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Recent Delaware Case Enjoining Annual Meeting of Stockholders Highlights Board's Duty of Disclosure in Corporate Elections

The recent temporary restraining order (TRO) enjoining the annual stockholder meeting of ChinaCast Education Corporation (ChinaCast) granted in the case of *Sherwood, et al. v. Chan Tze Ngon, et al.*, No. 7106-VCP (Delaware Court of Chancery, December 20, 2011) highlights the strong protections afforded to stockholders in the election of directors under Delaware law.

On December 20, 2011, Vice Chancellor Parsons enjoined ChinaCast from holding its annual stockholder meeting, scheduled to take place the following day, until January 10, 2012 (Beijing Standard Time), after ChinaCast removed incumbent director Ned Sherwood from its slate of nominees and proxy statement less than two weeks prior to the meeting. Because SEC proxy regulations require proxy materials to be on file with the SEC for at least 10 days prior to mailing, Sherwood would not have had time to solicit proxies for himself or a competing slate after his removal and prior to the December 21 meeting.

The court held that plaintiffs Ned Sherwood and his affiliate ZS EDU, L.P. set forth a colorable claim that: (1) ChinaCast failed to adequately disclose its reasons for removing Sherwood from its proxy statement; (2) such deficiency constituted a risk of irreparable harm caused by an uninformed stockholder vote; and (3) a balancing of the hardships on the parties weighed in favor of granting the TRO. The TRO also permitted the plaintiffs to solicit proxies for their competing slate of directors at the annual meeting, despite ChinaCast's contrary interpretation of the company's advance notice bylaws.

Summary

ChinaCast (NASDAQ: CAST) is a publicly traded Delaware corporation with its principal place of business in Hong Kong, China. The company offers post-secondary education and e-learning services in China, including three- and four-year bachelor's degrees and diploma programs through its three accredited universities.

Ned Sherwood, an incumbent on ChinaCast's Board of Directors (Board) since December 2009 and the beneficial owner of approximately 7 percent of ChinaCast through his interest in ZS EDU, was nominated for re-election in ChinaCast's initial proxy statement filed on November 14, 2011. Sherwood was the designee of affiliates of Fir Tree, Inc. pursuant to an agreement between Fir Tree and ChinaCast. After announcing a postponement of the annual meeting until December 21, 2011, ChinaCast announced on December 8, 2011 Sherwood's removal from ChinaCast's slate of director nominees based on the recommendation of its nominating committee. ChinaCast identified the following reasons for its nominating committee's recommendation:

(1) Sherwood had violated ChinaCast's trading policies;

(2) an email sent by Sherwood proposing changes to management's bonus plan was inappropriate;

(3) Sherwood violated ChinaCast's code of ethics and communications policy; and

(4) Sherwood's general behavior, personal attacks and unwillingness to consider contrary views were not conducive to a productive and professional working relationship. Specifically, ChinaCast stated in its supplemental proxy materials that "Sherwood's unwillingness to consider contrary views and his personal attacks upon those who disagree with him have had a severely negative effect on the Board's decision-making" and that his "conduct and behavior at Board meetings and at other times has become a significant distraction to the effective functioning of the Board."

Sherwood responded by publicly claiming that ChinaCast was retaliating against him for his independence from management and criticism of certain policy decisions of the Board. Sherwood then filed suit in Delaware seeking to enjoin the annual meeting so that he could solicit proxies for a competing slate of directors. He also alleged, among other claims, that ChinaCast breached its duty of disclosure by failing to disclose genuine policy disputes between Sherwood and other directors of ChinaCast relating to a share repurchase program and a third-party offer to purchase all outstanding stock of the company.

ChinaCast denied that the disclosure in its proxy statement was misleading, responding that it accurately stated the nominating committee's reasons for recommending the removal of Sherwood from the company's slate. ChinaCast also asserted that the advance notice bylaws of the company prevented Sherwood from soliciting proxies for an alternative slate of directors.

The Chancery Court noted that this case appears to be a result of a dispute between two directors, Sherwood and the company's Chairman, Chan, who disagreed about the best way to advance the interests of ChinaCast's stockholders. The Vice Chancellor observed that it is not the place of incumbent management or the court to decide if one candidate is preferable to another for election, and that this decision belongs to the stockholders. The TRO was granted to give the stockholders a fair opportunity to vote their preference on the future of the company.

Legal Standard

The ChinaCast case involved an emergency request for a TRO. Therefore, the plaintiffs were required to demonstrate: (1) the existence of a colorable claim; (2) the existence of irreparable harm if the TRO was not granted; and (3) a balancing of the hardships favoring the plaintiffs. Given the emergency nature of the request, the limited factual record at the early stage of the case and the short duration of the requested TRO, the Chancery Court applied a "less exacting merits-based scrutiny" analysis. Using this standard, Delaware courts will likely grant the temporary relief if imminent irreparable harm is shown, unless the claim is frivolous, granting the remedy would cause greater harm than denying it, or the plaintiff contributed in some way to the emergency nature of the need for relief. Accordingly, the Chancery Court did not focus on the probability of success on the merits of plaintiffs' claims.

Colorable Claim — Breach of Duty of Disclosure

The plaintiffs alleged that: (1) the defendants breached their duty of disclosure by failing to disclose the genuine policy disputes between Sherwood and the company, which plaintiffs contended motivated Sherwood's removal from the company's slate; and (2) that the disclosure relating to Sherwood's alleged trading activities and his proposed changes to the management bonus plan omitted material facts and were materially misleading. In deciding whether to grant the TRO, the Chancery Court did not make any factual determinations at the preliminary stage of the case, but rather determined whether a colorable disclosure claim had been set forth by the plaintiffs.

The Chancery Court reiterated the principle that a board's duty of disclosure when seeking stockholder approval is a specific application of the directors' duties of care and loyalty under Delaware law, which requires directors to "disclose fully and fairly all material information within the board's control when it seeks shareholder action." Whether information is material to stockholders is not subject to the "business judgment rule," but is instead determined by the court.

The standard applied by Delaware courts is analogous to the 10b-5 standard under US securities regulations, providing that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or if an omission of an otherwise immaterial fact "renders the partially disclosed information materially misleading." Once ChinaCast engaged in disclosure regarding the removal of Sherwood from its slate, its duty of disclosure required ChinaCast to disclose its motivations candidly. Applying this standard, the Chancery Court found at least two ways in which the ChinaCast proxy statement may have been materially misleading, forming the basis for a colorable disclosure claim.

First, the timing and circumstances under which Sherwood was initially nominated and then removed just days before the annual meeting arguably supports an inference that self-interest motivated Sherwood's removal, particularly given the incumbent directors' argument to the court that the company's advance notice bylaws prevented Sherwood from proposing a competing slate of directors. Therefore, Sherwood could conceivably prove that the Board failed to candidly disclose its motivations in the proxy statement. The court further noted that Sherwood "make[s] a colorable claim that, to whatever degree Sherwood may have been obstinate, that obstinance relates to sincere policy disputes" and that "a desire to avoid those disputes may have motivated" his removal. The Chancery Court explained that "it also is important that directors be able to register effective dissent, even if that might offend the sensibilities of some of their co-directors."

Second, the Chancery Court found that a fact finder could ultimately conclude that the disclosure relating to Sherwood's alleged trading policy violations contained one or more materially misleading disclosures.

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Disclosure Violations as Irreparable Harm

The plaintiffs argued that failure to enjoin the meeting would result in irreparable harm to the company's stockholders because it would leave insufficient time to consider corrective disclosures made by ChinaCast and Sherwood's competing slate of nominees.

The Chancery Court agreed with the plaintiffs regarding the existence of irreparable harm, concluding that enjoining the meeting was necessary to prevent stockholders from losing "the opportunity to express their fully informed views . . . via a fair election." Holding the annual meeting on its scheduled date would therefore not comport with the "scrupulous fairness" required of corporate elections.

ChinaCast argued that holding the annual meeting on schedule would not cause irreparable harm to its stockholders because ChinaCast believed that Sherwood had already missed the deadline for nominating a competing slate of directors under the company's bylaws. The Chancery Court was skeptical of this interpretation of the company's advance notice bylaws and also concluded that the risk of irreparable harm was present even in an uncontested election when stockholders are not fully and fairly informed, as stockholders still must make an informed choice as to whether to vote "for" or "withhold" with respect to each nominee.

The Chancery Court agreed with the plaintiffs regarding the existence of irreparable harm, concluding that enjoining the meeting was necessary to prevent stockholders from losing "the opportunity to express their fully informed views . . . via a fair election." Holding the annual meeting on its scheduled date would therefore not comport with the "scrupulous fairness" required of corporate elections.

Balance of the Equities

Granting a TRO to enjoin a stockholder meeting is a severe remedy that may have various consequences for an issuer beyond rescheduling the meeting. Accordingly, courts will weigh the hardships on the defendants caused by granting a TRO against the hardships on the plaintiffs caused by denying a request for a TRO.

ChinaCast argued that granting the TRO would result in a variety of hardships to the company, including that: (1) the company would incur additional expenses to prepare and issue additional proxy materials; (2) postponing the meeting would violate Section 213(a) of the Delaware General Corporation Law, which requires the record date to be no more than 60 days prior to the date of the meeting; and (3) postponing the annual meeting past December 31, 2011 would result in the violation of NASDAQ Rule 5620, which requires issuers to hold annual stockholder meetings within one year of the close of its prior fiscal year, subjecting the company to a delisting notice.

The Chancery Court gave little weight to the first two asserted hardships because the plaintiffs offered to post a secured bond in the amount of expected additional costs to the company and because the Section 213(a) issue could be easily solved. By permitting the annual meeting to be opened and immediately adjourned prior to the 60th day, the company would satisfy Section 213(a), which provides that the same record date applies to any adjournment of a meeting, unless the board fixes a new record date. Although the Chancery Court acknowledged that the threat of violating exchange rules is not taken lightly, the Court reasoned that this threat did not outweigh the equities in favor of granting the TRO. The plaintiffs also argued that the deficiency from the failure to hold a stockholder meeting would be cured before any NASDAQ hearing on the delisting notice, mitigating the harm alleged by the defendants.

ChinaCast also argued that enjoining the meeting would create market uncertainty that could induce short-selling and otherwise adversely affect its stock price. This prospect, which the Court noted would have been the case for all previous companies which have had stockholder meetings enjoined, was dismissed by the Chancery Court as "insufficient to allow a tainted shareholder vote to proceed."

In its balancing of the equities, the Chancery Court also reviewed the claims of laches and unclean hands alleged by both sides. The Court noted that the defendants claimed that Sherwood knew of the "unauthorized" meeting by a director with a private equity firm, the "lackluster pace of share purchases" under the company's share repurchase program, the Board's hesitancy to form a special committee in response to another company's offer, and the growing acrimony between Sherwood and Chan well before the October 28 deadline for notice of director nominations. More telling from the Chancery Court's perspective was the fact that Sherwood had been led to believe that he was on the company's slate of directors until "well after the deadline for notice under the advance bylaw had passed" and that Sherwood had acted relatively quickly once he learned that he would no longer be nominated by the company. The most favorable interpretation of the defendants' actions was that they "had to make a tough call regarding Sherwood's place on the company's slate, and that they did not make that call until after the opportunity for a meaningful and transparent proxy contest arguably had been lost."

As to the balance of equities, the plaintiffs asserted that the failure to provide stockholders with a meaningful opportunity for a fully informed vote outweighed any potential hardships to the company caused by postponing the annual meeting by a couple of weeks. The Chancery Court agreed, concluding that the balance of equities as between the defendants and the company's stockholders, "tips decidedly in favor of granting the TRO."

The TRO required ChinaCast to postpone its annual meeting until January 10, 2012 (Beijing Standard Time) (although the Court permitted the company to convene the stockholder meeting before December 24, not to conduct business, but solely to permit compliance with Section 213) and enabled Sherwood to solicit proxies for his competing slate of directors.

Advance Notice Bylaw Provision

The Chancery Court noted that ChinaCast's bylaw provision requiring advance notice for director nominations was ambiguous as to the effect of the various postponements of the annual meeting on the deadline for stockholders to notify the company regarding an opposing slate. ChinaCast's bylaws state that if less than 70 days notice of the date of the annual meeting is given, "notice by the stockholder, to be timely, must be received no later than the close of business on the tenth (10th) day following the day on which such notice of the date of the meeting was mailed or such public disclosure was made, whichever first occurs." The bylaws were silent as to whether any postponement or adjournment resets the 10-day notice requirement.

Although the Chancery Court did not make a determination as to the interpretation or validity of the bylaw provision, it noted that the absence of typical language in the bylaws as to the effect of a postponement of the date of the meeting suggests an ambiguity in this regard, and stated the judicial principle that "ambiguities in advance notice bylaws are construed 'in favor of the stockholders' electoral rights.'"

Proxy Fight

Following the Chancery Court's decision to enjoin the ChinaCast annual meeting, Sherwood solicited proxies for a competing slate of six directors, which included himself and one other incumbent director who also appeared on the company's slate. Sherwood subsequently reduced his slate to a "short slate" of three directors, which Sherwood stated was partly in response to public statements by the company that the management team had indicated that they would resign if Sherwood's slate gained control of the Board.

> *Although the Chancery Court did not make a determination as to the interpretation or validity of the bylaw provision, it noted that the absence of typical language in the bylaws as to the effect of a postponement of the date of the meeting suggests an ambiguity in this regard, and stated the judicial principle that "ambiguities in advance notice bylaws are construed 'in favor of the stockholders' electoral rights.'"*

Following a heated proxy fight during which Sherwood and ChinaCast aired their policy disputes via numerous public fight letters and press releases, ChinaCast filed a Form 8-K and sent an open letter to its stockholders on January 17 announcing that Sherwood and his other two nominees had been elected to the Board at the annual meeting, replacing two of ChinaCast's nominees (one of Sherwood's nominees also appeared on the company's slate). In the letter, Chan indicated that, notwithstanding the reservations asserted by ChinaCast at the annual meeting, the company would honor the results of the corporate election and the decision of its stockholders.

Lessons for Boards of Directors

The ChinaCast case serves as an important reminder to boards of directors and issuers regarding their disclosure obligations. Courts have broad latitude to take action they view as necessary to protect the stockholder franchise, particularly when there is even the appearance that a board may be acting in its own self-interest to silence an independent director.

The Chancery Court's decision to enjoin the ChinaCast annual meeting did not require a determination that the ChinaCast Board was acting with the primary purpose of thwarting a stockholder vote. Instead, the fact that an independent director who had disagreements with the Board was excluded from running for re-election led the Chancery Court to enjoin the meeting so that the stockholders would have the opportunity to vote their preference on the most suitable candidates for election to the Board.

> *Courts have broad latitude to take action they view as necessary to protect the stockholder franchise, particularly when there is even the appearance that a board may be acting in its own self-interest to silence an independent director.*

Boards of directors and issuers should consider the following "take-aways" from the Chancery Court's decision:

- Carefully consider the disclosure implications of any policy disputes between any director who is not nominated or fails to stand for re-election, and the company's management or the other directors. Such disclosure must be an accurate, full and fair characterization of the information disclosed. Note that beyond Delaware requirements under the duty of disclosure, disclosure under US securities laws may also be required. For example, Item 5.02 of Form 8-K requires certain disclosures if any director resigns or refuses to stand for re-election due to a disagreement with the issuer.

- More generally, it is important that "directors be able to register effective dissent, even if that might offend the sensibilities of some of their co-directors." Boards of directors sometimes put a premium on collegiality as a key to good board dynamics, but boards should think twice about taking steps to stifle dissent from an independent director, particularly a "zealous advocate of a policy position" at odds with the majority.

- Conduct periodic reviews of bylaw provisions. It is in the best interest of issuers and their stockholders to ensure that the requirements relating to director nominations and stockholder meetings are unambiguous. Advance notice bylaws have been the subject of considerable litigation in recent years. Prudence dictates that advance notice bylaws be reviewed substantively as well as against other companies' advance notice provisions to identify potential ambiguities or omissions. An issuer's description of the advance notice bylaw provisions in the proxy statement should also be clear and include all material information necessary for a stockholder to understand the deadlines and procedures for nominating directors.

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Under the new regime, holders of financial and other instruments, including contractual agreements, that either (i) grant them a unilateral right to acquire issued and outstanding voting shares in a German public company, or (ii) merely enable them to acquire issued and outstanding voting shares in a German public company, are now obligated to report to the issuer and BaFin within not more than four trading days if their holding of these financial and other instruments reaches, exceeds or falls below 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% (the New Instrument Disclosure Obligations).

Tightened German Disclosure Obligations Now in Force — Are You Affected?

Following the use of cash-settled equity derivatives in a number of high profile M&A transactions in Germany in recent years — most notably, the contemplated takeover by Porsche of Volkswagen and the takeover by Schaeffler of Continental — there was pressure on legal policy makers to counter silent stakebuilding in German public companies. As a result, the Act to Strengthen the Protection of Investors and to Improve the Efficiency of the Capital Markets (*Gesetz zur Stärkung des Anlegerschutzes und zur Verbesserung der Funktionsfähigkeit des Kapitalmarkts* — or AnSFuG) was passed into law.

The New AnSFuG Regime — Overview

Effective February 1, 2012, German disclosure obligations have been tightened. The current regime relating to disclosure of significant holdings of voting shares in German public companies, i.e., the obligation of holders of voting shares to notify the issuer and the German Federal Financial Supervisory Authority (BaFin) within not more than four trading days if their holding reaches, exceeds or falls below 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% (the Share Disclosure Obligations) remains unchanged, save only for increased sanctions. However, the disclosure obligations on holders of financial and other instruments have been significantly expanded. Under the new regime, holders of financial and other instruments, including contractual agreements, that either (i) grant them a unilateral right to acquire issued and outstanding voting shares in a German public company, or (ii) merely enable them to acquire issued and outstanding voting shares in a German public company, are now obligated to report to the issuer and BaFin within not more than four trading days if their holding of these financial and other instruments reaches, exceeds or falls below 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% (the New Instrument Disclosure Obligations).

In Depth — The New Instrument Disclosure Obligations

As a consequence, the following financial and other instruments that grant the holder a unilateral right to acquire issued and outstanding voting shares in a German public company now fall within the scope of the New Instrument Disclosure Obligations:

- repurchase agreements;
- a lender's claim for return of the voting shares under share lending arrangements;
- share purchase agreements, potentially including rights of first refusal and tender rights; and
- shareholders' agreements,

in each case, provided, that (re-)acquisition is not contingent on circumstances outside of the sphere of influence of the holder of the relevant instrument.

Moreover, under the new regime, disclosure is required of financial or other instruments that enable the holder (or a third party) to acquire voting shares without granting an enforceable right to acquire voting shares, such as:

- contracts for difference (CFDs);
- total return equity swaps;
- cash-settled call options;
- the position of an option writer in a put option;
- physical call options subject to conditions, such as price thresholds and antitrust clearances, arguably including mandatory convertible bonds and rights to delivery of voting shares under stock option plans; and
- financial instruments relating to baskets and indices.

Aggregation and Disclosure

The holdings in all reportable financial and other instruments, as well as all such instruments held by a party related to the holder of the reportable financial and other instruments and thus attributable to that holder, must be aggregated for purposes of determining the relevant thresholds. The notification to the issuer and BaFin must specify the relevant total number of voting shares (including those which the holder of financial or other instruments may acquire under those financial or other instruments) and, at the same time, differentiate between each such financial or other instrument.

Sanctions

Contrary to the sanctions imposed on holders of voting shares for non-compliance with the Share Disclosure Obligations, non-compliance with the New Instrument Disclosure Obligations will not generally lead to a loss of voting, dividend and other rights attached to the underlying voting shares. In both cases, however, BaFin may now impose a fine of up to €1,000,000 per violation.

Grandfathering vs. Portfolio Notification

Portfolio holdings of financial or other instruments that represent the right to purchase 5 percent or more of a German public company's voting shares (including when aggregated with other reportable financial or other instruments) will not be grandfathered but have to be reported to the issuer and BaFin within 30 trading days of February 1, 2012.

Therefore, effective February 1, 2012, any party holding financial or other instruments that grant a right to purchase shares representing 5 percent or more of a German public company's voting shares must notify the issuer and BaFin of the total number of voting shares which the holder may acquire under those financial or other instruments and identify each such financial or other instrument by not later than March 13, 2012.

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In cases where corporate governance initiatives are on the ballot, companies should consider what steps to take to best communicate with their stockholders to effectuate the desired changes. These steps include increasing proxy solicitation efforts, and informing stockholders of the relevant proposals well in advance of stockholder meetings to allow ample time for submission of proxy instructions.

NYSE Further Narrows Approach to Broker Discretionary Voting Under Rule 452

On January 25, 2012, the NYSE announced that it will no longer allow brokers to vote on certain corporate governance proposals without specific client instructions under NYSE Rule 452. Certain matters that NYSE previously ruled as “Broker May Vote” will be treated as “Broker May Not Vote” matters going forward, including, for example:

- de-staggering a company’s board of directors;
- majority voting in director elections;
- eliminating supermajority voting requirements;
- providing for the use of written consents by stockholders;
- providing rights to call a special meeting; and
- overriding certain types of anti-takeover provisions.

The change is the latest move in NYSE’s increasingly narrow approach to broker discretionary voting under Rule 452. For example, in 2010, NYSE amended its rule to prohibit broker discretionary voting in the election of directors, other than directors of an investment company registered under the Investment Company Act of 1940. In addition, brokers cannot vote on executive compensation matters under the Dodd-Frank Act.

One practical effect of this change is that the number of shares voted by proxy will likely be reduced, making it more difficult for management to obtain majority approval for corporate governance proposals. Where corporate governance initiatives are on the ballot, companies should consider what steps to take to best communicate with their stockholders to effectuate the desired changes. These steps include increasing proxy solicitation efforts, and informing stockholders of the relevant proposals well in advance of stockholder meetings to allow ample time for submission of proxy instructions.

Although NYSE’s announcement does not specify matters other than those enumerated above, the new limitation may apply to additional types of corporate governance proposals. A proposal to ratify independent auditors will presumably continue to be considered a “routine” matter on which brokers may vote, and such votes may count towards a quorum, so companies should include this proposal in proxy materials when corporate governance matters are on the ballot to ensure the ability to establish a quorum.

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The business judgment rule is the well-known presumption under corporate law that when making business decisions on behalf of a corporation, a board of directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. Jurisdictions have been divided, however, on the question of whether the business judgment rule applies to officers of corporations as well as directors.

California's Business Judgment Rule Gives No Quarter to Corporate Officers

The business judgment rule is the well-known presumption under corporate law that when making business decisions on behalf of a corporation, a board of directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. Jurisdictions have been divided, however, on the question of whether the business judgment rule applies to officers of corporations as well as directors.

Delaware courts have applied the rule to both officers and directors, while California decisions have arguably limited application of the rule only to directors. This split among jurisdictions is further highlighted by a recent federal court decision in California. In *Federal Deposit Insurance Corporation v. Matthew Perry*, No. CV 11-5561 ODW (MRWx) (December 13, 2011), the US District Court for the Central District of California ruled that, under California corporation law, the business judgment rule, as codified under §309 of the California Corporations Code, does not apply to decisions of corporate officers made on behalf of the corporation.

The Federal Deposit Insurance Corporation (FDIC), as receiver for Indymac Bank, F.S.B., sued defendant Perry alleging that, as Indymac Bank's former CEO, Perry breached his fiduciary duties by negligently allowing the bank to produce a pool of more than $10 billion in risky, residential loans for sale into the secondary market. As a result of volatility in the secondary market, the bank was forced to transfer the loans into its own investment portfolio which resulted in losses to the bank in excess of $600 million. In July of 2008, Indymac Bank closed and the FDIC was appointed as receiver.

Perry moved to dismiss the complaint on grounds that the FDIC failed to plead facts sufficient to overcome the presumption of the business judgment rule, and that the business judgment rule thus insulated him from personal liability relating to his alleged actions. The court denied the motion and held that the plaintiff was not required to plead around a defense based on the business judgment rule because the business judgment rule does not apply to corporate decisions of officers in California.

The court found no judicial precedent in California applying a common law business judgment rule to corporate officers, and relied on a decision by the California Court of Appeal holding that the judicial deference afforded under the business judgment rule does not apply to interested directors who were effectively acting as officers.[1] The court also examined the statutory language and legislative history of §309 of the California Corporations Code, which codifies California's common law business judgment rule, and concluded that when the California legislature had the opportunity to codify the rule, it purposely excluded any application to corporate officers.

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[1] *Gaillard v. Natomas*, 208 Cal.App.3d 1250, 1265 (1st Dist. 1989).

There is no express codification of the business judgment rule in Delaware. The law in Delaware is less clear on the application of the business judgment rule to officers. In *Gantler v. Stephens*, 965 A.2d 695 (Del. Supr. 2009), the plaintiff shareholders of a bank holding company brought a breach of fiduciary duty action against officers and directors of the company alleging, among other claims, that the defendant officers and directors violated their fiduciary duties by rejecting opportunities to sell the company and opting instead to reclassify the company's shares in order to benefit themselves.

The lower court granted defendants' motion to dismiss, partly on grounds that certain counts failed to allege facts sufficient to overcome the business judgment presumption, and the plaintiffs appealed. In addressing the claims made against the officers of the company, the Delaware Supreme Court held that the fiduciary duties of officers of Delaware corporations are the same as those of directors. In so doing, the court applied the same analysis to both officers and directors in concluding that the complaint pleaded facts sufficient to overcome the motion to dismiss.

Although the court did not explicitly hold that the business judgment rule applies to officers as well as directors, once it found that the plaintiffs pleaded sufficient facts to overcome the business judgment rule with respect to the defendant directors, it proceeded in the same vein to analyze and determine that the plaintiffs pleaded sufficient facts to state a claim of breach of fiduciary duties by the defendant officers.

With this latest federal district court ruling applying California law, corporate officers in California corporations and foreign corporations with sufficient contacts to be deemed quasi-California corporations under §2115 of the California Corporations Code are now on notice that, although they generally owe the corporation the same fiduciary duties as directors, they do not have the protection of the business judgment rule.

Under California law, if directors meet the requirements of the business judgment rule, they are entitled to immunity from personal liability for ordinary negligence.[2] Without the protection of the business judgment rule, however, officers may find themselves subject to the ordinary negligence standard when determining whether they are personally liable for breaching their duty of care under California law.[3]

With this latest federal district court ruling applying California law, corporate officers in California corporations and foreign corporations with sufficient contacts to be deemed quasi-California corporations under §2115 of the California Corporations Code are now on notice that, although they generally owe the corporation the same fiduciary duties as directors, they do not have the protection of the business judgment rule.

However, the decision in California should not come as a complete surprise when one considers certain fundamental distinctions between the respective roles of officers and directors. Unlike non-officer directors, officers have more direct knowledge of and access to the day-to-day operations and are typically the true managers and decision makers of the corporation.

Presumably, with the higher level of knowledge and involvement, and also compensation with respect to higher-level executives, comes a higher level of accountability and potential liability. The decision is also not so incongruous when viewed against the backdrop of the current socio-economic climate in the United States. The economy is still living with the hangover from the subprime mortgage crisis, and banks such as Indymac were active participants in that market. The public backlash exemplified by the "Occupy" protests throughout the country may also have influenced and manifested itself in the court's decision to some extent.

Officers of California corporations or foreign corporations with sufficient contacts to be deemed quasi-California corporations under §2115 of the California Corporations Code are well advised to be mindful of this recent decision. Without the protections of the business judgment rule in California, officers of corporations subject to California corporation law should assess what other

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[2] *FDIC v. Castetter*, 184 F.3d 1040 (9th Cir. 1999).

[3] *Burt v. Irvine Co.*, 237 Cal.App.2d 828 (1st Dist. 1965); *FDIC v. McSweeney*, 976 F.2d 532 (9th Cir. 1992).

available protections and rights are in place to mitigate potential personal liability.

Such an assessment should include, at a minimum, a review of indemnification provisions in the corporation's charter, applicable coverages and limits of D&O insurance policies and individual indemnity agreements between the corporation and its officers. These items may not provide the same substantive cover as the business judgment rule, but should under the appropriate circumstances provide an officer with the resources required to mount an adequate defense.

Officers may also find it prudent to document and maintain a record of the information, analysis and rationale behind their business decisions in order to have evidence available to defend against potential negligence claims.

Without the protections of the business judgment rule in California, officers of corporations subject to California corporation law should assess what other available protections and rights are in place to mitigate potential personal liability.

The bar for stating claims of breach of fiduciary duties against officers has been lowered under California law, and unless a California court concludes that the Perry court misapplied California law, such complaints are more likely to survive motions to dismiss.

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Let the Buyer Beware — And Carry a Big Seal!

A recent Delaware case regarding the interplay between contractual provisions and the statutory limitations period highlights the importance of the choice of governing law — and attention to technical details within a jurisdiction.

For this article, we look only to Delaware and New York for potential governing law. A survey of the statutes of limitations in 48 other states would be just too boring for the reader (and the writer).

The general statute of limitations for claims based on contract, including breach of contract, is three years in Delaware and six years in New York.

Let us assume that a purchase agreement with a typical set of negotiated time periods within which to give notice of a claim for indemnification of a breach of representation looks something like this:

- all representations survive the closing;
- the "basic representations," such as due organization, good standing, enforceability and authority, capitalization, brokers and finders, and perhaps related-party transactions, will survive "indefinitely" — or another way of saying this: "a claim may be made at any time";
- representations with respect to certain governmental matters (where the government might initiate action) — such as representations on taxes, employee benefits and environmental matters — will survive for the "statute of limitations applicable to the underlying claim"[1];
- all other representations survive for a stated period, such as two or three years.

Simply put: for this buyer to get the benefit of its bargained-for period in which to bring a claim for breach, the contract must be governed by Delaware law <u>and</u> it must be executed under seal.

[1] This might also include voluntary extensions of the statutory period. This provision must be clear that it refers to the applicable regulatory statute of limitations and <u>not</u> the state statute for breach of contract.

Otherwise, notwithstanding the words of the contract:

- a claim on basic representations must be made within three years of closing under Delaware law and within six years under New York law;[2]
- notwithstanding the reference to the "applicable statute of limitations," the period to make claims on "governmental representations" will likewise terminate in three years or six years under Delaware and New York law, respectively, unless the buyer can establish that the claim didn't accrue until well after the closing; and
- a claim on the balance of the representations will survive for the stated period under Delaware law but may survive for the full six-year period in New York if the time limitation is not carefully drafted.

Shortening the Statute of Limitations — Enforceable in Delaware, May be Enforceable in New York

In *GRT Inc.* v. *Marathon GFT Technology, Ltd. and Marathon Oil Company*,[3] the Delaware Court of Chancery held that a survival clause expressly terminating a representation after one year, and stating that the sole remedy for a breach of that representation terminated along with the representation itself, established a one-year limitations period. The Court noted that ***Delaware does not have a bias against contractual clauses that shorten the three-year statute of limitations for breach of contract claims***. The Delaware courts have held that an abbreviation of the time for filing a claim, so long as it is reasonable, complements the policy behind a statute of limitations — to discourage litigation of old or stale claims. However, the Court did not find that an "indefinite" survival period would <u>extend</u> the statute of limitations. Chancellor Strine stated that "a survival clause that states generally that the representations and warranties will survive closing, or one that provides that the representations and warranties will survive indefinitely, is treated as if it expressly provided that the representations and warranties would survive for the applicable statute of limitations."[4] Accordingly, a claim for a breach of these representations must be brought within the three-year period.

A survival clause in a contract governed by New York law may operate to shorten the statutory period. However, ***New York courts will strictly construe the language of a survival clause that reduces the period to make a claim***. The survival clause must contain clear and explicit language in order for a court to conclude that it will act to set the limitations period. This has developed out of a public policy concern that disfavors contract clauses that "limit the right to sue to a period shorter than that granted by statute . . . because they are in derogation of the statutory limitation. Hence, they should be construed with strictness against the party invoking them." *Hurlbut v. Christiano*, 405 N.Y.S. 2d. 871, 873 (App. Div., 4th Dep't, 1978).[5] In *Hurlbut*, the agreement included the following: "The parties hereto further agree that the representations and warranties set forth in Sections 4.01(d) and 4.03(g) of the Purchase Agreement between them dated February 29, 1972 shall survive the closing for a period of three (3) years." The Court found that "[t]he language of the agreement is clear and unambiguous and suggests nothing from which a shortened period of limitations can be inferred" — and that "[t]he parties neither expressly nor impliedly shortened the applicable six year Statute of Limitations."

Interestingly, in *GRT*, the Court expressly noted that it believed the survival clause at issue would satisfy the stricter standard of New York law, as it not only terminated the representations and warranties but also terminated the indemnification remedy for breach of the representations and warranties. The *GRT* court noted that the fact that indemnification was the sole remedy for breach, coupled with the survival clause applying to the indemnification right of the buyer, underscored "the parties' intention to make indisputably clear . . . that the Survival Clause was intended to establish the statute of limitations for

[2] Arguably, the 3- and 6-year periods may run from the date the agreement is signed.

[3] *GRT Inc. v. Marathon GFT Technology, Ltd. and Marathon Oil Company*, 2011 WL 2682898 (Del. Ch. July 11, 2011).

[4] *GRT Inc.* at 37.

[5] Also see *Dorff* v. *Taya*, 194 App Div 278 (First Department 1922).

claims alleging a breach of the [representations and warranties]."[6]

Extending the Statute of Limitations — Not Enforceable in Delaware or New York

Delaware courts have held that a contractual survival period which attempts to lengthen or extend the statute of limitations violates the public policy interests underlying statutes of limitation and will not be enforceable.[7]

Similarly, the parties to a contract governed by New York law cannot extend the statute of limitations beyond the legally prescribed period. New York law provides that an agreement to extend the limitations period to assert a claim for breach can be made only in writing after accrual of the cause of action for breach (*e.g.*, pursuant to a tolling agreement).[8] An agreement that would extend the period made prior to such accrual has no effect.

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Contracts Under Seal — 20 Year Statute of Limitations in Delaware; 6 Year Statute of Limitations in New York

There is an exception to the three-year statute of limitations in Delaware for contracts executed under seal. Delaware law provides that the limitations period for a breach of contract claim under a contract executed under seal (a "specialty contract") is 20 years. In *Whittington* v. *Dragon Group, et. al.*, 991 A.2d 1 (Del. 2009), the Delaware Supreme Court, after finding that the contract in dispute was executed under seal, reversed the Court of Chancery's ruling that a cause of action for breach of contract was barred by the three-year statutory period.[9] Writing for the majority, Justice Holland remarked that "one exception to the three-year statute of limitations for contract actions . . . is for contracts under seal, for which the common law twenty-year period applies."

The New York Code of Civil Procedure provides that an action upon a sealed instrument may be brought within six years after the accrual of a cause of action arising from it. As this limitations period is the same as the general statutory period for a breach of contract claim, the fact that a New York contract is executed under seal will not be effective to extend the limitations period.

How Do I Create a Seal?

The *Whittington* case involved a contract between individuals. The Court noted that "[i]n Delaware, in the case of an individual . . . the presence of the word 'seal' next to an individual's signature is all that is necessary to create a sealed instrument, irrespective of whether there is any indication in the body of the obligation itself that it was intended to be a sealed instrument."[10] In contrast, the Court cited cases holding that, in the case of corporations, the affixing of an actual seal in addition to contractual language affirming that the contract is being executed "under seal" may be required.

Accordingly, we recommend the following:

- if the party is an individual, the word "SEAL" should be included in parentheses by the name on the signature page;
- if the party is not an individual, it must affix a seal that was adopted by corporate board or equivalent entity-level action. In many cases, this

[6] *GRT Inc.* at 24.

[7] *Shaw v. Aetna Life Ins. Co.*, 395 A.2d 384, 386 (Del. Super. 1978) (citing *Keller v. President, Directors and Co. of Farmers Bank of State of Delaware*, 41 Del. 471 (Del. Super. 1942)).

[8] N.Y. Gen. Oblig. Law §17-103(1).

[9] The issue before the court was whether there was sufficient evidence that the document was under seal. The Court noted that while "documents of debt, such as mortgages or promissory notes, escape the three-year limitation if they contain the most minimal reference to a seal, actions arising from other types of contracts must show a clearer intent to enter into a contract under seal." *Whittington* at 18 (citing *Whittington v. Dragon Group L.L.C.*, C.A. No. 2291-VCP, 2008 WL 4419075 (Del. Ch. Sept. 30, 2008)).

[10] *Whittington* at 26-27 (internal quotations omitted).

will have been done as part of the initial organization process (most corporate by-laws include a provision establishing the corporation's seal), and

- in all cases, the document should recite that it is being signed under seal and each signature should be under seal.

Equally important: don't extend your agreement inadvertently by slapping one of those pretty gold seals on the last page. You may find you have a 20-year claims period you did not intend.

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Debt to Equity Conversions

As a result of current economic conditions, many companies have been having difficulty generating sufficient cash flow and net income to comply with their covenants and, often, satisfying their payment obligations under their existing credit facilities. Many of these companies seek to restructure their debt in order to avoid a bankruptcy proceeding. If such a restructuring is unsuccessful or unavailable, the company's creditors (including bank lenders) may force the company into a bankruptcy proceeding to take advantage of the protection afforded by such a proceeding. The ultimate outcome of either of these options is often conversion of lenders' existing debt into equity of the company.

The following are some important issues that should be considered in contemplating a debt to equity conversion.

1. Capital Structure

The existing capital structure must be analyzed and a determination made regarding what, if any, existing equity will remain outstanding after the restructuring and what, if any, rights the pre-restructuring equityholders (the "Pre-Equityholders") will have in the company following the restructuring. The Pre-Equityholders may retain only a nominal amount of the equity (or none at all) in the reorganized entity or may only receive warrants to acquire equity with certain exercisability triggers (*i.e.*, time vesting or requirements relating to the value of the company increasing by an amount that provides for the lenders to receive a certain percentage of their investment back). As described below, there will be various approvals necessary for the reorganization to be consummated. Therefore, providing the Pre-Equityholders with a continuing interest in the company may facilitate obtaining the necessary approvals.

2. Outstanding Debt

The terms of the outstanding debt must be analyzed, including the relative rights and preferences of the debtholders. If there are various classes of debt (secured, unsecured, senior, junior, etc.), a determination needs to be made as to how each of these classes will be treated in the proposed restructuring. The senior secured debtholders generally receive most, if not all, of the equity in the reorganized company. Holders of other classes of debt may receive equity that is subordinate to the equity to be received by the senior secured debtholders, such as common vs. preferred stock, or warrants that are exercisable when certain trigger events have been satisfied, usually relating to time vesting or valuation issues as noted above. In addition, consideration needs to be given to how much of the existing debt will be extinguished and if the company requires an additional working capital facility to continue operations after the restructuring.

3. Lenders as Equityholders

A major issue to be resolved in any debt to equity conversion relates to the manner in which the lenders will hold the equity to be issued in exchange for the debt to be extinguished. Choosing the appropriate method may be influenced by factors such as the number of lenders that will be receiving equity, such lenders' internal policies, the anticipated exit plan for the investment, regulatory restrictions and potential tax consequences of holding equity.

The two principal methods for lenders to hold equity are (a) directly, where each lender would own its percentage of the equity of the company, or (b) indirectly, through an entity such as a limited liability company (a "Holdco") in which each lender would hold its pro rata percentage of the equity of the Holdco. If there are relatively few lenders, or if there would be a public market for the shares following the restructuring, then it is likely that the lenders would want to hold the shares directly. If no public market exists and the lenders hold shares directly, then they will likely enter into a stockholders agreement to provide for certain rights relating to owning and transferring the shares.

These agreements typically provide for rights relating to appointing the board of directors, special voting rights, pre-emptive rights and agreements relating to transfer restrictions. The transfer restrictions may include rights of first refusal, tag-along and drag-along rights, restrictions on transferring to a competitor, and restrictions on transfers that would result in a change of control.

In addition, if the lenders are also funding a new working capital or credit facility, there may be requirements to keep the new debt and equity stapled for a period of time (*i.e.*, those who hold the debt must hold a proportionate amount of the equity and vice versa).

The two principal methods for lenders to hold equity are (a) directly, where each lender would own its percentage of the equity of the company, or (b) indirectly, through an entity such as a limited liability company (a "Holdco") in which each lender would hold its pro rata percentage of the equity of the Holdco.

The other principal way for lenders to hold equity issued in the conversion of debt is indirectly through a Holdco where each lender receives an interest in the Holdco and the Holdco owns the equity of the company. As members of the Holdco, which often will be structured as a limited liability company, the lenders would become parties to a limited liability company agreement. This limited liability company agreement would contain arrangements with respect to the management of the Holdco and transfer restrictions similar to those described above for the stockholders agreement.

It may also contain specific provisions to determine how the Holdco will vote on certain matters presented to Holdco as the equityholder of the underlying company. Having the lenders hold their equity through a Holdco may be helpful for the ultimate sale of the company as the company will have one controlling shareholder, assuming the Pre-Equityholders and management receive only a small piece of the equity.

This would facilitate a sale of the equity of the company as the Holdco would be able to approve a sale of assets or merger of the company, subject to the special voting rights that are contained in the limited liability company agreement. The Holdco would also be able to sell the shares it owns in the company without requiring each lender to individually sell its shares. In addition, if the lenders hold the equity through a Holdco, they will not hold both the debt and the equity of the same entity, which could raise equitable subordination issues. In determining how the lenders would hold their shares, each lender will need to review their individual needs.

4. Corporate Governance Issues

The lenders will need to decide how involved they want to be in the management of the company. If they have a majority of the equity they will have the right to elect a majority of the board of directors, or all directors, subject to rights they agree to give to Pre-Equityholders, subordinated debt or management to have representatives on the board. Often, these rights are provided to the lenders receiving the larger equity stakes in the company, but they may also be provided to the former administrative agent who has historically served as the representative of the lenders.

A determination needs to be made as to the size of the board, management's role on the board and the inclusion or exclusion of outside directors on the board, including, if desired, recruiting such outside directors. Some lenders may not want to be involved directly on the board and may rely on independent directors that the company may retain. In some cases, there may be trigger events that change the composition of the board, such as changes in ownership percentages, satisfaction of certain financial conditions, passage of time.

5. Approvals

If the restructuring is acceptable outside of a bankruptcy proceeding, then (a) the existing credit documents will govern what percent of the lenders need to approve modifications to the existing arrangements, and (b) the existing shareholder agreements (or similar agreements), bylaws and applicable corporate law will govern what approvals are required by the equityholders and board of directors of the company.

In a bankruptcy reorganization, the lender approvals needed will be determined by the bankruptcy plan, which plan the board of directors of the company must, and the bankruptcy court will need to, approve. There are no equityholder approvals necessary. In certain out-of-court restructurings, the lenders may also request releases from the equityholders to confirm that they have no further rights in the company. Typically, these will only be obtainable if the Pre-Equityholders receive some equity in the reorganized company.

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6. Management

In order to retain those members of management who the lenders desire to retain or to attract new management members, the lenders will have to determine what type of compensation, including incentive compensation, should be offered, such as whether such incentive compensation will take the form of equity in the restructured company.

Since companies considering debt to equity conversions are often short on cash, equity compensation may be able to provide compensation to key employees who can't otherwise get salary increases. Such equity incentive can be in several different forms, including direct equity, equity with vesting restrictions, options to acquire equity at a later date or if certain targets are met, and phantom equity. As described below, there will also be tax consequences to management that receives equity compensation.

7. Tax Consequences

The tax consequences of converting debt to equity must be analyzed. Certain lenders may have already taken write-downs on their debt. If this is the case, those lenders will have a different basis in the equity they receive than other lenders. The tax consequences to the company will depend on a number of factors. If the company is a partnership, such tax consequences will flow through to the current owners of the partnership.

If the company is a corporation, the exchange of debt for equity will result in taxable cancellation of indebtedness (COD) income to the extent that the amount of debt forgiven exceeds the value of the equity that is received in the exchange unless (i) the company is insolvent, or (ii) the exchange is made pursuant to a reorganization approved by the bankruptcy court.

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To the extent that the company is not required to recognize taxable income as a result of having COD income, certain favorable tax attributes — primarily, net operating loss carryovers (NOLs) — will be reduced. Moreover, use of the company's remaining NOLs following a change with respect to the ownership of its equity will be limited. The impact of such limitation may sometimes be reduced by advance tax planning.

In addition, the tax rules with respect to the application of the post-ownership limitation on the use of NOLs are, in the case of a bankruptcy reorganization, dependent on an election that may be available to the company. In addition, depending on the type of equity to be granted under the management incentive plan, and the value of the equity at the time of issuance, management may have taxable income on the equity it receives, either at the date of grant or at a later date.

The type of equity to be provided to management will also have different tax consequences to the company. Although lenders should not have adverse tax consequences due to holding the equity directly or through a Holdco, it should be noted that lenders who exchange indebtedness with an initial maturity of more than five years may not be permitted to claim a current tax loss even though the fair market value of the equity received is less that the amount of the indebtedness that is exchanged therefor in the reorganization.

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