STATE CORNER

The New Targets of Shareholder Litigation: Officer Liability Under Delaware Law

By Jeffrey R. Wolters and Nathan P. Emeritz

Shareholder lawsuits for breach of fiduciary duty typically are brought against a corporation's directors. But such suits also may be brought—and with increasing frequency are being brought—against a corporation's officers. In several notable decisions, Delaware courts have allowed claims against officers to proceed and, in those decisions, discussed the potential liability that officers may face and offered certain practical suggestions for limiting the risk of liability faced by officers.

Liability Exposure for Officers: Same Duties, Less Protection

As a strictly legal matter, officers face a greater risk of personal liability than directors. First, although historically there was some uncertainty on the issue, recent cases have confirmed that officers owe the same fiduciary duties as directors.[1] Officers also are subject to the same personal jurisdiction that applies to directors, as the Delaware long-arm statute that applies to directors also subjects officers to personal jurisdiction in shareholder suits in Delaware.[2]

At the same time, officers have less legal protection than directors. In that regard, the law is less clear concerning the standards of review (*e.g.*, business judgment rule) that will be applied in assessing whether officers (as opposed to directors) have complied with their fiduciary duties. The Delaware Court of Chancery recently noted, but did not resolve, the "lively debate" regarding the degree to which officer decisions should be examined under the same standards applicable to director decisions.[3] A perhaps even more important point is not subject to debate: unlike directors, officers are not protected by a standard "Section 102(b)(7)" exculpation charter provision. Such provisions, which are contained in the charter of virtually every Delaware corporation, generally provide that directors cannot be held personally liable for breach of the fiduciary duty of care. Thus, generally, unless a shareholder action for damages alleges a violation of the duty of loyalty, it may be dismissed as to directors. This is not the case as to officers. Finally, officers also face a "dual threat" of liability, in that suits have been brought against them both for personally breaching their own fiduciary duties *and* for aiding and abetting a breach of fiduciary duty by the board.[4]

Given the legal landscape and potential for liability, officers and the lawyers who advise them should be aware of certain recurring fact patterns that have led to personal liability claims against officers. Three recent cases involving such fact patterns are discussed below.

Gantler: Obstructing the Diligence Process

In *Gantler v. Stephens*,[5] the Delaware Supreme Court expressly stated for the first time that officers owe the same fiduciary duties as directors. The Court then found that claims alleging breach of such duties, and seeking damages against two top officers, should not have been dismissed by the trial court. The claims focused on alleged manipulation of due diligence in a sale process.

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Specifically, after the board initiated a process to attract third-party buyers to purchase the company, management suggested a management-led going-private transaction instead. According to shareholder plaintiffs, the Chairman-CEO and Vice President-Treasurer sought to sabotage the sale process by delaying and obstructing the bidders' due diligence. Ultimately one interested party withdrew its bid, and another potential buyer had its offer rejected by the board. The CEO then circulated a proposal to privatize the company by reclassifying holders of small blocks of shares, and the board approved the reclassification proposal.

The Supreme Court held that the alleged conduct of the CEO and Treasurer in obstructing the diligence process would, if proven, constitute a breach of their fiduciary duties which could potentially subject them to personal damages. With respect to the CEO, who was also a director, the Court noted that his alleged misconduct would be a breach of duty in both his capacity as a director and an officer. With respect to the Treasurer, who was not also a director, the Court stated that it was reasonably inferable that he had aided and abetted the CEO's breach of duty and that, because he was dependent on the CEO, had breached his duty of loyalty by assisting in the sabotage of the due diligence process. The Supreme Court reversed the dismissal of claims against the officers and remanded the case to proceed in the Court of Chancery.

El Paso: Management Self Interest in Promoting an MBO

In *In re El Paso Corp. S'holder Litig.*,[6] at the preliminary injunction stage, then-Chancellor Strine found that the CEO of El Paso Corporation likely had breached his fiduciary duty of loyalty when, after being given sole responsibility for negotiating the sale of El Paso to Kinder Morgan, he began to pursue a potential transaction in which management would buy one particular El Paso business from Kinder Morgan. The CEO neither disclosed to the El Paso board his interest in the management transaction before signing, nor requested board permission before approaching the Kinder Morgan CEO post-signing.

On a motion for preliminary injunction, the Chancellor inferred that the CEO's interest in the management "side deal" with Kinder Morgan may well have motivated him not to seek the highest price from Kinder Morgan for El Paso as a whole. The Chancellor found this inference borne out in the negotiating history, in which the CEO made a counteroffer well below the lowest amount authorized by the board and agreed to even less in the final merger price, along with terms favorable to Kinder Morgan: "Of course, for an MBO [i.e., the management side deal to buy El Paso's E&P assets] to be attractive to management and to Kinder Morgan, not forcing Kinder Morgan to pay the highest possible price for El Paso was more optimal than exhausting its wallet, because that would tend to cause Kinder Morgan to demand a higher price for the E & P assets."[7]

In addition, the Chancellor observed that "a fist fight of a negotiation might leave a bloodied Kinder unreceptive to a bid from [the CEO] and his team."[8] As a general rule, the Chancellor stated, "When anyone conceals his self-interest– as [the CEO] did–it is far harder to credit that person's assertion that that self-interest did not influence his actions."[9] Although Chancellor Strine declined to preliminarily enjoin the vote on Kinder's acquisition of El Paso, he noted the likelihood that plaintiffs would succeed on a future claim for money damages against the CEO (and potentially others). The case ultimately settled without an actual ruling on liability or damages. But in approving the settlement, the Chancellor again made clear his view concerning damages against the CEO:

> If you have an idea as a CEO about buying an asset or something, the people who ought to be hearing about it is your

> board, not somebody else. That's not really anything innovative. It's pretty fundamental.... assuming [plaintiffs] were successful, they would still — you would be looking for somebody for a billion dollars or something, an individual or an officer.[10]

Chen: Inference of Favoritism

Finally, and most recently, the Delaware Court of Chancery again addressed alleged breach of fiduciary duty by officers in *Chen v. Howard-Anderson.*[11] There, the alleged misconduct centered on the alleged favoritism by the CEO and CFO of one particular bidder in a sale process, including alleged manipulation of the target company's projections to make the winning bidder's offer look fairer. Vice Chancellor Travis Laster denied summary judgment and allowed post-closing claims to proceed to trial against the CEO and CFO.

The case involved Occam Networks, which was acquired by Calix, Inc. following a sale process. In that process, it was alleged that management was cooperative and responsive to Calix, but uncooperative with another interested party that was conducting diligence. The Vice Chancellor focused particularly on the fact that the CFO had prepared projections indicating a greater value for Occam, but such projections were not provided to the disfavored bidder to elicit a higher bid. Ultimately, the disfavored bidder was given 24 hours to make a bid (as directed by the board), but dropped out of the process. The CFO then allegedly worked to reduce management's projections to support the fairness of the bid received by Calix, but did not explain to the board how the new projections changed the valuation analysis of the board's financial advisor. It also was alleged that the CEO confirmed with Calix that it would honor management's severance contracts.

In considering the claims for breach of fiduciary duty against the CEO and CFO, the Vice Chancellor held that there were triable questions of fact concerning the officers' actions that appeared intended to favor the winning bidder and support the financial fairness of its offer, without fully informing the board. The case currently is proceeding to trial.

Practical Takeaways

As Delaware courts address more claims regarding officers' fiduciary duties, the risk of liability increases for these officers, but the clarity of the law around their duties also increases. Officers protect themselves from potential liability when they disclose to, and take direction from, the corporation's board of directors. In all three cases discussed above, a key factor that increased the officers' exposure to potential personal liability was the fact that their actions were not fully disclosed to and approved by the board. For example, if the officers tasked with running the diligence in *Gantler* had received direction from the board to suspend the sale process to focus on the recapitalization, they could have safely done so; but, it was not for management to effectively push the board in that direction by unilaterally deciding to undermine the diligence in the sale process. Similarly, in *El Paso*, if the CEO had informed the board of his plans with respect to a management side deal, the board could have decided whether and how to allow such plans to proceed—and, importantly, also could have decided whether to direct or limit the CEO's role in negotiating the main deal for the company.

The most recent decision, *Chen v. Anderson*, again suggests a course of conduct that could have mitigated management's exposure. In particular, if management legitimately came to the conclusion that one bidder should have been favored over another, it could have made its case to the board and sought authority to do so. It also could have carefully made a record of informing the board concerning any changes to the projections given to bidders and the board's financial advisor and walked the board through the basis for such changes and their impact on valuation and fairness.

These suggestions are the "flip side" of what the Delaware courts have long told boards, particularly in situations where management has a conflict: it is the board's ultimate duty to be proactive, take control of the process, and provide clear direction to management. Rather than chafe at such control, management can find significant personal protection by ensuring that the board is fully informed and makes a clear record that any potentially controversial decisions by management were in fact directed or approved by the board.

Notes

1. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).
2. 10 *Del. C.* § 3114(b) (stating that by agreeing to serve as an officer any such person is deemed to have consented to service of process; "officers" for purposes of that statute include president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, chief accounting officer, a person identified in the corporation's SEC public filings as one of the most highly compensated executive officers, or a person who has consented to be identified as an officer for purposes of that section).
3. *Chen v. Howard-Anderson*, 87 A.3d 648, 666 n.2 (Del. Ch. 2014).
4. *See Gantler*, 965 A.2d at 709; *Chen*, 87 A.3d at 686-687 (discussing *Gantler*).
5. 965 A.2d 695 (Del. 2009).
6. 41 A.3d 432 (Del. Ch. 2012).
7. *Id.* at 444.
8. *Id.*
9. *Id.* at 445.
10. *In re El Paso S'holders Litig.*, C.A. No. 6949-CS, at *33-34 (Del. Ch. Dec. 3, 2012).
11. 87 A.3d 648, 666 n.2 (Del. Ch. 2014).