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DE Court Rules on Deficiencies in Proxy Materials

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In *In re Transkaryotic Therapies, Inc.*, 2008 WL 2462767 (Del. Ch., June 19, 2008), the Court of Chancery of Delaware recently granted summary judgment to Transkaryotic directors alleged to have breached their fiduciary duties of disclosure (also sometimes referred to as the duty of "candor") and loyalty in connection with Shire Pharmaceuticals' acquisition of Transkaryotic. Chancellor Chandler's decision in noteworthy in two respects. First, with regard to the duty of disclosure, the court held that damages are not an appropriate remedy for material disclosure deficiencies and, once a stockholder vote has been taken and the transaction closed, it is too late to grant injunctive relief. Second, with regard to the duty of loyalty, the court refused to characterize engaged and active behavior of directors who had relationships with a major stockholder and the CEO of the acquiring company as disloyal, absent a showing of a material personal benefit or bias.

Background

This case arose from the actions of three Transkaryotic directors — Yetter, Moorhead and Leff — in the months leading up to the acquisition of Transkaryotic by Shire in a merger transaction consummated on July 27, 2005. In October 2004, the CEO of Shire, a diversified pharmaceutical company, confidentially expressed interest in a transaction to acquire Transkaryotic, a specialized biopharmaceutical company, in a telephone call to Yetter, with whom Shire's CEO had a previous relationship. The following month, Shire delivered an official expression of interest. Yetter, Moorhead and Leff supported pursuing a takeover by Shire, while the other four directors expressed concerns.

After several months of negotiations, in February 2005, Shire formally offered to purchase Transkaryotic for $31 per share. Following a heated discussion, the Board passed a resolution rejecting the offer, with Moorhead and Leff dissenting. In April, however, the Board approved a sweetened $37 per share offer by a vote of five to two. Thereafter, Leff took the lead in promoting the merger and reached out to stockholders to express the Board's view in support of the merger. In July, the merger was approved by Transkaryotic stockholders. Appraisal actions were filed by dissenting stockholders between August and November 2005. After discovery in the appraisal actions, plaintiffs filed suit against the defendant directors, alleging breaches of their fiduciary duties and seeking monetary damages. Notably, this action was not filed until March 2007, nearly two years following stockholder approval of the transaction.

Duty of Disclosure

Plaintiffs alleged that the defendants breached their fiduciary duty of disclosure by failing to disclose, or by misrepresenting certain facts to Transkaryotic stockholders in the proxy materials used to solicit votes in favor of the merger with Shire. Because plaintiffs' claims were brought after Transkaryotic stockholders voted for the merger and the transaction closed, the court ruled that plaintiffs were not entitled to any remedy, regardless of the merits of their claims.

The court began its analysis by noting that although the "somewhat nebulous" duty of disclosure is often labeled as a separate fiduciary duty, it is in fact "merely a specific application of the duties of care and loyalty." According to the court, "The Delaware Supreme Court has been clear that outside the recognized fiduciary duties of care and loyalty (and perhaps good faith), there are not other fiduciary duties. In certain circumstances, however, specific applications of the duties of care and loyalty are called for … ." As a means of further explaining this construct, the court noted that directors' so-called "Revlon duties," which are triggered when a corporation engages in a sale of control transaction, are another example of a specific application of the twin duties of care and loyalty.

Next, the court explained that Delaware case law recognizes that "an after-the-fact damages case is not a precise or efficient method by which to remedy disclosure deficiencies. [T]he right to cast an informed vote is peculiar and specific and it cannot be adequately quantified or monetized." Instead, the appropriate remedy to address the "irreparable harm" caused by material disclosure deficiencies is the "issuance of a preliminary injunction that persists until the problems are corrected" through revised or additional disclosures. Injunctive relief "specifically vindicates the stockholder right at issue — the right to receive fair disclosure of the material facts necessary to cast a fully informed vote — in a manner that later monetary damages cannot and is therefore the preferred remedy, where practicable."

Having ruled that an injunction — rather than monetary damages — is generally the appropriate remedy to address the irreparable harm caused by disclosure deficiencies, the court went on to explain that once such irreparable harm has occurred, it is, by definition, too late to remedy that harm when the "metaphorical merger eggs have been scrambled." At that point, an injunctive order would be "an exercise in futility and frivolity." Accordingly, the court held that in the specific circumstance where, three

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years prior to the ruling, a stockholder vote has occurred and the transaction closed, neither injunctive relief nor monetary damages was available to remedy the disclosure deficiencies alleged by the plaintiffs.

While this ruling is quite logical, it will leave plaintiffs without a remedy for legitimate disclosure claims if they neglect to press their claims, or do not discover the deficiencies, until after the transaction has been consummated.

Duty of Loyalty

In analyzing plaintiffs' breach of duty of loyalty claims, Chancellor Chandler cautioned that "all corporate combinations leave in their wake certain artifacts — documents, e-mails, conversation, and notes. If one digs through enough of the rubble of a consummated merger, one will almost invariably find something questionable. A clever corporate archeologist can extrapolate from these suspicious artifacts and concoct a theory of malfeasance, disloyalty, and bad faith. Yet, theories alone cannot lead to liability."

In framing their breach of duty of loyalty claims, the plaintiffs sought to deny Moorhead, Leff and Yetter the protection of the business judgment rule, accusing them of being conflicted in carrying out their duties and responsibilities as directors of Transkaryotic with respect to the Shire transaction, and of basing their decisions on "extraneous considerations or influences." The court analyzed the claims against each director separately, noting that "the mere fact that a director received some benefit that was not shared generally by all shareholders is insufficient; the benefit must be material."

Leff

Leff, the official Board representative of Warburg Pincus LLC, Transkaryotic's largest single investor, was accused of having divided loyalties. Plaintiff claimed that Leff pushed for a prompt sale "at an unfairly low price" because Warburg was "tired of its investment" and "wanted an exit." In support of their claim, plaintiffs presented evidence of what they characterized as "aggressive and stubborn attempts" by Leff to "force the deal," his "micromanagement of the valuation process" and his lobbying of stockholder votes after the merger was announced. The court rejected this claim for three reasons:

First, the court stated that the mere fact that a director has an affiliation with a large stockholder "does not disable the business judgment rule." On the contrary, the court found it likely that the interests of a director who is also a stockholder are aligned with other stockholders, and that such director has "powerful economic (and psychological) incentives to get the best available deal" with "the largest return for all shareholders."

Second, the court found no evidence that Warburg needed to divest itself of the Transkaryotic shares or that Warburg had definitively decided to do so. Rather, the evidence revealed concerns by Warburg with respect to its investment and continual evaluation of it. According to the court, evidence of a stockholder's concern with its investment is insufficient evidence of disloyalty; rather, continuous evaluation is "what private equity funds are supposed to do."

Third, the court felt that the evidence presented in support of Leff's disloyalty could similarly be evidence of his diligence. According to Chancellor Chandler, "there is nothing inherently wrong with eager, engaged, and involved directors. On the contrary, the law requires and encourages director involvement." Specifically, once a board determines that a transaction is favorable to the corporation, it may pursue various avenues to achieve a favorable outcome on a stockholder vote. The fact that a director is an "enthusiastic salesman" for a transaction does not equate to a breach of the duty of loyalty.

Moorhead

Moorhead, a senior investment professional with Warburg but not an official designee of Warburg on the Transkaryotic Board, was accused of breaching his duty of loyalty by acting as Leff's "stooge" in supporting the Shire transaction. The court found this notion to be unsupported by the facts, and specifically noted that Moorhead's dissent from the initial Board vote rejecting Shire's offer was insufficient to support a finding of disloyalty.

Yetter

Yetter had a prior relationship with the CEO of Shire, and the plaintiffs alleged that his failure to disclose his prior relationship and eagerness to complete a deal with Shire amounted to a breach of his fiduciary obligations. The court noted that even if a prior relationship amounts to an "extraneous consideration," the relationship must be of a "bias-producing nature" to create a reasonable doubt of director independence. "[P]ersonal friendships, without more … are … insufficient to raise a reasonable doubt regarding a director's independence." Furthermore, "the law is clear that outside business ties to an acquirer and interlocking directorships, without more, are insufficient to prove disloyalty."

This aspect of the Transkaryotic decision should be warmly received by corporate directors who have grown fearful that any common or innocent relationship could be used by unhappy stockholders as a basis to assert a claim for personal liability in the wake of an unpopular decision or transaction. Instead, the court made it clear that plaintiffs who do not point to "specific facts supportive of their claim" of disloyalty on the part of directors, but instead "offer only unsupported allegations and inferences," will see their claims defeated.

DGCL Section 102(b)(7)

There is one other noteworthy aspect of the Transkaryotic decision. Section 102(b)(7) of the Delaware General Corporation Law allows a corporation to include in its certificate of incorporation a provision exempting directors from personal liability for monetary damages for a breach of the duty of care, but not for a breach of the duty of loyalty. Building upon its analysis of the duty of disclosure as, in essence, a "specific application" of the duties of care and loyalty rather than a stand-alone duty, the court noted that a recovery of personal damages from the Transkaryotic directors was not available to plaintiffs in connection with defendants' alleged breach of the duty of disclosure because: 1) the exemptive provision of Transkaryotic's certificate of incorporation precluded personal liability for a director's breach of the duty of care; and 2) as discussed above, the court found that the directors had not violated their duty of loyalty.

The court cited the foregoing analysis as an alternative basis for granting summary judgment to the defendant directors. Had the court viewed the duty of disclosure as a duty separate and apart from the twin duties of care and loyalty, it would have had a more difficult time utilizing the Transkaryotic exemptive provision as an alternative ground for ruling in favor of the defendants. This is an important byproduct of the methodology applied by the Court in analyzing the duty of disclosure.