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contents

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Dear Clients and Friends,

In this issue we highlight some important recent developments in Delaware law. One important development relates to the indemnification of outside directors where the director is entitled to indemnification benefits from both the corporation and a stockholder of the corporation (for example, a private equity sponsor). Also, the Delaware courts have clarified that fiduciary duties are owed by non-director officers of a Delaware corporation and have suggested that such officers (like directors) should be afforded the presumptions and protections of the Business Judgment Rule. Finally, we discuss a recent Delaware case about developments relating to shareholder proposed bylaw amendments.

We are also including in this issue a short article about the viability of noncompete agreements in California along with a summary about updated interpertative guidance from the SEC about website disclosure.

DELAWARE LAW DEVELOPMENTS

By Eric Kintner and Bianca Stoll

Eric Kintner

Bianca Stoll

Clarifying Indemnification Protection for Outside Directors

Section 145 of Delaware's General Corporation Law permits a corporation to indemnify its directors, officers, employees, or agents against losses by reason of the fact that such person was serving at the request of the corporation and was acting in good faith and in the best interests of the corporation. Under Section 145(e), corporations may also advance legal fees to such persons before the final disposition of any litigation so long as the indemnified person promises to repay any amounts if it is ultimately determined that he or she is not entitled to indemnification. Many corporations make mandatory such indemnification and advancement obligations in their charters, bylaws, or through separate indemnification agreements with directors and key personnel.

In *Levy v. HLI Operating Co., Inc.*[1] and *Schoon v. Troy Corp.*,[2] the Delaware Court of Chancery discussed the rights of outside directors to seek indemnification under Delaware law. In *Levy*, the court determined that outside directors were not entitled to indemnification from the corporation where a private equity stockholder-sponsor had fully reimbursed their losses pursuant to a separate indemnification agreement. Rather, the court determined that such stockholder (but not the director) had standing to seek reimbursement directly from the corporation via the theory of contribution. In contrast, the court in *Schoon* determined that an outside director had standing to seek indemnification from the corporation where the stockholder-sponsor had no contractual obligation to continue advancing costs to its representative director on the theory that the director had no assurance that he may not sustain actual out-of-pocket costs in the future.

Also in *Levy* and *Schoon*, the court considered the rights of outside directors to seek advancement of legal fees under Delaware law. In *Levy*, the court invalidated a provision in a director's indemnification agreement that required the corporation to advance the director's legal expenses regardless of whether such director was ultimately determined to be entitled to indemnification. The court based its decision on Delaware's statutory framework, case law, and public policy that the court determined was designed to permit indemnification only upon a successful determination that the director was entitled to be indemnified.

In *Schoon*, the court upheld a bylaw amendment eliminating the right to indemnification and advancement of expenses for former directors, even though the director seeking indemnification and advancement had served on the board during a period when the bylaws required indemnification and advancement of expenses. Prior to *Schoon*, many practitioners presumed that a director's right to indemnification and advancement vested at the time of the director's service as a director and could not be eliminated unilaterally by the corporation after the fact.

1 924 A.2d 210 (Del. Ch. 2007).

2 2008 WL 821666 (Del. Ch., Mar. 28, 2008).

Levy v. HLI Operating Co., Inc.

The *Levy* court held that if a private equity stockholder-sponsor fully satisfies a joint indemnification obligation it shares with the corporation covering the same director and the same activity, such stockholder must seek reimbursement by pursuing the corporation in its own name on a theory of contribution.

In this case, former outside directors[3] (the "Fund Directors") nominated by a 34% stockholder of the corporation (the "Fund") filed suit against HLI Operating Company, Inc. ("Old Hayes") to obtain indemnification for amounts paid in settlement on their behalf by the Fund pursuant to the Fund's limited partnership agreement. In 2001, Old Hayes announced that it needed to restate its reported financial results from 1999 to early 2001. After the announcement, Old Hayes' stockholders and bondholders filed a class-action lawsuit against Old Hayes, its outside directors, and other defendants, alleging violations of the Securities Exchange Act. Old Hayes then filed for protection under Chapter 11 of the Bankruptcy Code, and pursuant to its plan of reorganization, emerged as an operating subsidiary of a newly-created company, Hayes Lemmerz International, Inc. ("New Hayes").

In 2005, the parties reached an agreement with the insurance carriers that underwrote Old Hayes' director and officer insurance coverage for the insurance carriers to contribute $20.3 million, and for the Fund Directors to each pay $1.2 million, towards settlement of the class-action claims. Documents produced in discovery revealed that the Fund had contributed the full $1.2 million on behalf of each Fund Director pursuant to the Fund's indemnification obligations under its limited partnership agreement. Nevertheless, the Fund Directors sought indemnification from Old Hayes and New Hayes pursuant to the Old Hayes bylaws, their personal indemnification agreements and the bankruptcy reorganization plan. Both Old Hayes and New Hayes denied the directors' indemnification requests.

The court determined that the Fund Directors were entitled to indemnification for monies paid out of their pockets, but the Fund Directors were not entitled to indemnification for amounts paid on their behalf by the Fund because their indemnifiable expenses were paid in full by the Fund, and thus, they suffered no out-of-pocket loss. With respect to amounts paid by the Fund on behalf of the Fund Directors, the court determined that the appropriate cause of action was one for equitable contribution brought directly by the Fund against Old Hayes and/or New Hayes, rather than for claims seeking subrogation or indemnification through the Fund Directors. To succeed on a contribution claim, the Fund would have to show concurrent obligations existed to the same person, and that the Fund essentially insured the same interests and the same risks as Old Hayes/New Hayes.

In *Levy*, the court also considered whether the Fund Directors were entitled to retain the fees and expenses advanced by Old Hayes under their indemnification agreements while litigating their unsuccessful claims. The indemnification agreements included a provision that required Old Hayes to advance any fees and expenses "regardless of whether [the party] is ultimately determined to be entitled to [i]ndemnification." In reaching its decision to invalidate this provision, the court reviewed past Delaware

3 Six former outside directors were plaintiffs in this case, four of which were nominated by the Fund. The focus of this article is on the court's analysis of the overlapping indemnification obligations owed to the Fund Directors by the corporation and the Fund.

court decisions and reasoned that to validate a contract provision that mandates indemnification in unsuccessful litigation would contravene the public policy articulated in prior cases, thus to encouraging parties seeking advancement or indemnification claims to raise only meritorious claims and for corporations to settle worthy claims.

Schoon v. Troy Corp.

In *Schoon,* the court held that a former director's right to advancement under his former corporation's bylaws did not vest until an indemnifiable claim was asserted against the director and that, prior to the assertion of such a claim, the corporation could amend the bylaws to limit or repeal the former director's advancement rights.

In this case, both a former and current director, each of which had been nominated by a 33% stockholder, were sued by the corporation for breach of fiduciary duties. During the former director's tenure, the corporation's bylaws provided for mandatory advancement of expenses incurred by current and former directors in connection with corporation-related litigation. Three months prior to the corporation's suit against the directors, the corporation's board amended the bylaws to remove the word "former" from the definition of directors entitled to advancement.[4]

The former director sought advancement of his legal fees, claiming that his rights should be governed by the corporation's bylaws as they existed when he took office as a director. The court determined that a director's advancement rights were triggered at the time that such director was named in a lawsuit, not at the time the director took office. The court reasoned that until such time as a director is named in a proceeding for which advancement is available, the director has no vested legal right to advancement, and the director's rights can be lawfully terminated.

The *Schoon* court also considered whether the current director could seek indemnification against the corporation if his costs had been advanced by the stockholder that nominated him to the board. However, unlike the stockholder in *Levy*, the private equity stockholder-sponsor in *Schoon* had no contractual obligation to indemnify the director; rather, the stockholder had voluntarily undertaken to pay the director's fees. The court determined that without the stockholder's obligation to cover the director's expenses, the director could suffer actual out-of-pocket losses in the future, and therefore, had sufficient injury to establish standing and seek indemnification.

Implications

In light of these recent decisions, corporations (particularly Delaware corporations), as well as their directors and officers, should review with their counsel the corporation's current indemnification provisions and how they might interact with other indemnification agreements. In light of the *Schoon* decision, corporations should consider the implications (pro and con) of entering into separate indemnification agreements with directors and key personnel to provide contractual rights to indemnification and advancement of fees that cannot be unilaterally revoked by the corporation. In addition, corporations may want to consider whether their bylaws should prohibit or permit retroactive amendments by a subsequent board.

4 The bylaws permitted the directors to alter or repeal any bylaws provision at any regular or special meeting of the board.

Fiduciary Duties for Non-Director Officers

Delaware courts have often indicated (although not always directly) that officers who are not also directors owe fiduciary duties equivalent to those owed by directors. Many commentators have disagreed as to whether officers should have the same or stricter duties as directors, and whether such officers, like directors, should be afforded the same protections and presumptions under the Business Judgment Rule[5]. In several recent decisions, Delaware courts have affirmed that non-director officers owe fiduciary duties to the corporation they work for and its stockholders. In *Miller v. McDonald*,[6] the Delaware bankruptcy court held that officers, like directors, owe *Caremark* oversight duties that require the implementation and monitoring of reporting or information systems to detect corporate wrongdoing.

Recent Delaware court decisions have also suggested a willingness to afford officers, like directors, the protections and presumptions of the Business Judgment Rule, which requires a plaintiff to rebut the presumption that officers acted in good faith and with due care. In *Gantler v. Stephens*[7] and *Midland Grange No. 27 Patrons of Husbandry v. Walls*,[8] the Delaware Chancery Court dismissed claims against officers for breaches of fiduciary duties on the grounds that the plaintiffs had failed to show that the officers had acted unreasonably, not in good faith, or with gross negligence in breach of their duties of care.

Officer Oversight Duties

In *Miller*, Delaware's bankruptcy court declined to dismiss claims brought by the bankruptcy trustee against a former vice president and general counsel of a corporation involving allegations of fraud against the former president. The case arose from the Chapter 7 liquidation of World Health Alternatives, Inc. ("World Health"), a health care staffing firm. After World Health became a public corporation in 2003, it raised almost $40 million to buy eight different businesses in the health care staffing industry, but the businesses' accounting systems were ineffective, and World Health filed several fraudulent SEC reports in which significant amounts of liabilities were unreported.

The *Miller* court stated that the basis for the trustee's claim was that the officer breached his duty of care by failing to implement an adequate monitoring system and/or the failure to utilize such system to safeguard against corporate wrongdoing as required of corporate directors in *Caremark*.[9] Under *Caremark*, a director has "oversight liability" if such director (a) utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or control, consciously failed to monitor or oversee its operation thus disabling him from being informed of risks or problems requiring attention. The *Miller* court also noted that Section 307 of the Sarbanes-Oxley Act imposed on a general counsel the affirmative duty to inspect the truthfulness of all SEC filings, and required that an attorney report evidence of a material violation of securities law or breach of

5 The Business Judgment Rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). If the business judgment rule is applicable, the court will not substitute its judgment for that of the board if the latter's decision can be attributed to "any rational business purpose."

6 385 B.R. 576 (Bankr.D.Del. 2008)

7 2008 WL 401124 (Del. Ch. Feb. 14, 2008).

8 2008 WL 616239 (Del. Ch. Feb. 28, 2008).

9 In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967-71 (Del. Ch. 1996).

fiduciary duty or similar violation by an issuer up-the-ladder within the company.

Based on Delaware case law and these statutes, the *Miller* court agreed with the trustee that the officer had an oversight duty and that as the in-house general counsel had a duty to know, or should have known, of these corporate wrong doings and reported such breaches of fiduciary duties by the management.

Business Judgment Rule Presumption for Officers

In *Gantler*, the Delaware Chancery Court stated that a non-director officer owed fiduciary duties of care and loyalty to the corporation he served and its stockholders. This statement in *Gantler* was a minor issue in the case, which primarily involved stockholders' claims against the board for breach of fiduciary duties for its decision to abandon a board-initiated process to sell the corporation and adopt a reclassification proposal of the corporation's shares. The plaintiffs claimed, in part, that the officer had breached his fiduciary duties of care and loyalty by sabotaging the due diligence process in connection with the board-authorized sale process. The court found, however, that the plaintiffs' complaint failed to allege sufficient facts for the Court to reasonably infer that the officer acted in bad faith or was grossly negligent. Although the court did not expressly state that it was applying the Business Judgment Rule to the officer's conduct, we believe its opinion suggests just that—a court will refuse to second-guess a rational business decision when it appears to have been made in good faith and with due care.

In *Midland Grange*, the Delaware Chancery Court also considered the issue of officer fiduciary duties and the Business Judgment Rule in a case that involved a challenge to a non-profit fraternal organization's sale of real estate arranged by two former officers. The organization claimed the sale should be rescinded on the grounds that the officers breached their fiduciary duties because they failed to adhere to the bylaws' sale procedure and because the sales price for the property was below market value.

The *Midland Grange* court determined that the officers had fiduciary duties of care and loyalty to the organization regardless of whether they were officers or directors. The court ultimately held that the plaintiffs failed to establish that the officers had breached their duties of care because their decision to disregard the sale procedure specified in the bylaws and use of a secret ballot was reasonable in this case given the small size of the organization's membership and was not grossly negligent so as to trigger a breach of the duty of care. In addition, the court stated that the organization failed to show that the sale price of the property was not within the range of reasonable prices at the time of sale.

Finally, the court held that the organization failed to show that the officers breached their duty of loyalty by not acting with the good faith belief that their actions were in the best interests of the organization. The court specifically noted that the officers were not sophisticated corporate executives of a for-profit entity, but "they gave their best effort to selling the [p]roperty given the circumstances confronting the [organization] and their rudimentary understanding of bylaws" and properly informed themselves and the organization's members of all material facts regarding the sale. Therefore, although the *Midland Grange* court (like the *Gantler* court) did not state it so explicitly, we believe its opinion to dismiss breach-of-fiduciary-duty claims—on the grounds that the plaintiff failed to establish the officers had acted with gross negligence and not in good faith—is exactly what the Business Judgment Rules provides.

Shareholder Proposed Bylaw Amendments

The Delaware Supreme Court recently decided *CA, Inc. v. AFSCME Employees Pension Plan*,[10] in which it held that a shareholder-proposed bylaw that mandated the board of directors to reimburse shareholder costs associated with nominating a dissident slate of directors, while a proper subject for shareholders to vote on, would violate Delaware law because the directors did not have the ability to refrain from reimbursing expenses.

CA, Inc. ("CA"), a public company, received a shareholder proposed bylaw from one of its shareholders, AFSCME Employees Pension Plan's ("AFSCME"). The bylaw proposed that CA's board of directors would cause the company to reimburse a shareholder for reasonable expenses incurred in connection with nominating one or more candidates in a contested election of directions (subject to conditions). CA sought to exclude this proposed bylaw from its annual proxy materials by requesting a no-action letter from the SEC.

CA provided with its no-action request a legal opinion that the proposed bylaw was not a proper subject for stockholder action and that if implemented would violate Delaware law. AFSCME responded with a contradictory legal opinion that the proposed bylaw was a proper subject for shareholder action and if adopted would be permitted under Delaware law.

The SEC, confronted with two contradictory legal opinions grounded in Delaware state law, sought the guidance of the state's highest court. Under a recent amendment to the Delaware state constitution that authorized the court to hear and determine questions of law certified by the SEC (in addition to other tribunals and agencies), the SEC certified two questions to Delaware's highest court. This case marked the first instance in which the SEC certified questions to the Delaware Supreme Court.

The SEC asked the court to determine (i) whether the proposed bylaw was the proper subject for action by a shareholder as a matter of Delaware law and (ii) whether the proposed bylaw, if adopted, would cause CA to violate Delaware law.

Proper Subject For Shareholder Action

The court noted that under Delaware General Corporation Law ("DGCL") Section 109(a) both the board of directors and shareholders of a Delaware corporation are permitted to amend and repeal the corporation's bylaws. However, the court also noted that this authority does not exist in a vacuum and it must be read together with Section 141(a), which limits shareholders' ability to amend and repeal a corporation's bylaws by granting to the board of directors authority to manage the business and affairs of the corporation.

In making its case, AFSCME relied heavily on DGCL Section 109(b), which generally provides that the bylaws of a corporation may contain any provision relating to the rights or powers of stockholders and directors. CA argued that the proposed bylaw would limit the board of director's "substantive decision-making authority" and would therefore need to be included in the certificate of incorporation.

The court found CA's position too extreme because the practical application would result in eliminating the shareholders' statutory right to adopt, amend, or repeal bylaws. The court noted that it is well-established that a "proper function of bylaws is not to mandate *how* the board should decide specific substantive business decisions,

10 2008 WL 2778141(Del. 2008).

but rather, to *define the process and procedures by which those decisions are made*." In short, the court found that the AFSCME proposed bylaw had the intent and effect of regulating the process for electing directors of CA and this was a proper subject for shareholder action.

The court's reasoning was that shareholders of a Delaware corporation have the right to participate in selecting contestants for election to the board, and they are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for re-election. The court concluded that the proposed bylaw was an appropriate matter for shareholder action, and merely because a proposal would require the expenditure of corporate funds did not in and of itself make such a bylaw an improper subject matter for shareholder action.

Violation of Delaware Law

Having answered the SEC's first question affirmatively, the court moved onto the second certified question. Typically, a court would determine whether a bylaw at issue would violate Delaware law under a particular set of facts. However, the court did not have any facts under which it could analyze the AFSCME proposed bylaw and instead had to conduct its review in the abstract. Accordingly, the Court needed to consider an infinite number of circumstances in which the proposed bylaw could violate Delaware law. The court found that because the bylaw *mandated* reimbursement of expenses, the board did not have discretion to withhold reimbursement if doing so would cause the board to violate its fiduciary duties. By way of example, the court was concerned with the situation where a proxy contest was motivated by petty concerns or was to promote interests that were adverse to the corporation. In such circumstances, a board's fiduciary duties could reasonably preclude reimbursement of expenses altogether. The court ultimately found that the proposed bylaw as written would violate the DGCL. Accordingly, the SEC confirmed that CA could omit AFSCME's proposed bylaw from its annual proxy materials.

Practical Implications

Most notably, *CA v. AFSCME* confirms Delaware's long standing principle that the board manages the affairs of the corporation absent any contradictory provision in the corporation's certificate of incorporation.

In addition, this case opens the door to future more carefully drafted bylaw proposals from shareholders that fit within the court's guidance. For example, the court hinted that a more "benign" proposal could pass muster as long as the board was not *forced* to violate their fiduciary duties. Although the court was able to draw on a hypothetical example of when the reimbursement of expenses in a contested election would violate the board of directors' fiduciary duties, we believe this is likely more of the exception than the rule.

Beware of Noncompete Agreements for California Employees

By Christy Joseph

Christy Joseph

California has long upheld the principle that it wants to encourage fair competition. In furthering this principle the California Supreme Court recently tolled the death knell for noncompete agreements in *employment* contracts and held, "this court generally condemns noncompetition

agreements."[11] In *Edwards v. Arthur Andersen*[12], the court also makes clear that nonsolicitation agreements as to the company's clients or customers, will be considered to be illegal noncompete agreements, unless the nonsolicitation agreement is necessary to protect a trade secret or confidential proprietary information.

Some multistate companies may not be aware of these restrictions, or some may have chosen to develop employment agreements with standard uniform terms that are enforceable in many other states knowing that as to particular terms they may not be able to enforce the provision for California employees. More and more however, such practices could expose the company to the risk of litigation and liability in excess of any potential contract damages. Former employees have brought and successfully litigated actions that allege they were retaliated against or terminated for refusing to sign an employment agreement with a noncompete or overly broad nonsolicitation agreement. Employees may also characterize themselves as whistle blowers and allege they complained about such provisions in company contracts and suffered some detriment in their employment relationship. There is also a risk where an employee leaves an employer that implemented a noncompete or overly broad nonsolicitation agreement and then claims that another company refuses to hire them because of the fear of the risk of litigation involving the original employer—i.e., an interference with prospective economic advantage claim. Moreover, it is likely that similar complaints might be included under California's "unfair business practice" statute, which allows for a private right of action. And behind the specter of these various causes of action is the employee's ability to request tort damages—e.g., emotional distress and punitive damages—which go beyond any damages strictly related to the contract damages. With these risks in mind, companies should consider seriously whether to keep or insert such provisions in agreements with California employees. What to do?

- Review and modify agreements that contain noncompetes with employees.

- For noncompetes that are tied to the sale of a business or one part of a company—include the noncompete provisions in a separate agreement to clearly show they qualify for one of the limited exceptions.

- Review and modify nonsolicitation agreements that are not necessary to protect the company's trade secret or confidential proprietary information.

- If you have nonsolicitation agreements that are necessary to protect the company's trade secrets or confidential proprietary information—make sure the company is taking steps to ensure the confidentiality of that information. Too frequently what a company would like to consider confidential information not generally known to the marketplace is discussed, used and disseminated to those outside the company in such a way that it may be difficult to assert its confidential nature. Once that occurs the nonsolicitation agreement could be viewed as an illegal noncompete agreement.

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11 California has limited exceptions to its bar on noncompete agreements. These exceptions are generally associated with the sale of goodwill or ownership interests in a business or partnership.

12 SC S147190 August 7, 2008.

SEC INTERPRETATIVE GUIDANCE REGARDING WEBSITE DISCLOSURE

By Melissa Sallee

Melissa Sallee

Summary

In July, the SEC updated its interpretive guidance about how companies can use their web sites to publicly disclose information and the related securities laws implications. The SEC last issued extensive guidance on the use of web sites in 2000.

When Information is Public

The SEC guidance focuses on whether and when information posted on a company's web site is considered "public" for purposes of Regulation FD. The SEC clarified that the determination of whether posted information is "public" is a facts and circumstances determination and it will vary from company to company and situation to situation. Factors that a company should consider in determining if posted information is "public" include:

- Whether a web site is a recognized channel of distribution. This is a facts and circumstances analysis and a company should look to whether it has promoted its web site as a vehicle for the purpose of distributing information. In other words, is your company's web site where investors go for information about your company?

- Whether there has been a reasonable waiting period for investors and the market to react to the posted information. This factor likely depends on the size of a company, the extent that the web site is regularly accessed, and the nature and complexity of the information.

Applicability of Rule 10b-5 to Information Posted on Company Web Site

The SEC's guidance confirms that Rule 10b-5 (and similar antifraud rules) apply to information posted on, or hyperlinked from, a company's web site. The guidance provides:

- A company is generally not required to update and/or replenish old information on its website, such as historical financial information. However, a company should make clear to investors that the old information is in fact "old," for example, by dating the information.

- A company may be liable for third party information that is hyperlinked from its web site if the company explicitly or implicitly endorses the hyperlinked information or was involved in the preparation of the information. To limit exposure liability for the content of hyperlinked information, a company should explain on its web site why it is providing a particular hyperlink and consider the use of methods, such as exit notices or intermediate screens to notify a reader that the information is from a third party. Companies should be particularly cautious about hyperlinking to analyst reports.

- A company should use appropriate explanatory language and titles or headings on summary information and direct readers to the location of the more complete information.

- Statements made by the company on blogs or other interactive web sites are subject to the antifraud provisions of federal securities

laws, even where investors waive their federal securities laws protections in order to enter a company's blog or forum.

Disclosure Controls and Procedures

The interpretive release provides that if the company uses its web site to make any *required* disclosures under the Exchange Act, disclosure controls and procedures would apply to such information. Under such circumstances, the company's principal executive officer and principal financial officer certifications about disclosure controls and procedures would cover the information that is posted on the web site in lieu of being presented in a required Exchange Act report, but would not necessarily cover all information posted on the company's web site.

Printer-Friendly Formatting

Information on a company's web sites will only be required to be in a printer-friendly format if specifically required by securities laws, such as the e-proxy rules.

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