

CORPORATE COUNSEL

Officers Owe Corporations the Same Fiduciary Duties That Directors Owe

By John D. Cromie and Noel D. Humphreys

From now on, it may be more difficult to get corporate officers dismissed from shareholder-instituted litigation that alleges a breach of loyalty. The Delaware Supreme Court recently ruled in *Gantler v. Stephens*, 965 A.2d 695 (2009), that corporate officers owe to their corporations the same duties of care and loyalty that directors owe. Moreover, as a result of this decision, the consequences imposed may be different for officers and directors who breach those duties.

The plaintiff shareholders in *Gantler* instituted an action against the other directors and officers and alleged breach of fiduciary duties for rejecting an allegedly valuable opportunity to sell the company. The board had approved the idea of a sale of the company, and potential acquirers had shown interest. William Stephens served as longtime chairman, president and CEO of the company. The board instructed Stephens and another officer, Lawrence Safarek, vice president and treasurer, to work with the board's finan-

Cromie is a partner and Humphreys is counsel to Connell Foley in Roseland. Cromie is chair and Humphreys is a member of the firm's transactional and corporate practice group.

cial advisor and to provide the potential acquirers with responses to due diligence requests.

Stephens and Safarek did not initially furnish any due diligence materials, and one of the potential suitors withdrew. Despite the board's instructions, Stephens dragged his feet but then relented and sent the material. As a result of the delay, the proposed offer was substantially lower. The board ended up rejecting the less favorable proposal without any discussion.

Instead, the board pursued a reclassification of the stock. Under the reclassification, the holders of fewer shares, including the officers, would receive preferred shares. As a result of the reclassification, the company's shares were de-listed from the NASDAQ.

To complicate matters, the shareholders ended up approving the reclassification proposal based on a disputed proxy statement. The proxy statement noted that company's directors and officers had a conflict of interest because a director "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 directors and officers would also have lost their positions in the acquisition and otherwise were arguably motivated financially to maintain the sta-

tus quo.

The Chancery Court in Delaware dismissed the complaint against the directors and Safarek, based on the business judgment rule. On appeal, the Delaware Supreme Court reversed the dismissal. The *Gantler* Court in the appeal stated the business judgment rule this way: "First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly?" If the court could answer both questions in the affirmative, then the court would allow the judgment of the board to prevail. If the Court answered either of the questions negatively, then the board's actions would be subject to further scrutiny.

In answering the first question, the court had to consider whether plaintiff had alleged a cognizable claim that the board had breached the duty of loyalty of the respective directors on an individual basis. In the court's view, plaintiff's pleading of facts regarding the three defendant directors was sufficient. The Court inferred that it was possible that Stephens failed to respond to the due diligence requests because of his own financial interests. Directors Kramer and Zuzolo were vendors to the company and stood to lose their income sources if a potential acquirer completed the proposed transaction.

The *Gantler* Court found that the portion of the complaint that alleged facts regarding Stephens as a corporate officer overcame a motion to dismiss. In the court's view, Stephens may have violated his duty of loyalty by failing to respond to a due diligence request and by failing to properly inform the board of the request; thereby, his own financial interest may have motivated such failures, the court

inferred.

The Supreme Court also kept Safarek, a nondirector officer, in the case. The court observed that, as the company's vice president and treasurer, Safarek "depended upon Stephens' goodwill to retain his job and the benefits that it generated. Because Safarek was in no position to act independently of Stephens, it could be inferred that, by assisting Stephens to 'sabotage' the due diligence process, Safarek also breached his duty of loyalty."

The complaint's factual allegations sufficiently described enough "disloyalty" in enough directors and officers to induce the *Gantler* Court to overturn the lower court's dismissal that had been based on the presumptions of the business judgment rule. In other words, the Delaware Supreme Court's opinion suggested that claims in derivative actions against officers and directors are appropriate on the same basis. In addition, an officer's personal interest in maintaining the favor of more senior management deprives the officer of the protection of the business judgment rule.

The business judgment rule potentially protects both corporate officers and directors. The effect of the business judgment rule is that the court will not second-guess the actions of a well-informed director or officer if the rule applies. In *Gantler*, fundamentally, the difference between the Chancery Court and the Delaware Supreme Court is that the Chancery Court believed that the business judgment rule applied and, accordingly, the Chancery Court discounted plaintiff's allegations of breach of loyalty. The Supreme Court thought the allegations of breach of loyalty were arguably too serious to apply the protection and defenses afforded by the business judgment rule.

The *Gantler* Court noted that Delaware General Corporation Law Section 102(b)(7) provides that a certificate of incorporation may cut off a director's liability to the corporation for an adjudicated duty of

care. Directors of many corporations, both publicly held and closely held, and, indeed, perhaps even the vast majority of Delaware corporations, have relied upon certificates of incorporation that exculpate directors as permitted by the statute. The result of a Section 102(b)(7) exculpation provision is that trial courts often dismiss, at an early stage, a plaintiff's claims of breach of due care.

These exculpatory clauses represent an important public policy. The state legislature intended to encourage capable individuals to serve as directors of corporations by providing to directors freedom to make risky, good-faith business decisions without fear of personal liability. In other words, when a derivative-suit plaintiff alleges that directors breached their duty of due care, a court should dismiss those counts against those directors when the answer articulates that the certificate of incorporation includes an exculpation clause.

However, the statute does not provide a similar potential exculpation for officers, although the *Gantler* court said such a provision is "legislatively possible." For breaches of the duty of care, corporate officers appear potentially more exposed to liability than directors. As a result of the *Gantler* decision, claims against officers will continue even after a court has dismissed breach of due care claims against directors. The *Gantler* decision may also induce plaintiffs' lawyers to articulate more breach of due care claims against officers, since courts are less likely to dismiss such claims at the beginning of the case.

The *Gantler* decision's effects will likely include more potential liability for officers, higher insurance premiums on directors and officers insurance and more self-protection by documentation of officers' decisions. In part, Delaware's adoption of Section 102(b)(7) came in response to high directors and officers insurance rates in an era of active, contested takeovers. The *Gantler* decision potentially risks a return to an era of complaints by

insureds over costs and scope of coverage in such insurance.

Similarly, legal counsel may wish to advise corporate officers to pay attention to whether actions may heighten their potential exposure to liability. Corporations may now have to consider providing independent counsel to officers to assist them in evaluating their actions in questionable situations, such as contested takeovers. Counsel may also have to consider potential conflicts of interest when assisting corporate officers in documenting their decisions in light of *Gantler's* clarification of potential claims against officers.

Section 145 of Delaware's General Corporation Law permits the corporation to indemnify both officers and directors under certain circumstances, but obviously exculpation from liability (including dismissal of claims at an early stage) is better (from the defendant's point of view) than a promise to pay the liability.

Section 142 of the General Corporate Law does not specify what corporate roles result in individuals being deemed officers. The statute provides that the bylaws or board resolutions establish the names of corporate officers and their roles. Section 158 provides that share certificates must be signed by a chairman, vice-chairman, president or vice president, on the one hand, and by a treasurer, secretary, assistant treasurer or assistant secretary, on the other hand. Apparently, the legislature intended for individuals to hold those titles.

In a case of first impression, the Delaware Supreme Court has clarified explicitly what has been previously implied: Officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and the fiduciary duties of officers are the same as those of directors. In these difficult times, corporate officers may have to pay more attention to the potential that they could become named defendants in derivative actions, in addition to the ordinary risks of employment. ■