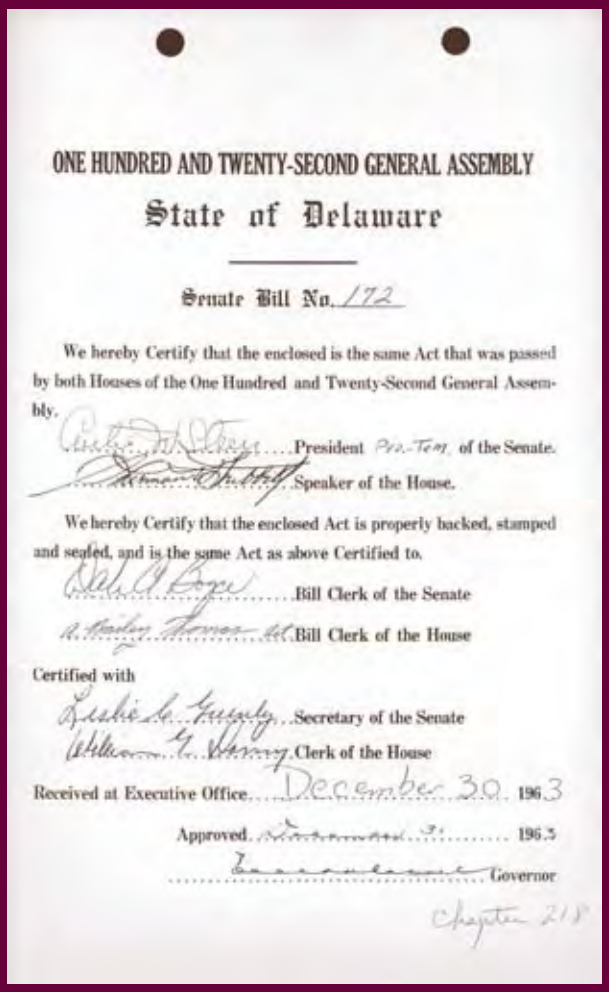
INSIDE: Revisiting the First State's Landmark Achievement Through the Eyes of the Drafters

Delaware Lawyer

A PUBLICATION OF THE DELAWARE BAR FOUNDATION
VOLUME 26 ◆ NUMBER 1
$3.00 ◆ SPRING 2008



ONE HUNDRED AND TWENTY-SECOND GENERAL ASSEMBLY

State of Delaware

Senate Bill No. 172

We hereby Certify that the enclosed is the same Act that was passed by both Houses of the One Hundred and Twenty-Second General Assembly.

.....President Pro-Tem of the Senate.

.....Speaker of the House.

We hereby Certify that the enclosed Act is properly backed, stamped and sealed, and is the same Act as above Certified to.

.....Bill Clerk of the Senate

.....Bill Clerk of the House

Certified with

.....Secretary of the Senate

.....Clerk of the House

Received at Executive Office December 30 1963

Approved 1963

.....Governor

Chapter 218

Folk at 40: The Past and Future of the Delaware General Corporation Law

0 74470 79067 9 01>

Nonprofit Organization
U.S. Postage
PAID
Wilmington, Delaware
PERMIT NO. 697

Delaware Lawyer

CONTENTS SPRING 2008

ON THE COVER: Senate Bill 172 appropriated funds to begin the DGCL revision. Pictured clockwise from bottom left are Richard F. Corroon, Henry M. Canby, Professor Ernest L. Folk III and S. Samuel Arsht.

Archival images and photographs appearing on the cover and throughout this issue are used with permission of The Delaware State Archives, except for the photographs of Professor Folk (courtesy of the University of Virginia School of Law) and of Richard Corroon and Charles Crompton (courtesy of Potter Anderson & Corroon LLP).

Frederick H. Alexander
is a partner in the corporate practice group of Morris, Nichols, Arsht & Tunnell LLP, which specializes in providing advice on corporate transactions, particularly those involving Delaware corporation law. Alexander received his J.D. from the Georgetown University Law Center in 1988 and a B.A. from the University of Maryland in 1985.

R. Franklin Balotti
is a director at Richards, Layton & Finger, and has argued many of the leading cases defining the duties of directors under Delaware law. A pre-eminent practitioner and a graduate of Cornell Law School, he is the author of numerous articles and a frequent speaker on a host of corporate law topics.

Michael Barry
is a director in the Wilmington office of Grant & Eisenhofer. Barry's practice focuses on securities and corporate governance litigation, as well as advising clients on SEC matters. He co-authored the *Shareholder Activism Handbook* (Aspen, 2004) with Jay Eisenhofer.

Lucian A. Bebchuk
is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics and Finance and director of the program on corporate governance at Harvard Law School. He is also an elected member of the American Academy of Arts and Sciences.

Donald A. Bussard
is the senior member of Richards, Layton & Finger's corporate transactional group. Known for his expertise in connection with corporate governance and transactional matters and recognized repeatedly by his peers as one of the nation's leading lawyers, he graduated from Temple University School of Law.

Michael P. Dooley
is the William S. Potter Professor of Law at the University of Virginia. He is a member of the American Bar Association's Committee on Corporate Laws and the Reporter for the ABA's *Model Business Corporation Act.*

Charles M. Elson
is the Edgar S. Woolard Jr. Chair in Corporate Governance and Director of the Weinberg Center for Corporate Governance, Lerner College of Business & Economics at the University of Delaware.

Joel Edan Friedlander
is a stockholder of Bouchard Margules & Friedlander, where he litigates matters of Delaware corporate law on behalf of stockholders, directors and corporations. He is listed in *The Best Lawyers in America*, was selected for the list of Delaware "Super Lawyers" published in *Philadelphia Magazine* and has published articles on constitutional and corporate law.

Stuart Grant
is managing director of Grant & Eisenhofer, an institutional investor law firm with offices in Delaware, New York and Washington, D.C. Grant's practice focuses primarily on securities and corporate governance litigation. He is a member of the Corporation Council of the Delaware State Bar Association and served on the subcommittee on appraisals.

J. Travis Laster
is a founding partner of Abrams & Laster LLP, a Delaware corporate and business law boutique focusing on high-stakes litigation and transactional advice where there is a high risk of litigation or which involve complex or novel issues of Delaware law.

Theodore N. Mirvis
is a partner in the Litigation Department at Wachtell, Lipton, Rosen & Katz. Mirvis has been with the firm for more than 30 years and, during that time, has litigated some of the landmark cases regarding corporate governance issues, mergers and acquisitions, stockholder's rights and numerous other matters involving corporate and securities litigation.

James C. Morphy
is a managing partner of Sullivan & Cromwell LLP, and would like to acknowledge the assistance of Jing Wang in the preparation of his article.

Mark A. Morton
is a partner with Potter Anderson & Corroon LLP, a law firm in Wilmington. His practice includes providing advice concerning the Delaware General Corporation Law and on Delaware fiduciary duty matters (particularly with respect to mergers and acquisitions transactions). He is a frequent speaker and author on Delaware corporate law issues.

Robert S. Saunders
is a partner in Skadden's Wilmington office, and a 1991 graduate of the University of Virginia School of Law, where he edited the *Virginia Law Review.* With Edward P. Welch, he co-authors *Folk on the Delaware General Corporation Law*, now in its fifth edition.

William Savitt
is a partner in the Litigation Department of Wachtell, Lipton, Rosen & Katz. He specializes in representing corporations and directors in litigation involving mergers and acquisitions, proxy contests, corporate governance disputes, class actions involving allegations of breach of fiduciary duty and regulatory enforcement actions relating to corporate transactions.

Bruce L. Silverstein
is a partner in Young Conaway Stargatt & Taylor, LLP, where he is the Chair of the firm's Corporate Counseling and Litigation Practice Group. He also is a member of the Corporate Council of the Corporate Law Section of the Delaware State Bar Association.

Leo E. Strine Jr.
is vice chancellor of the Delaware Court of Chancery, Austin Wakeman Scott Lecturer in Law at the Harvard Law School and adjunct professor of law at the University of Pennsylvania and Vanderbilt law schools. He previously was counsel to Delaware Gov. Thomas R. Carper and a corporate litigator at Skadden, Arps, Slate, Meagher & Flom.

Robert B. Thompson
is the New York Alumni Chancellor's Professor of Law and Professor of Management at Vanderbilt University. He has served since 1991 as editor of the *Corporate Practice Commentator*, served as an adviser for the American Law Institute's *Restatement (Third) of Agency* and chaired two sections of the Association of American Law Schools.

Thomas A. Uebler
is an associate at Richards, Layton & Finger, focusing on litigation involving commercial disputes, and corporate governance and control. He graduated *summa cum laude* from Widener University School of Law. In law school, he served as a clerk to the Hon. Randy J. Holland on the Delaware Supreme Court.

Edward P. Welch
is a partner in the Wilmington office of Skadden, Arps, Slate, Meagher & Flom LLP. He graduated in 1976 from Villanova University School of Law, where he edited the *Villanova Law Review.* He is chair of the Corporation Law Council of the Delaware State Bar Association.

R. Franklin Balotti, Donald A. Bussard and Thomas A. Uebler

The (Mis)Application of Section 144

The statutory tests of § 144 have been erroneously intertwined with longstanding common law principles and have eroded the plain meaning of unrelated statutory law.

Professor Ernest L. Folk III advocated the enactment of § 144 to validate self-dealing transactions involving directors and officers when those transactions comply with any one of three statutory safeguards.[1] Since its enactment in 1967, however, courts and litigants have created confusion by invoking § 144 in circumstances beyond its narrow scope. As a result, the statutory tests of § 144 have been erroneously intertwined with longstanding common law principles regarding director liability and have eroded the plain meaning of unrelated statutory law.

Gov. Charles Terry, Secretary of State Elisha C. Dukes and Gov. Elbert N. Carvel

Section 144 deals solely with the validity of self-dealing transactions. "A contract or transaction covered by the statute is not void or voidable solely because those approving a transaction have a conflict of interest . . . . *The validating effect does not go beyond removing the spectre of voidability* ..."[2] Section 144 was not intended to displace or otherwise affect Delaware courts' equitable standards for imposing liability upon directors for breach of fiduciary duty.[3] The Court of Chancery has recognized this limitation by stating that the "question of when an interested transaction might give rise to a claim for breach of fiduciary duty — i.e., to a claim in equity — was left to the common law of corporations to answer."[4]

Delaware courts, however, have not uniformly adopted this approach. Both the Court of Chancery and the Supreme Court have, erroneously in the view of the authors, cited compliance with § 144 as limiting or eliminating director liability.

By considering § 144 in director liability analyses, Delaware courts have erroneously expanded the role of § 144. First, a court should consider § 144 only when determining whether a transaction is void or voidable. Director liability analyses should be wholly unrelated to § 144. Second, the court's duty to determine the fairness of acts by fiduciaries is rooted in Delaware's common law, not § 144.[5]

While the common law entire fairness standard is substantially identical to that in § 144(a)(3),[6] the two tests serve distinct purposes. The question is whether it makes a difference if § 144 is permitted to affect director liability. Recent cases in the Court of Chancery show that it does matter.

In *Valeant Pharmaceuticals International v. Jerney*, the plaintiff corporation sought damages from its former director and president for breach of the duty of loyalty related to a self-dealing transaction.[7] In its analysis, the Court considered § 144 and determined that entire fairness was the appropriate standard of review because the transaction was neither approved under § 144(a)(1) nor ratified under (a)(2).[8] Under entire fairness scrutiny, the Court deemed the transaction voidable and found the defendant liable for breach of fiduciary duty.[9]

The Court's application of § 144 in *Valeant* seemed to be inextricably intertwined with its analysis of director liability. The Court went further, however, and eroded another section of the DGCL, § 141(e). Rejecting the argument that good faith reliance on the advice of experts under § 141(e) provides a defense to liability, and reaffirming

that such reliance is merely one factor in the entire fairness calculation, the Court stated:

> To hold otherwise would replace this court's role in determining entire fairness under 8 *Del. C.* § 144 with that of various experts hired to give advice to the directors in connection with the challenged transaction, *creating a conflict between sections 141(e) and 144 of the Delaware General Corporation Law.*[10]

To the contrary, recognizing good faith reliance on the advice of experts as a defense to liability — as § 141(e) instructs — would not create a statutory conflict because § 144 has no role in determining director liability. By linking § 144 to § 141(e), the Court muddied the proper role and effect of both provisions and created further uncertainty for directors who rely in good faith on the advice of experts.

Unless a court must determine the validity of a self-dealing transaction before it considers a director's equitable conduct and potential liability, § 144 should not be considered when determining director liability. Until the General Assembly instructs otherwise, § 144 should be limited to the purpose expressed by Professor Folk 40 years ago — validation of self-dealing transactions. ◆

FOOTNOTES

1. Ernest L. Folk III, *Report to the Corporate Law Revision Committee* 67 (1965–1967).
2. Ernest L. Folk III, *The Delaware General Corporation Law: A Commentary and Analysis* 82 (1972) (emphasis added).
3. *See* Folk, *supra* note 1, at 74.
4. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 615 (Del. Ch. 2005).
5. *See Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952).
6. *See Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987). *But see Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1371 n.7 (Del. 1995).
7. 921 A.2d 732 (Del. Ch. 2007).
8. *Id.* at 745-46.
9. *Id.* at 752.
10. *Id.* at 750-51 (emphasis added).