



M&A and Corporate Governance Newsletter

District Court Rules on Allergan’s Insider Trading Claims Against Valeant and Pershing Square

Court Raises Serious Questions About the Legality of the Tactics Employed but Declines to Enjoin Hostile Bidders from Voting Shares

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On November 4, 2014, the district court in *Allergan, Inc. v. Valeant Pharmaceuticals Int’l, Inc.*, Case No. SACV 14-1214 (C.D. Cal.) ruled on Allergan’s claims that Pershing Square Capital Management, L.P., a hedge fund that teamed up with Valeant in its battle for control of Allergan, committed insider trading in violation of Securities Exchange Act Section 14(e) and Rule 14e-3 when it caused a jointly funded special purpose entity (the JV entity) to purchase a 9.7 percent stake in Allergan prior to Valeant’s commencement of a tender offer for all outstanding Allergan shares. In ruling on Allergan’s motion for a preliminary injunction, the court found that Allergan had raised serious questions going to the

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merits of the insider trading claim. However, the court declined to enjoin the JV entity from voting the shares at an upcoming special meeting of shareholders because Allergan failed to show that it would suffer irreparable harm.

The court first found that plaintiffs had raised serious questions as to whether Valeant had taken substantial steps to commence the tender offer prior to the JV entity's acquisition of shares.

In February 2014, Valeant and Pershing Square entered into a letter agreement that outlined a plan for acquiring control of Allergan. Between February and April, Pershing Square acquired 9.7 percent of Allergan's shares through the JV entity at a cost of more than \$3 billion, \$75.9 million of which was contributed by Valeant. In June 2014, Valeant publicly announced a tender offer for all outstanding Allergan shares. Valeant and Pershing Square also commenced a consent solicitation to call a special meeting of stockholders in order to remove six directors from Allergan's nine-person board as part of a plan to gain control of the Allergan board. Allergan agreed to hold a special meeting on December 18, 2014. Among the litigation brought in connection with the hostile offer, Allergan filed an action in the District Court for the Central District of California alleging various violations of federal law by Pershing Square and Valeant in connection with their tender offer and proxy solicitation. Allergan sought a court order that would preliminarily enjoin the JV entity from voting or exercising any ownership privilege over its 9.7 percent stake in Allergan, and preliminarily enjoin Valeant and Pershing Square from voting any proxies at the special

meeting until corrective disclosures were made to their proxy materials.

The main issue before the court was whether the purchase of the 9.7 percent stake constituted insider trading in violation of Section 14(e) and Rule 14e-3. Section 14(e) is an anti-fraud rule applicable to tender offers. Rule 14e-3(a) provides, in relevant part, that once an "offering person" has taken "a substantial step or steps" to commence a tender offer, any other person who is in possession of material nonpublic information relating to the tender offer which the person acquired from the offering person must abstain from trading or disclose the information prior to trading. The court first found that plaintiffs had raised serious questions as to whether Valeant had taken substantial steps to commence the tender offer prior to the JV entity's acquisition of shares. The court based its finding on factors such as: the Valeant board having met multiple times to discuss a combination with Allergan with the understanding (evidenced by board materials) that there was a high likelihood that a transaction would involve a hostile tender offer; Valeant having hired three law firms and contacted bankers to begin due diligence; Valeant representatives having executed a confidentiality agreement and a letter agreement with Pershing Square, the latter contemplating a detailed plan by which the acquisition would be accomplished; and Valeant and Pershing Square having formed a JV entity and referred to themselves as co-bidders. All of these steps preceded the date of the acquisition of the shares by the JV entity.

The court then considered whether Pershing Square could be considered a co-offering person, so that its conduct falls outside the prohibition of Rule 14e-3. The court held that

the term “offering person” in Rule 14e-3 encompassed the possibility that two or more persons may act together as one “offering person.” The court noted the absence of legal authority addressing the difference between a co-offering person and any other person for purposes of Rule 14e-3. Looking in part to the SEC’s multi-factored test for “bidder” and “offeror” for Regulation 14D purposes and prior case law, the court stated that an offeror “should be more than a financier, and should actually make an offer to purchase shares and should have some degree of control over the terms of the tender offer and over the surviving entity.” In addition, the designation “offering person” should also further Rule 14e-3’s purpose of “limiting the universe of persons permitted to trade on insider information only to the person making the tender offer,” and thus the court emphasized factors such as control over the terms of the offer, the surviving entity and the named bidder. In applying the test to Pershing Square, the court recognized that Pershing Square played an active role in helping Valeant craft its strategy and finance its offer. However, it noted that Pershing Square had no control over the offer price or consideration mix, the bidding entity or withdrawal of the offer, did not appear likely itself to ever hold any Allergan shares, and was not seen by Valeant as a co-bidder other than for SEC purposes. Given these facts, the court found that plaintiffs had raised serious questions regarding whether Pershing Square was a co-offeror exempt from Rule 14e-3’s “disclose or abstain” rule, and therefore also serious questions going to the merits of plaintiffs’ Rule 14e-3 claim.

The court found that plaintiffs had raised serious questions regarding whether Pershing Square was a co-offeror exempt from Rule 14e-3’s “disclose or abstain” rule.

In considering plaintiffs’ requests that the JV entity be enjoined from exercising any voting or other ownership privileges over the 9.7 percent stake at the December shareholders meeting, the court noted the absence of any final determination of facts, the novel issues of law, and the speculative nature of irreparable harm. The court found that plaintiffs had not demonstrated a likelihood of harm given the large number of intervening events that would have to occur, including defendants prevailing at the shareholder meeting to remove directors and in connection with a subsequent Delaware court proceeding to force an election at which their nominees would be eligible to join the board. As a result, the court declined plaintiffs’ request for a preliminary injunction. The court did, however, require defendants to make corrective disclosures in their proxy materials pursuant to various disclosure claims also made by plaintiffs.

The court’s decision leaves Valeant free to continue its hostile bid for Allergan. However, continuation of the bid is not without risks. The court left open the possibility that Pershing Square may be found liable for insider trading in violation of Rule 14e-3 in connection with the JV entity’s acquisition of a 9.7 percent stake. If Pershing Square is ultimately found liable, damages could be in the hundreds of millions, or possibly billions, of dollars. Valeant’s increasing the offer price and completing the offer is likely to only increase the potential damages, given that it will increase the disparity between what

former shareholders received from the JV entity for their shares and what they could have received in the tender offer. Valeant has significant indemnification obligations to Pershing Square under their letter agreement, and will need to factor in the potential damages as an additional cost to the deal.

The court's decision leaves Valeant free to continue its hostile bid for Allergan. However, Pershing Square may be found liable for insider trading in violation of Rule 14e-3.

In addition, the court noted defendants' statements in their proxy statement that if they are successful in removing the Allergan directors and if the remaining Allergan directors do not put the Valeant nominees on the Allergan board, the defendants will file a lawsuit in the Delaware Court of Chancery to force an election. Section 223(c) of the Delaware General Corporation Law provides that if at the time of filling a board vacancy the directors then in office constitute less than a majority of the whole board, holders of at least 10 percent of the voting stock can petition the Court of Chancery to order an election to fill the vacancies. However, Allergan can raise the potential violation of Rule 14e-3 in any such case in an argument that Valeant should not be permitted to avail itself of Section 223(c) because it would be profiting from its own violation of law. Delaware courts have recognized that "inequitable action does not become permissible because it is legally possible." See, e.g., *Schnell v. Chris-Craft Industries*, 285 A.2d 437, 439 (Del. 1971).

As the *Allergan* court noted in denying a preliminary injunction, the court's decision falls far short of determining the outcome of the Pershing Square/Valeant takeover attempt. However, the decision provides a cautionary note to any hedge funds or strategic acquirers contemplating similar partnerships. (See our [earlier article](#) for other reasons for caution.) The decision also serves as a reminder to boards of directors that they have possible defenses through assertion of the federal securities laws when faced with an activist attack. Boards of directors continue to have a duty to take action that they believe serves the best long-term interests of the corporation and its stockholders.



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Divorce—Limited Liability Company Style

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In forming a limited liability company, members are generally focused on issues relating to management, capital obligations and transfer restrictions. Sometimes they also consider how matters should be handled if arrangements don't work out as expected. Because members of a limited liability company generally spend a significant amount of time negotiating their limited liability company agreement, it is important that they consider including provisions on potential breakups. Even if these issues have been discussed and memorialized in the limited liability company agreement, the Delaware LLC Act provides the Court of Chancery the ability to intervene in a dissolution. In *Comerica Bank v. Global Payments Direct*, C.A. No. 9707-CB (Del. Ch. Aug. 1, 2014), Chancellor Bouchard of the Delaware Court of Chancery appointed a liquidating trustee to assist with and oversee the winding up of Global Payments Comerica Alliance LLC (Alliance), pursuant to Section 18-803(a) of the Delaware Limited Liability Company Act (the Act), at the request of Comerica Bank and over the objections of Global Payment Direct, Inc. (Global Direct).

Comerica Bank and Global Direct were the sole members of Alliance, and they disagreed on how to wind up the company. Comerica Bank claimed that Global Direct was intentionally delaying and inhibiting Alliance's wind up for its sole gain and as retribution for Comerica Bank's termination of its service agreement with Global Direct. Until the windup of Alliance was completed, Global Direct continued to receive payments from

Alliance. The court determined that Global Direct had the right to dissolve Alliance, but that a liquidating trustee needed to be appointed to conduct the wind up. This was despite the fact that the Alliance limited liability company agreement had specific provisions authorizing Global Direct to wind up the company under certain circumstances (which the court determined had occurred). Section 18-803(a) of the Act permits the Court of Chancery to "wind up [a] limited liability company" upon application and a showing of "cause" by any member of a limited liability company and in connection therewith, appoint a liquidating trustee pursuant to the Act.

The term "cause" is not defined in the Act. The court looked to precedent to determine the meaning of "cause" in this context. In *Spellman*, the court determined that the requisite cause to appoint a liquidating trustee was established by the members' inability, unwillingness and contractual obligation to implement the wind-up process following dissolution. Two years later, in *Phillips*, the court again appointed a liquidating trustee after finding that the members' history of large and small disputes effectively created a deadlock with regard to winding up the LLC. Based on these cases, the court determined that cause exists to appoint a liquidating trustee when "the history of the parties suggest(s) they would be unable or unwilling to undergo a wind-up process in an orderly or timely manner."

Although the Act provides the court with the ability to intervene, it is surprising that it would do so under these circumstances given the court's deference to the contractual rights of parties to a limited liability company agreement. This was not a situation where the parties had been silent on dissolution procedures, or one in which the language in the limited liability company agreement was ambiguous. In this situation, Global Direct owned a 51 percent equity interest in Alliance, had the right to appoint three of the five representatives managing the company, had the right to dissolve the company upon the occurrence of certain events and had the right to wind up the company following such dissolution.

In determining that the appointment of a liquidating trustee was warranted, the court considered the parties' interactions since 2013 and concluded that the record "amply demonstrate[d]" that the parties were deeply divided over how to wind up Alliance, and that Global Direct had "taken a confrontational approach antithetical to [its] obligation to wind up Alliance promptly so as to maximize the value of the property to be distributed to its members." Global Direct's approach included an alleged tripling of its fees, stalling regarding a split of Alliance's merchant portfolio of customers between Global Direct and Comerica Bank, and refusing Comerica Bank's request for Alliance's merchant information to begin its transition away from Alliance to a new processor. The court also considered Comerica Bank's delay in notifying Global Direct about the details of its information request, but noted that this delay "pale[d] in comparison" to Global Direct's efforts to "string out the wind-up process as long as possible to Comerica's detriment." The court also noted that managers of an LLC owe

fiduciary duties, which include obligations to distribute the assets of the company promptly and consistent with maximizing the value of those assets in connection with the winding up. Fiduciary duties were recently added to the provisions of the Delaware LLC Act, however, the LLC Act also provides that members may waive some duties (excluding the implied contractual covenant of good faith and fair dealing) (see Section 18-1101 of Delaware LLC Act). In Alliance, the members had not waived any of the fiduciary duties. Global Direct's delaying the wind up to serve its own self-interest influenced the court's determination that "cause" existed in this scenario.

The court's deviation from its practice of relying on the contractual provisions agreed to by the parties when one party is using such provisions for its own benefit makes this case noteworthy.

The court has only appointed a liquidating trustee pursuant to Section 18.803(a) of the Act a handful of times in the last 10 years. However, the court's deviation from its practice of relying on the contractual provisions agreed to by the parties when one party is using such provisions for its own benefit makes this case noteworthy.

In negotiating an LLC agreement, clients should address possible divorce situations. LLCs are somewhat different than corporations, as the law permits greater flexibility regarding dissolution procedures if the LLC agreement provides such provisions. If the assets of a company are unique or not easily devisable among the partners, the LLC agreement should provide some mechanism to dispose of those assets in an equitable manner

(i.e., a sale of the assets to a third party, a method to distribute certain assets to specified members or a buy-out provision between the members). If the Alliance LLC Agreement had included this type of specific distribution provision, Comerica would likely have had a contractual claim to enforce the LLC agreement terms, rather than needing to resort to the court to appoint a third-party liquidating trustee.



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Chancery Court Decision Provides Further Guidance on When a Minority Stockholder Will Be Deemed to Be a Controlling Stockholder

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The Delaware plaintiffs' bar continues to look for novel ways to argue that the entire fairness standard, rather than the business judgment rule, should be applied in the review of mergers and other business combination transactions. A recent decision by Chancellor Bouchard of the Delaware Chancery Court¹ addressed the novel question of whether a one percent stockholder of a Delaware corporation could be deemed a controlling stockholder—thus owing fiduciary duties to the other stockholders—in a case involving a merger of a company in which KKR owned one percent of the outstanding shares, and where the company was subject to a management agreement with a KKR affiliate.

On April 30, 2014, KKR & Co. L.P. (KKR) acquired KKR Financial Holdings LLC (KFN) in a merger approved by the stockholders of KFN, including a majority of the outstanding KFN common shares not held by KKR and its affiliates. An affiliate of KKR managed the day-to-day business of KFN under a management agreement, making KFN dependent on KKR for day-to-day operations. KKR owned less than one percent of the outstanding common shares of KFN.

Nine lawsuits were filed in Chancery Court challenging the transaction; these were consolidated and the operative complaint alleged that the KFN board breached its

fiduciary duties by approving the merger, that KKR breached its duty as a controlling stockholder by causing KFN to enter into the merger agreement and that KKR and its subsidiaries aided and abetted the KFN breach of duty.

Plaintiffs sought to rebut the presumption of the business judgment rule, alleging that KKR was a controlling shareholder of KFN. Plaintiffs contended that KKR dominated and controlled KFN by virtue of the management agreement by which the KKR affiliate provides all of KFN's management and operations. KFN had disclosed that it had no separate employees and that it was completely reliant on its manager under the management agreement. The management agreement could only be terminated under certain conditions, and plaintiffs alleged that if the management agreement was terminated without cause at the end of 2012, the termination fee would have exceeded the cash and cash equivalents on its balance sheet at that time. The management agreement did explicitly provide that KFN was subject to the supervision of KFN's board of directors.

Chancellor Bouchard reviewed the law regarding controlling stockholders, explaining that a less-than-50-percent stockholder could be a controlling stockholder if it "exercised control over the business affairs of the

¹ *In re KKR Fin. Holdings LLC Shareholder Litig.*, No. CIV.A. 9210-CB, 2014 WL 5139489 (Del. Ch. Oct. 14, 2014)

corporation.”² Then-Vice Chancellor Strine had found in 2003 that a 35 percent stockholder could be a controlling stockholder where he was the company’s visionary founder, a hands-on chairman and CEO, and, in practical terms, held “a large enough block of stock to be the dominant force in any contested [Company] election.”³ Then-Vice Chancellor Strine explained in 2006, however, that the “actual control” test “is not easy to satisfy” and “can only be met where stockholders, although lacking a clear majority, have such formidable voting and managerial power, that they, as a practical matter, are no differently situated than if they had majority voting control.”⁴ Strine noted that this theory of control is premised on the idea that “the controller’s power is so potent that independent directors and minority stockholders cannot freely exercise their judgment, fearing retribution from the controller.”⁵

The Chancellor explained that the one percent position would create no concern that KKR had sufficient voting power to remove the directors if they rejected the merger.

Chancellor Bouchard explained that Delaware case law has focused on control of the board in considering if a less-than-50-percent stockholder is a controlling stockholder, noting that in a 2006 case the court had rejected the idea that separately negotiated contract rights could supply the requisite

degree of control. There the court held that the concern is that the shareholder will “use its power to obtain (or compel) favorable action **by the board.**”⁶ The court held that the allegation that the contracting party had taken advantage of its contractual rights for its own purposes was, without more, insufficient to allege that the contracting party is a controlling stockholder bound by fiduciary duties. In 2013, then-Chancellor Strine again held that the analysis for determining when a minority stockholder will be deemed controlling focuses on the stockholder’s alleged ability to control the board, explaining “**the minority blockholder’s power must be ‘so potent that independent directors . . . cannot freely exercise their judgment, fearing retribution’ from the controlling minority holder.**”⁷

In the case of KFN, plaintiffs argued that KKR had actual control over the corporate conduct of KFN because of the management agreement. Chancellor Bouchard agreed that these allegations demonstrate that KKR, through its affiliate, managed the day-to-day operations of KFN, but held that they did not support a reasonable inference that KKR controlled the KFN board “such that the directors of KFN could not freely exercise their judgment in determining whether or not to approve and recommend to stockholders a merger with KKR.” The Chancellor explained that the one percent position would create no concern that KKR had sufficient voting power to remove the directors if they rejected the merger. No facts were alleged that there was any right by KKR to appoint any members of the board, to veto any board action or to

² *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1113-14 (Del. 1994).

³ *In re Cysive, Inc. S’holders Litig.*, 837 A.2d 531, 551-52 n. 30 (Del. Ch. 2003).

⁴ *In re PNB Holding Co. S’holders Litig.*, 2006 WL 2403999, at *9 (Del. Ch. 2006).

⁵ *Id.*

⁶ *Superior Vision Servs., Inc.*, 2006 WL 2521426, at *4 (emphasis added).

⁷ *In re Morton’s Restaurant Group, Inc. Shareholders Litigation*, 74 A.3d 656 (Del. Ch. 2013)(emphasis added).

prevent the board from hiring advisors and gathering information to be fully informed. There was no “coercive power over the board’s ability to independently decide whether or not to approve the merger.”

The Chancellor explained that there were no well-plead facts to permit an inference that KKR could veto any action of the KKR board, or that “KKR had the power to exact retribution by removing KFN directors from their offices if they did not bend to KKR’s will in their consideration of the proposed merger.”

Chancellor Bouchard did note that there was one case in which the Chancery Court held that two stockholders (Cox and Comcast) who together held 17.1 percent of the voting stock of At Home were reasonably inferable as controlling stockholders, placing “significant weight on the ability of the stockholders to ‘shut down the effective operation of the At Home board of directors by vetoing board actions.’”⁸ In the current case, the Chancellor explained that there were no well-plead facts to permit an inference that KKR could veto any action of the KKR board, or that “KKR had the power to exact retribution by removing KFN directors from their offices if they did not bend to KKR’s will in their consideration of the proposed merger.” Thus the plaintiffs failed to demonstrate that KKR was a controlling stockholder under Delaware law.

Plaintiffs also argued that four of the eight independent directors were tainted by their relationships with KKR, and thus not independent. Chancellor Bouchard found that

there were insufficient facts to infer that any of these four KFN directors were not disinterested and independent. Chancellor Bouchard explained that a director’s independence is not compromised by virtue of being nominated to a board by an interested stockholder, that a director who served as an officer in another company with four KKR-affiliated directors was not compromised where KKR affiliates did not constitute a majority of that company’s board and did not have the power to hire or promote the office, and that the “naked assertion of a prior business relationship” is not enough to overcome a presumption of independence. In this factual setting, plaintiffs needed to allege facts giving rise to a reasonable inference that the particular director was currently beholden to the other party to the merger, here KKR.

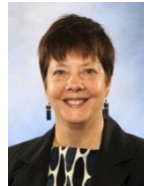
Plaintiffs needed to allege facts giving rise to a reasonable inference that the particular director was currently beholden to the other party to the merger.

Chancellor Bouchard also held that even if plaintiffs had alleged sufficient facts to reasonably support an inference that a majority of the KFN board was not disinterested or independent, the business judgment review standard would still apply where a majority of KFN’s disinterested stockholders approved the merger in a fully-informed vote. The consolidated complaint was therefore dismissed with prejudice.

While this case demonstrates the difficulty of plaintiffs alleging that a non-majority stockholder is a controlling stockholder owing fiduciary duties to the other stockholders, it is worth keeping in mind that the facts drive the application of the review standard. Thus, in

⁸ *Williamson v. Cox Communications, Inc.*, 2006 WL 1586375, at *5 (Del. Ch. 2006)

situations where a significant stockholder seeks to exercise its power, or some directors have current relationships with the significant stockholder or its affiliates from which a quid pro quo or possible ability to coerce action could be inferred, the board should take care to interpose independent directors not tainted by any such inference to make any decisions in which the significant stockholder might have an interest.



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Delaware Court's *Quadrant* Decision Provides That Directors Pursuing Risky Business Strategies in Insolvencies Will Be Subject to Business Judgment Rule Standard Even Where Creditors Bear the Downside Risk

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A recent decision in the Delaware Court of Chancery, *Quadrant Structured Products Co., Ltd. v. Vertin*, C.A. No. 6990–VCL, 2014 WL 5099428 (Del. Ch. Oct. 1, 2014), offers critical insight into how courts evaluate the fiduciary responsibilities of directors of insolvent firms, especially in instances where conflicted directors prioritize a controlling shareholder's interests to the detriment of senior creditors. Among other things, *Quadrant* emphasizes that a business decision made by the board of an insolvent firm affecting the value of the entity *as a whole* will receive considerably more deference than a decision that transfers value directly and exclusively to the controlling party.

Facts

Athilon is a credit derivative product company that became insolvent in late 2008 after making \$368 million in termination payments on credit default swaps it had guaranteed on behalf of a subsidiary. As originally drafted, Athilon's operating guidelines closely restricted its business activities and the types of investments it could make. In addition, the guidelines required Athilon to gradually wind itself up in the event of a credit rating downgrade, which it eventually received as a result of its capital deficiency.

In 2010, EBF & Associates (now Merced Capital) gained control of Athilon by purchasing all of Athilon's junior subordinated notes and subsequently all of its equity. To exert influence, EBF designated four individuals on Athilon's five-member board, including one of its own partners, an EBF attorney and a former EBF employee.

The plaintiff, Quadrant, holds certain senior debt securities issued by Athilon. As a creditor of an insolvent firm, Quadrant is allowed under Delaware law to bring derivative actions for breach of fiduciary duty against the firm and its directors.¹ In this case, Quadrant's complaint alleged three primary fiduciary breaches on the board's part, all of which involved contentions that Athilon's directors used the company's assets to benefit the controlling entity, EBF, instead of trying to maximize the company's economic value on behalf of its senior creditors.

The first alleged breach concerned the board's decision to relax the investment restrictions in Athilon's operating guidelines, which allowed the company to implement a high-risk/high-reward strategy with its remaining resources. As the plaintiff noted in its complaint, EBF

¹ See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

bore none of the downside risk involved in the new strategy because EBF's equity and junior debt investments were already underwater at the time of the shift. Instead, 100 percent of the risk fell to the senior creditors, like Quadrant, who would have recouped all of the company's remaining value if Athilon had continued with its orderly liquidation. Because EBF was also in position to capture all of the potential benefit of the riskier strategy by virtue of its controlling stake in Athilon, the plaintiff alleged that Athilon's directors had impermissibly acted contrary to the senior creditors' interests in breach of their fiduciary duties.

Unlike the first alleged breach, the second and third contested board actions involved actual transfers of value from Athilon to EBF. Specifically, the second allegation accused the board of refusing to exercise its right to defer the interest payments on EBF's junior notes. The third alleged breach concerned the board's decision to pay increased, above-market fees to one of EBF's affiliates despite a substantial reduction in the amount of services the affiliate provided to Athilon. The plaintiff argued that an independent board presented with either situation would have elected to conserve such funds for Athilon's senior creditors instead of allowing EBF to recover them.

Athilon and the individual director defendants moved to dismiss Quadrant's complaint.

The court held that the board's decision to pursue a riskier business strategy was entitled to a high degree of deference, as applied under the "business judgment" doctrine.

Analysis

The Delaware Court of Chancery (Laster, VC) allowed the plaintiff's claims regarding the interest payments and fees to go forward but dismissed the claim regarding Athilon's new "risk-on" business approach. Importantly, the court decided to grant "business judgment" deference to the shift in strategy, whereas the board's other contested decisions prompted a stricter, "entire fairness" review, thus allowing the related claims to avoid dismissal.

The court held that the board's decision to pursue a riskier business strategy was entitled to a high degree of deference, as applied under the "business judgment" doctrine, because the plaintiff had not shown that the board's decision was irrational or in bad faith despite the apparent conflict of interest. The key factor in the court's analysis was the notion that the board's risk-on strategy would affect the value of the company *as a whole*, as opposed to transferring value to a particular person or class of stakeholders. In summarizing its conclusion, the court declared that "when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others." *Quadrant*, 2014 WL 5099428 at *21. In addition, the court

noted that allowing creditors of insolvent companies to assert these kinds of fiduciary claims would create a conflict for directors in that directors would be tasked with both maximizing enterprise value and safeguarding individual creditors' interests simultaneously.

The court declared that “when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others.”

In contrast, the court applied a more exacting degree of scrutiny to the board's decisions to defer the payments on EBF's notes and to pay the elevated fees to EBF's affiliate. The court's analysis highlighted the variation in the allocation of fiduciary responsibility that hinges on a wholly owned subsidiary's status as solvent or insolvent: in a solvent scenario, the court noted, a transfer of value between the subsidiary and its 100 percent shareholder cannot result in a fiduciary wrong because the directors of the subsidiary are acting solely for the benefit of the parent. In an insolvent scenario, however, the subsidiary's creditors join with shareholders as residual beneficiaries of any increase in value; therefore, any actual *transfer* of assets out of the insolvent subsidiary to its parent benefits the shareholder class at the expense of the creditor class. In this case, the court recognized that EBF stood on both sides of each flow of funds from Athilon, its insolvent subsidiary, thus giving rise to a potential fiduciary wrong and requiring an elevated level of review.

Conclusion

Ultimately, this outcome provides a measure of support for directors of insolvent firms who choose to pursue more risky business strategies instead of adopting conservative, potentially lower return strategies, even if the riskier approaches may negatively affect senior lender recoveries. However, where a conflict of interest is apparent, the board of an insolvent company should expect that the entire fairness doctrine will continue to be the operative standard by which directors are judged in instances where they authorize a transfer of value directly from an insolvent entity to a controlling entity or its affiliate.



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Damages Awarded Against RBC Capital Markets in Rural/Metro Corporation Stockholders Litigation

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On October 10, 2014, Vice Chancellor Travis Laster issued a decision in the damages phase of the Rural/Metro Corporation Stockholders Litigation, awarding the stockholder class damages against RBC Capital Markets LLC (RBC) of \$75,798,550.33, together with interest on the damage award from the merger closing date of June 30, 2011 through the date of payment. His decision discusses the appropriate measure of damages for breaches of fiduciary duty in merger and acquisition transactions, rights of contribution among joint tortfeasors, the impact of settlements by some defendants on the claims against non-settling defendants and the interplay of these issues with the exculpation permitted by Section 102(b)(7) of the Delaware General Corporation Law.

Background

The litigation arises from the sale process conducted by Rural/Metro Corporation (Rural or the Company) that resulted in its acquisition by Warburg Pincus LLC (Warburg) on June 30, 2011. The plaintiffs asserted claims for breaches of fiduciary duty against the members of Rural's board of directors and claims for aiding and abetting those breaches against Rural's financial advisors (RBC and Moelis & Company LLC (Moelis)), the buyer (Warburg and its acquisition subsidiaries) and the Company. Prior to trial, the plaintiffs dropped their claims against Warburg and its acquisition subsidiaries and against the one member of the board of directors who had

not voted on the merger.¹ Moelis and the directors settled before trial for payments to the class of \$5 million and \$6.6 million, respectively. The terms of each settlement included dismissal with prejudice of the claims against the settling defendants, a general release of the settling defendants on behalf of all class members and a bar of claims against the settling defendants by any other defendant, whether for contribution or otherwise. The settlements were approved by the court, and RBC asserted cross-claims against the settling defendants solely for purposes of determining the degree, if any, to which any damage award against RBC would be reduced by reason of the settlement (i.e., the cross-claims did not seek recovery of damages from the settling defendants).

The case proceeded to trial solely against RBC, and Vice Chancellor Laster issued a decision on March 7, 2014 holding RBC liable for aiding and abetting breaches of fiduciary duty by the directors. He identified the following breaches by the directors:

- Allowing one of the directors, Christopher Shackelton (Shackelton), and RBC "to initiate a sale process for the Company in December 2010, without board authorization and contrary to the board's

¹ Vice Chancellor Laster's opinion noted that the complaint "oddly" named the Company as a defendant, since neither the breach of fiduciary duty nor the aiding and abetting breaches of fiduciary claims can be asserted against the corporation that the fiduciaries serve.

instruction that the Special Committee should simply pursue ‘an in-depth analysis of the alternatives discussed during the [March 8, 2010] meeting.’” A factor in that claim was the court’s finding that RBC had designed the sale process with a view to obtaining a role for RBC in the financing of the expected acquisition of Emergency Medical Services Corporation (EMS), without having disclosed that purpose to the board.

- The board’s approval of the merger only three hours after receipt of valuation information from its financial advisors and without knowledge of what the court found to be RBC’s manipulation of valuation metrics.
- Disclosure to stockholders in the proxy statement that RBC had used “Wall Street research analyst consensus projections” to derive the Company’s EBITDA. That disclosure was inaccurate; RBC used EBITDA derived from the Company’s actual reported results without adjustment for one-time expenses, which was contrary to the Wall Street consensus.
- Disclosure to stockholders that RBC had been permitted to offer staple financing because “it could provide a source for financing on terms that might not otherwise be available to potential buyers of the Company...” The court found that statement to be false, noting that the board had never concluded that RBC could provide financing that would otherwise not be available and no evidence to that effect was introduced at the trial.
- Failure to disclose to stockholders “how RBC used the initiation of the Rural sale process to seek a role in the EMS acquisition financing,” the fees RBC

received from the EMS acquisition financing and RBC’s efforts to obtain a role in the financing of Warburg’s acquisition of the Company at the same time as it was preparing its fairness opinion.

As the directors and Moelis had settled, the parties did not request the court to—and it did not—determine whether the directors’ breaches were breaches of the duty of care or of the duty of loyalty or whether they had failed to act in good faith. These questions were not relevant to RBC’s liability since Vice Chancellor Laster concluded that RBC’s liability for aiding and abetting breaches of fiduciary duty would not be affected by exculpation under Section 102(b)(7) of the directors who committed the breaches of fiduciary duties.²

Vice Chancellor Laster concluded that RBC’s liability for aiding and abetting breaches of fiduciary duty would not be affected by exculpation under Section 102(b)(7) of the directors who committed the breaches of fiduciary duties.

Damages

Having found that the sale process had been compromised by the defendants’ breaches of fiduciary duty, the court determined that the appropriate measure of damages was the “fair” or “intrinsic” value of the Rural stock at the time of the merger, less the price actually paid in the merger—a “quasi-appraisal” remedy. The court did not require the plaintiffs to show a direct relationship between the defendants’ breaches and the amount of

² See [Delaware Chancery Court Holds Investment Bank Liable for Aiding and Abetting Exculpated Director Breach of Fiduciary Duties](#), Kaye Scholer Mergers & Acquisitions Alert dated March 17, 2014.

damages. Instead it appears to have proceeded on the basis of an unstated assumption that stockholders would have received the “fair” or “intrinsic” value of their shares if the defendants had not breached their fiduciary duties. After considering the conflicting evidence presented by the parties’ respective experts, the court determined the “fair” or “intrinsic” value of Rural at the time of the merger to have been \$21.42 per share, resulting in damages of \$4.17 per share after subtracting the \$17.25 per share paid in the merger. The class held 21,900,133 shares at the time of the merger, resulting in total damages of \$91,323,554.61.

If the directors and Moelis had not settled, all defendants found to have any liability would have been jointly and severally liable for the entire amount of the damages. But they had settled on terms that barred any claims for contribution by RBC pursuant to 10 *Del. C.* §6304(b), which provides:

A release by the injured person of 1 joint tortfeasor does not relieve the 1 joint tortfeasor from liability to make contribution to another joint tortfeasor unless the release is given before the right of the other tortfeasor to secure a money judgment for contribution has accrued, and provides for a reduction, to the extent of the pro rata share of the released tortfeasor, of the injured person’s damages recoverable against all the other tortfeasors.

The effect of Section 6304(b) is that RBC would be entitled to a reduction in the damages awarded against it (a settlement credit) if the settling defendants were joint

The effect of Section 6304(b) is that RBC would be entitled to a reduction in the damages awarded against it (a settlement credit) if the settling defendants were joint tortfeasors from whom RBC could have sought contribution in the absence of the settlement.

tortfeasors from whom RBC could have sought contribution in the absence of the settlement. In evaluating whether and to the extent to which RBC was entitled to a settlement credit, Vice Chancellor Laster considered the following:

Is Contribution Available for Intentional Torts?

Plaintiffs argued that because RBC’s liability was based on intentional conduct, it would not have been entitled to contribution and thus was not entitled to any settlement credit. After noting that the relevant statute in Delaware does not bar contribution for intentional torts, the court reviewed relevant Delaware and other case law—the official commentary to the Uniform Act on which the Delaware statute was based and the Restatement of Torts—and concluded that there was no bright-line rule in Delaware that would make contribution unavailable for intentional torts, although the court recognized that there were some circumstances in which a court could deny an intentional tortfeasor contribution (e.g., the intentional infliction of physical injury). The court concluded that the intentional nature of RBC’s conduct would not have barred it from seeking contribution.

Equitable Defenses

The plaintiffs argued that the doctrines of *in pari delicto* and unclean hands would have barred RBC from obtaining contribution and

thus should bar it from receiving a settlement credit. The court concluded that the *in pari delicto* doctrine was inapplicable because RBC did not engage in criminal or illegal conduct, but concluded that the unclean hands doctrine would have been available to bar contribution from a joint tortfeasor who was defrauded by RBC. The court held that because RBC affirmatively misled the directors with respect to the facts giving rise to the disclosure claims in the case and misled them both affirmatively and by omission in connection with the final approval of the merger, RBC would not have been able to obtain contribution from the directors with respect to those claims and was thus not entitled to any settlement credit. The court held that RBC would not be barred from seeking contribution from directors with respect to the claims relating to the initiation of the sale process.

Joint Tortfeasor Status— Preliminary Matters

The plaintiffs argued that RBC should not be allowed to argue that the settling defendants were joint tortfeasors since it failed to assert that claim at trial and RBC argued that the fact of the settlement established that the settling defendants were joint tortfeasors. The court rejected both arguments, permitting RBC to argue, based on the existing record in the case, that it had met its burden of establishing that settling defendants were joint tortfeasors.

Section 102(b)(7)

RBC argued that the liability phase of the trial had established that the settling directors had breached their fiduciary duties, which should be dispositive as to whether they were joint tortfeasors from whom contribution could be obtained. The court concluded that the determination of breach, though a necessary

element of joint tortfeasor status, was not sufficient; the directors would not be joint tortfeasors liable for contribution unless they would have had monetary liability to the plaintiffs for the underlying claim despite the exculpation permitted by Section 102(b)(7). Ultimately, the court held that RBC had met its burden of establishing the unavailability of exculpation only with respect to Shackelton and one other director.³

Moelis

The court determined that RBC had not met its burden of showing that Moelis was a joint tortfeasor that would have been liable to the plaintiffs, noting that Moelis “played a secondary role in advising the Board” and had not been found to have conflicting interests similar to RBC’s or to have provided misleading information.

Based on this analysis, the court found that RBC, Shackelton and one other director were joint tortfeasors for purposes of the contribution/settlement credit analysis, but did not accept RBC’s argument that each should have equal responsibility (resulting in a settlement credit equal to two-thirds of the total damages). Instead, it allocated a share of the total damages to each breach. It first weighted the disclosure claims and the sale process claims equally; since RBC would not have been entitled to contribution with respect to the disclosure claim as a result of its unclean hands, responsibility for 50 percent of the total damage award was allocated to RBC.

³ Allocation of the burden to RBC appears to have been significant. The court made its determination based on the record already established at a trial that was not focused on the liability of alleged joint tortfeasors and considered the issue to be a close one with respect to a third director who had not testified at trial. The court noted that it would take a “powerful and persuasive evidentiary showing” to establish that a director acted disloyally or in bad faith when the court did not have an opportunity to evaluate his credibility.

The sale process claims, which accounted for the remaining 50 percent, were then divided between those relating to initiation of the sale process and those relating to approval of the merger and each of those was weighted equally (25 percent each). RBC's unclean hands would have denied it contribution with respect to the claims relating to the approval of the merger, increasing the total allocation to RBC to 75 percent. The court allocated the 25 percent relating to initiation of the sale process 10 percent to Shackelton, 8 percent to RBC and 7 percent to the third director, so that RBC was held responsible for 83 percent of the total damages and entitled to a settlement credit of 17 percent.⁴

The court found that RBC, Shackelton and one other director were joint tortfeasors for purposes of the contribution/settlement credit analysis, but did not accept RBC's argument that each should have equal responsibility.

Attorneys' Fees

In late October 2014, plaintiffs filed a motion for attorneys' fees equal to one-third of the total damages awarded (including interest) and sought to recover those fees from RBC (and not from the damages award), alleging that RBC had conducted the litigation in bad faith. RBC has not yet responded.



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⁴ Settlement credit is generally the greater of the amounts paid in settlement and the share of the aggregate liability allocable to joint tortfeasors liable for contribution. Since 17 percent of the total damages exceeded the total amount of the settlement payments, the court did not need to decide whether RBC could claim a settlement credit for settlement payments made by parties that were not found to be joint tortfeasors.

Ninth Circuit Court of Appeals Holds MD&A Disclosure Rules Do Not Create a Duty to Disclose Under Rule 10b-5

Nicholas O'Keefe Partner

In upholding the district court's dismissal of a securities fraud action against NVIDIA Corporation and other defendants, the Court of Appeals in *In re: NVIDIA Corporation Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014) held that the duty of disclosure under Item 303 of Regulation S-K is not actionable under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The decision sensibly avoids turning the MD&A section of periodic reports into a back door for plaintiffs' firms to bring Rule 10b-5 actions.

Plaintiff shareholders claimed that NVIDIA knew it would be liable for the defective products long before the 2008 disclosure, and should have informed investors several months before it did. Plaintiffs claimed that NVIDIA's failure to inform investors, in light of other statements regarding its financial condition in NVIDIA's SEC filings, constituted a violation of Section 10(b) and Rule 10b-5. The district court dismissed plaintiffs' amended complaint, holding it failed to sufficiently plead *scienter*. Among their arguments on appeal, plaintiffs claimed that the district court erred in failing to consider their allegations of *scienter* in the context of Item 303 of Regulation S-K. Plaintiffs claimed that Item 303 requires disclosure of certain

information, and if that information is material, failure to disclose it constitutes a material omission for purposes of Section 10(b) and Rule 10b-5. Plaintiffs claimed that an analysis should be undertaken to determine whether the defendants acted with *scienter* in violating Item 303's disclosure requirements.

In addressing the material misstatement or omission requirement, the appellate court noted that neither Section 10(b) nor Rule 10b-5 creates an affirmative duty to disclose all material information.

In considering plaintiffs' claims, the appellate court first set forth the following six elements for establishing a violation of either Section 10(b) or Rule 10b-5: (1) a material misrepresentation or omission by the defendant; (2) *scienter*; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. Pursuant to the Private Securities Litigation Reform Act of 1995 (the PSLRA), a

complaint must plead both falsity and *scienter* with particularity.

Item 303's disclosure standard is very different from the materiality test set forth in *Basic*.

In addressing the material misstatement or omission requirement, the appellate court noted that neither Section 10(b) nor Rule 10b-5 creates an affirmative duty to disclose all material information. The appellate court cited the rule in *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) that “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.” However, the appellate court noted, the *Basic* court did not explain what would give rise to a duty to disclose. The appellate court noted that while it was an issue of first impression in the Ninth Circuit, precedent strongly suggested that Item 303 does not create such a duty to disclose. The appellate court then referenced with approval the reasoning in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), where the court in that case explained that Item 303's disclosure standard is very different from the materiality test set forth in *Basic*.

Item 303 requires “disclosure of known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” According to SEC interpretive guidance, determining whether disclosure is required under Item 303 entails a two-part test. If the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, no disclosure is

required. If management cannot make the determination, an evaluation is required of the consequences if it comes to fruition.

Disclosure is required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. The *In re NVIDIA* appellate court contrasted that test with the test regarding the materiality of forward-looking information set forth in *Basic*, which depends “upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” The appellate court noted that management's duty to disclose under Item 303 is much broader than the duty to disclose under *Basic*. Thus, “because the materiality standards for Rule 10b-5 and Item 303 differ significantly, the demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5.” In upholding the district court's failure to consider plaintiffs' allegations of *scienter* in the context of Item 303, the appellate court held that “Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5. Such a duty to disclose must be separately shown according to the principles set forth by the Supreme Court in *Basic and Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011).”

Because the materiality standards for Rule 10b-5 and Item 303 differ significantly, the demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5.

The plaintiffs in *In re NVIDIA* tried to use the MD&A disclosure rules as a tool to help them avoid dismissal. The decision will be welcomed by issuers and securities lawyers responsible for drafting those sections of periodic reports. Note that the decision does not address other potential duties to disclose. For example, in reaching its decision, the court distinguished actions brought under Sections 11 and 12(a)(2) of the Securities Act of 1933, where liability arises from “an omission in contravention of an affirmative legal disclosure obligation,” as compared to Section 10(b), where disclosure is not required

unless omission of the information “would cause other information that is disclosed to be misleading.” The decision also does not address the potential duty to update statements made in press releases or otherwise outside the context of Item 303. Issuers and their counsel should therefore continue to be vigilant of their duty to provide materially complete disclosure in their SEC filings and other public disclosure documents.



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UK Court Sheds Light on De Facto and Shadow Directors

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In *Smithton Ltd v Naggarr*,¹ the Court of Appeal has further delineated the boundaries between the board of a company and its shareholders. The judgment is instructive of the English courts' current approach to defining the role of director, as well as addressing a question which often arises in practice—whether a director of a holding company is also a director of its subsidiary. While the decision reminds us that it is what someone actually does rather than job titles that matters, it might also provide some reassurance that investors' active stewardship of portfolio companies will not necessarily result in board-level responsibility.

When Is Someone a Director?

This is a crucial question in light of the myriad statutory and common law duties incumbent on directors, including their potential personal liability when things go wrong. As per Section 250 of the Companies Act 2006 (CA), a “director” includes any person occupying the position of a director, by whatever name called. Under English law, there are three classes of director: de jure, de facto and shadow directors. A de jure director is one who is formally appointed as director in accordance with a company's constitutional documents. A de facto director exercises the duties of a director but is not formally appointed.² A shadow director is defined in

Section 251 CA as a person in accordance with whose directions or instructions the directors of a company are accustomed to act.³

The case of *Smithton* provides insight on factors the court will take into account when determining the existence of a de facto directorship. The issue in the case was whether Naggarr, a de jure director of a former holding company (DDI), was also the de facto director of its subsidiary joint venture brokerage company, Hobart, and had subsequently infringed his directorial duties. At trial, as on appeal, the issue of de facto and shadow directors was dealt with simultaneously with the former being given greater consideration as befitting the facts of the case.

The High Court held that Naggarr was not a de facto or shadow director of Hobart because he was acting at all times in a different capacity or wearing a different “hat” to that of a director of Hobart.

director. Since then, the definition has expanded to include those who hold themselves out as director (*Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180). At present, the leading case on the matter is the Supreme Court decision in *HMRC v Holland* [2010] 1 WLR 2793 which considers the acts of the director and whether the acts fall within the ambit of the director's duties.

¹ *Smithton Ltd (formerly Hobart Capital Markets Ltd) v Guy Naggarr* [2014] EWCA Civ 939.

² Prior to the 1980s, the term “de facto director” was used in cases where the appointment requirements had not been complied with or where someone ceased to be a formal

³ However, a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity.

First Instance

The High Court held that Naggar was not a de facto or shadow director of Hobart because he was acting at all times in a different capacity or wearing a different “hat” to that of a director of Hobart. While it was not at trial disputed that Naggar’s conduct was “directorial” in nature, it was held that, when considered objectively, such conduct was also capable of being attributed to his other roles as chairman of the majority shareholder or as a major client and furthermore that, in fact, Naggar had acted in such other capacity. In support of her finding of fact the judge at first instance referred to the existence of a detailed joint venture agreement (JVA) which, among other things, included a schedule of reserved matters requiring the consent of the majority shareholder and prescribed the constitution of Hobart’s board. Significantly, the JVA did not provide for Naggar to be a director of Hobart. It was also found that in its dealings with third parties, including regulatory authorities, Hobart had never held out Naggar as one of its directors and there was no evidence that a majority of Hobart’s board was accustomed to acting in accordance with Naggar’s instructions. Furthermore, the court noted that Naggar had not held himself out as a director and had never attended board meetings.

Court of Appeal

The Court of Appeal was not persuaded to set aside the High Court’s judgment that Naggar had not been involved in Hobart’s affairs in the capacity as a director of Hobart and unanimously dismissed Hobart’s appeal. The court referred to the leading case of *Holland*.¹ In that case, the Supreme Court (by a majority

of three) decided that a director of a corporate director, which was the sole director of 43 trading subsidiaries, was not a de facto director of the trading subsidiaries, as the director had only acted “within his ambit” as a director of the corporate director. The Court of Appeal in *Smithton* adopted the capacity-based approach in *Holland*.² Determining “capacity” is a matter of assessing the evidence, taking into account all the circumstances, and the Court of Appeal was not prepared to overrule the High Court’s findings in that regard.

The Court of Appeal in *Smithton* adopted the capacity-based approach in *Holland*. Determining “capacity” is a matter of assessing the evidence, taking into account all the circumstances, and the Court of Appeal was not prepared to overrule the High Court’s findings in that regard.

Lady Justice Arden, giving the main judgment in *Smithton*, specifically cited Lord Collins’ holding in *Holland* that there is no definitive test for a de facto director. She did, however, identify a number of points arising out of *Holland* and previous cases which she described as being of general practical

¹ *HMRC v Holland* [2010] 1 WLR 2793.

² Lord Collins was conscious of the principle of separate legal personality in English corporate law and did not want to impose fiduciary or legal duties on a director whose acts were only referable to a corporate director and not the trading subsidiaries. The dissenting judgments in *Holland*, namely that of Lord Walker, felt that this enabled individuals to use artificial corporate structures to evade liability to the detriment of unsecured creditors; especially when, in substance, the director is the only ‘person’ running the show. Perhaps due, in part, to the *Holland* case, there is currently a bill before Parliament which, if it becomes law, would prevent the appointment of corporate directors (clause 76, Small Business, Enterprise and Employment Bill 2014).

importance in determining who is a de facto director:

- The concepts of shadow director and de facto director are different but there is some overlap.
- A person may be a de facto director even if there was no invalid appointment. The question is whether he had assumed responsibility to act as a director.
- To answer that question, the court may have to determine in what capacity the director was acting (as in *Holland* and *Smithton*).
- The court will in general¹ also have to determine the corporate governance structure of the company so as to decide, in relation to the company's business, whether the individual's acts were directorial in nature.
- The court is required to look at what the director actually did and not any job title actually given to him.
- A defendant does not avoid liability if he shows that he in good faith thought he was not acting as a director. The question whether or not he acted as a director is to be determined objectively and irrespective of the defendant's motivation or belief.
- The court must look at the cumulative effect of the activities relied on and at all the circumstances in the round.
- It is also important to look at the acts in their context. A single act might lead to liability in an exceptional case.

- Relevant factors include:
 - Whether the company considered the defendant to be a director and held him out as such; and
 - Whether third parties considered that he was a director.
- The fact that a person is consulted about directorial decisions, or that his approval is sought, does not in general make him a director because he is not making the decision.
- Acts outside the period when he is said to have been a de facto director may throw light on whether he was a de facto director in the relevant period.
- A de facto or shadow director's role need not cover all of a company's activities; and
- Whether a person is a de facto or shadow director is a question of fact and degree.

Conclusion

The Court of Appeal's judgment in *Smithton* would appear to support the view that a person acting like a director will not necessarily be a director; to be so, there must be sufficient evidence to establish that, in fact, a person was acting in the capacity of director and not in a different capacity. That said, in the absence of a clear judicial test to answer the question—when is someone a director—the risks of ambiguous or informal corporate governance structures, where roles are blurred, is self-evident. Cases like *Smithton* and *Holland* remind us of the importance of effective corporate governance structures,

¹ As noted above, this was less relevant in *Smithton* because the defendant had accepted that his conduct was 'directorial' in nature.

supported by detailed constitutional documents which set out the often overlapping yet distinct roles and responsibilities of directors, investors and other key players, with regular board meetings which are properly minuted to record what was decided, by whom and in what capacity.



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