SEYFARTH SHAW

Securities and Corporate Governance Litigation Quarterly

Decisions of Interest for Corporate and Transactional Lawyers

By William L. Prickett, Andrew T. Stark, Christopher F. Robertson, and Lauren J. O'Connor

Welcome to the seventh issue of Securities and Corporate Governance Litigation Quarterly, *Seyfarth's quarterly publication of the Securities & Financial Litigation Group focusing on decisions or other items of interest for corporate and transactional lawyers. Each summary below is followed by key practice takeaways.*

Delaware Chancery Court Clarifies Roadmap for Avoiding Challenges to Director Compensation Decisions

In a much awaited decision, the Delaware Court of Chancery recently decided *In re Investors Bancorp. Inc. Stockholder Litig.*, No 12327-VCS (Del. Ch. April 5, 2017), in which it applied the business judgment standard of review and rejected the stockholders' challenge to compensation amounts the directors set for themselves.

Background

For many years, the court consistently had applied business judgment review to director compensation decisions because, although the director decisions themselves were self-interested (and would thus be subject to entire fairness), a vote approving those compensation amounts by a majority of fully informed stockholders would cleanse the interested nature of the board's decisions. However, two seemingly conflicting decisions in 2012 and 2015, *Seinfeld v. Slager* and *Calma v. Templeton*, created doubt regarding whether director compensation plan challenges would continue to receive business judgment review. In *Seinfeld*, the court held, for the first time in nearly 60 years, that business judgment review is not appropriate, even with stockholder approval, if the compensation plan is too open ended and does not provide "meaningful limits" on the amounts that can be awarded to employees or directors. Then, in *Calma*, the court somewhat modified the approach taken in *Seinfeld*, holding that there needs to be a meaningful limit with respect to the compensation of each category of prospective recipients, such as officers or directors. Because the plan in question included a general limit applicable to all potential recipients, the stockholders had not been asked to ratify a specific limit to directors themselves. The court therefore again rejected the directors' ratification defense and application of the business judgment rule.

Investors Bancorp. is the first case to squarely address the issues raised in *Calma* and *Seinfeld*, and was thus closely watched. Unlike in *Calma* and *Seinfeld*, however, the compensation plan approved by the stockholders, while benefiting a wide

©2017 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

number of potential recipients (officers, directors, employees), did contain specific limits for outside directors. The court therefore held that the Investors Bancorp stockholders were asked to ratify the specific limits stated in the plan for directors and that the ratification defense was therefore available to the defendant directors. The court specifically rejected the shareholders' argument that even though there was a specific cap, there nevertheless was no 'meaningful limit' on the potential amounts available to directors because the cap (30% of outstanding shares) was so large. The court held that because the plan did state a specific cap, there was no "carte blanche" or "blank check" approval as there had been in *Seinfeld*. And, the amount, or reasonableness, of that cap was determined by the fully informed and uncoerced stockholders when they ratified that amount.

Practice Takeaways:

- Investors Bancorp. clarifies that the "meaningful limit" on director compensation plans, initially applied by the court in *Seinfeld*, relates solely to a specific cap on the amounts available to directors. This standard therefore does not apply, as plaintiffs argued, to both the *magnitude* of the cap and to whom it applies. Rather, it simply requires a specific cap as to the applicable category of recipients and the reasonableness of that cap is determined by the stockholders who ratify it.
- When preparing stock or compensation plans for company wide application or for specific categories of directors, stating a clear and specific cap for amounts available to directors in a given year, together with subsequent stockholder approval, should insulate directors from stockholder challenges. The only other remedy that should be available to stockholders in that scenario is corporate waste, which is nearly impossible to show or prevail upon.

Massachusetts Supreme Judicial Court Addresses Shareholder Inspection Rights for the First Time

In an important decision (*Chitwood v. Vertex Pharmaceuticals*, 476 Mass. 667 (2017), the Massachusetts Supreme Judicial Court ("SJC") has provided new guidance on the scope of the Massachusetts shareholder inspection statute, Mass. Gen. Laws. ch. 156D, § 16.02, and the necessary showing for a books and records demand under the statute. The SJC distinguished § 16.02 from its Delaware counterpart, 8 Del. C. § 220, noting that because the Massachusetts statute is more limited in the scope of books and records that may be demanded, the burden placed on the Massachusetts shareholder who seeks to inspect them should be lower as well.

Background

In *Vertex*, a shareholder made a written demand under § 16.02 to inspect Vertex's corporate books and records. The shareholder contended that the books and records were needed to investigate potential wrongdoing, mismanagement, and breach of fiduciary duty by the Vertex board of directors in its oversight of Vertex's financial reporting and insider stock sales following a publically announced scientific breakthrough. The shareholder demanded the inspection and copying of seven categories of records, including the records of all meetings of the Vertex board and a special committee of independent directors that had been formed to investigate a prior demand by the shareholder to commence litigation based on the same alleged misconduct; the special committee's final report and any drafts of it; all documents distributed at any board or special committee meeting; and all documents concerning a separate internal review relating to the underlying allegations of wrongdoing. The board rejected the shareholder's demand on the grounds that it did not infer a "proper purpose" because the shareholder failed to show that there was a credible basis for further investigation following the special committee's inquiry and because the demand essentially sought discovery which would have been barred under Mass. Gen. Laws ch. 156D, § 7.44 had he brought a derivative action, the demand far exceeded the narrow scope of § 16.02(b), and disclosure of the requested non-public material information would adversely affect the company.

Dissatisfied with the board's rejection, the shareholder sued to compel the inspection of the records under § 16.04. After two years of extensive motion practice and a one-day bench trial, the court dismissed the shareholder's complaint with prejudice, holding that his demand was overbroad and that he failed to satisfy his burden of showing a "proper purpose"

©2017 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

under § 16.02(b). Looking to Delaware law, the trial court held that the shareholder did not meet his burden because he failed to "present some evidence of wrongdoing; simply replying on the timing of certain events is not sufficient." The court also reasoned that had the shareholder brought a derivative suit under § 7.44, the evidence that he presented at trial would not have entitled him to any discovery.

On appeal, the SJC reversed, noting that this case "was an expensive litigation war of attrition that was fought for nearly nothing." Specifically, the Court held that the trial court applied "too demanding a standard" when looking to Delaware law for what constitutes a "proper purpose" under the Massachusetts statute. Delaware courts require a shareholder offer specific evidence showing "a credible basis from which the [court] can infer there is possible mismanagement that would warrant further investigation." However, the scope of records that potentially may be inspected under the Delaware statute is far greater than under § 16.02. While the Massachusetts statute specifically articulates the limited categories of records that a shareholder may potentially inspect, the Delaware counterpart permits inspection of a corporation's "books and records" generally, and without specific limitations. As a result, the SJC reasoned, the burden on the shareholder should be greater in Delaware than in the Commonwealth. The SJC held that where, as here, a shareholder seeks to investigate board action concerning allegations of insider trading after an allegedly inaccurate public announcement and the board has rejected his demand for a derivative action, the proper purpose standard is satisfied. The Court stated that the shareholder is entitled to "trust but verify" the board's actions. The Court stressed that the shareholder need not, as the trial court ruled, "provide evidence of wrongdoing beyond the timing of the press releases and the insider trades to obtain these excerpts of the original minutes." The Court further stated that in applying this heavy burden, the trial court essentially required the shareholder to meet the burden under § 7.44(d) to defeat a motion to dismiss brought by a corporation that had declined the plaintiff's derivative demand. The right of inspection under § 16.02, however, is "an independent right of inspection" that is not intended to substitute for or diminish any rights of inspection that may exist under another statute, the common law, or the right of discovery in shareholder litigation, and it may be made at any time.

The Court further noted that the records sought by the shareholder far exceeded the scope of records that are within the right of inspection under § 16.02. The Court held that the only records within the scope of the statute were the excerpts of minutes or comparable records that reflected the actions taken at the board or special committee meetings. The rest of the records sought were not available for inspection, including any "documents that were provided to board members for consideration of [a] proposed action or of the minutes memorializing the debate . . . as to whether to take that action." While these records "are precisely the type of records that a plaintiff shareholder might seek in discovery in a derivative action in an attempt to show that the special committee's inquiry into the allegations was not reasonable or that the independent directors did not act in good faith," the Court found they are outside the scope of inspection at this stage.

Practice Takeaways:

- The SJC has clarified that although a Massachusetts corporation shareholder has a lower burden to demonstrate a "proper purpose" for inspection of corporate books and records than in Delaware, the shareholder may only seek the narrower categories of documents set forth in the inspection statute. Records of directors' deliberations, as well as reports and other board materials, will be protected from inspection.
- Since excerpts of minutes on certain topics may, as happened here, be subject to inspection in any given case, this case reconfirms that corporate secretaries and counsel drafting board minutes should continue to take care in memorializing actions taken by a board.

Massachusetts Court in Rejecting Dell-EMC Merger Suit Signals End to Direct Merger Suits

The highest state court in Massachusetts recently affirmed the dismissal of a shareholder suit challenging the $67 billion merger between Dell Inc. and EMC Corp. ("EMC"). In a dramatic departure from both its own precedent and long-held

©2017 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

principles of Delaware corporate law, the Supreme Judicial Court ("SJC") held in *IBEW Local No. 129 Benefit Fund v. Tucci et al.*, SJC-12137, 2017 Mass. LEXIS 124 (Mar. 6, 2017) that directors of publicly traded Massachusetts corporations do not owe a fiduciary duty to shareholders.

Background

Plaintiff shareholders of EMC sued to challenge the proposed merger, claiming that the cash payment for their EMC stock was too low. They alleged, among other things, that the defendants (including Joseph Tucci, the long-time CEO of EMC), improperly prioritized EMC's "federated structure"—where EMC acted as a parent company to numerous related but independently functioning businesses—which caused EMC's shares to trade at a "conglomerate discount." Under pressure to sell off a more profitable part of EMC for a premium, the defendants negotiated the sale of EMC and all of its subsidiaries to Michael Dell, Tucci's long-time friend and business associate. The transaction was unanimously approved by EMC's board of directors.

The trial judge in granting the defendants' motion to dismiss ruled that EMC's board owed no fiduciary duty directly to the shareholders in this case. It further held that Plaintiffs should have brought suit derivatively rather than directly because any alleged harm to the shareholders was not distinct from harm to EMC. Plaintiffs appealed.

Decision

The SJC began by noting that whether the shareholders' claim is one that may be pursued directly against the directors or must be pursued derivatively depends on whether the type of harm they claim to have suffered resulted from a breach of duty owed directly to them, or whether the harm claimed was derivative of a breach of duty owed to the corporation. The Court further noted that the operative Massachusetts statute, c. 156D (the Massachusetts Business Corporation Act), stated explicitly that a director may consider "the long-term and short-term interest of the corporation and its shareholders" in the context of determining what the director reasonably believes to be in the best interests of the corporation. Emphasizing the permissive nature of this section, the Court held that the statute did not create a fiduciary duty owed by a corporate director directly to the shareholders.

In reaching this conclusion, the Court had to grapple with one of its prior decisions, *Chokel v. Genzyme*, 449 Mass. 272, 278 (2007), in which it had explicitly stated that "[d]irectors owe a fiduciary duty to their shareholders." The Court held that the language in *Chokel* was "too broad." It further noted that there are only two exceptions to the general rule that a director of a Massachusetts corporation owes a fiduciary duty only to the corporation itself and not the shareholders: (1) close corporations, in which the duties of loyalty extend to shareholders, and (2) where a controlling shareholder who is also a director proposes and implements a self-interested transaction that is to the detriment of minority shareholders. Neither exception applied here:

> [T]he wrong alleged by the plaintiffs, undervaluing EMC to secure the merger and sale of the federation of companies, qualifies as a direct injury to the corporation, the entity to which the directors clearly owed a fiduciary duty of good faith and loyalty. Flowing from that alleged injury is a claimed derivative injury to each shareholder, whose individual shares, as a consequence of the asserted undervaluing of EMC itself, are consequently undervalued as well. We agree with the motion judge that the injury posited by the plaintiffs, and the alleged wrong causing it, fit squarely within the framework of a derivative action.

The Court rejected the Plaintiffs' urging to follow Delaware law, which treats the Plaintiffs' type of claim as a direct one, rather than one which must be brought derivatively. In declining to follow Delaware law, the Court noted that Delaware's corporation act differed from Massachusetts, and further that Delaware has a "history of asserting that directors stand in a fiduciary relation to stockholders of the company, in contrast to our own precedent." Finally, the Court rejected Plaintiffs' equitable arguments regarding standing: Namely, that dismissal of the case was unjust because a merger is likely to close before the conclusion of a derivative case challenging the transaction, and a plaintiff would then lose standing as it is no

©2017 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

longer a shareholder. The Court noted that Plaintiffs could have properly made and preserved a derivative demand on EMC and pursued injunctive relief to halt the closing of the deal pending the outcome of the lawsuit, but elected not to do so.

Practice Takeaways:

- This decision removes any uncertainty that shareholders of Massachusetts public corporations will now have to pursue their merger claims derivatively. It remains to be seen how many of them will actually do so. There can be substantial obstacles to bringing a derivative claim: a shareholder must first file a written demand on a corporation (regardless of whether the demand can be shown to be futile); the shareholder must then wait 90 days to file suit, and as the Plaintiffs in *Tucci* noted, this may very well mean that the merger has concluded by the time the shareholders can litigate, mooting their claims. Though shareholders could still pursue injunctive relief, they would have to demonstrate irreparable harm or a likelihood of success on the asserted challenge. If injunctive relief is denied, the challenging shareholders would lose significant leverage and eventually standing to maintain the suit.
- At bottom, merger litigation is now more difficult to pursue in Massachusetts. To that end, companies incorporated in Massachusetts should consider adopting exclusive forum bylaws, mandating that any derivative litigation be filed in Massachusetts.

To sign up to receive Securities and Corporate Governance Litigation Quarterly, please click here.

William L. Prickett is Chair of Seyfarth's Securities & Financial Litigation Practice Group, and a partner in the Boston office. Andrew T. Stark is an associate in the firm's Boston office. Christopher F. Robertson is a partner in the firm's Boston office. Lauren J. O'Connor is an associate in the firm's Boston office.

If you would like further information, please contact a member of the Securities & Financial Services Litigation Practice Group of Seyfarth Shaw LLP, William L. Prickett at wprickett@seyfarth.com, Andrew T. Stark at astark@seyfarth.com, Christopher F. Robertson at crobertson@seyfarth.com, or Lauren J. O'Connor at loconnor@seyfarth.com.

www.seyfarth.com

Attorney Advertising. This Newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

©2017 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.