CURTIS

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CORPORATE GOVERNANCE CLIENT ALERT

A REVIEW OF DIRECTORS' FIDUCIARY DUTIES BEYOND SARBANES

SECOND IN A SERIES OF FOUR EDITIONS:

REVISITING THIRD-PARTY LIABILITY FOR BREACHES OF FIDUCIARY DUTY IN THE U.S.

A REVIEW OF DIRECTORS' FIDUCIARY DUTIES BEYOND SARBANES: INTRODUCTION TO THE SERIES

Prompted by a host of corporate and accounting scandals, President Bush signed the Sarbanes-Oxley Act ("Sarbanes") into law on July 30, 2002, the most sweeping piece of securities legislation enacted by Congress since the Great Depression.

Sarbanes signals a trend toward increased scrutiny of apparent conflicts of interest and breaches of fiduciary duty. This has prompted us to remind our clients of certain well-established common law duties owed by directors and officers to their companies and stockholders.[1]

The following topics will be addressed in Curtis' *A Review of Directors' Fiduciary Duties Beyond Sarbanes*.

EDITION 1 – Revisiting Dual Directorships
In our first edition, we discussed the problems faced by directors in the U.S. who simultaneously serve on the boards of a parent company and its subsidiary and who must fulfill the fiduciary duties attendant to each position.

EDITION 2 – Revisiting Third-Party Liability
This edition addresses the potential liability of tender offerors, parent companies and other controlling stockholders that transact or otherwise deal with directors of a counterparty.

EDITION 3 – Heightened Fiduciary Duties of Certain Officers
This edition will examine the duties owed by officers and the possibility that officers, because of their greater familiarity with, and proximity to, the workings of the company, may be subject to a higher standard than directors.

EDITION 4 – Directors' Duties in Financially-Distressed Companies
This edition will discuss the manner in which the focus of a director's fiduciary duties change from equityholders to debtholders, employees and other interested groups when a company becomes financially distressed.

[1] The following commentary focuses primarily on Delaware law due to the persuasiveness of Delaware court decisions in the area of corporate governance.

REVISITING THIRD-PARTY LIABILITY: AN INTRODUCTION

Corporate bidders and controlling stockholders, when transacting or otherwise dealing with directors of a counterparty, should conduct their affairs with a cautionary eye. In the event that such a counterparty's directors are found to have breached their fiduciary duty of care or loyalty, the corporate bidder or controlling stockholder may be accused of aiding or abetting such a breach. This client alert addresses three specific scenarios in which such third-party liability might arise, including (i) tender offers, (ii) dual directorships in the parent-subsidiary context, and (iii) directorships in the context of controlling stockholders.

In a tender offer, hard bargaining with the target company's board of directors is the rule rather than the exception. The negotiation process is often a heated affair, with the bidder attempting to exert the maximum amount of pressure in order to obtain the lowest price possible.

Shareholders' derivative suits can potentially recast these negotiation processes (and, indeed, certain other interactions between the bidder and the target's board) as being manipulative. Such a showing could, in turn, give rise to substantial third-party liability for the bidder.

Parent companies placing certain of their own directors on the boards of their subsidiaries, as well as other controlling stockholders electing directors to the boards of controlled companies, also have reason to exercise caution. Their dealings with such directors can potentially give rise to liability under a theory of civil conspiracy, if it can be inferred from the facts that the parent or other controlling stockholder coerced or manipulated the breaching director, or otherwise participated or was complicit in the breach.

KEY CONCEPTS: KNOWING CONFEDERATION

A third-party who knowingly participates in the breach of a fiduciary's duty may be held jointly and severally liable for damages flowing from such breach. "Knowing participation" in this context amounts to an act of civil conspiracy – the aiding and abetting of a fiduciary in an act of wrongdoing. In order to establish such a claim, a plaintiff must successfully plead four elements:

1. the existence of a fiduciary relationship;
2. a breach of the fiduciary's duty;
3. knowing participation in the breach by the defendant third-party; and
4. damages proximately caused by the breach.

Unlike the first, second and fourth elements outlined above, the presence or absence of "knowing participation" by the defendant can involve more nuanced enquiries.

Assuming a plaintiff can establish the other three elements, it also must show that the third-party acted with the knowledge that (i) the fiduciary was endeavoring to breach his duty of care or loyalty, and (ii) the third-party's conduct facilitated such a breach of duty. While case law articulates an actual knowledge standard, assumedly one need only show that the third-party defendant *should* have known that its act of aiding or abetting assisted in a breach of fiduciary duty.[2] In the event the third-party's encouragement or assistance is deemed to have been a substantial factor in causing damage, the third-party may be held vicariously liable for the damage caused by the fiduciary's breach. The question of when liability for such civil conspiracy attaches is highly fact-intensive and even the courts have acknowledged the difficulty of determining when one must refrain from dealing with fiduciaries.[3]

TENDER OFFERS

Much of the case law addressing third-party liability for breaches of fiduciary duty is set in the context of takeover bids. Shareholders' derivative suits may allege that, due to conflicts of interest, the board of directors of the selling company did not obtain the best price available and, moreover, the bidder aided and abetted – i.e., "knowingly participated in" – the board's breach of fiduciary duty.

As a general rule, however, a bidder's attempt to reduce the sale price through good faith, arm's-length negotiations cannot give rise to liability for aiding and abetting a breach of fiduciary duty by the target company's board of

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[2] A claim of knowing participation need not be pled with particularity; moreover, there must be factual allegations in the complaint from which knowing participation can be reasonably inferred. See, *In re Shoe-Town, Inc. Stockholders Litig.*, 1990 Del. Ch. Lexis 14, *23 (Del. Ch. 1990).

[3] See, *Greenfield v. Tele-Communications, Inc.*, 1989 Del. Ch. Lexis 49, *7 (Del. Ch. 1989), stating that "[t]rust law principles suggest that 'knowledge' of a breach of trust may give rise to a duty not to cooperate in any respect (even as an arms-length negotiator) if to do so assists completion of the breach…But even if this principle is imported fully into corporation law, it will, I suppose, usually be problematic to discern what, less than a confession by the fiduciary or a solicitation to join in a plain wrong, constitutes 'knowledge' of the breach." (citations omitted).

directors.[4] However, at least one court has acknowledged the possibility that some transactional terms may be "so suspect" as to permit, if proven, an inference of knowledge of an intended breach of trust.[5]

A bidder may be liable to the target's stockholders if the bidder attempts to create or exploit conflicts of interest in the target's board of directors. Similarly, a bidder may be liable for aiding and abetting a fiduciary breach by the target's board if the bidder and the board conspire in or agree to the breach.

So, while a bidder may negotiate at arm's-length with the target's board to obtain the lowest possible price for the desired stock or assets, it may not knowingly participate in the target board's breach of fiduciary duty by extracting terms which require the counterparty to prefer the bidder's interests at the expense of the counterparty's stockholders.[6]

DUAL DIRECTORSHIPS

While there is sparse precedent regarding third-party liability for knowing participation in a dual director's breach of fiduciary duty, a parent company that places one or more of its own directors on the board of a subsidiary with minority stockholders may face such liability.

As discussed in Edition 1 of this series, directors who simultaneously serve on the boards of a parent and its subsidiary owe fiduciary duties of due care and undivided loyalty to both companies and to all of the companies' stockholders, whether majority or minority. The tension that exists among these competing allegiances creates the potential for both intentional and unwitting breaches of fiduciary duty, if a dual director acts in the interests of one class of beneficiary, but to the detriment of the other.

Civil conspiracy claims can arise if a third-party – here, most likely the parent company – influences the dual director's conduct in terms of voting or in the selective disclosure of confidential information. For example, were the parent to direct the dual director (i) to vote at the subsidiary level in a manner not in accordance with the director's fiduciary duties to the subsidiary, or (ii) to refrain from disclosing to the subsidiary's board information impacting the subsidiary's interests, the subsidiary's minority stockholders may have a civil conspiracy claim against the parent.

Liability under these circumstances could extend not only to the parent itself, but also to the parent's board of directors, in the event the board authorized (or even merely discussed) the dual director's (i) wrongful voting at the subsidiary level, (ii) non-disclosure of information to the subsidiary, or (iii) other breach of fiduciary duty. More importantly, a finding of civil conspiracy could be predicated merely on a reasonable inference that the parent's board had knowledge of the dual director's wrongful conduct and that he had acted with the board's implicit approval.

CONTROLLING SHAREHOLDERS

Any controlling stockholder that elects one or more directors onto the board may be liable to the controlled company and its other stockholders for civil conspiracy if it manipulates or coerces any of these directors in the discharge of their fiduciary duties, e.g., their voting practices or treatment of confidential information.

THE COST

Liability for knowingly participating in a breach of fiduciary duty can be significant. A third-party conspirator is jointly and severally liable for any damages flowing from the fiduciary breach and, hence, may be sued for the entirety of any damages award, with its sole consolation being the right to sue the fiduciary (who may well be judgment-proof) for contribution.

PREVENTATIVE MEASURES

Conspiracy claims are, by their very nature, unpredictable, given that they typically rest upon allegations of circumstantial fact viewed in retrospect.

Bidders should be careful, therefore, to avoid conduct that could be construed as manipulative or coercive with actions taken or decisions made by the target's board that will be viewed as breaching the board's fiduciary duties. Every effort should be made to document the negotiation process to show that it was, in fact, arm's-length and not a manipulation of the decision-making processes of the target's board members.

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[4] Notably, some courts have held that a complaint need not allege the absence of arm's-length negotiations. See, e.g., *Penn Mart Realty Co. v. Becker*, 298 A.2d 349 (Del. Ch. 1972); *In re Shoe-Town, Inc. Stockholders Litig.* at *23. Cf., *Repairman's Service Corp. v. Nat'l Intergroup, Inc.*, 1985 Del. Ch. Lexis 405, *26 (Del. Ch. 1985) (denying aiding and abetting claim because "there was intensive arm's-length bargaining between the parties with demands made and concessions granted on both sides" and "no indication in this record that the…defendants conspired with their…counterparts to breach a duty owed…).

[5] See, *Greenfield v. Tele-Communications, Inc.*, at *9.

[6] *Gilbert v. The El Paso Co.*, 1988 Del. Ch. Lexis 150, (Del. Ch. 1988).

Parent companies and other controlling stockholders electing dual directors onto the boards of controlled companies should likewise exercise caution in their dealings with such directors by avoiding circumstances which could give rise to an inference of either manipulation of the director's decision-making process or a conspiracy to commit a breach of fiduciary duty.

Finally, bidders, parent companies and other controlling stockholders should remain mindful that the standard for determining whether third-party liability attaches for knowingly participating in a breach of fiduciary duty is opaque. Their actions and the surrounding facts will be subjected to a hindsight bias, with every inference probably drawn in the light most favorable to the plaintiff. Accordingly, careful consideration should be given to the legal issues raised in this client alert by anyone negotiating, or otherwise dealing, with a fiduciary in these situations. It is therefore highly advisable that such parties seek counsel with regard to the legal pitfalls and risks at issue.

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