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# Corporate Governance Group Client Alert

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## DELAWARE COURT DISMISSES DERIVATIVE CLAIMS CHALLENGING DIRECTOR CONDUCT AND OVERSIGHT IN CONNECTION WITH M&A TRANSACTIONS

*Determines that Plaintiff Shareholders  
Failed to Establish Lack of Independence or  
Bad Faith on the Part of Directors Necessary  
to Plead Demand Futility*

In *In Re The Dow Chemical Company Derivative Litigation*,<sup>1</sup> the Delaware Court of Chancery recently dismissed a derivative action brought by shareholders of Dow Chemical Company against members of its board of directors. Plaintiffs claimed that the Dow directors had breached their fiduciary duties in two ways: (i) by approving a merger agreement without a financing “out,” despite questions about the availability of financing to complete the deal, and (ii) by allegedly failing to exercise proper oversight over management in connection with the merger and a related transaction. In ruling that plaintiffs were not excused from making demand on the Dow board as a pre-condition to bringing their derivative claims, the Court re-emphasized that the business judgment rule protects diligent and unconflicted directors against hindsight evaluation of their substantive decisions, and again demonstrated the significant burden on plaintiffs seeking to impose oversight liability on directors.

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<sup>1</sup> Civil Action No. 4349-CC.

### *Background*

Between late 2007 and mid-2008, Dow negotiated two significant transactions as part of its “transformative strategy” to diversify into the specialty chemicals business. The first, memorialized in a Memorandum of Understanding signed in December 2007, provided for Dow to receive a \$9 billion cash payment from Kuwait’s Petrochemicals Industries Company upon Dow’s transfer of a 50% interest in five global commodities chemical businesses to a new venture (“K-Dow”) jointly owned with the Kuwaiti company. The second, memorialized in a merger agreement with Rohm & Haas Company (“R&H”) signed in July 2008, provided for Dow to acquire all of R&H’s stock for \$18.8 billion in cash. Because deal certainty was of paramount importance to R&H following a highly competitive auction process, Dow did not bargain for a financing “out” and agreed “to assume all risk regarding negative developments affecting the chemical industry or financial markets” between signing and closing. Although the merger agreement required Dow to pay additional amounts if closing was delayed, these payments were not “liquidated damages” and R&H retained the right to seek specific performance of Dow’s obligation to complete the merger.

Dow anticipated that the \$9 billion in proceeds from the K-Dow joint venture would be available to help finance the R&H acquisition. However, in the event that the R&H acquisition closed before the K-Dow transaction, Dow also expected to be able to finance the acquisition by tapping its available cash balances, \$4 billion from investments by Berkshire Hathaway and the Kuwait Investment Authority, and a syndicated bridge loan of \$13 billion led by Citigroup. In fact, the Dow board “informed stockholders that the financing for the [R&H] Merger did not depend on Dow entering into a binding contract with Kuwait.” Further, Dow’s CEO stated at a July 10, 2008 press conference that “we are not counting on the [K-Dow deal]. We can do [the R&H] deal without the Kuwait money, and we will stay investment grade.”

The tightening of the credit markets in the second half of 2008 led to a “drastic change in circumstances” for Dow. Dow’s earnings and share price “declined precipitously” and its cash reserves “plummeted.” Then, at the end of the year, the three major rating agencies all lowered Dow’s credit rating to just above junk status. These developments constrained Dow’s ability to access its lines of credit, including the \$13 billion bridge loan.

As these events unfolded, the K-Dow joint venture received the necessary approval from the Supreme Petroleum Council of Kuwait, and the parties set a closing date of January 2, 2009. On December 28, 2008, however, the Council rescinded its approval without explanation, although rumors and later press reports intimated that bribery and political corruption of senior Kuwaiti officials may have played a role in the rescission. Nevertheless, Dow issued a press release stating that the R&H transaction was on track for a closing in early 2009 and reiterated that the closing was not dependent on receipt of proceeds from the K-Dow transaction.

Despite this public posture, when it came time to close the R&H merger on January 27th following receipt of all necessary regulatory approvals, Dow reneged, citing “economic concerns and viability of the combined entities.” R&H filed suit against Dow, seeking specific performance of the merger agreement. The parties settled their dispute before the case went to trial and the merger was completed on April 1, 2009, albeit on “substantially altered financial terms.”

Subsequently, two Dow shareholders filed “virtually identical” derivative actions, which were merged into a single action, alleging that the directors had breached their fiduciary duties by, among other things, (1) approving a merger agreement that “unconditionally obligated Dow to consummate the merger,” thereby placing Dow “in a precarious position, facing potential financial ruin,” (2) failing to monitor, detect and prevent “alleged bribery” by Dow officers of senior Kuwait officials and (3) allowing Dow to misrepresent that it did not need to complete the K-Dow transaction in order to finance the R&H acquisition.<sup>2</sup>

The defendants moved to dismiss, citing plaintiffs’ failure to make demand on the Dow board before bringing their derivative lawsuit. The Court ruled in the defendants’ favor.

### *The Court’s Analysis*

#### **Demand Futility**

Initially, the Court noted that in order to bring a derivative action under Delaware law, a shareholder must either “make pre-suit demand on the corporation’s board of directors or allege demand futility.” Because plaintiffs had not made demand on the Dow board, the Court turned to an examination of whether demand was futile, and therefore excused.

In the case of actions challenging *board action* (in this case, the decision to enter into the merger agreement with R&H), the Court explained that Delaware courts apply the two-pronged test developed in *Aronson v. Lewis*<sup>3</sup> to assess demand futility. On the other hand, in the case of actions calling into question a board’s *failure to act* (in this case, the Dow board’s alleged failure to detect bribery on the part of company officers or to prevent misrepresentations relating to the financing for the R&H acquisition), Delaware courts assess demand futility under the standard established in *Rales v. Blasband*.<sup>4</sup>

#### *Approval of the R&H Merger Agreement – the Aronson Test*

According to the Court, demand will be considered futile under *Aronson*, and thus excused, if plaintiff is able to “plead particularized facts that raise a reasonable doubt either (i) that a majority of the directors who approved the transaction in question were *disinterested and independent*, or (ii) that the transaction was the product of the board’s *good faith, informed business judgment*” [emphasis added].

With respect to the first prong of the *Aronson* test, the Court observed that “where there is no director who is interested in the transaction, there is no need to consider the independence of the ... directors.” In determining that none of the Dow directors was “interested” in the R&H transaction, the Court noted that “none of the outside directors stood on both sides of the transaction” or were “alleged to have received a personal benefit from it other than one devolved on all Dow stockholders alike,” and that none of the directors otherwise was alleged to be “interested in the deal.” For good measure (although not necessary to its ruling), the Court rejected plaintiffs’ arguments that the directors’ independence was compromised either by “various business

<sup>2</sup> Plaintiffs also alleged unlawful insider trading by three directors and three officers, as well as wasteful and excessive compensation.

<sup>3</sup> 473 A.2d 805 (Del. 1984).

<sup>4</sup> 634 A.2d 297 (Del. 1993).

or personal relationships” between Dow’s CEO and other Dow directors, by some of the directors serving together at other companies, or by the CEO’s role as a director of Citigroup (the bank leading the syndicate for Dow’s bridge loan). According to the Court, “mere outside business relationships . . . , standing alone, are insufficient to raise a reasonable doubt about a director’s independence,” and the fact that a relationship creates “the potential for a conflict of interest . . . does not reasonably lead to the conclusion that a conflict existed.”

With respect to the second prong of the *Aronson* test, the Court noted that “plaintiffs must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision.”<sup>5</sup> As to whether the directors acted in an informed manner, the Court found plaintiffs’ complaint “devoid of any allegations that the board failed to put in the time and effort necessary to properly evaluate the risks and benefits of that transaction . . . . On the contrary, plaintiffs unintentionally concede . . . that defendant directors did perform some due diligence.” Rather, the Court noted, “plaintiffs take issue with the substantive decisions of the R&H Transactions, instead of the process the board followed. The Court made clear in *Citigroup* that substantive second-guessing of the merits of a business decision, like what plaintiffs ask the Court to do here, is precisely the kind of inquiry that the business judgment rule prohibits.” Quoting from last year’s decision on *Citigroup*,<sup>6</sup> in which the Court dismissed a derivative action against the Citigroup board in connection with that company’s disastrous foray into the subprime mortgage market, the Court explained that “[S]o long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests’ the court will not second-guess a board’s business decisions.”

Next addressing whether the directors had acted in good faith, the Court cited the Delaware Supreme Court’s recent clarification of the concept of “bad faith” in *Lyondell Chemical Co. v. Ryan*<sup>7</sup> “that ‘[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarded their duties.’ Plaintiffs must show that defendants completely and ‘utterly failed’ to even attempt to meet their duties.” In the absence of “specific factual allegations” permitting an inquiry into the “state of mind” of individual Dow directors, the Court was “unconvinced that the directors acted in any way other than honestly and in good faith.”

#### *Failure to Supervise – the Rales Test*

Because the remainder of plaintiffs’ derivative claims were predicated on the board’s alleged failure to adequately supervise Dow officers and employees under *Caremark*,<sup>8</sup> the Court explained that, under *Rales*, demand is excused only if defendant directors face a “substantial likelihood of personal liability” and, therefore, “are deemed interested in the transaction.” As the Court further explained, “[d]emand is not excused solely because the directors would be deciding to sue themselves.’ Rather, ‘demand will be excused . . . only in the rare case when a plaintiff is able to show director conduct is ‘so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.’”

<sup>5</sup> *In re J.P. Morgan Chase & Co. S’Holders Litig.*, 906 A.2d 808, 824 (Del. Ch. 2005) (citing *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003)).

<sup>6</sup> *In re Citigroup Inc. S’holder Derivative Litig.*, C.A. No. 3338-CC (Del. Ch. 2009). For a discussion of *Citigroup*, please see our Client Alert entitled “*In Dismissing Derivative Claims Against Citigroup’s Directors, Delaware Court of Chancery Discusses Board’s Duty to Monitor and Manage Risk*” (March 17, 2009).

<sup>7</sup> 2009 WL 1024764 at \*7 (Del. 2009). For a discussion of *Lyondell*, please see our Client Alert entitled “*Delaware Supreme Court Overturns Court of Chancery Decision in Ryan v. Lyondell; Determines That Revlon Duties Do Not Prohibit Acceptance of a Compelling, Pre-Emptive Bid From a Strategic Buyer*” (April 13, 2009).

<sup>8</sup> *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

Again relying on *Citigroup*, the Court found that plaintiffs' allegations were insufficient to carry this heavy burden. In the Court's view, plaintiffs' claim ("sketchy (at best)") that the board failed to detect and prevent bribery related to K-Dow "is simply too attenuated to support a *Caremark* claim." Recognizing that the Dow board had adopted corporate governance policies aimed at prohibiting "any unethical payments to third parties," the Court ruled that "[w]ith neither knowledge of bribery, nor any reason to suspect such conduct, the defendant directors could not 'conscious[ly] disregard' their duty to supervise against bribery." Similarly, with respect to plaintiffs' complaint concerning the board's responsibility for the alleged misrepresentations, the Court concluded that "even assuming the ... statements were false, plaintiffs have alleged no reason for the board to suspect, let alone condone, that the statements were false and misleading."

### *Conclusion*

The Court's opinion in *Dow Chemical* is noteworthy in several respects. *First*, it provides a level of comfort to directors that courts will uphold the protections of the business judgment rule in cases where a plaintiff challenges substantive, rather than procedural, aspects of a board's decision, even when the result of that decision is not favorable. *Second*, it reiterates the high burden on plaintiffs to demonstrate demand futility in derivative claims; mere tangential connections that *may* lead to conflicts of interest are not sufficient to establish a lack of independence on the part of directors. And, *finally*, it illustrates the value of a corporation adopting corporate governance procedures aimed at thwarting corruption and ethical violations in the event that directors are later claimed to have failed in their oversight duties.

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