

NACD Event Highlights

Breakfast with the Delaware Chancery November 10, 2009

Breakfast event speaker Stephen P. Lamb stepped down as Vice Chancellor of the Delaware Chancery Court in June 2009. In his position as one of five jurists on the primary court for disputes involving Delaware corporations, Vice Chancellor Lamb has heard many of the most important recent cases regarding standards and practices in corporate governance. Before being appointed to the Delaware Chancery bench in 1997, he practiced for a number of years in the area of corporate and securities litigation in Delaware, at first with Skadden, Arps, Slate Meagher and Flom, and then as a principal in several smaller firms.

Introduced by John Reed, partner with the law firm of Edwards Angell Palmer & Dodge, Vice Chancellor Lamb discussed some of this year's Delaware Chancery Court decisions in the areas of review standards for certain merger transactions, the fiduciary duty of directors to effectively manage business risk, and governance policy on director elections.

Vice Chancellor Lamb first commented on a recent Delaware Chancery Court decision (*Hammons*) that provided new guidance on the corporate governance provisions necessary to ensure applicability of the business judgment standard of review to merger transactions in which a controlling stockholder receives a different price for tendered shares than minority stockholders. In any transaction involving a controlling stockholder, the key question for minority stockholders is whether they are receiving a fair price for their shares.

In a previous decision (*Kahn v. Lynch Communication Systems*) the Chancery ruled that in a cash-out merger transaction, the controlling stockholder has the burden of meeting entire fairness review – establishing that minority stockholders received a fair deal and a fair price – rather than the more lenient business judgment standard. In deciding *Hammons*, the court denied each party's motion for summary judgment, leaving the issue up in the air for now.

However, the Chancery's *Hammons* decision indicates that it would be advantageous for boards involved in this type of merger to (1) establish a functional, independent special committee to negotiate the transaction, (2) maintain a policy of full disclosure to all stockholders, and (3) condition the transaction on approval by a majority of all the minority stockholders – including those not voting.

Vice Chancellor Lamb then turned to a February 2009 Chancery Court decision in a lawsuit brought by shareholders against current and former directors of Citigroup. Courts have long held that directors have certain duties to monitor certain types of corporate risk. This includes ensuring the adequacy of internal control systems, monitoring legal compliance, and assuring that corporate executives and employees faithfully maintain standards of business ethics. Shareholders in *Citigroup* alleged that the company's current and former directors breached their fiduciary duty by failing to properly monitor, manage and disclose the company's exposure to risk in the subprime lending market.

In *Citigroup*, the Chancery ruled against the shareholders, basing its decision in large part on the business judgment rule, holding that Citigroup's board did not fail to execute their fiduciary duty to monitor risk, but rather, while paying sufficient attention to risk management, failed to recognize the company's subprime lending problems and thus made decisions that, in hindsight, proved to be bad. The court said that a ruling in favor of the plaintiffs would have required the court to do precisely the kind of management second guessing that business judgment review guards against.

Against the backdrop of growing shareholder interest in proxy access, Vice Chancellor Lamb concluded his prepared remarks by highlighting a recent Chancery Court decision regarding the

“Pfizer plan” approach to board policy on director elections. In 2005, Pfizer’s board responded to activist shareholders by requiring sitting directors who fail to receive a majority vote to tender their resignations from the board. The nominating committee then decides whether to accept or reject the resignation.

In 2008, Sumitomo Heavy Industries made several tender offers for Massachusetts-based Axcelis Technologies, which the board rejected. Axcelis subsequently held its annual shareholders’ meeting, which included a vote on the reelection of three directors. In accordance with the company’s “Pfizer” policy, the directors submitted their resignations, which were then rejected by the board. Axcelis continued to negotiate with Sumitomo, but the negotiations ended at a time when the company’s stock price was substantially lower than when the initial tender offer was made.

Early in 2009 an Axcelis shareholder put forward a “books and records” request to obtain information about the board’s negotiations with Sumitomo and the decision to reappoint the three directors. The Delaware Chancery recently rejected both requests. Again underlining the importance of business judgment review, the court was not persuaded that the board’s rejection of Sumitomo’s was a breach of fiduciary duty, or that the board’s refusal to accept the directors’ resignation was motivated by entrenchment or defensive in nature.

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