Gantler v. Stephens (Del 2009)
The duties to which corporate officers are subject are essentially the same as the duties which apply to directors, however officers may be at greater risk of being held to be liable in damages for their breaches of duty than directors. DGCL s 102(b)(7), which allows corporations to insulate directors from liability in damages for breach of the duty of care, does not apply to corporate officers. In this case shareholders alleged that officers and directors of First Niles Financial Inc. breached their fiduciary duties by rejecting a valuable opportunity to sell the company, by deciding to reclassify the company's shares to benefit themselves, and by distributing a materially misleading proxy statement to induce the shareholders to approve the reclassification. . What follows is from the Delaware Supreme Court's judgment:

In late 2003, First Niles was operating in a depressed local economy, with little to no growth in the Bank's assets and anticipated low growth for the future. At that time Stephens, who was Chairman, President, CEO and founder of First Niles and the Bank, was beyond retirement age and there was no heir apparent among the Company's officers. The acquisition market for banks like Home Federal was brisk, however, and First Niles was thought to be an excellent acquisition for another financial institution. Accordingly, the First Niles Board 3 sought advice on strategic opportunities available to the Company, and in August 2004, decided that First Niles should put itself up for sale (the "Sales Process")....
...on April 18, 2005, Stephens circulated to the Board members a document describing a proposed privatization of First Niles ("Privatization Proposal"). That Proposal recommended reclassifying the shares of holders of 300 or fewer shares of First Niles common stock into a new issue of Series A Preferred Stock on a one-to-one basis ... The Series A Preferred Stock would pay higher dividends and have the same liquidation rights as the common stock, but the Preferred holders would lose all voting rights except in the event of a proposed sale of the Company. The Privatization Proposal claimed that the Reclassification was the best method to privatize the Company because it allowed maximum flexibility for future capital management activities, such as open market purchases and negotiated buy-backs. Moreover, First Niles could achieve the Reclassification without ... having to buy back shares in a fair market appraisal...
...In the Reclassification Proxy, the Board represented that the proposed Reclassification would allow First Niles to "save significant legal, accounting and administrative expenses" relating to public disclosure and reporting requirements under the Exchange Act... The Proxy also disclosed the benefits of deregistration as including annual savings of $142,500 by reducing the number of common shareholders, $81,000 by avoiding Sarbanes-Oxley related compliance costs, and $174,000 by avoiding a one-time consulting fee to design a system to improve the Company's internal control structure. The negative features and estimated costs of the transaction included $75,000 in

Reclassification-related expenses, reduced liquidity for both the to-be-reclassified preferred and common shares, and the loss of certain investor protections under the federal securities laws...

The Reclassification Proxy also disclosed alternative transactions that the Board had considered, including a cash-out merger, a reverse stock-split, an issue tender offer, expense reduction and a business combination. The Proxy stated that each of the directors and officers of First Niles had "a conflict of interest with respect to [the Reclassification] because he or she is in a position to structure it in such a way that benefits his or her interests differently from the interests of unaffiliated shareholders." The Proxy further disclosed that the Company had received one firm merger offer, and that "[a]fter careful deliberations, the board determined in its business judgment the proposal was not in the best interests of the Company or our shareholders and rejected the proposal."

The Company's shareholders approved the Reclassification on December 14, 2006... the trial court concluded that of the 1,384,533 shares outstanding and eligible to vote, 793,092 shares (or 57.3%) were voted in favor and 11,060 shares abstained. Of the unaffiliated shares, however, the proposal passed by a bare 50.28% majority vote....

Count I of the complaint alleges that the defendants breached their duties of loyalty and care as directors and officers of First Niles by abandoning the Sales Process. Specifically, plaintiffs claim that the defendants improperly: (1) sabotaged the due diligence aspect of the Sales Process, (2) rejected the First Place offer, and (3) terminated the Sales Process, all for the purpose of retaining the benefits of continued incumbency.... the Court of Chancery analyzed Count I under the business judgment standard, and concluded that the Count I allegations failed to rebut the presumption of business judgment. Because the Board had "initiated the Sales Process on its own accord, seemingly as a market check as part of an exploration of strategic alternatives[,]" that supported the Board's stated business purpose -- to reduce corporate expense associated with federal securities law compliance. The Vice Chancellor also concluded that the complaint failed to plead facts sufficient to infer disloyalty, and that given the Board's extensive discussions with, and receipt of reports from, the Financial Advisor, and given the involvement of specially retained Outside Counsel, the alleged facts were insufficient to establish a violation of the duty of care. The court therefore concluded that the challenged conduct was entitled to business judgment protection...

...We conclude that the Court of Chancery erroneously dismissed Count I of the complaint ...

...A board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework. In that context the board is entitled to a strong presumption in its favor, because implicit in the board's statutory authority to propose a merger, is also the power to decline to do so...

...Our analysis of whether the Board's termination of the Sales Process merits the business

judgment presumption is two pronged. First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly? For the Board's decision here to be entitled to the business judgment presumption, both questions must be answered affirmatively...

Here, the plaintiffs allege that the Director Defendants had a disqualifying self-interest because they were financially motivated to maintain the status quo. A claim of this kind must be viewed with caution, because to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological. By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain corporate control, other facts sufficient to state a cognizable claim that the Director Defendants acted disloyally...

..The plaintiffs have done that here. At the time the Sales Process was terminated, the Board members were Stephens, Kramer, Eddy, Zuzolo and Gander. Only Gander voted to accept the First Place merger bid. The pled facts are sufficient to establish disloyalty of at least three (i.e., a majority) of the remaining directors, which suffices to rebut the business judgment presumption. First, the Reclassification Proxy itself admits that the Company's directors and officers had "a conflict of interest with respect to [the Reclassification] because he or she is in a position to structure it in a way that benefits his or her interests differently from the interest of the unaffiliated stockholders." Second, a director-specific analysis establishes.. that a majority of the Board was conflicted.

Stephens: Aside from Stephens losing his long held positions as President, Chairman and CEO of First Niles and the Bank, the plaintiffs have alleged specific conduct from which a duty of loyalty violation can reasonably be inferred. Stephens never responded to Cortland's due diligence request. The Financial Advisor noted that Stephens' failure to respond had caused Cortland to withdraw its bid. Even after Cortland had offered First Niles an extension, Stephens did not furnish the necessary due diligence materials, nor did he inform the Board of these due diligence problems until after Cortland withdrew. Cortland had also explicitly stated in its bid letter that the incumbent Board would be terminated if Cortland acquired First Niles. From these alleged facts it may reasonably be inferred that what motivated Stephens' unexplained failure to respond promptly to Cortland's due diligence request was his personal financial interest, as opposed to the interests of the shareholders. That same inference can be drawn from Stephens' response to the First Place bid: Count I alleges that Stephens attempted to "sabotage" the First Place due diligence request in a manner similar to what occurred with Cortland.

Thus, the pled facts provide a sufficient basis to conclude, for purposes of a .. motion to dismiss, that Stephens acted disloyally.

Kramer: Director Kramer's alleged circumstances establish a similar disqualifying conflict. Kramer was the President of William Kramer & Son, a heating and air

conditioning company Click for Enhanced Coverage Linking Searchesin Niles that provided heating and air conditioning services to the Bank. It is reasonable to infer that Kramer feared that if the Company were sold his firm would lose the Bank as a client. The loss of such a major client would be economically significant, because the complaint alleges that Kramer was a man of comparatively modest means, and that his company had few major assets and was completely leveraged. Because Kramer would suffer significant injury to his personal business interest if the Sales Process went forward, those pled facts are sufficient to support a reasonable inference that Kramer disloyally voted to terminate the Sales Process and support the Privatization Proposal.

Zuzolo: ... Director Zuzolo was a principal in a small law firm in Niles that frequently provided legal services to First Niles and the Bank. Zuzolo was also the sole owner of a real estate title company that provided title services in nearly all of Home Federal's real estate transactions. Because Zuzolo, like Kramer, had a strong personal interest in having the Sales Process not go forward, the same reasonable inferences that flow from Kramer's personal business interest can be drawn in Zuzolo's case.

In summary, the plaintiffs have alleged facts sufficient to establish, for purposes of a motion to dismiss, that a majority of the First Niles Board acted disloyally. Because a cognizable claim of disloyalty rebuts the business judgment presumption, we need not reach the separate question of whether, in deciding to terminate the Sales Process, the Director Defendants acted advisedly (i.e., with due care). Because the claim of disloyalty was subject to entire fairness review, the Court of Chancery erred in dismissing Count I as to the Director Defendants on the basis of the business judgment presumption...

In dismissing Count I as to the Officer Defendants, the Court of Chancery similarly erred. The Court of Chancery has held, and the parties do not dispute, that corporate officers owe fiduciary duties that are identical to those owed by corporate directors.That issue--whether or not officers owe fiduciary duties identical to those of directors--has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold. The only question presented here is whether the complaint alleges sufficiently detailed acts of wrongdoing by Stephens and Safarek to state a claim that they breached their fiduciary duties as officers. We conclude that it does.

..Stephens and Safarek were responsible for preparing the due diligence materials for the three firms that expressed an interest in acquiring First Niles. The alleged facts that make it reasonable to infer that Stephens violated his duty of loyalty as a director, also establish his violation of that same duty as an officer. It also is reasonably inferable that Safarek aided and abetted Stephens' separate loyalty breach. Safarek, as First Niles' Vice President and Treasurer, depended upon Stephen's continued good will to retain his job and the benefits that it generated. Because Safarek was in no position to act independently of Stephens, it may be inferred that by assisting Stephens to "sabotage" the due diligence

process, Safarek also breached his duty of loyalty.
The Court of Chancery found otherwise. Having characterized Safarek's actions as causing "a delay of a matter of days, or at most a couple of weeks," the Vice Chancellor observed that he could not see how that "conceivably could be a breach of Safarek's fiduciary duties." This analysis is inappropriate on a motion to dismiss. The complaint alleges that Safarek never responded to Cortland's due diligence requests and that as a result, Cortland withdrew a competitive bid for First Niles. Those facts support a reasonable inference that Safarek and Stephens attempted to sabotage the Cortland and First Place due diligence process. On a motion to dismiss, the Court of Chancery was not free to disregard that reasonable inference, or to discount it by weighing it against other, perhaps contrary, inferences that might also be drawn. By dismissing Count I as applied to Stephens and Safarek as officers of First Niles, the trial court erred.
..In granting defendants' motion to dismiss Count II, the Court of Chancery ruled that the defendants' allegedly misleading disclosures and non-disclosures relating to the Sales Process and Reclassification were immaterial, because they did not alter the "total mix" of information available to shareholders. Plaintiffs appeal only from certain of those materiality rulings. With respect to the Sales Process, the plaintiffs claim that the complaint adequately alleges that the defendants failed to disclose: (i) the circumstances of Cortland's withdrawal and (ii) insufficient deliberations by the Board before deciding to reject the First Place bid. With respect to the Reclassification, plaintiffs claim that the complaint adequately alleges that (iii) the defendants were motivated by a desire to increase their ability to effect stock buy-backs and increase the liquidity of participants in the Employee Stock Ownership Plan ("ESOP"). By holding otherwise, plaintiffs contend, the Court of Chancery reversibly erred.... We conclude that the Proxy disclosures concerning the Board's deliberations about the First Place bid were materially misleading. Because we reverse the dismissal of Count II on that basis, we do not reach the plaintiffs' remaining disclosure claims...
It is well-settled law that "directors of Delaware corporations [have] a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." That duty "attaches to proxy statements and any other disclosures in contemplation of stockholder action." The essential inquiry here is whether the alleged omission or misrepresentation is material. The burden of establishing materiality rests with the plaintiff, who must demonstrate "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."...
The plaintiffs claim that ... because the Proxy disclosures were materially misleading, no fully informed shareholder vote took place. The plaintiffs also urge that in determining the number of unaffiliated shares that were voted, the Court of Chancery took improper judicial notice of shares owned by the defendants. The defendants respond that the Vice Chancellor's ratification ruling is correct and should be upheld. Alternatively, they argue

that we should overturn the Vice Chancellor's determination that the Board had a disqualifying self-interest.
We conclude that the Court of Chancery legally erred in upholding Count III on shareholder ratification grounds, for two reasons. First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.
...Under current Delaware case law, the scope and effect of the common law doctrine of shareholder ratification is unclear, making it difficult to apply that doctrine in a coherent manner....
..To restore coherence and clarity to this area of our law, we hold that the scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action)...
To avoid confusion about the doctrinal clarifications ... we note that they apply only to the common law doctrine of shareholder ratification. They are not intended to affect or alter our jurisprudence governing the effect of an approving vote of disinterested shareholders under 8 Del. C. § 144.
The Court of Chancery held that although Count III of the complaint pled facts establishing that the Reclassification Proposal was an interested transaction not entitled to business judgment protection, the shareholders' fully informed vote "ratifying" that Proposal reinstated the business judgment presumption. That ruling was legally erroneous, for several reasons. First, the ratification doctrine does not apply to transactions where shareholder approval is statutorily required. Here, the Reclassification could not become legally effective without a statutorily mandated shareholder vote approving the amendment to First Niles' certificate of incorporation. Second, because we have determined that the complaint states a cognizable claim that the Reclassification Proxy was materially misleading... that precludes ruling at this procedural juncture, as a matter of law, that the Reclassification was fully informed. Therefore, the approving shareholder vote did not operate as a "ratification" of the challenged conduct in any legally meaningful sense.”