The attached article, Corporate Governance Update: *Dow* Reaffirms Delaware's Business Judgment Rule, was published in the New York Law Journal on January 28, 2010.

January 28, 2010

Corporate Governance Update: *Dow* Reaffirms Delaware's Business Judgment Rule

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The Delaware Chancery Court recently issued a resounding affirmation of the business judgment rule in the case *In re the Dow Chemical Company Derivative Litigation*.[1] Directors can take comfort in this timely reminder that, despite challenging economic circumstances and an environment of heightened scrutiny of boards and individual directors, the protections of the business judgment rule remain robust in Delaware.

The *Dow Chemical* Case

Dow was a shareholder derivative suit filed nearly a year ago amid turmoil over Dow's planned acquisition of another chemical company, Rohm & Haas, for aggregate consideration of approximately $18.8 billion. The Dow stockholders alleged that the directors and officers of Dow had breached their fiduciary duties in at least three different respects: first, in approving the Rohm & Haas transaction without a financing contingency; second, in misrepresenting the connection between the Rohm & Haas transaction and another pending transaction, a joint venture with a Kuwaiti company for which a memorandum of understanding had been entered into six months previously; and third, in failing to detect and prevent various corporate misdeeds during the course of both transactions, including bribery, misrepresentation, insider trading and wasteful compensation.

In brief, the undisputed facts are as follows: Due to a variety of unfortunate circumstances (among them the collapse of the Kuwaiti transaction, pursuant to which Dow had expected to receive $9 billion, though Dow executives had maintained that the Rohm & Haas closing did not depend on the completion of the Kuwaiti transaction) Dow found itself unable, though obligated, to close the Rohm & Haas deal when the appointed time arrived. The Dow/Rohm & Haas merger agreement included a

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[1] Del. Ch. Civ. No. 4349-CC (Jan. 11, 2010) ("*Dow*"), available at courts.delaware.gov/opinions/download.aspx?ID=132000. The opinion was written by Chancellor William Chandler.

"ticking fee" to accrue daily if the deal was not consummated within six months of entering into that agreement. When it became clear that Dow would not close the acquisition on schedule, Rohm & Haas sued Dow in Delaware for specific performance (after which the *Dow* derivative suit was filed), alleging that Dow did not have any basis not to proceed with the merger transaction. Subsequently, Dow and Rohm & Haas reached a settlement in which the merger was completed in accordance with its initial terms (but with certain of Rohm & Haas' largest stockholders agreeing to simultaneously purchase a new issue of Dow preferred stock). The opinion of the court is instructive as to current Delaware law and is worth examining in some detail.

The Chancery Court, in evaluating defendants' motion to dismiss the shareholder suit, noted that derivative suits are subject to a demand requirement under Delaware law.[2] Rather than make a pre-suit demand on Dow's board, the plaintiffs alleged demand futility. Demand is deemed futile by a Delaware court only if a majority of the directors have such a personal stake in the issue that they are incapable of making a proper business judgment in response to a demand.[3] Delaware courts evaluate demand futility under two different tests: With respect to actions a board has taken, the seminal case of *Aronson v. Lewis* requires that plaintiffs "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."[4] With respect to a board's unconscious failure to act, *Rales v. Blasband* requires that a plaintiff show that directors face such a substantial likelihood of personal liability that they are unable to evaluate the plaintiff's demand using independent and disinterested business judgment.[5]

Aronson and *Citigroup*

The court evaluated the Dow board's approval of the Rohm & Haas transaction under the *Aronson* standard and found that no director was interested in the transaction.[6] However, the plaintiffs argued that a majority of the directors were not independent because of their various business or personal relationships with the chairman of the board, who was also the chief executive officer of the company. In rejecting this argument, the court stated clearly that "the beholdenness or dominance of any director is irrelevant because there is no fear that the dominating director, without a personal or adverse interest, will do anything contrary to the best interest of the company and its

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[2] *Dow* at 14-16.

[3] *Dow* at 15 (citing *Aronson v. Lewis*, 472 A.2d 805, 814 (Del. 1984)).

[4] *Dow* at 18.

[5] *Rales v. Blasband*, 634 A.2d 927, 930, 934 (Del. 1993).

[6] *Dow* at 19.

stockholders."[7] In other words, the fact that directors have outside business or personal relationships with each other—such as being colleagues at another institution, nominating each other for directorships, or having interlocking positions on board committees within the company—is not, without some allegation of improper influence or conflict of interest, enough to establish lack of independence.[8] The court observed that these situations are common and not, in and of themselves "enough to establish lack of independence."[9]

The central remaining question to be evaluated under *Aronson* was whether the Rohm & Haas transaction was the product of the board's good faith, informed business judgment.[10] The plaintiffs were required to raise reasonable doubt that the board's action was taken honestly and in good faith or that the board was adequately informed in its decisionmaking.

Since the plaintiffs did not allege that the board was uninformed and did not challenge the process by which the board reached its decision, the court observed that fundamentally, the plaintiffs were unhappy with the Rohm & Haas transaction on the merits. Chancellor Chandler referred to the Chancery Court's decision in *In re Citigroup Shareholder Derivative Litigation* in holding that "substantive second-guessing of the merits of a business decision … is precisely the kind of inquiry that the business judgment rule prohibits."[11]

The plaintiffs unsuccessfully attempted to distinguish *Citigroup* primarily on the theory that higher stakes should yield a different standard. They argued, in essence, that a decision affecting the future of the company as a going concern—a "bet-the-company" transaction—should be subject to heightened inquiry. Chancellor Chandler made it quite clear that

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[7] *Dow* at 21.

[8] *Dow* at 23.

[9] *Dow* at 23 ("It is a business reality that current directors often nominate new directors, and some former relationship usually factors in to the nomination." "[Board] [c]ommittees may, and often do, have overlapping members.").

[10] Plaintiffs presented three claims relating to the Rohm & Haas transaction: (1) a breach of fiduciary duty of loyalty claim for insider trading by some defendants—plaintiffs abandoned this claim—(2) breaches of fiduciary duty by the defendants for, among other things, approving the Rohm & Haas transaction, misrepresenting the relationship between the Rohm & Haas transaction and another pending transaction and failing to detect and prevent bribery and misrepresentations relating to the transactions; and (3) claims for contribution and indemnification against the defendants for unidentified future claims—this claim was deemed unripe for judicial determination.

[11] *Dow* at 25 (citing *In re Citigroup S'holder Litig.*, 964 A.2d 106, 122 (Del. Ch. 2009) ("[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 protections of the business judgment rule apply.)).

> Delaware law simply does not support this distinction. A business decision made by a majority of disinterested, independent board members is entitled to the deferential business judgment rule regardless of whether it is an isolated transaction or part of a larger transformative strategy. The interplay among transactions is a decision vested in the board, not the judiciary.[12]

Further, the Chancery Court decision cited the recent Delaware Supreme Court opinion of *Lyondell Chemical Co. v. Ryan* for the proposition that in the context of a business transaction, an "extreme set of facts"—involving the complete and utter failure of the directors "to even attempt to meet their duties"—would be necessary to support a claim that disinterested directors were intentionally disregarding their duties.[13] *Lyondell* indicates that a breach of the good faith component of the duty of loyalty requires much more egregious conduct than that necessary for a breach of the duty of care.[14]

Notably, the court dismissed the derivative claims for breach of fiduciary duties relating to the Rohm & Haas transaction with prejudice under Delaware Court of Chancery Rule 15(aaa).[15] The Court of Chancery, with the full support of Chancellor Chandler, enacted Rule 15(aaa) in 2006 specifically to end the wasteful but routine practice of repeated amendment of complaints after motions to dismiss.[16] Under Rule 15(aaa), plaintiffs have a choice when faced with a motion to dismiss: they may either amend the pleading to address its deficiencies or respond to the motion on the merits. If they choose to respond to the motion and lose, the complaint is dismissed with prejudice unless the Court finds that it would be unjust to do so. *Dow* provides a clear illustration of Rule 15(aaa) in action.

Rales and *Citigroup*

As to board inaction, the plaintiffs alleged that the directors were not able to exercise disinterested business judgment in responding to their demand for suit because they faced a substantial threat of liability due to the conscious disregard of their

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[12] *Dow* at 25-26.

[13] *Dow* at 27 (citing *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 at 243-44 (Del. 2009)).

[14] *Lyondell* at 243-44 ("[I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.").

[15] *Dow* at 29.

[16] *In the Court of Chancery in the State of Delaware*, *In re Amendments to Court of Chancery Rule 3 et al.* (Jan. 4, 2006).

Caremark oversight duties.[17] The demand-futility inquiry under *Rales* is whether the board can impartially consider a shareholder demand without being influenced by improper considerations. While a "substantial likelihood of personal liability" would preclude impartiality under *Rales*,[18] plaintiffs are required under *Citigroup* to show bad faith on the part of the directors in order to establish oversight liability.[19] The court found that the plaintiffs failed to allege facts sufficient to establish a substantial likelihood of liability and dismissed the claims accordingly.

Reaffirmation of the BJR

Dow is most significant for its reiteration of the long-held principle of Delaware law that the business judgment rule protects the business decisions of boards, so long as those decisions are taken in good faith by disinterested directors. Neither the stakes of a decision nor its appearance in hindsight has any bearing on the protections of the business judgment rule. That said, directors should be sure that they are acting on a fully informed basis before they proceed with any decision.

In the volatile conditions of the current economic environment, directors facing difficult decisions and uncertain risks can act with confidence that their business judgment cannot be challenged simply because of the failure of a venture or the subsequent consequences of such failure to the company. The business judgment rule long has been a bulwark against shareholder attempts to micromanage or second-guess the oversight of the board of directors in business decisions, and in *Dow* it has been fortified once again.

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[17] *Dow* at 30-31 (citing *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

[18] *Dow* at 31 (citing *Rales* at 936).

[19] *Citigroup*, 964 A.2d at 123. In addition, Dow had adopted a provision in its charter requiring plaintiffs to plead particularized facts in evidence of bad faith in order to show a substantial likelihood of personal directorial liability. *Dow* at 32. Dow adopted the charter provision pursuant to Delaware Corporation Law S. 102(b)(7).