporation that have not yet matured or been asserted — claims based on all the little explosions waiting to happen, or the pollution not yet unearthed (or not yet even defined as *pollution). Here, you say in response, is* the essential trade-off exacted by the statute in exchange for the protection it affords to directors and stockholders.

While in the old days corporations could pay off present claimants and leave subsequent claimants to their remedies, if any, against stockholders and directors, the judicial dissolution procedure requires the Court to fix security "reasonably likely to be sufficient to provide compensation for claims that have not been made known to the corporation or that have not arisen but that, based on the facts known to the corporation or successor entity, are likely to arise or to become known to the corporation ... ."[17] Thus, unknown but likely future claimants must be protected to some degree as a condition to judicial approval of the liquidation. Of course, those protected are only those claimants whose claims arise within five to ten years after dissolution, depending on the cutoff date selected by the Court.[18]

"So," your client says, "I would have been better off if I had never commissioned that actuarial study and the environmental engineering report. Having done that, we're now committed to post as security the amounts specified in those reports, right?" At least those amounts, you say, and maybe more depending on whether the guardian ad litem and his experts find fault with those reports. You go on, though, to assure your client that had such reports not been commissioned in the first place they would have been necessary as part of the court approval process. Knowledge of possible future personal injury and environmental liability claims is inescapable, and given such knowledge, the corporation is obliged under the statute to submit to the Court a basis on which to determine whether the proffered security is "reasonably likely to be sufficient."[19]

So having been such a generous provider at the outset, says your client, am I and the other stockholders assured of getting the unclaimed balance distributed to us if and to the extent that personal injury claims arising in the five- to ten-year cut-off period don't reach the level of security provided? Not quite, you say. Nothing in the statute limits other corporate claimants from pursuing corporate assets set aside for the benefit of another class of creditors. If your environmental costs, for example, exceed the amount reserved for them, environmental claimants can look to unused security previously set aside for personal injury claimants.[20] While those who administer the liquidation can pay claimants in any order, in full, as their claims mature, only empty pockets can prevent a corporate

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EDWARD M. MCNALLY AND JOHN H. SMALL

Alternative Entities: The Multiple Choices Available in Delaware

To the traditional sole proprietorship, general partnership and corporation have been added a plethora of new business structures.

Delaware is justifiably known as the home of the corporation. However, there are many other ways to organize a business under Delaware law. Six of these alternatives to the traditional corporation are discussed in this article. Each has its own advantages and potential disadvantages, and each can be crafted to fit the particular needs of almost any business. The article will focus on how each form of business entity is created, the fees it pays to the State of Delaware, the liability of investors in such an entity, the tax treatment of investors, and the relationship among the investors, particularly with respect to their duties to one another.[1]

Unlike the Delaware General Corporation Law, the statutes controlling these entities do not have a fully developed body of precedent to fill in the blanks between the statutory provisions. Thus, there are both opportunities and potential pitfalls in choosing any one of these alternatives.

General Partnerships

Except for the sole proprietorship, perhaps the oldest method of doing business is a general partnership. Not only is this still a common form of business entity, it is one of the easiest to set up. Indeed, it is possible to create a general partnership without actually intending to do so, for example, by agreeing with someone else to share the profits from the business that the two of you operate. More commonly, however, at least today, general partnerships are formed by entering into a written partnership agreement.[2] There is no requirement that this agreement be filed with any government office, and there are no fees due when a general partnership is formed and continued under Delaware law.[3]

Each of the partners in a general partnership is liable for partnership obligations and is jointly and severally liable for the wrongful acts of each co-partner as well. For this reason, general partnerships have become less favored as a vehicle for doing business, particularly when a sizeable business is to be conducted. Indeed, this joint and several liability has been the principal impetus for the creation of other forms of business entity.

A general partnership agreement usually provides for a division of the profits and losses of the partnership. The partnership itself does not have any tax liability, filing only an informational tax return. Each of the partners reports on his or her tax return their share of the partnership losses or profits. In the absence of an agreement, however, the partners share equally in profits and losses and an individual partner is not entitled to be compensated for services performed for the partnership. The obvious inequity of such an arrangement is one reason why it is better to have a written general partnership agreement.

Under Delaware law, a general partner has fiduciary duties to each of the other partners and to the partnership. The scope of these duties is very broad and includes the duty of loyalty and due care. In this respect, a partner's fiduciary duties are much like the fiduciary duties of a member of the board of directors of a Delaware corporation. As with any contractual arrangement, there is also an implied covenant of good faith and fair dealing.

Registered Limited Liability Partnerships

The most recent form of business entity to be recognized in Delaware is the Registered Limited Liability Partnership. This form of entity was authorized by the General Assembly in June 1993.[4] As general partnerships became extremely large, the potential liability of an individual partner for the acts of a co-partner increased geometrically. In the case of very large certified public accounting firms (and similar professional partnerships), this risk became intolerable in the wake of litigation blaming those large accounting firms for business failures in the savings and loan industry and elsewhere. Yet, professional associations generally required a partnership as the form of business entity to be used by their membership. Hence the creation of the Registered Limited Liability Partnership to provide a cure for the liability problem.

Briefly, a Registered Limited Liability Partnership is formed by having the parties enter into a written general partnership agreement and then filing an "application" with the Delaware Secretary of State to register the entity as a Limited Liability Partnership. This registration is effective for one year and must be accompanied by payment of an annual fee of $100 for each partner.

The principal advantage of a Registered Limited Liability Partnership is that the partnership agreement may limit the liability of each individual partner for the misdeeds of another partner.[5] The limitation on liability is offset by the requirement that the Limited Liability Partnership maintain liability insurance of $1 million specifically designated and segregated for the satisfaction of any judgment. For the major accounting firms, this form of business entity should prove to be very popular.

Registered Limited Liability Partnerships are treated for tax purposes much the same as general partnerships. The partners pay tax on their share of profits and may deduct their share of losses. The entity itself does not pay any taxes and, like a general partnership, files only an informational return.

The partners in a Registered Limited Liability Partnership owe fiduciary duties to one another and to the partnership itself, just as they would in a general partnership.

Limited Partnerships

For many years Delaware has authorized the formation of limited partnerships.[6] A Delaware limited partnership is formed by filing a Certificate of Limited Partnership with the Delaware Secretary of State. There is a $200 filing fee and a franchise tax of $100 per year for a Delaware limited partnership.

Limited partnerships were created to permit some limitation on the potential liability of individual investors. A Delaware limited partnership has at least one "general partner" who is liable for all of the partnership obligations, just as a general partner is in a general partnership. In addition to the general partner, a limited partnership has one or more "limited partners." The limited partner is liable to the extent of his or her investment in the limited partnership, providing for a defined risk.[7] When a corporation is used as the general partner, moreover, the risk involved in investing in the "general partner" can also be limited. Hence, this has proved to be a very attractive investment vehicle over the last fifteen years or so.

Each of these alternatives to the traditional Delaware corporation has its purposes, its advantages and its disadvantages.

In addition to the limited liability characteristics of a limited partnership, this vehicle is also attractive for its tax advantages. As in a general partnership, there is no taxation at the entity level. Both the general and limited partners are entitled to deduct losses in accordance with their partnership interests and their limited partnership agreement, and are taxed on any gains allocated to them. Unfortunately, there are some limits on the tax advantages of a limited partnership. Briefly, the general partner cannot be a mere shell without any assets if the limited partnership is to enjoy favorable tax treatment. Instead, it is generally thought that the general partner must have assets equal to 10 percent of the value of the limited partnership assets. If this level of capitalization is not reached, then the potential exists that the limited partnership will be taxed as a corporation at the entity level with double taxation in effect for distributions to the partners.

As originally authorized by the Uniform Limited Partnership Act, a limited partnership was to be managed by its general partner and the basic function of the limited partners was to make a passive investment. While this remains true, the Delaware Revised Uniform Limited Partnership Act does authorize a broad range of activities by the limited partners, including activities that constitute some level of management of the enterprise. It is the general view that because the statute authorizes the limited partnership agreement to permit this delegation of authority to limited partners, the exercise of such authority will not jeopardize the limited liability status of the limited partners, causing them to be treated as general partners with unlimited liability. As limited partners demand greater and greater management rights, or at least the power to veto certain decisions by the general partner, tension in this area mounts. Given the breadth of the authorization contained in the Delaware statute, however, it is hard to imagine an instance in which a limited partner would be deemed to be a general partner merely by exercising power conferred in the limited partnership agreement.

The Delaware courts have consistently recognized that a general partner owes fiduciary duties to the limited partnership and its limited partners.[8] Furthermore, the Delaware courts have also held that, in the case of a corporate general partner, its directors and its controlling stockholder, if any, also owe fiduciary duties directly to the limited partnership and its limited partners.

Limited Liability Companies

In 1992, Delaware authorized the formation of Limited Liability Companies ("LLC's"). An LLC is formed by a written agreement of "members" concerning how the company's affairs are to be conducted. A certificate is then filed with the Secretary of State together with a $50 filing fee. The company also pays an annual franchise tax of $100.

LLC's were created to provide both limited liability for investors and favorable tax treatment akin to that of general partnerships. The members of an LLC, who are roughly equivalent to stockholders in a corporation or partners in a partnership, do not have any liability to third parties for the entity's debts or other obligations. Moreover, all the investors in an LLC have this immunity from exposure to additional losses beyond the scope of their investment. Unfortunately, LLC's are not recognized in every state. As a result, there is some doubt about whether the courts of a state that does not recognize LLC's will nonetheless respect this limitation on liability bestowed by Delaware law on members of the LLC. However, as an increasing number of states authorize LLC's, this concern has been greatly diminished.[9]

LLC's are treated much like general partnerships for tax purposes. Moreover, as there is no general partner in an LLC, there is no need to capitalize such a general partner to obtain this favorable tax treatment. Indeed, it is for this reason that LLC's are becoming popular vehicles for a business enterprise. To illustrate, Delaware LLC's have been formed to develop real estate, conduct medical practices and make venture capital investments.

In an LLC, members may have different rights, powers and duties, depending upon the terms of the LLC agreement. This permits the creation of different types of membership interest that are best suited to fit different types of investors. In this respect, membership in an LLC is a matter of pure contractual right. Presumably, however, the courts would recognize some form of fiduciary duty to protect such investors against abuse at the hands of a majority of the members.

Business Trusts

For many years, going back at least to the 1800's, Massachusetts recognized a form of entity known as a "business trust." This entity had many of the characteristics of a more typical testamentary trust, with a "trustee" who was responsible to "beneficiaries." Delaware, too, recognized the validity of a common law business trust and many such arrangements were formed over the years. However, in 1988, the Delaware General Assembly specifically adopted a statute authorizing business trusts.[10] A Delaware business trust is formed by filing with the Secretary of State a Certificate of Trust, which must name a Delaware trustee. There is a $100 filing fee, but no annual franchise tax.

In a business trust, as in other trusts, neither the beneficiary nor the trustee has any liability to third persons, except to the extent of their interests in the assets of the business trust itself. The trust is a separate legal entity that may sue and be sued. The trustee is roughly analogous to an officer of a corporation, and the beneficiaries are equivalent to corporate stockholders.

The tax treatment of a business trust is somewhat complicated. In general, to the extent the business trust has the characteristics of a corporation, it will be treated as a corporation for tax purposes. On the other hand, if the business trust has more of the characteristics of a partnership, then it will be subject to more typical trust taxation which is very similar to partnership taxation. The beneficiaries are allocated their respective shares of profits and losses for tax purposes and there is no taxation at the entity level.

Business trusts are particularly useful as investment devices. However, while a true "trustee" is involved in the trust, the statute provides great flexibility with respect to the beneficiaries' right to control trust management. In this respect the flexibility given to the beneficiaries is equivalent to that provided to limited partners by the Delaware Revised Uniform Limited Partnership Act. Of course, as in any trust, the trustee owes fiduciary duties to the beneficiaries. However, the statute also specifically immunizes trustees from liability to the beneficiaries where they have acted in good faith reliance on the provisions of the business trust agreement. The statute further provides that a trustee's duties and liabilities may be expanded or restricted by the provisions of the business trust agreement. In theory, this would permit a business trust to absolve the trustee of any responsibility to the beneficiaries. As discussed later, this reading of the statute is probably too expansive.

Close Corporations

In 1967, when the Delaware General Corporation law was substantially revised, a need to provide for a more informal management structure for the closely held corporation was recognized. The result was the creation of the "close corporation."[11] A close corporation is formed in much the same way as a general corporation. In addition, the certificate of incorporation must contain a

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claimant from looking to general corporate assets for satisfaction.

The bottom line is this. Those involved in dissolving and winding up the affairs of a Delaware corporation should closely examine their options under the rapidly evolving statutory provisions. Attention and effort at the outset may yield substantial protection from claims that, increasingly, find no bar in traditional statutes of limitation.

The authors, Lawrence. A. Hamermesh (Morris, Nichols, Arsht & Tunnell) and Donald J. Wolfe, Jr. (Potter, Anderson & Corroon), gratefully acknowledge the assistance of their associates David G. Thunhorst and Michael A. Pittenger.

FOOTNOTES

2. Section 281 (c).
3. Section 282 (a).
4. In a 1992 ruling, the Delaware Court of Chancery construed the former version of the statute to require that in voluntary dissolution procedures, both present and future claimants must be paid ratably, where assets are insufficient to pay all claims in full. In re RegO Company, Del. Ch., 623 A.2d 92, 106 n.32 (1992). Necessarily unsure what future claims would amount to, and with no apparent basis for resisting matured valid claims, directors presiding over a voluntary dissolution seemed to have an impossible task in complying with the ratable payment requirement identified in RegO.
5. Section 281 (b) (i) and (ii), as amended in 1994.
6. Section 281 (b) (iii).
7. In re RegO Company, 623 A.2d at 109 n. 35.
8. E.g., Citron v. Fairchild Camera & Instrument Corp., Del. Supr., 569 A.2d 53, 64 (1989).
9. RegO, 623 A.2d at 95 n.4 (citing Wood v. Drummer, 3 Mason C.C.Rpts. 308, Fed. Cas. No. 17,944 (1824) and Mumma v. The Potomac Co., 33 U.S. (8 Pet.) 281 (1834))
10. RegO, 623 A.2d at 96 (citations omitted).
11. Section 282(b). As in extrajudicial liquidation, a claim made before the winding-up period expires may be pursued against a stockholder to the lesser of the amount distributed or the stockholder's pro rata share of the claim.
12. Section 280(a) (1).
13. Section 280(c).
14. Section 280(a) (2) and (4).
15. Section 280(c) (1).
16. See, e.g., Jim Walter Corp. v. Allen, Del. Ch., C.A. No. 10974, Allen, C., slip op. at 7-9 (Jan 12. 1990).
17. Section 280(c) (3).
18. Section 280(c) (3).
19. It is a fair question whether the Court of Chancery, perhaps assisted by a guardian ad litem, would determine that there are no "facts known to the corporation," for purposes of Section 280(c) (3), from which claims "are likely to arise" that are not addressed by a proposed security determination. Absent such a determination, directors and stockholders may be subject to challenge by such claimants that they improperly failed to account for "facts known" and failed to petition for required security.
20. In theory, the Court in determining the appropriate security ultimately unnecessary to satisfy the secured claim or class of claims reverts to the stockholders. The more conservative approach, however, is to provide that such amounts be applied first to pay other creditors.◆

heading stating that the entity is a "close corporation" and must contain special provisions that limit the number of stockholders to thirty or less and restrict transfers of stock. The fees for a close corporation are the same as those for a general corporation.

A close corporation, like a general corporation, has limited liability for its investor/stockholders. Close corporations differ from general corporations most particularly in the relationship among the stockholders and management. The certificate of incorporation of a close corporation may permit the stockholders to effectively do away with a board of directors and manage the corporation themselves. In a general corporation, management by the stockholders is not permitted and if it occurs may justify imposing liability on those stockholders by "piercing the corporate veil" that would otherwise protect them.

Close corporations are taxed much like general corporations. However, the close corporation statute is drafted to closely track the requirements of Subchapter S and this is frequently the tax status selected by close corporations. As a result, all profits and losses are passed through the corporation to its stockholders in proportion to their stockholdings.

Unresolved Issues

The central characteristic of each of these alternative entities is that their statutory authorization permits broad freedom to structure the entity and the internal relationships among its members/partners/beneficiaries and trustees in almost any way the parties choose. This is particularly significant because Delaware has long recognized a clear distinction between relationships governed by fiduciary duty and those governed by contract.[12] Which sort of analysis is applied may dramatically affect the outcome of any particular issue.

Under a traditional corporation law analysis, the board of directors and majority stockholders have an overarching fiduciary duty to the corporation and its other stockholders. When such a duty is present, the fiduciary may not take action to benefit himself even if that benefit is not obtained at the expense of the corporation. In addition, a fiduciary must not take action that will harm the stockholders or the corporation, even if the fiduciary is expressly empowered to do so under the corporation law or the certificate of incorporation. In short, fiduciary duties may override statutory or certificate empowerment.

In contrast, under a traditional contract law analysis, the terms of the parties' agreement will determine their respective rights and obligations.[13] Thus, if the governing instrument of the alternative entity provides that management will have certain rights even at the expense of the members, limited partners or beneficiaries, then the exercise of those rights would be upheld even if the result might be different under a fiduciary duty analysis.

The potential for a different result depending upon which analysis is applied is present in at least two areas. First, the entities discussed here have authorizing statutes that will generally permit full indemnification of management. The Delaware Revised Uniform Limited Partnership Act, for example, permits the partnership agreement to authorize indemnification of "any partner or other person from and against any and all claims and demands whatsoever."[14] This is much broader authority than contained in the Delaware General Corporation Law.[15] There are only two restraints on this broad power. First, too broad indemnification provisions might not be acceptable in the marketplace and the entity might not be able to attract investors. Second, it is probable that a court would refuse to enforce a right to indemnification in truly egregious circumstances, such as deliberate harm to the entity, on the grounds of public policy. If a contract law analysis applies, however, indemnification rights should be very broad because Delaware law permits a party to be indemnified against liability for its own negligence if the contractual language is sufficiently specific.

The second area where the difference between fiduciary and contract principles may have an impact lies in self-dealing by management. At common law, officers and directors were not permitted to deal with their corporation and any such transactions were void. While the Delaware General Corporation Law has reversed this common law rule, such transactions are still required to be intrinsically fair and are voidable in appropriate circumstances if they fail to meet this test.

These restrictions do not necessarily apply, however, in the case of the alternative entities discussed here. For example, the business trust statute specifically provides that it is the "policy of this chapter to give maximum effect to the principle of freedom of contract and the enforceability of governing instruments" and that a trustee's fiduciary duties may be modified by a provision in the governing instrument.[16] Similarly, under the Limited Liability Company Act, a manager of an LLC may deal with the entity on the same basis "as a person who is not a member or manager."[17] Once again, it remains to be seen what restrictions will be imposed on these broad powers, but it is probable that public policy will at least limit some potential abuses.

Conclusion

Each of these alternatives to the traditional Delaware corporation has its purposes, its advantages and its disadvantages. Given the flexibility provided by Delaware law, each entity may be tailored to the particular transaction or business involved.

FOOTNOTES

1. This article will not deal with sole proprietorships, perhaps the most common method of engaging in business. Nor will it deal with joint ventures which are really entities formed by temporarily joining one or more other entities to accomplish one specific task, such as building a complex manufacturing facility.

2. See 6 Del.C. Chapter 15.

3. However, if the partnership is operating under a trade name, it should make a filing with the Prothonotary. 6 Del. C. §3103.

4. See 6 Del.C. §1544 (69 Del. Laws, c. 42).

5. The statute specifically excludes attorneys from this ability to avoid liability. Furthermore, a partnership of attorneys is, by rule of the Delaware Supreme Court, not authorized to limit liability in this respect.

6. Del. C. Chapter 17.

7. In the 1980's, publicly held limited partnerships were frequently formed to make investments in such areas as energy and real estate. Today, as the result of changes in the economy, such large limited partnerships are no longer in vogue. However, even today, substantial sums are invested in large and small private venture capital limited partnerships.

8. The Delaware Revised Uniform Limited Partnership Act (6 Del.C. § 17-403) imposes the same fiduciary duties on a general partner in a limited partnership as are imposed on a general partner in a general partnership.

9. By the end of 1994, it is anticipated that at least 40 states will have adopted legislation authorizing limited liability companies.

10. 12 Del.C. Chapter 38.

11. See 8 Del.C. § 341, et seq.

12. Perhaps the clearest example of this is preferred stock which is generally held to have contract rights, but not rights arising out of a fiduciary duty.

13. There is, of course, a duty of fair dealing under any contract, but the scope of that duty is often quite narrow.

14. 6 Del. C. §17-108.

15. Cf. 8 Del. C. §145.

16. 12 Del. C. §3819 and 3806(c). See also 6 Del. C. §17-1101 (c) with respect to limited liability companies.

17. 6 Del.C. §18-107. ◆

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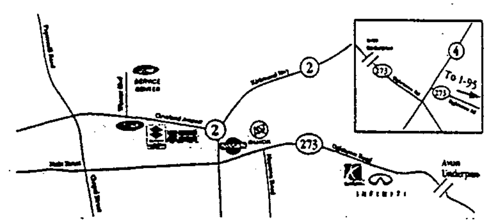
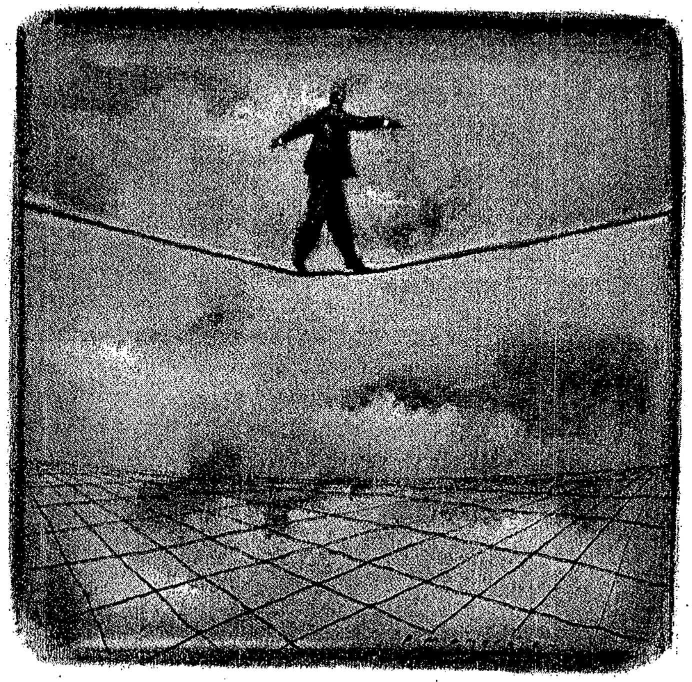


EDWARD P. WELCH AND MATTHEW F. BOYER

Delaware Further Strengthens Directors' Safety Net

Advances in Indemnification



Protecting honest directors from personal exposure in stockholder litigation.

Suppose you reach that point in life where you are widely regarded as a pillar of the community and a paragon of virtue, one who, in the eyes of the business community, would be the perfect candidate to serve on a board of directors as an "outside independent director." Suppose further that a distinguished CEO approaches you and asks you to serve on the board of his equally distinguished Delaware corporation, whose exploits are regularly featured in the pages of The Wall Street Journal. What do you say?

Do you imagine yourself spearheading a new marketing offensive, broadening the company's diversity efforts or shaping the company's direction for the 21st century? Or, given the litigious nature of our society, do you envision yourself the target of multiple stockholder suits, spending long hours at depositions surrounded by unpleasant (non-Delaware) lawyers speaking a strange lingo sprinkled with such esoteric terms as bust-up, boot-strap bids, Revlon duties, scorched earth policies, shark repellants, white knights, *enhanced scrutinies*, *omni*present specters and a strange array of ESOP's, ISOP's, IPO's, LBO's, CFO's and UFO's? After this vision, you might be inclined to say to your friend, "Are you kidding?"

But suppose the CEO reminds you that you will be aided by the formidable protections of the "business judgment rule," under which courts will be loathe to second-guess your decisions provided they are made in good faith after adequate investigation. You may still say, "Yes, but that's cold comfort after I've lost my life savings defending a meritless suit by some shakedown artist."

At this point, your CEO friend (or corporate counsel) may say, in a quietly reassuring tone, "Haven't you heard of the broad indemnification rights under section 145 of the Delaware General Corporation Law?" Your friend may go on to explain that indemnification has evolved to soothe the nerves of people just like you, who would be excellent directors but who do not wish to lose their shirt in the process. In fact, by virtue of several amendments passed just this year, the statute has been improved even further.

Section 145 of the Delaware General Corporation Law says that Delaware corporations may indemnify their directors, officers and other agents for expenses, including attorneys' fees, incurred by them as a result of pending or threatened action stemming from the fact they are or were a director, officer or agent of the corporation. To the extent that you are successful in defending an action against you, the statute says that you "shall be indemnified" against expenses reasonably and actually incurred. But even if you settle the case or, in some cases, lose it, the *corporation still may indemnify you*. All you have to show, in most instances, is that you acted in good faith and in a manner you reasonably believed was not opposed to the best interests of the corpora-

Illustration by Paul Anderson

tion, and, in a criminal case, that you had no reasonable cause to believe that your conduct was unlawful. Even if you are found liable to the corporation, indemnification can still be provided if the Court of Chancery finds that, in view of all the circumstances, you are still "fairly and reasonably" entitled to it.[1]

You may say, "It sounds like this statute gives corporations the power to indemnify me, but it doesn't force them to unless I win. So why would they unless they have to?" In fact, most corporations do provide for broad indemnification rights through provisions in their certificates of incorporation or bylaws, and this makes good sense. As the Court of Chancery put it, the indemnification provisions of Section 145 encourage capable persons "to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[2] For the same reasons, Section 145 promotes the desirable end that corporate officials will resist what they consider unjustified suits and claims.[3]

You may ask, "What if some plaintiff drags me through the court system for years? Do I have to foot my own bill for the course of the litigation until, at the very end, someone decides whether or not they're going to indemnify me?" That's a good question, one that Section 145 answers in your favor. Section 145(e) broadly permits corporations to offer advancement of expenses provided that you sign an "undertaking" that you will pay it back if it is ultimately determined that you are not entitled to be indemnified by the corporation. (And no, the person who shows up at your door to enforce this promise is not called the "undertaker.") Advancement used to be limited to those situations in which it had been authorized by the directors "in the specific case." However, a 1986 amendment permits general authorization of advancement of expenses, including by a mandatory charter or bylaw amendment to that effect. In one recent case, the Court of Chancery noted that "mandatory advances, like indemnification, serve the salutary purpose of encouraging qualified persons to become or remain as directors of Delaware corporations, by assuring them ... that they may resist lawsuits that they consider meritless, free of the burden of financing (at least initially) their own legal defense."[4]

You may say, "All this sounds fine, but can't some smart lawyer always find a way to tie me up in knots so that I don't get an advancement until it's too late to do any good?" Truth be told, there have been problems, ones that new subsection 145(k) is designed to correct. For example, suppose your "former friend," the CEO, does not like a decision that you made and says that you don't qualify for advancement? What do you do? Sue, right? But how long does it take to win advancement, while you're paying two sets of lawyers — one to defend you in the original suit, and one to prosecute your action for advancement?

Indemnification provisions encourage capable persons to serve as corporate directors. secure in the knowledge that expenses incurred in upholding their honesty and integrity will be borne by the corporation they serve.

In recent years, claims for advancement have themselves resulted in prolonged litigation. For one thing, there was the jurisdictional question whether such suits belonged in the Court of Chancery as a corporate matter or in the Superior Court as a contract claim. Second, there was the delay in litigating such suits to conclusion.

The situation that unfolded in Citadel Holding Corp. v. Roven[5] illustrates the problem well. In that case, a former director brought suit in the Court of Chancery after the corporation refused to advance expenses incurred in defending an action brought by the corporation. The advancement action was transferred to the Superior Court in February 1990, and in March 1991, that court held that the former director was entitled to advancement of nearly $1 million in fees and expenses. However, an appeal followed, which was not resolved until February 1992, over two years after the filing of the action for "advancement" and long after the director could have been forced to dip into his own wallet to defend the original suit against him.

Similarly, in Salaman v. National Media Corp.,[6] the former director filed an action in the Court of Chancery on November 22, 1991. In January 1992, the Court of Chancery determined that it did not have subject matter jurisdiction, and the case was transferred to the Superior Court. In October 1992, the Superior Court determined that the former director was entitled to advances; however, the issue of the reasonableness of the expenses claimed did not go to trial until March 1994. The jury assessed $388,000 in compensatory damages — the entire amount requested — and $1.55 million in punitive damages against the corporation.[7] Even if the punitive damages award does not stand, it is clear the former director was vindicated.

New Section 145(k) will expedite the treatment of actions brought under Section 145 in two ways. First, subsection (k) provides that the Court of Chancery will have exclusive jurisdiction within the State of Delaware to resolve disputes arising under Section 145. Thus, preliminary disputes over subject matter jurisdiction are eliminated.

Second, new Section 145(k) expressly provides that the Court of Chancery may "summarily determine" rights to advancement. Thus, actions for advancement will join a limited number of actions that are statutorily designated as summary proceedings, such as actions to compel an annual meeting, actions to inspect books and records, and actions to fill vacant directorships.[8] As with these other statutory provisions, Section 145(k) expressly permits summary proceedings to ensure meaningful enforcement of rights.[9]

The 1994 amendment to Section 145 also amended subsection (d) of that section to permit a minority of the board of directors to take action on requests by their fellow directors and others for indemnification. Prior to the amendment, Section 145(d) required that indemnification determinations by the board of directors be made "by a majority vote of a quorum consisting of directors who were not parties to such action, suit or proceeding." The amendment to Section 145(d) permits such decisions to be made "by a majority vote of the directors who are not parties to such action, suit or proceeding, even though less than a quorum."

"Okay," you may say, "I appreciate what you've done to help secure advancement and indemnification. But one thing still bothers me, and that is the two sets of lawyers. Even if I win my suit for advancement, and my bill from the first set of lawyers is paid, won't I still have to absorb the cost of the second set of lawyers, who prosecuted the advancement action for me? Is there no way that I can make the corporation cover the cost of my having to sue for advancement?"

Yes, there is a way. Section 145 provides you with the flexibility to do just that. Section 145(f) says that the indemnification and advancement rights provided in the statute are not to be deemed exclusive of any other rights to which directors may be entitled under any other agreement with the corporation. Therefore, you may negotiate an agreement that the corporation will cover the expenses that you incur if you are forced to sue for advancement or indemnification. The only limitation is that such an agreement must still require that, in bringing the advancement action, you acted in good faith.[10]

Finally, just as the jury in the Salaman case, discussed above, vindicated a director's advancement rights, so also have courts resisted attempts to thwart the application of long-standing indemnification and advancement rights. For example, in In re Central Banking System,[11] a corporate trustee proposed that the Court of Chancery approve a settlement order which would have authorized the postponement of certain distributions to one of the directors of the corporation who had been receiving advancement of litigation expenses pursuant to the corporate bylaws and an indemnification agreement. The trustee argued that, if the director was ultimately found to be not entitled to indemnification, the director would be unable to repay the corporation for the substantial amounts advanced to him for payment of litigation costs, and that some form of security was therefore required.

The Court rejected the argument, noting that both the corporate bylaws and the indemnification agreement created a valid contractual right to mandatory advances of litigation expenses. The Court went on to hold that:

> "The only condition imposed by the By-laws is that the recipient furnish an undertaking to repay the amounts advanced in the event he is found to be not entitled to indemnification. That condition has been satisfied. Neither that provision nor any provision of Delaware law requires that the undertaking be secured or be accomplished by a showing of the indemnitees' financial responsibility. Therefore, no basis in law has been shown for the proposed escrow arrangement.[12]

The Court also emphasized that there was no public policy that would justify creating an exception where the corporation perceives a potential risk of nonpayment.[13]

Delaware law or indemnification continues to evolve, providing greater protection to those who serve as directors of Delaware corporations.

* * *

In summary, Delaware law on indemnification continues to evolve, providing greater protection to those who serve as directors of Delaware corporations. When you receive the call inquiring about your interest in serving as a director, know that our law, which is constantly monitored and refined by expert corporate practitioners and judges, will stand you in good stead.

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FOOTNOTES

1. 8 Del. C. §145 145 (a) and (b).

2. Mooney v. Willy-Overland Motors, Inc., 204 F.2d 888, 898 (3d Cir. 1953).

3. Essential Enterprises Corp. v. Automatic Steel Products, Inc., Del. Ch., 164 A.2d 437, 441-42 (1960).

4. In re Central Banking System, Inc., Del. Ch., C.A. No. 12497, slip op. at 7, Jacobs, V.C. (May 11, 1993).

5. Del. Supr., 603 A.2d 818 (1992).

6. DEl. Super., C.A. No. 92C-01-161 (Mar. 12, 1994). Although the Court of Chancery, in which such suits will now be brought, does not award punitive damages, it may be expected to take the same dim view of unwarranted attempts to deny indemnification rights.

8. Del. C. § 211, 8 Del. C. § 220, 8 Del. C. § 223.

9. The legislative synopsis to the amendment creating new subsection (k) provides as follows:

> The amendment adding new subsection "(k)" provides the Court of Chancery with exclusive jurisdiction to hear and determine actions brought pursuant to section 145, including but not limited to actions brought pursuant to charter and bylaw provisions, resolutions and contracts regarding indemnification and advancement. The provision is consistent wtih a number of other sections of the Delaware General Corporation Law that grant exclusive jurisdiction to the Court of Chancery.
>
> The amendment further provides for the summary treatment of actions brought pursuan to seciton 145 seeking a determination as to whether a corporation is oblibated to advance expenses prior to the final disposition of litigation.

10. See Waltuch v. Conticommodity Services, Inc., 854 F. Supp. 302, 309 (S.D.N.Y. 1993.

11. Del. Ch., C.A. N. 12497, Jacobs, V.C. (May 11, 1993).

12. **In re Central Banking System**, slip op. at 5-6 (citations omitted).

13. Id., slip op. at 7. The Court also noted that a corporation does have the undoubted power to require, either in its bylaws or ina private contract authorized by applicable law, that the recipient of advanced indemnifications furnish appropriate security or demonstrate financial responsibility as a condition to receiving advances. However, the corporation had not done so here.

For a comprehensive review of recent developments in Delaware law governing the subject of advancement of litigation expenses, see Valihura and Valihura, *A Delaware Perspective on Advancing Directors' and Officers' Litigation Expenses*, 12 Bank and Corporate Governance Law Reporter 66 (1994). ◆

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