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# THE IMPORTANCE OF INDEPENDENT AND DISINTERESTED DIRECTORS FOR CORPORATE LITIGATION IN TEXAS

Directors of public companies often take comfort in the knowledge that they will be protected for their business decisions if they have no personal interest in a transaction and make a decision on an informed basis, in good faith, and in the best interests of the corporation.[1] However, in situations commonly facing boards in this troubled market—including shareholder demands, the appointment of special committees, and shareholder challenges to corporate transactions—the business judgment rule requires more. This *Commentary* discusses the nature and operation of the business judgment rule in each of those circumstances. Ultimately, the most important step is to ensure that a majority of the board or committee members making the decision are independent, disinterested, and actively involved in the process.[2] For this reason, while a director should always exercise due care and loyalty when making a business decision, the director also must look to whether the majority of his or her fellow directors are independent and disinterested as well, to ensure the full protection afforded by the business judgment rule.

## SHAREHOLDER DEMANDS AND DERIVATIVE CLAIMS

In a shareholder derivative lawsuit, "the individual shareholder steps into the shoes of the corporation

1 *See*, *e.g.*, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

2 The New York Stock Exchange and the NASDAQ rules both require listed companies to have a majority of independent directors, but these rather bright-line rules for "independence" are not necessarily a safe harbor for director independence and disinterestedness in corporate litigation. *Contrast* NYSE Listed Company Manual, Section 303A.02 and NASDAQ Listing Rule 5605(a)(2) *with Beam v. Stewart*, 845 A.2d 1040 (Del. 2004), and *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

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and usurps the board of directors' authority to decide whether to pursue the corporation's claims."[3] Before the shareholder may do so, however, most states—including Texas—impose standing and other requirements on the shareholder, including the requirement to serve a pre-suit demand on the corporation.[4]

A shareholder of a Texas corporation must make a demand in nearly every case. Under the Texas Business Organizations Code, which recodified Article 5.14 of the Texas Business Corporations Act,[5] a shareholder of a Texas corporation lacks standing to pursue a derivative action until 91 days *after* he or she serves a written demand on the corporation that states "with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action."[6] None of the limited exceptions to this "universal" demand requirement excuses demand simply because it would be futile.[7]

In contrast, Delaware law recognizes a "futility" exception and excuses demand if the shareholder can allege particularized facts creating a reasonable doubt that the directors are disinterested and independent or that the challenged transaction "was otherwise the product of a valid business judgment."[8] Under Delaware law, the demand-futility analysis focuses squarely—if not entirely—on whether the directors of the corporation are sufficiently independent and disinterested to fairly consider the demand.[9] When fiduciary duty claims are brought, however, the directors enjoy certain procedural advantages. For example, the business judgment rule requires courts to presume that directors are informed and acting in good faith and in the best interests of the corporation. To overcome that presumption, the shareholder has a "heavy" burden to allege facts without the benefit of discovery demonstrating that directors are not independent and disinterested.[10] Further, Delaware imposes "stringent" pleading requirements of factual particularity that "differ substantially from permissive notice pleadings."[11]

## SPECIAL LITIGATION COMMITTEES

Director independence and disinterestedness are also of paramount importance when a board appoints a committee to evaluate a shareholder's demand and determine whether pursuit of the claims is in the company's best interests.[12]

3 *In re Crown Castle Int'l Corp.*, 247 S.W.3d 349, 355 (Tex. App.—Houston [14th Dist.] 2008, mandamus denied).

4 Courts generally agree that the pre-suit demand is a substantive—not procedural—requirement. Thus, the law of the state of incorporation governs whether a demand is required. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96–97 (1991) ("In our view, the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of 'substance,' not 'procedure.' "); *In re Crown Castle Int'l Corp.*, 247 S.W.3d at 354 ("Delaware courts hold the heightened pleading requirement for derivative suits is substantive, not simply a technical rule of pleading.").

5 Tex. Bus. Orgs. Code Ann. § 21.551, *et seq. See also In re Crown Castle Int'l Corp.*, 247 S.W.3d at 353.

6 Tex. Bus. Orgs. Code Ann. § 21.553(a). Texas law also requires that the shareholder be a shareholder of the corporation at the time of the challenged act or omission and that he or she "fairly and adequately represent[ ] the interests of the corporation in enforcing the right of the corporation." *Id.* § 21.552(b).

7 *Id.* § 21.553(b); *see also In re Schmitz*, 285 S.W.3d 451, 455 (Tex. 2009) ("a shareholder can no longer avoid a demand by proving it would have been futile").

8 *Aronson*, 473 A.2d at 814; *see also Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993); Del. Ch. R. 23.1.

9 *See*, *e.g.*, *Connolly v. Gasmire*, 257 S.W.3d 831, 844–50 (Tex. App.—Dallas 2008, no pet.) (finding that trial court did not abuse its discretion in granting special exceptions to shareholders' consolidated derivative petition where shareholders failed to comply with the standards of pleading demand futility).

10 *See*, *e.g.*, *Beam*, 845 A.2d at 1056 ("In general, derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility."); *In re Crown Castle Int'l Corp.*, 247 S.W.3d at 354–56 (granting writ of mandamus because trial court erred in ordering defendants who were directors of a Delaware corporation to respond to discovery before the shareholders "met Delaware's heightened pleading requirements for demand futility").

11 *Brehm*, 746 A.2d at 254 ("Rule 23.1 is not satisfied by conclusory statements or mere notice pleading. On the other hand, the pleader is not required to plead evidence. What the pleader must set forth are particularized factual statements that are essential to the claim. Such facts are sometimes referred to as 'ultimate facts,' 'principal facts' or 'elemental facts.' Nevertheless, the particularized factual statements that are required to comply with the Rule 23.1 pleading rules must also comply with the mandate of Chancery Rule 8(e) that they be 'simple, concise and direct.' ").

12 The "determination of how to proceed on allegations made in a demand … must be made by an affirmative vote of the majority of" (among others) a committee of "independent and disinterested" directors. Tex. Bus. Orgs. Code § 21.554(a).

Unlike the demand-futility context, however, the SLC (and not the shareholder) bears the burden of establishing its independence, and the shareholder is entitled to take discovery on the issue. As the Delaware Court of Chancery recently explained in *London v. Tyrrell*:

> Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be "like Caesar's wife"—"above reproach." Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.[13]

The *London* case provides a sharp picture of these shifting burdens at work. The Chancery Court denied the SLC's motion to dismiss a derivative action because it found the existence of a material fact "as to the independence of both SLC members based on their relationships" to one of the defendants.[14] In particular, and applying the two-step analysis articulated in *Zapata Corporation v. Maldonado*,[15] the Chancery Court observed that the first director's wife was a cousin of a defendant. Emphasizing that the SLC had the burden to establish its independence, the court stated: "[A]ppointing an interested director's family member to an SLC will always position a corporation on the low ground" from which "the corporation must fight an uphill battle to demonstrate that, notwithstanding kinship, there is no material question as to the SLC member's objectivity."[16] While the court at this stage of the proceedings could not "say unequivocally that [the SLC member's] independence is impaired," it also could not say "with certainty that [the SLC member] would not have considered the potentially awkward situation of showing up to [the defendant's] annual party after the family rumor mill had spread the word that [the SLC member] had recommended that a lawsuit should proceed against the host."[17] The court questioned the independence of a second SLC member because he had hired the defendant to work at another company and eventually promoted him to CFO. The SLC member testified that he had "great respect" for the defendant and that the defendant was "very helpful in helping [him] get a good price for" the company when it was sold.[18]

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13 *London v. Tyrrell*, C.A. No. 3321-CC, 2010 WL 877528, at *12 (Del. Ch. Mar. 11, 2010) (citing *Beam*, 845 A.2d at 1055).

14 In *London*, two of the founders and former directors of a government contracting company that does business as "iGov" alleged that three other directors and/or officers of iGov breached their fiduciary duties by approving an equity incentive plan that was based on financial forecasts that purposefully understated the fair market value of the company. Plaintiffs further alleged that the equity plan was designed to entrench the defendants while simultaneously diluting the plaintiffs' equity interests in iGov. After the Chancery Court denied the company's motion to dismiss for failure to make demand, iGov's board of directors formed an SLC that was composed of the two directors who had joined the board after the equity plan had been approved. The SLC hired independent legal and financial advisors and conducted a four-month investigation during which it interviewed 12 witnesses and reviewed relevant documents. Ultimately, the SLC's report concluded that the derivative claims were not in the best interests of the company and recommended that the lawsuit be dismissed. *See generally id*.

15 430 A.2d 779 (Del. 1981) (rejecting the contention that the SLC's recommendation should be subject to business judgment review and establishing a two-step analysis that applies to an SLC's motion to dismiss). As the *London* court explains: "The first step of the analysis is mandatory. The Court reviews the independence of SLC members and considers whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions. The second step of the analysis is discretionary. The Court applies its own business judgment to the facts to determine whether the corporation's best interests would be served by dismissing the suit. The second step is designed for situations in which the technical requirements of step one are met but the result does not appear to satisfy the spirit of the requirements." 2010 WL 877528, at *11.

16 2010 WL 877528, at *14.

17 *Id.*

18 *Id.* at *15. The court also questioned the impartiality of the SLC's investigation, given that one of the SLC members testified that he and the rest of the board had reviewed the plaintiffs' complaint and apparently decided to "attack" it. *See id.* at *16.

## MERGERS AND ACQUISITIONS

Director independence and disinterestedness can also be critical in merger and acquisition ("M&A") contests. While the business judgment rule generally protects ordinary business decisions made by corporate officers and directors, courts often apply different standards to M&A transactions. Under Delaware law, which governs or influences many M&A disputes, there are at least three different standards used to evaluate board conduct. Under each standard, the involvement of independent and disinterested directors can be a decisive factor.

**Business Judgment Rule Standard.** When a board of directors approves a transaction that does not involve a sale of control, or decides to remain independent by rejecting a proposed sale of control, the decision is generally reviewed under the business judgment rule presumption.[19] While directors can still be held liable for gross negligence in these cases, their decisions are generally protected by the business judgment rule.[20] Absent allegations that directors lack independence or have some personal financial interest in the transaction, these cases usually focus on whether directors were independent and adequately informed before making the decision.[21] For example, in *Paramount Communications, Inc. v. Time Inc.*,[22] the Delaware Supreme Court applied the business judgment rule to a stock-for-stock merger that was not deemed a sale of control transaction and commented extensively on the active participation of the board's 12 independent directors in considering and evaluating the transaction.

**Enhanced Scrutiny.** If a board adopts defensive measures in response to a potential M&A transaction or agrees to enter into a sale of control transaction, courts will apply enhanced scrutiny to the transaction "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[23] When defensive measures such as a "poison pill" plan are adopted, the burden shifts to directors to prove that (a) they had reasonable grounds to believe there was a danger to corporate policy and effectiveness, and (b) their action was within the range of reasonable responses to the threat perceived.[24] When a board decides to enter into a sale of control transaction, particularly when it includes a "no shop" clause, a "breakup" fee, or a "lockup" option, the burden shifts to the directors to show that they obtained the best value reasonably available for shareholders under the circumstances.[25]

When a court applies enhanced scrutiny to a transaction involving defensive measures, the board can materially enhance its proof if the board comprised a majority of outside independent directors who acted in good faith after a reasonable investigation. Likewise, in a sale of control transaction, "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial."[26] For this reason, companies often form special committees of independent, disinterested, nonmanagement directors to negotiate the terms of M&A transactions.

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19 *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985). Texas has a stricter formulation of the business judgment rule presumption. *See Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 724 n.9 (5th Cir. 1984) ("[T]he Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act.").

20 Since *Van Gorkom* was decided, many companies have adopted exculpatory charter provisions that eliminate director liability for breach of the duty of care but not for breaches of loyalty. *See* 8 Del. C. § 102(b)(7); *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) (ruling that directors who were grossly negligent for approving the sale of a subsidiary at an unreasonably low price could not be liable for breach of care when there was an exculpatory charter provision).

21 *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812).

22 571 A.2d 1140 (Del. 1989).

23 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

24 *Id.* at 954; *see also Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387–88 (Del. 1995).

25 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985). *See also Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

26 *QVC*, 637 A.2d at 44; *see also Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 (Del. 1988).

**Entire Fairness.** If a board approves a transaction where management or a controlling shareholder has a financial interest (such as a going-private transaction, an acquisition of an entity controlled by a director, or any transaction with a majority or controlling shareholder), courts will examine the entire fairness of the transaction. The entire-fairness standard encompasses both fair dealing (*i.e.*, how the transaction was timed, initiated, structured, negotiated, disclosed to the directors, and approved) and fair price (*i.e.*, economic and financial considerations).[27] In these cases, the board has the burden of proof, but it can be shifted to the plaintiff if the transaction was negotiated by a special committee of active, informed, independent, and disinterested directors with real bargaining power, including the ability to say no to the transaction.[28]

Under each of the three standards applicable to M&A transactions, a court will carefully examine the process followed by the board or special committee in negotiating or approving the deal. The court will evaluate the independence, disinterestedness, and active involvement of individual directors in the factual context of the M&A transaction, including, among other things, the nature and quality of advice received from investment bankers and other advisors; the extent of the deliberative process; the alternatives considered, including rejection of coercive proposals; and deal-protection measures adopted to encourage or discourage potential suitors. Given the range of Delaware opinions addressing these issues, a board would be well advised to confer with qualified counsel before negotiating any major M&A transaction, particularly those that might result in court review under the enhanced-scrutiny or entire-fairness standard.

27 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

28 *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117–20 (Del. 1994).

## CONCLUSION

In each of the three situations discussed in this *Commentary*—a shareholder demand, the appointment of a special committee, and a shareholder challenge to a corporate transaction—it is imperative that the directors charged with making the decision on the company's behalf not only exercise due care and loyalty to the corporation but also ensure that the majority of their fellow directors are independent, disinterested, and actively involved in the process. By so doing, they will greatly enhance the chance that their business decisions are protected and not second-guessed by a court. Involving independent and disinterested directors may lead to better decisions and better corporate governance as well.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

**Patricia J. Villareal**
+1.214.969.2973
pjvillareal@jonesday.com

**Scott Fletcher**
+1.832.239.3846
sfletcher@jonesday.com

**Evan P. Singer**
+1.214.969.5021
epsinger@jonesday.com

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