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How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations

By

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Under Delaware law, the question remains, however, whether approval by a majority of disinterested stockholders will, pursuant to DGCL § 144(a)(2),[1327] cure any invalidity of director actions and, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.[1328] In *Gantler v. Stephens*, the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction 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.
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> [T]he 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).[1329]

In *Gantler*, the Court in effect held that stockholder ratification of a transaction that was voidable because of director fiduciary duty breaches in its approval did not validate the transaction. If, however, the stockholders had in an express and separate ratification vote (after full disclosure) ratified the action, the transaction would have been cleansed of breaches of fiduciary duty even if a vote is required by statute and revive the presumptions of the business judgment rule.[1330]

Since *Gantler* only dealt with the infection of action by a conflicted board of directors, *Gantler* does not address holdings of earlier cases regarding the distinction between void and voidable actions, and leaves standing the concept that a void action cannot be ratified so as to give it the retroactive effect of validating the action from the original date. In earlier cases, the

1327 *See supra* notes 372-380 and related text.

1328 *See Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979).

1329 965 A.2d 695, 712-13 (Del. 2009). Texas courts have also held that ratification of the results of conduct without full knowledge of the conduct cannot constitute ratification of the conduct. *See First Nat'l Bank v. Wu*, 167 S.W.3d 842, 846 (Tex. App.—Houston [14th Dist.] 2005, pet. granted) (citing *Spangler v. Jones*, 861 S.W.2d 392, 394-96 (Tex. App.—Dallas 1993)).

1330 *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (American Law Institute 2006); *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 21 (Tex. App.—San Antonio 2006, pet. denied) ("Transactions between corporate fiduciaries and their corporation are capable of ratification by the shareholders .... Ratification by any means, however, is effective only when the officer has fully disclosed all material facts of the transactions to the board of directors or shareholders.").

Delaware courts have held that a void act (e.g. an *ultra vires* action or an action that does not comply with law or governing documents) cannot be ratified, and thus given retroactive sanctification and effect.[1331]

XII. Asset Transactions.

A. Shareholder Approval.

A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners depending on the nature of the transaction, the entity's organization documents and applicable state law.[1332] In most states, shareholder approval of an asset sale has historically been required if the corporation is selling all or substantially all of its assets.[1333]

1. DGCL.

The Delaware courts have used both "qualitative" and "quantitative" tests in interpreting the phrase "substantially all," as it is used in DGCL § 271, which requires stockholder approval for a corporation to "sell, lease or exchange all or substantially all of its property and assets."[1334]

In *Hollinger Inc. v. Hollinger International, Inc.*,[1335] the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271. Without reaching a conclusion, the Chancery Court commented in dicta that "[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent's board can, without any appreciable stretch, be viewed as selling assets of the parent itself."[1336] The Chancery Court acknowledged that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of "its" assets, but found that analyzing

1331 *Triplex Shoe Co. v. Rice*, 152 A. 342, 369 (Del. 1930) (stock issued without proper consideration in violation of charter or DGCL is void; "the act was void and not merely voidable, and ... is incapable of being cured or validated by an attempted ratification by amendment or other subsequent proceeding"); *see Starr Surgical Co. v. Waggoner*, 588 A.2d 1130, 1131 (Del. 1991); C. Stephen Bigler & Seth Barrett Tillman, *Void or Voidable? – Curing Defects in Stock Issuances Under Delaware Law*, 63 Bus. Law. 1109 (2008).

1332 *See* TBCA arts. 5.09, 5.10; TBOC § 10.251. *See also* Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-88 (Winter 2001); Byron F. Egan & Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Sec. on Corp., Bank. & Bus. L. 1, 11-12 (No. 1, Sept. 1987).

1333 *See Story v. Kennecott Copper Corp.*, in which New York court held that under New York law the sale by Kennecott of its subsidiary Peabody Coal Company, which accounted for approximately 55% of Kennecott's consolidated assets, was not a sale of "substantially all" Kennecott's assets requiring shareholder approval even though Peabody was the only profitable operation of Kennecott for the past two years. 394 N.Y.S.2d 353, 353 (Sup. Ct. 1977).

1334 *See Gimbel v. The Signal Cos., Inc.*, 316 A.2d 599 (Del. Ch. 1974) (holding that assets representing 41% of net worth but only 15% of gross revenues were not "substantially all"); *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 443 (Del. 1996) (holding that sale of subsidiary with 68% of assets, which was primary income generator, was not "substantially all"; Court noted that seller would be left with only one operating subsidiary, which was marginally profitable).

1335 858 A.2d 342, 345 (Del. Ch. 2004), *appeal ref'd*, 871 A.2d 1128 (Del. 2004); *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus Law. 843, 855-58 (2005).

1336 *Hollinger*, 858 A.2d at 375.