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Business Torts and Delaware Fiduciary Duty Law

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COVER: "Hoover Dam," photograph by Larry Gustafson, Dallas.

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FROM THE SECTION CHAIR

As the bar year comes to a close, I thought that I would take this opportunity to look back over a few Section highlights. Under Mike Ferrill's fine editorship, we continued to publish the *Texas Business Litigation Journal*, which featured articles on a number of topics ranging from antitrust to class actions. This issue contains updates on business torts by Bill Katz and Julie Abernethy and Delaware fiduciary duty law by Todd Murray.

We also undertook several new initiatives, which included a complete overhaul of the section website (www.tablit.org), conduct of a member survey to help bring Section programming in line with rapidly developing member expectations, and implementation of a new *pro bono* program aimed at helping clinics at Texas law schools (SMU's Dedman Law School received the inaugural award). In the programming department, we launched the first in a series of regional bar collaborations by partnering with the Dallas Bar Association's Antitrust Section and have taken steps to provide periodic on-demand CLE opportunities through the Section web site.

By the time you read this, the Section will have held its annual meeting, which was capped with a CLE presentation by Professor Doug Moll from the University of Houston Law Center. This program should soon be available for viewing on the Section website. The annual meeting was also the occasion for presenting Charles "Tippy" Newton with the Section's annual Distinguished Counselor Award.

In closing, I would like to thank the members of the Section and of the Council for supporting me so well this year. Particular thanks go to Justice Jim Moseley (Past-Chair), Bill Katz (Chair-elect) and Leslie Hyman (Secretary-Treasurer).

Best regards,
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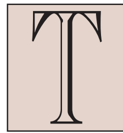

This issue of the Journal features the annual survey article on business torts by Bill Katz and Julie Abernethy and the annual survey on Delaware fiduciary duty law by Todd Murray.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, arbitration, class actions, D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor

Business Torts Update – Spring 2008

By William M. Katz, Jr. and Julie C. Abernethy[1]

William M. Katz, Jr.

Julie C. Abernethy

This survey examines significant business torts decisions by Texas courts for the period from April 2007 through March 2008. "Business torts" obviously covers a broad spectrum and, in narrowing the survey, we included cases that either decided new issues or examined issues of particular interest to business litigators. During the survey period, Texas courts addressed: (1) the evidence required to prove actual malice in a defamation suit; (2) whether tort claims against a non-signatory corporate employee and corporate affiliate fell within a contractual arbitration clause; (3) whether a court may exercise subject matter jurisdiction over a professional negligence claim against a pastor without unconstitutionally impinging on the church's disciplinary process; (4) the proof required to discover the identity of anonymous defendants in a defamation case; and (5) the evidence required to establish fraudulent inducement and breach-of-fiduciary-duty claims.

I. Evidence of Actual Malice in a Defamation Case

In *Belo Corp. v. Publicaciones Paso Del Norte, S.A. de C.V.*[2], the El Paso Court of Appeals reversed the lower court's denial of summary judgment in a defamation case because no evidence of actual malice existed. The court based its holding on (1) the plaintiff's failure to show that the defendant's interpretation of the plaintiff's statements and selective presentation of the plaintiff's reports evidenced actual malice; and (2) the fact that proof of an injurious motive was not by itself enough to establish actual malice.

In 2004, *The Dallas Morning News* published an article comparing two newspapers' opinions about the over 400 murders of young women that occurred on the El Paso/Juarez border beginning in 1993. The article discussed how Juarez's two local newspapers, *El Diario* and *Norte de Cuidad Juarez (Norte)*, viewed the murders and the murders' effect on Juarez's image. While *Norte* perpetuated conspiracy theories, such as theories that organ traffickers or Satanists committed the murders, *El Diario* theorized that domestic violence caused the women's deaths. Most importantly, the article highlighted *Norte's* allegations that *El Diario* dismissed the murders as mere domestic violence-related killings in exchange for more government advertising. The article concluded: "Mr. Rodriguez [*El Diario's* owner] said he's in no one's pocket…. He said government advertising accounts for only a small fraction of his ad revenue…. But *El Diario* is full of advertising, while *Norte* is not."

Publicaciones Paso Del Norte, S.A. de C.V. (*El Diario*) sued Belo Corporation, *The Dallas Morning News*, L.P., Belo Interactive, Inc., *The Dallas Morning News of Texas, Inc.*, and the article's authors (collectively "Belo") for defamation and business disparagement. *El Diario* eventually non-suited its business disparagement claim. Belo filed traditional and no-evidence summary judgment motions arguing both that the evidence negated actual malice and that no evidence of actual malice existed. After the trial court denied both summary judgment motions, Belo filed an interlocutory appeal with the El Paso Court of Appeals.

The El Paso Court of Appeals held that *El Diario* failed to raise a genuine issue of material fact that Belo acted with actual malice. First, the court set out the elements that *El Diario* had to prove for its defamation claim. *El Diario* admitted it qualified as a public figure. Therefore, to establish its defamation claim, *El Diario* had to prove (1) Belo published a factual statement; (2) capable of a defamatory meaning; (3) concerning *El Diario*; (4) while acting with actual malice regarding the truth of the statements. The court held that this

case depended only on the fourth element—whether Belo acted with actual malice regarding the truth of its statements.

The court noted that the defamation claim in this case differed from other defamation suits. Most other libel suits arise from a publication's individual false statements. Here, the defamation claims arose from the alleged false impression the article's statements created that *El Diario* softened its reports on the Juarez murders in exchange for more government advertising. A public figure that bases its defamation claim on the alleged defamatory impression a publication creates must show evidence that the defendant either knew or "strongly suspected" that the publication as a whole could present a false and defamatory impression of events. Evidence of negligence is insufficient. Instead, the evidence must show that the defendant had a "high degree of awareness of…[the] probable falsity of his statements." Public figures may use circumstantial evidence to prove a defendant's state of mind.

Here, no evidence of actual malice existed. The court held that the affidavits Belo submitted constituted some evidence negating actual malice, therefore shifting the burden to *El Diario* to raise a fact issue on actual malice. The article's authors submitted affidavits stating that they (1) believed the article's statements were true when they published the article; (2) did not believe the article conveyed a false or misleading impression; and (3) wrote what they intended as a truthful and factually accurate article. *The Dallas Morning News'* foreign editor also stated in his affidavit that he knew the authors as reliable journalists and that he had no doubts regarding the article's truthfulness.

Next, the court held that *El Diario's* evidence failed to raise a fact issue on actual malice. First, the court held that *El Diario's* evidence of Belo's alleged "distortions" of Rodriguez's interview for the article and of *El Diario's* reports on the murders showed no evidence of actual malice. Rodriguez claimed the article distorted his words when it changed his description of Juarez from a "mean, murderous town" to a "flawed border town." But the court viewed this a distinction as inconsequential. The article merely paraphrased Rodriguez's description rather than directly quoting it. Rodriguez also argued that Belo acted with actual malice by ignoring examples of *El Diario's* reports that exposed government corruption. But the court disagreed. In order to prove that Belo acted with actual malice by selectively presenting evidence, *El Diario* had to show the omission so distorted the article's character that "one could infer that the defendant knew, or at least suspected, that the omission would create a false impression." The article in this case merely summarized *El Diario* and *El Norte's* different views of the Juarez murders. Finally, *El Diario* argued that the article distorted *El Diario's* critics by relying on a biased source and inventing another source. In the article, Belo noted activist group Casa Amiga's criticism of *El Diario's* reporting. *El Diario* alleged that Casa Amiga was a biased source because *El Diario* had published a story accusing Casa Amiga of profiting from the Juarez murders. But the court held that Belo's reliance on a biased source did not amount to actual malice. Similarly, Belo's implication that actress Jane Fonda's comment asking "why it took international movie stars to show up before the news media covered the story" specifically criticized *El Diario* was, at most, an error in judgment. Mere errors in judgment do not constitute evidence of actual malice. Thus, *El Diario* failed to show that these alleged distortions constituted evidence of actual malice.

Second, the court held that the article's paraphrase of Rodriguez's comments also failed to constitute any evidence of actual malice. *El Diario* claimed that the article's statement that "Mr. Rodriguez said he's in no one's pocket" substantially differed from Rodriguez's actual quote that the government's advertising income "is not determinate for the newspaper." But this paraphrasing showed no evidence of actual malice. *El Diario* failed to establish either that Belo purposefully misinterpreted Rodriguez's remarks or that only a reckless publisher would have made the mistake.

Third, the court held that *El Diario's* evidence of Belo's alleged financial motive to harm *El Diario* showed no evidence of actual malice. *El Diario* claimed that Belo intentionally published defamatory material because it wanted to expand into the Hispanic newspaper market and failed to reach a joint venture agreement with *El Diario*. Although the court considered *El Diario's* evidence of Belo's alleged injurious motive as a factor in determining the existence of actual malice, the court held that an injurious motive does not by itself establish actual malice.

Finally, the court held that it could not infer actual malice in this case because no more than a scintilla of evidence existed on which to base an inference of actual malice. A court may infer actual malice from the parties' relationship, the circumstances surrounding the publication, the terms of the publication itself, and from the defendant's acts or words before, during, or after the publication. *El Diario* argued that the court could infer actual malice because the evidence showed that the authors selected and distorted two of *El Diario's* numerous reports on the Juarez murders despite their extensive investigation of *El Diario's* reports on the murders. The court rejected an inference of malice because the authors' selection of *El Diario's* reports and paraphrasing of Rodriguez's quotes amounted to no more than a scintilla of evidence on which to base an inference of malice. Therefore, based on all the evidence, the court concluded that less than a scintilla of evidence existed to create a genuine issue of material fact concerning actual malice. The court accordingly reversed the trial court's denial of summary judgment and rendered summary judgment in Belo's favor.

II. Arbitration of Claims against Non-signatory Employees and Affiliates of Signatories

In *In re Merrill Lynch Trust Co. FSB*,[3] the Texas Supreme Court conditionally granted mandamus relief and compelled investors to arbitrate their claims against a Merrill Lynch employee when the investors had signed an arbitration agreement with Merrill Lynch.

But the court held that the plaintiff investors' claims against Merrill Lynch affiliates did not fall within the arbitration clause.

In September 1993, Juan Alaniz recovered a large settlement in a personal injury lawsuit. To help preserve this settlement, Alaniz and his wife hired Merrill Lynch to set up a financial plan through its employee, Henry Medina. The Alanizes opened several cash and investment accounts with Merrill Lynch. For each account they opened, the Alanizes signed an agreement promising to arbitrate any disputes that arose with Merrill Lynch. In addition to the accounts, the Alanizes also set up an irrevocable life insurance trust with Merrill Lynch Trust Company ("ML Trust") as trustee. ML Trust then purchased a life insurance policy from Merrill Lynch Life Insurance Company ("ML Life"). ML Trust and ML Life are both Merrill Lynch affiliates, and the Alanizes signed separate contracts with each one. Neither contract with these affiliates included an arbitration clause.

In April 2003, the Alanizes sued ML Trust, ML Life, and Medina, alleging property, insurance, and business and commerce code violations, Texas Deceptive Trade Practices Act violations, breach of fiduciary duty, fraudulent conversion, theft, negligent misrepresentation, unjust enrichment, and negligence. The Alanizes did not sue Merrill Lynch. The defendants moved to compel arbitration, but the trial court denied their motion. The Thirteenth Court of Appeals denied mandamus relief. The Texas Supreme Court then conditionally granted mandamus relief to address whether, under the Federal Arbitration Act, the Alanizes' claims against non-signatory employees and non-signatory affiliates of a signatory fall within a contractual arbitration clause.

The supreme court held that (1) the Alanizes' claims against Merrill Lynch employee Medina fell within the arbitration clause because they essentially constituted claims against Merrill Lynch; but (2) the Alanizes' claims against ML Trust and ML Life did not fall within the arbitration clause because these entities were merely affiliates of Merrill Lynch and had their own contracts with the Alanizes. The court compelled the Alanizes to arbitrate their claims against Medina for two reasons. First, contracting parties generally intend to include disputes about their agents' actions when they agree to arbitrate all disputes "under or with respect to" a contract. A corporation's acts encompass the actions of its corporate agents, which include a corporation's employees. Second, the Alanizes' claims were essentially against Merrill Lynch. Medina acted within the course and scope of his employment when he took the complained-of actions. The court also rejected the Alanizes' argument that their lawsuit pertained only to Medina's actions as an insurance agent for ML Life. Even though Medina sold the Alanizes their insurance policy from ML Life, Medina did not change employers merely because he sold ML Life's product. ML Life paid the commission on the insurance policy directly to Merrill Lynch, not Medina. The Alanizes could not evade the arbitration agreement with Merrill Lynch by suing Medina for his actions as Merrill Lynch's agent.

The court cautioned, however, that employees cannot always claim inclusion under their employer's arbitration agreement. If the employee acts outside the scope of his employment and cannot attribute his actions to his employer, the employer's arbitration provision does not encompass the employee's actions.

The court also dismissed the Alanizes' arguments (1) that the arbitration agreements were illusory because Merrill Lynch could arbitrarily modify or rescind the agreements; and (2) that the arbitration agreements were invalid because the Alanizes failed to read them. First, a challenge to a contract's validity as a whole, and not specifically to the contract's arbitration clause, qualifies as a question for the arbitrator. So the Alanizes' defense that the agreement was illusory did not preclude the arbitration clause's application. Second, the failure to read an arbitration agreement does not relieve the Alanizes of the arbitration provision. When a party has the opportunity to read an arbitration agreement and signs it, a presumption exists that the party knows its contents.

In contrast to the Alanizes' claims against Medina, however, the supreme court declined to compel arbitration for the Alanizes' claims against ML Trust and ML Life. Because a corporation's affiliates constitute separate businesses from the corporation, a contract with the corporation usually does not include its affiliates. Courts may bind one corporation to the other corporation's arbitration agreement under an alter-ego theory, but this exception applies only if a corporation and its affiliate operate as one business. The Alanizes did not allege an alter-ego theory here. The arbitration agreements did not refer to ML Trust or ML Life. ML Trust and ML Life signed their own contracts with the Alanizes that did not include arbitration clauses. Compelling the Alanizes to arbitrate their claims against ML Trust and ML Life would rewrite the Alanizes' contracts with these affiliates.

The court also declined to compel arbitration based solely on ML Trust and ML Life's alleged concerted-misconduct estoppel theory for four reasons. First, the United States Supreme Court has held that the Federal Arbitration Act makes arbitration agreements no more enforceable than other contracts. Compelling arbitration merely because two claims arise from the same transaction would make arbitration agreements more inclusive than other contracts. Second, federal courts have rarely applied concerted-misconduct estoppel to compel arbitration with non-signatory defendants. Two cases in the Fifth and Eleventh Circuits compelled arbitration only when the non-signatories sought a direct benefit under a contract containing an arbitration clause in addition to engaging in concerted misconduct. Furthermore, in two Fifth Circuit cases discussing concerted-misconduct estoppel, the court compelled arbitration based solely on concerted-misconduct estoppel in only one case. Third, although federal circuit courts have compelled arbitration when a non-signatory has a "close relationship" with a signatory, courts have limited this exception to situations where a signatory sues the other party's non-signatory principals or agents. But estoppel based on concerted misconduct has no "close relationship" element.

And compelling arbitration with a non-signatory based solely on concerted-misconduct estoppel would allow non-signatory independent entities and other complete strangers to arbitration agreements to invoke those agreements. Fourth, Texas law has never bound a nonparty to a contract using a tort theory. Rather, Texas courts have bound nonparties to contracts using only contract theories, such as agency. Thus, contrary to the Arbitration Act's purpose, allowing arbitration contracts to bind nonparties based on concerted-misconduct estoppel would make arbitration contracts easier to enforce than other contracts.

Therefore, the court held that ML Trust and ML Life could not invoke the arbitration agreement. But the court noted that this holding was tentative. The United States Supreme Court has not yet clarified (1) whether federal law includes concerted-misconduct estoppel; or (2) whether federal or state law governs concerted-misconduct estoppel's application to arbitration agreements.

Thus, the supreme court conditionally granted mandamus and held (1) that the Alanizes must arbitrate their claims against Merrill Lynch employee Henry Medina; but (2) the Alanizes' claims against ML Trust and ML Life were not subject to the arbitration agreement. Because the Federal Arbitration Act requires arbitration to occur before litigation when an issue is pending in both arbitration and litigation, the court stayed the Alanizes' litigation against ML Trust and ML Life until arbitration with Medina concluded.

III. Tort Actions Arising from Acts of Church Discipline

In *Westbrook v. Penley*,[4] the Texas Supreme Court held that the United States Constitution's Free Exercise Clause precluded the trial court from exercising subject matter jurisdiction over the plaintiff's professional negligence claim against her former pastor. The court reasoned that exercising jurisdiction over the plaintiff's claim would unconstitutionally impinge on the religious function of church discipline because the professional negligence claim was inseparable from the church disciplinary process in which the allegedly tortious events occurred.

In 1998, Lee Penley and her husband sought marital counseling from C.L. "Buddy" Westbrook, a licensed professional counselor and fellow parishioner at Penley's church. Penley and her husband attended and paid for several counseling sessions at Westbrook's house. A year later, Westbrook and Penley broke from their church and formed Crossland Community Bible Church ("Crossland"). Westbrook served as Crossland's pastor. Crossland's constitution contained a disciplinary policy, which allowed the church to announce a member's removal to the congregation if the member engaged in behavior that "violates Biblical standards" and the member refused to repent.

After Penley and her husband separated, they participated in weekly group counseling sessions at Westbrook's home with other couples. Penley considered these sessions to be extensions of her prior professional counseling relationship with Westbrook. Westbrook did not charge for these sessions, and all the other couples who participated in the counseling sessions were Crossland members. At one of these counseling sessions, Penley confided in Westbrook that she had engaged in an extramarital affair and planned to divorce her husband. When Westbrook warned Penley that her affair would force him to invoke the church disciplinary process, Penley told him she had decided to voluntarily resign from Crossland.

After Penley resignation, Westbrook disclosed Penley's affair and divorce to the other church elders. Westbrook and the church elders then distributed a letter to Crossland's members that (1) disclosed Penley's affair and impending divorce; (2) labeled Penley's affair and divorce as "Biblically inappropriate" under Crossland's disciplinary code; and (3) encouraged the congregation to shun Penley in order to obtain her repentance. The letter also cautioned the congregation not to share the matter with anyone outside of Crossland.

Penley sued Westbrook, Crossland, and the church elders for defamation, negligence, breach of fiduciary duty, and intentional infliction of emotional distress. Westbrook filed a plea challenging the court's jurisdiction. He argued that the United States Constitution's First and Fourteenth Amendments prevented the court from adjudicating church disciplinary matters. Crossland and the church elders filed similar motions to dismiss. The trial court dismissed the case. Penley appealed, but then dismissed her appeal as to the church and the elders. The court of appeals affirmed the trial court's dismissal of all claims against Westbrook except for the professional negligence claim. The appellate court held that Penley's professional negligence claim did not invoke the First Amendment because it concerned Westbrook's role as Penley's secular professional counselor. The Texas Supreme Court granted Westbrook's petition for review to address whether the trial court had jurisdiction over Penley's professional negligence claim under the First and Fourteenth Amendments' religion clauses.

The supreme court reversed the appellate court's decision. First, the court addressed the inherent conflict in this case between the constitutional interest in preserving the church's independence in managing its own affairs and the secular confidentiality interest that Penley's professional negligence claim advanced. The court emphasized the First and Fourteenth Amendments' mandate prohibiting the government from encroaching on a church's ability to manage its internal affairs. The court analogized the struggle between the religious and secular interests that this case implicated to cases involving claims of employment discrimination in church-minister relations. In those cases, courts have uniformly held that the First Amendment mandate to preserve church independence outweighs the government's interest in eliminating discrimination in the workplace. Courts cannot intrude into church governance in a coercive manner even if the alleged discrimination does not involve religious doctrine. Similar to employment discrimination cases against churches, the court concluded that the government's interest in enforcing a licensed counselor's confidentiality duties must yield to the constitutional interest in preserving church autonomy.

The court also dismissed Penley's argument that the neutral-principles exception to the doctrine of church autonomy applied in this case. The neutral-principles exception permits courts to resolve disputes over ownership of church property. Courts allow judicial resolution of these property disputes because their resolution does not require judicial interpretation of religious doctrine. Penley alleged that her complaint focused only on Westbrook's initial disclosure of confidential information to church elders and thus did not require the court to evaluate religious doctrine. But the court disagreed for two reasons. First, Westbrook's initial disclosure to the elders was inseparable from Crossland's disciplinary process. Crossland's disciplinary code motivated Westbrook's initial disclosure. Westbrook had to disclose Penley's affair and divorce in order to abide by Crossland's rules. Second, imposing tort liability on Westbrook for initiating Crossland's disciplinary process would burden churches' ability to administer their laws. Although Penley's professional negligence claim against Westbrook involved neutral principles, applying those principles to impose tort liability on Westbrook would encroach on Crossland's ability to govern itself. Therefore, the court declined to expand the neutral-principles exception to this case.

The court also distinguished cases that imposed tort liability on church leaders for conduct not involving church teachings or beliefs. Penley argued that members of the clergy enjoy no constitutional protection for misconduct when they act as professional marriage counselors. But the cases Penley cited to support this proposition involved clergy members who developed sexual relationships with parishioners they counseled. The courts imposed tort liability on the clergy members in those cases because the clergy members' alleged tortious conduct fell outside the clergy's religious beliefs and teachings. The clergy members could not claim that their religious beliefs motivated their sexual relationships with the parishioners they counseled. In this case, however, church doctrine and Westbrook's religious beliefs required him to breach his confidentiality duty to Penley. Furthermore, his disclosure did not endanger Penley or the public's health or safety.

Finally, the court noted that Penley's implication that Westbrook could not have been performing a pastoral function when he disclosed confidential information because Penley voluntarily resigned from Crossland lacked merit. In Westbrook and Crossland's view, Penley's voluntary resignation from Crossland did not negate the Crossland disciplinary policy's requirement to encourage Penley's repentance by disclosing her alleged "Biblically inappropriate behavior." Westbrook based his decision to reveal Penley's affair and divorce on Crossland's interpretation of certain Bible verses. Thus, because Penley's professional negligence claim against Westbrook unconstitutionally impinged upon Westbrook and Crossland's ability to manage its own affairs, the court concluded that it lacked subject matter jurisdiction over Penley's claim. Accordingly, the court reversed the court of appeals' judgment and dismissed Penley's suit against Westbrook for lack of subject matter jurisdiction.

IV. Defamation Actions Against Unknown Defendants

In *In re Does 1-10*,[5] the Texarkana Court of Appeals defined the circumstances under which a defamation plaintiff may discover the defendant's identity. In a matter of first impression in Texas, the court held that a plaintiff must support its defamation claim with facts sufficient to survive a summary judgment motion before the plaintiff may obtain the defendant's identity.

When anonymous bloggers posted comments on a website criticizing Paris Regional Medical Center ("PRMC") and disclosing confidential patient information, PRMC sued Does 1-10 for defamation and breach of contract. On July 19, 2007, PRMC filed a petition against the Does along with an "ex parte request to non-party to disclose information" asking the trial court to order SuddenLink Communications, the Internet service provider, to disclose the Does' identities. Although it initially granted PRMC's request, the trial court later issued a second "agreed" order providing notice to the Does and an opportunity for them to respond. But if the Does did not respond, then the trial court would order Suddenlink to disclose the Does' identities. After counsel appeared for Doe 1, the trial court held a hearing on September 7, 2007. At the hearing, the trial court possessed only PRMC's unsworn petition, and PRMC did not attach any exhibits or affidavits. Neither party produced any evidence. The trial court ordered additional briefing.

On September 14, the trial court sent a letter to PRMC and Doe 1's counsel stating that PRMC had shown good cause to discover the Does' identities under the Cable Communications Policy Act ("CCPA"). The letter directed counsel to prepare an order for the court's signature. On September 24, Doe 1's counsel filed a letter objecting to the court's conclusions. The letter argued that "even the lowest level of review suggested by the courts" did not authorize discovery of the Does' identities because PRMC had provided no evidence to support its claims.

Three days later, PRMC provided a petition with an affidavit from a hospital representative affirming the petition's statements. PRMC also attached copies of the blog and other documents intended to support its breach of contract claim against Does 2-10. On October 1, the trial court signed an order stating that it had considered all the filings and ordered SuddenLink to disclose Doe 1's name and address. Doe 1 filed for mandamus relief, asking the Texarkana Court of Appeals to order the trial court to withdraw its order.

The Texarkana Court of Appeals conditionally granted the writ of mandamus and ordered the trial court to withdraw its order directing SuddenLink to disclose Doe 1's identity. First, the court held that Doe 1 satisfied the two requirements for petitioning for mandamus relief. Doe 1 had no other adequate remedy on appeal because (1) the appellate court would not be able to cure PRMC's discovery of Doe 1's identity; and (2) irreparable harm would be

done to Doe 1's constitutional right to anonymous free speech if discovery proceeded absent constitutional safeguards. Doe 1 met the second requirement for mandamus because the trial court committed a clear abuse of discretion. A trial court's failure to analyze or correctly apply the law constitutes an abuse of discretion. Here, the trial court's discovery order conflicted with the Texas Rules of Civil Procedure. Thus, mandamus was available to Doe 1.

Second, the court held that Doe 1 had standing to assert a petition for writ of mandamus. Although the court never served Doe 1 with citation, Texas Rule of Civil Procedure 192.6 allows any person affected by a discovery request to move for a protective order. The rule further permits a court to make any order in the interest of justice that denies or limits discovery, including relief from discovery that constitutes an "invasion of personal, constitutional, or property rights." Here, ordering SuddenLink to disclose Doe 1's name involved an invasion of personal and constitutional rights. Therefore, the Texas Rules of Civil Procedure conferred standing to Doe 1 to petition for mandamus relief.

Third, the Court of Appeals held that the trial court abused its discretion when it used the CCPA as an independent ground for ordering SuddenLink's disclosure of Doe 1's identity. Instead, the trial court could rely only on the Texas Rules of Civil Procedure to justify its order. Although an exception to the CCPA's general ban on disclosure of subscriber information allows cable operators to disclose subscriber information to private parties pursuant to a court order, parties may not substitute the CCPA for applicable procedural rules when requesting court orders to discover a subscriber's identity. The CCPA exists to prevent disclosure of subscriber names. It contains an exception intended only to protect cable operators from liability when disclosing subscriber identities pursuant to a court order. The exception cannot serve as an alternative method for discovering a defendant's identity. Rather, parties must use procedural rules when seeking to discover a defendant's identity.

The court further rejected the idea that any basis other than the discovery rules would justify the trial court's order compelling disclosure of Doe 1's identity. The court of appeals could not uphold the trial court's order as an equitable bill of discovery. The Texas Supreme Court long ago held that common law equitable bills of discovery no longer exist under Texas law.[6] Further, the supreme court also held that absent an extraordinary reason to depart from the discovery rules, Texas courts have no inherent powers to create their own procedures. In this situation, the Texas discovery rules contain specific procedures governing discovery from nonparties.[7] So the trial court lacked authority to grant a discovery order other than in accordance with the Texas discovery rules. A discovery order failing to apply the discovery rules is an abuse of discretion that justifies issuing a writ of mandamus.

Fourth, and most importantly, the court of appeals identified the standard for determining when a plaintiff may discover the defendant's identity in light of First Amendment protections. Like any anonymous speaker, Internet users cannot post defamatory speech without incurring civil liability. But because Internet users have a First Amendment right to anonymous speech, courts must balance this right with a plaintiff's right to litigate his or her claims against an anonymous defendant. Therefore, plaintiffs must present sufficient proof before a court may override First Amendment protections and order discovery of an anonymous speaker's identity. Since no Texas case has addressed this issue, the court adopted the Delaware Supreme Court's standard set forth in *Doe v. Cahill*.[8] Under *Cahill*, a plaintiff must support his claim with facts sufficient to defeat a summary judgment motion in order to obtain an anonymous defendant's identity. The court emphasized that this test does not require a plaintiff to prove its case as a matter of law; rather, the plaintiff must produce evidence sufficient to establish a prima facie case for each required element of the plaintiff's claim. Therefore, the court conditionally granted the writ of mandamus and ordered the trial court to vacate its order compelling discovery of Doe 1's identity and comply with this holding.

V. Fraudulent Inducement and Breach of Fiduciary Duty

In *Anglo-Dutch Petroleum International, Inc. v. Smith*,[9] the Houston Fourteenth District Court of Appeals held that (1) the evidence was insufficient to prove that a petroleum company fraudulently induced investors to sign investment contracts; and (2) confidentiality agreements did not create an informal fiduciary relationship between investors and the petroleum company. The court also reversed the trial court's verdict against the petroleum company for conversion and found that the investment agreements were not usurious loans and did not violate public policy.

In 2000, Anglo-Dutch Petroleum International Company sued Halliburton Company over a failed joint venture to explore an oil and gas field in Kazakhstan (the "Halliburton lawsuit"). Anglo-Dutch needed money to finance the lawsuit, so it entered into several financing agreements (the "Agreements"). Under the Agreements, the investors promised to provide financing for the Halliburton lawsuit in exchange for part of Anglo-Dutch's recovery. One investor, Smith, signed two Agreements in which Anglo-Dutch promised to pay Smith his initial $50,000 investment plus 85 percent and then an additional 85 percent each year from the Agreement's date to the date of Anglo-Dutch's recovery.

Before settling with Halliburton, Anglo-Dutch attempted to negotiate a reduced payment with the investors. Smith refused to negotiate and sued Anglo-Dutch and its majority shareholder, Van Dyke, for fraud, breach of fiduciary duty, conversion, and breach of contract. The trial court found Anglo-Dutch and Van Dyke liable on all of Smith's claims and awarded actual and exemplary damages. Anglo-Dutch and Van Dyke appealed. The Houston Fourteenth District Court of Appeals affirmed in part, reversed in part, and rendered a judgment that Smith take nothing on his claim for exemplary damages.

First, the court of appeals held that the evidence was insufficient to prove fraudulent inducement. The trial court based its holding that Anglo-Dutch fraudulently induced Smith to sign the Agreements on its findings that (1) Van Dyke made false, material representations that the Agreements were investments when he actually believed they were usurious loans and intended Smith to rely on these misrepresentations; and (2) Smith relied on these misrepresentations when he signed the Agreements. But the trial court's other findings of fact refuted this conclusion. The Agreements did not obligate Anglo-Dutch to repay any amount of money. Based on this fact, the trial court concluded that Anglo-Dutch intended the agreements as investments and that the Agreements were not loans or usurious loans. Furthermore, no evidence existed that Van Dyke intended not to perform any promises he made in the Agreements. Though Van Dyke may have realized that usury laws precluded Smith from enforcing the Agreements as loans, Van Dyke created the Agreements as investments, not loans. And Smith presented no evidence that Van Dyke did not intend to pay the investment returns required under the Agreements. Therefore, no support existed to hold Anglo-Dutch and Van Dyke liable for fraudulent inducement.

Second, the court held that Smith could not recover on his conversion claim because Smith sought only money under the Agreements. Smith argued that the Agreements assigned him a property interest in his proportionate share of the Halliburton lawsuit's recovery. But the court disagreed for two reasons. First, the Agreements assigned Smith merely collateral security interests in the Halliburton lawsuit's recovery. Second, the trial court awarded Smith a single damage amount for all of his claims against Anglo-Dutch and Van Dyke. It did not award Smith's conversion recovery out of identifiable recovery proceeds. Therefore, the trial court had no basis for holding Anglo-Dutch and Van Dyke liable for conversion.

Third, the court held that the evidence was legally and factually insufficient to find that Anglo-Dutch and Van Dyke breached a fiduciary duty to Smith. No fiduciary relationship existed between Smith and the defendants. Smith argued that the confidentiality agreements he signed prohibiting disclosure of information regarding the Agreements created an informal fiduciary relationship with the defendants. Smith alleged that these confidentiality agreements required him to trust and rely upon the defendants to protect his interest in the settlement proceeds because he could not disclose his interest to Halliburton's counsel. An informal fiduciary relationship may arise from a moral, social, domestic, or personal relationship of trust and confidence. But this special relationship of trust and confidence must exist prior to and separate from the agreement forming the basis of the lawsuit in order for courts to find an informal fiduciary duty existed. And not every relationship of trust and confidence creates a fiduciary relationship. Here, the confidentiality agreements Smith signed did not create a fiduciary duty. No authority equates confidentiality agreements with relationships of trust and confidence that rise to the level of fiduciary duties. Moreover, few contractual agreements create fiduciary duties, even though they require one party to trust that the other will perform its obligations. Thus, in this case, Smith presented no authority that a fiduciary relationship existed between himself and Anglo-Dutch and Van Dyke.

Fourth, the court upheld the defendants' liability for breach of contract. Anglo-Dutch and Van Dyke alleged that (1) the Agreements were usurious; (2) alternatively, the Agreements were void, unregistered securities; and (3) the Agreements violated public policy. As the Texas Supreme Court previously held in *Anglo-Dutch Petroleum International, Inc. v. Haskell,*[10] none of these challenges precluded the defendants' breach of contract liability. First, the Agreements did not constitute usurious loans because the Agreements were investments, not loans. Second, even if the Agreements functioned as securities, the defendants did not have standing to claim that the Agreements were unregistered securities because the defendants acted as the securities' sellers, not purchasers. Third, because they did not give uninterested third parties control over the Halliburton lawsuit, the Agreements did not violate public policy.

Therefore, the court of appeals sustained Anglo-Dutch and Van Dyke's challenges to the trial court's findings of liability for fraudulent inducement, conversion, and breach of fiduciary duty. In accordance with this reversal, the court reversed the trial court's award of exemplary damages and rendered judgment that Smith take nothing on his claim for exemplary damages. The court affirmed the remainder of the trial court's judgment.

ENDNOTES

1 Mr. Katz is a partner and Ms. Abernethy is an associate in the Dallas office of Thompson & Knight LLP.

2 —-S.W.3d—-, No. 08-06-00113-CV, 2007 WL 2729867 (Tex. App.—El Paso Sept. 20, 2007, pet. filed).

3 235 S.W.3d 185 (Tex. 2007).

4 231 S.W.3d 389 (Tex. 2007).

5 —-S.W.3d—-, No. 06-07-00123-CV, 2007 WL 4328204 (Tex. App.—Texarkana Dec. 12, 2007, no pet.).

6 *See Cargill & Dennis v. Kountze Bros.*, 25 S.W. 13, 14 (Tex. 1894).

7 *See, e.g.*, Tex. R. Civ. P. 205.1 (authorizing discovery from a nonparty by serving a subpoena compelling production of documents and tangible things or by obtaining a court order); 205.3 (compelling production from a nonparty by serving notice and a subpoena compelling production or inspection).

8 884 A.2d 451, 460 (Del. 2005).

9 —-S.W.3d—-, No. 14-06-00580-CV, 2007 WL 4165346 (Tex. App.—Houston [14th Dist.] Nov. 20, 2007, pet. filed).

10 193 S.W.3d 87, 95-101, 103 (Tex. 2006).

2007 Update Of Delaware Fiduciary Duty Law

By Todd A. Murray[1]

The Delaware courts issued a number of opinions dealing with fiduciary duty during 2007. Set forth below are summaries of significant opinions concerning zone of insolvency determinations, going-private transactions, recapitalizations, and *Revlon* claims. Not addressed in this review are several opinions addressing directors' fiduciary duties for issuing stock options and options backdating. Because the law in this area is developing, Delaware decisions on these issues will be covered in next year's update.

North American Catholic Educational Programming Foundation, Inc. v. Gheewalla[2]

This case presented, as a matter of first impression, the question of whether creditors of an insolvent corporation, or a corporation operating in the zone of insolvency, could bring a direct breach of fiduciary duty claim against the corporation's directors.

The plaintiff, North American Catholic Educational Programming Foundation, Inc. ("NACEPF"), contracted with Clearwire Holdings for Clearwire to purchase rights to radio wave spectrum licenses.[3] The defendants, Gheewalla, Cardinale, and Daly, were directors of Clearwire allegedly able to control Clearwire despite not constituting a majority of its board. They served at the behest of Goldman Sachs & Co., Clearwires' only source of funding. Although NACEPF was not a Clearwire shareholder, it brought direct, not derivative, fiduciary duty claims against the Clearwire directors. NACEPF, a putative creditor, claimed that the defendants owed it a fiduciary duty because Clearwire was either insolvent or operating in the zone of insolvency.[4] The Court of Chancery held that no such duty existed.[5]

NACEPF's complaint contained three principal allegations. First, it alleged that the defendants fraudulently induced NACEPF to enter into a contract with Clearwire. Second, it alleged that the defendants owed fiduciary duties to NACEPF as a creditor, and breached those duties by failing to preserve Clearwire's assets. Third, it alleged that defendants tortiously interfered with NACEPF's ability to sell licenses to other buyers.[6] Because personal jurisdiction depended on a finding that the complaint properly stated a breach of fiduciary duty, the Chancery Court examined whether any duty was actually owed by Clearwire's directors individually to NACEPF as a Clearwire creditor. It concluded that no such duty existed.[7]

The Delaware Supreme Court agreed with the Court of Chancery's analysis. First, both courts recognized that Clearwire either was operating within the zone of insolvency or insolvent during a substantial portion of the relevant time periods. The Supreme Court then reiterated that, while shareholders' interests are protected by the directors' fiduciary obligations to them, creditors interests are protected by other sources of creditor rights including fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, contractual agreements, general commercial law, and bankruptcy law.[8] The court then concluded that a company within the zone of insolvency is "in most need of effective and proactive leadership – as the ability to negotiate in good faith with its creditors -- goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[9] As such, the directors' duty during such a period is owed only to the company and its shareholders. When a company is insolvent, however, a company's creditors may derivatively enforce the directors' fiduciary duty to the company.[10] Nevertheless, the Supreme Court affirmed that creditors of a Delaware corporation that is insolvent or operating in the zone of insolvency may not assert a direct claim against the corporation's directors for breach of fiduciary duty.[11]

Gatz v. Ponsoldtx[12]

This was an appeal from a decision by the Court of Chancery that dismissed the plaintiff-shareholders' claims after holding that their claims were exclusively derivative and the shareholders had not complied with the Rule 23.1 demand requirement.

In 1993, Regency Affiliates, Inc., a Delaware corporation, entered into a transaction with a Bahamian corporation controlled by William R. Ponsoldt, Sr. called Statesman Group, Inc.[13] Statesman transferred its interest in 75 million tons of rock ("the Aggregate") to a Regency subsidiary in return for 28.73% of Regency's common stock, irrevocable proxies to vote an additional 5% of Regency's common stock, and 100% of Regency Series C Preferred Stock,

whose value was tied to the value of the Aggregate (which at that time was $15 million).[14] This transaction enabled Ponsoldt, through Statesman, to designate three persons to fill vacancies on Regency's board of directors.[15]

One year later, Regency acquired a partnership interest in Security Land Development Company, L.P., which owned an office building in Maryland leased by the United States Social Security Administration.[16] Regency's partnership interest entitled it to receive 95% of Security Land's profits through 2003 and 50% of profits thereafter.[17]

Two years later, in 1996, Ponsoldt was elected Regency's chairman of the board.[18] He fired the existing CEO and President, and the board hired Ponsoldt to fill these positions as well.[19] The same day he was hired, the board granted to Statesman an option allowing Statesman to acquire 6.1 million shares of Regency common stock.[20] This option was apparently issued on the understanding that it would be exercised only to prevent a hostile takeover of Regency, but Statesman exercised the option in 2001 when no hostile takeover was imminent.[21] In exchange for the 6.1 million shares, Statesman delivered to Regency a promissory note for the $2.44 million exercise price.[22] As a result of the exercise of that option, the public shareholder class's ownership was reduced from 89.1% to 61.1%.[23]

Two months after Statesman exercised its option, the Regency subsidiary that held the Aggregate sold it to another Regency subsidiary for a promissory note in the principal amount of $18.2 million.[24] The plaintiff-stockholders contended that, because the value of the Series C Preferred stock was tied to the value of the Aggregate, this sale was intended to artificially increase the value of that stock held by Statesman/Ponsoldt.[25] One month later, Ponsoldt caused Regency to adopt a 1-for-10 reverse stock split and reduction of the par value of Regency common stock from $.40 per share to $.01 per share.[26]

In the meantime, Ponsoldt was conducting negotiations with Laurence Levy, the sole director, sole stockholder, and president of Royalty Management, Inc, which was the managing member of Royalty Holdings, LLC.[27] Levy wanted to cash out Regency's lucrative partnership interest in Security Land.[28] Levy and Ponsoldt worked out a proposed restructuring of Regency's interest in the partnership, but that plan was halted in April 2002 when stockholders sued Ponsoldt and Statesman in Nebraska federal court after Regency publicly disclosed the Aggregate sale.[29] Ponsoldt convinced that court, however, that the monetization of Regency's interest in Security Land was essential to Regency's financial health, and so the court allowed the transaction to proceed.[30]

A three-member special committee, all of whom had ties to Ponsoldt, voted to approve a recapitalization transaction that closed on October 17, 2002.[31] The recapitalization involved Royalty (owned and controlled by Levy), Regency and Statesman (both controlled *de facto* by Ponsoldt),[32] and had several effects: First, Royalty/Levy provided $4.75 million cash to Regency to finance the transaction, and in return received a Regency note for $1.25 million and 59.31% majority stock control of Regency.[33] Second, Statesman/Ponsoldt received $4 million of the $4.75 million cash paid by Royalty/Levy, and Statesman's obligation to pay Royalty $2.44 million—the exercise price on Statesman's option to acquire the 6.1 million shares of Regency stock—was cancelled.[34] It appeared, then, that Statesman acquired 6.1 million Regency shares for no consideration, and then sold those shares back to Regency (after the stock split) for $1.02 million.[35]

The third effect of the recapitalization transaction was that Regency, now controlled by Levy, received $500,000 of the $4.75 million provided by Royalty/Levy, after paying $250,000 in recapitalization expenses.[36] Finally, Regency's public shareholders received no economic benefit whatsoever, and their ownership percentage diminished from almost 62% to approximately 40%.[37]

After the recapitalization, one final transaction took place that is the subject of this litigation. It was publicly disclosed in 2005 that the Regency subsidiary that had acquired the Aggregate was in default on its note.[38] To avoid foreclosure, this Regency subsidiary reconveyed title to the Regency subsidiary that had originally held the Aggregate, and the note was deemed satisfied.[39] This "unwinding" of the Aggregate sale did not remedy all of the damage done, however, because in the recapitalization transaction, Regency paid for Statesman's consent to amend the Series C preferences—and those preferences were allegedly inflated as a result of the Aggregate sale.[40]

Regency's public shareholders sued Ponsoldt, Levy, and others based on both the Aggregate sale and recapitalization transaction. The Court of Chancery ruled that both claims were derivative, and thus dismissed both claims for failure to meet the demand requirement.[41] The Delaware Supreme Court, however, reversed the dismissal, holding that the shareholders' claims could be brought as direct claims.

The court explained that the case was governed by *Tri-Starx*[42] and *Rossette*,[43] which held that when there is an expropriation of value and voting power of the shares held by public stockholders that benefits a controlling shareholder, stockholders can bring their claim as either a direct or derivative claim.[44] The court explained that, as a consequence of such a transaction, "the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited. In such circumstances, the public shareholders are entitled to recover the value represented by that overpayment . . . directly and without regard to any claim the corporation may have."[45]

The court did acknowledge a factual difference between this case and *Tri-Star* and *Rossette*. In those cases, the controlling shareholder was the immediate beneficiary of the transaction. Here, on the other hand, the beneficiary was a third party—Royalty/Levy—rather than Regency's controlling shareholder, Statesman/Ponsoldt.[46] The court did not find this factual distinction to be salient, however.

It looked through the form of the recapitalization transaction to its substance and identified two separate transactions that Ponsoldt and Levy, "by creative timing and coordination, caused simultaneously to be rolled into one."[47] Had the two transactions been conducted sequentially, the court deemed it certain that the shareholders would have a direct claim under the *Tri-Star/Rossette* rule.[48] Thus, the court refused to deprive the shareholders of their right to seek redress in a direct action simply because the component transactions were designed to occur simultaneously rather than sequentially.[49]

Because the policy concerns that motivated *Tri-Star* and *Rossette* were present in this case as well, the court ruled that the public shareholders were entitled to bring a direct action.[50] The Supreme Court thus reversed the decision of the Court of Chancery and remanded for further proceedings.[51]

Rhodes v. Silkroad Equity, LLC.[52]

This case arose when plaintiffs Rhodes and Van de Groep, two former directors, officers, and shareholders of Colossus, Inc., filed a lawsuit against the then-current owner of SilkRoad Equity, Colossus, and that company's principals. Colossus, which did business as InterAct Public Safety Systems, took out a $5.2 million bank loan that included personal guarantees by Rhodes and Van de Groep.[53] Defendant Filipowski through his company SilkRoad Equity LLC purchased the loan. Using this foothold, SilkRoad Equity exchanged a senior note of up to $10 million for 80% ownership in Colossus.[54] Shortly thereafter, the parties signed a stockholder agreement establishing a seven member board for Colossus with Rhodes and Van de Groep taking two seats and SilkRoad Equity designating the other five. One of SilkRoad Equity's designees was defendant Roszak. Additionally, the agreement gave SilkRoad Equity the right to purchase Rhodes and Van de Groep's shares at fair market value, if they were removed as directors.[55]

According to the complaint, Filipowski and Roszak began abusing their position.[56] The alleged breaking point came when SilkRoad Equity requested the issuance of $3 of preferred Colossus stock for every dollar it had lent Collosus. Rhodes and Van de Groep refused. In response, SilkRoad Equity took steps to force their agreement. Instead, Rhodes and Van de Groep filed this lawsuit. SilkRoad Equity caused Collosus to fire them, and purchased their shares at an allegedly inadequate price.[57] Rhodes and Van de Groep asserted direct claims for breach of fiduciary duty against Filipowski and Roszak. Purportedly, Filipowski and Roszak engaged in self dealing transactions, such as using Colossus funds for personal expenses and transferring SilkRoad Equity employees to Colossus' books, designed to depress Colossus' stock price so that SilkRoad Equity could acquire Rhodes and Van de Groep's shares cheaply.[58]

The defendants filed a motion to dismiss. They argued, among other things, that the fiduciary duty claims were derivative, and because Thodes and Van de Groep were no longer stockholders, they lacked standing.[59] The court began its analysis of the fiduciary duty claims by applying the test set forth in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*: "[w]ho suffered the alleged harm – the corporation or the suing stockholder individually – and who would receive the benefit of the recovery or other remedy?"[60] For a direct claim, "[t]he stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation."[61] According to the opinion, the claims were derivative in nature.

However, the court did not stop there, noting that a claim can be both direct and derivative when the harm falls disproportionately on minority stockholders, as established in *Gentile v. Rossette*.[62] The "transactional paradigm" set forth in *Gentile* arises when:

> (1) a stockholder having majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.[63]

Focusing on the "true substantive effect" of the transaction, the court noted that SilkRoad Equity, as the controlling shareholder, did not suffer harm to the same extent or in the same form as Rhodes and Van de Groep. Furthermore, Filipowski and Roszak's actions in breach of their fiduciary duties allegedly facilitated their efforts to drive out Rhodes and Van de Groep. Based on this alleged motivation and the dual nature of the claims, the court denied the motion to dismiss.[64]

In re Lear Corporation Shareholder Litigation[65]

This opinion denied a request for a preliminary injunction that sought to halt the purchase of The Lear Corporation by Carl Icahn.

The Lear Corporation manufactures and supplies automotive interior systems. In recent years, Lear had struggled, as had the American automobile industry. During a restructuring, Carl Icahn purchased 4.9% of Lear's outstanding common stock for $100 million.[66] Thereafter, Lear's stock price increased by approximately $3 per share. Icahn continued to purchase stock, then negotiated bringing his holdings in Lear to 24%.[67]

Lear at the time had an eleven member board, two of whom were officers of the company – CEO Robert Rossiter and CFO James Vandenberghe – and one of whom was affiliated with Icahn.[68] Rossiter, who had invested substantial portions of his own wealth into Lear, asked Lear's compensation committee to accelerate his retirement plan. A compensation consulting firm had provided alternatives, although Rossiter had not moved forward on any of the options.[69]

A short time later, Icahn expressed interest in taking Lear private, indicating that he would retain the existing management if he

did so. Icahn also stated he would pursue a hostile takeover if the Lear board did not want to negotiate. After a week of discussions, the Lear Board of Directors was informed of the offer.[70] In response, the Board appointed a special committee. The committee, consisting of three independent directors, did not perceive Rossiter as having a disabling conflict. Therefore, it allowed Rossiter to negotiate with Icahn.[71]

Eventually, the two sides tentatively agreed to a $36 per-share price, subject to a go-shop period, a reverse break-up fee if Icahn breached, and a voting agreement that Icahn would support any superior proposal received. The Board approved proceeding with the going-private negotiations. The special committee discretely sought other potentially interested parties. None were found. JPMorgan prepared a fairness opinion and conducted a limited market canvass. Following the go-shop period, the special committee initially could not reach a consensus to recommend the merger, and Icahn threatened to withdraw his offer.[72] The committee then recommended the merger to the full Board, which approved it.

After signing the merger agreement, Lear's financial advisors contacted over forty potential buyers to request offers. Outside the agreement, Icahn reached accord with key Lear managers to continue their employment. This included the retention at increased salaries of Rossiter and other officers, as well as early payment of retirement benefits and options for stock in the surviving entity at the per-share merger price.[73]

The plaintiffs sought a preliminary injunction to halt the merger premised on two claims that the Lear board had breached its fiduciary obligations. First, the complaint alleged that the Board had failed to "disclose all material facts relevant to the stockholders' decision whether to approve the merger."[74] Second, the complaint alleged that the Board had failed to secure the highest reasonably available price for Lear's shareholders, a breach of the directors' *Revlon* duties.[75]

The relevant facts that the complaint alleged were absent from the proxy statement were (i) a DCF model related to the fairness opinion about the merger, (ii) how Icahn's negotiation methods limited Lear's ability to do a pre-signing market check, and (iii) the fact that Rossiter approached the board before the merger regarding whether it was in his best interest to continue as CEO considering the financial risk.[76]

The Chancery Court quickly discounted the first two "omissions" because they did not qualify as material. Indeed, there was no substantial likelihood that a reasonable shareholder would consider these important when deciding how to vote. As to the third alleged omission, the court, acknowledging that Rossiter's motives may be "entirely worthy of respect," opined that the information could be material.[77] As the court viewed it, "a reasonable stockholder would want to know an important economic motivation of the negotiator singularly employed by a board to obtain the best price for the stockholders, when that motivation could rationally lead that negotiator to favor a deal at a less than optimal price."[78]

Based on this reasoning, the court found that the plaintiffs had established a reasonable probability of success on the merits as to that omission, and that asking stockholders to vote without knowledge of material facts satisfied the irreparable injury prong of the preliminary injunction inquiry.[79]

The court then reviewed the allegations that the board breached its *Revlon* duties to secure the highest reasonably available price for Lear's shareholders.[80] In conducting this inquiry, the court considered Rossiter's motivations at length, including the fact that Rossiter "had powerful interests to agree to a price and terms suboptimal for public investors" if the resulting agreement gave him the right to liquidate his equity holdings, accelerate his retirement benefits, and continue his management position with a continued equity stake.[81] Based on these motivations, according to the court, the special committee should, at the very least, have had its chairman or lead banker participate in the negotiations with Rossiter, or given Rossiter "more substantial guidance about the strategy he was to employ."[82]

While acknowledging the special committee's less-than-ideal approach to negotiations, "[r]easonableness, not perfection, measured in business terms relevant to value creation, rather than by what creates the most sterile smell, is the metric."[83] Under this metric, the special committee's overall approach was reasonable because: (i) the corporation had eliminated its poison pill, (ii) the only offer received was Icahn's despite the fact that Lear had effectively been for sale since Icahn first invested, (iii) the termination fee in the agreement would not have deterred a rival bid, (iv) the match right in the agreement might have encouraged topping bids to be materially higher than Icahn's bid, (v) Icahn's presence in the deal did not discourage other potential bidders who "did not want to tangle with Icahn," and (vi) the board had sufficient evidence to support accepting the $36 per share price if a topping bid did not materialize.[84]

In light of all these considerations, the Chancery Court denied the preliminary injunction except for requiring, prior to the merger vote, a supplemental disclosure of Rossiter's conflict between securing his retirement and continuing as Lear's CEO.[85]

In re The Topps Company Shareholders Litigation[86]

This opinion granted a request for a preliminary injunction to halt a stockholder vote on a proposed merger.

The Topps Company, Inc. makes baseball and other entertainment cards, and also distributes Bazooka bubble gum and other old-style confections. Its current Chairman and Chief Executive Officer is Arthur Shorin, the son of one of the company's founders, and Shorin's son-in-law, Scott Silverstein, is Topps' President and Chief Operating Officer.[87]

Despite its household name, Topps' financial performance generally was sluggish over the past five years.[88] In 2005, Topps was

threatened with a proxy contest, which was settled by a promise to explore the possibility of a sale of its confectionary business.[89] Topps attempted to auction off the confectionary business, but a serious buyer never emerged.[90]

The following year, insurgents reemerged when Shorin was one of the three directors up for re-election to Topps' classified board.[91] Just before the votes were counted and defeat was imminent for the incumbents, Shorin cut a deal which expanded the board to ten members and ensured his re-election, along with the election of all the insurgent nominees.[92]

Meanwhile, Shorin had been contacted by former Disney CEO Michael Eisner, who had offered to be "helpful," presumably proposing a going private transaction.[93]

After Shorin and the insurgent nominees were seated on the board, an ad hoc committee comprised of two insurgent directors and two incumbent directors was formed to evaluate Topps' strategic direction.[94] The committee was starkly divided on the issue of whether and how Topps should be sold.[95] The insurgent—now dissident—directors were adamant that a sale should involve a public auction process, while the incumbent directors did not want to undertake an auction, having already failed in trying to auction the confectionary business.[96]

Eisner was immediately in contact with the ad hoc committee, expressing his interest in making a bid.[97] Two other buyers also expressed interest, but dropped out after making low-value offers.[98] At that time, Eisner was told by an incumbent director that the other incumbent directors might be willing to entertain a bid of $10 per share.[99] Eisner then bid $9.24 per share in a deal that promised the retention of existing management, including Shorin's son-in-law, Silverstein.[100] Eisner was willing to endure a post-signing go shop process, but not a pre-signing auction.[101]

The ad hoc committee split over whether to negotiate with Eisner. After one of the dissident directors refused the opportunity to participate in the negotiation process, one of the incumbent directors—an independent director—pursued negotiations and reached a merger agreement with Eisner at $9.75 per share.[102] The merger agreement contained a forty-day go shop period and gave Topps the right to accept a superior proposal, subject only to Eisner's right to match or receive a termination fee of $12 million.[103]

Shortly before the merger agreement was approved by the Topps board, Topps's chief competitor in the sports cards business, The Upper Deck Company, expressed a desire to make a bid.[104] Upper Deck had in fact been expressing its desire for a friendly deal since 1999.[105] However, the Topps board—split along incumbent/dissident lines—approved and signed the merger agreement without responding to Upper Deck.[106]

After the merger was approved, Topps' investment banker began the go shop process, contacting more than 100 potential bidders, but Upper Deck was the only serious bidder to emerge.[107] Near the end of the go shop period, Upper Deck expressed a willingness to pay $10.75 per share, subject to a number of conditions, including its receipt of additional due diligence.[108] At that point, Topps' board had the option under its merger agreement with Eisner to declare Upper Deck an "Excluded Party," meaning that the board considered it a party reasonably likely to make a superior proposal after the expiration of the go shop period, and continue to negotiate with Upper Deck. The Topps board, however, voted not to declare Upper Deck an Excluded Party.[109]

Upper Deck then made another unsolicited offer to buy Topps for $10.75 per share, this time including a "come hell or high water" promise to deal with any antitrust issues that might arise, but limiting Topps to a reverse break-up fee of $12 million.[110] Topps also refused to treat this offer as a superior proposal that would require Eisner to match it or step aside.[111]

Topps issued a proxy statement regarding the Eisner merger agreement that also disclosed Upper Deck's bid, but did so in a manner that questioned Upper Deck's sincerity.[112] Meanwhile, Upper Deck was subject to a standstill agreement that prohibited it from making public any information about its negotiations with Topps or making a tender offer without permission from the Topps board.[113] Topps refused to release Upper Deck from the standstill agreement.

A group of stockholders and Upper Deck moved for a preliminary injunction to stop the vote on the Eisner merger that was scheduled to occur within several weeks. They argued first, that Topps failed to disclose material facts about its negotiations with Upper Deck in the proxy statement, and second, that the Topps board would be violating its *Revlon* duties by denying stockholders the chance to make an informed decision between the Eisner and Upper Deck proposals.[114]

The court agreed that the proxy statement was misleading in a number of ways. First, the court ruled that the proxy statement should have disclosed that, under the Eisner agreement, certain Topps managers—specifically Shorin and his son-in-law—had been given assurances about their future with Topps.[115] Second, the court ruled that the proxy statement was materially misleading for failing to discuss advice regarding a prior, higher, valuation of Topps that Lehman Brothers had given the Topps board before the lower revised valuation disclosed in the proxy statement.[116] Finally, the court found that the proxy statement was materially misleading regarding Upper Deck's credibility as a bidder. For example, Topps failed to disclose that Shorin made statements to the market indicating that Topps was not for sale and failed to disclose that Upper Deck expressed its interest to Topps before the go shop period began.[117] In addition, the proxy statement implied that Upper Deck's bid was subject to a financing contingency when in reality, Upper Deck

would be subject to a $12 million reverse break-up fee—the same remedy available to Topps if Eisner breached.[118] The proxy statement also made no reference to the "come hell or high water" antitrust provision in Upper Deck's revised bid.[119] For all of these reasons, the court ruled that the proxy statement contained materially misleading statements.

Regarding the plaintiffs' *Revlon* claims, the court determined that plaintiffs were not likely to succeed on their claim that the Topps board breached its *Revlon* duty when it negotiated the merger agreement with Eisner, and thus denied a preliminary injunction on that basis.[120] The court did find, however, that the plaintiffs were likely to prevail on their claim that the board breached its *Revlon* duty by refusing to negotiate in good faith with Upper Deck and refusing to release Upper Deck from its standstill agreement so that Upper Deck could communicate with Topps's shareholders.[121]

The court then issued an injunction prohibiting Topps from proceeding with the merger vote until it granted Upper Deck a waiver of the standstill agreement to make a tender offer and communicate with shareholders about its version of events.[122] The Court also enjoined the merger vote from proceeding until Topps made corrective disclosures to its proxy statement.[123]

Crescent/Mach I Partnership, L.P. v. Turner[124]

This action for breach of fiduciary duty arose out of the acquisition of Dr. Pepper Bottling Holdings, Inc. through a merger with an entity controlled by Cadbury Schweppes PLC and the Carlyle Group LP.

Dr. Pepper Bottling is a beverage packager and distributor that operates primarily in Texas, where it holds franchises for soft drinks such as Dr. Pepper and Seven-Up.[125] Jim Turner was the chief executive officer and majority shareholder of Dr. Pepper Bottling, as well as one of its three directors.[126]

Dr. Pepper Bottling's major soft drink brands, Dr. Pepper and Seven-Up, were franchised by Cadbury, which had teamed up with Carlyle to develop its U.S. soft drink distribution business.[127] Cadbury and Carlyle approached Turner about a potential acquisition of Dr. Pepper Bottling in the summer of 1998. Due to peculiarities of the soft drink business, Turner was convinced that Cadbury was its only viable option for acquisition.[128] Thus, Turner began negotiations with Cadbury.

Cadbury initially proposed an acquisition price of $19.50 per share, but the parties eventually agreed to a price of $25 per common share.[129] Turner was to take the CEO position at the new entity at the same salary he received as the head of Dr. Pepper Bottling and would invest $25 million in the new venture.[130]

The board of Dr. Pepper Bottling approved the merger, and Donaldson, Lufkin & Jenrette ("DLJ") provided a fairness opinion in support of the merger.[131] That fairness opinion relied upon Turner's projection of 3% annual volume growth over the following five years.[132] However, after the merger was approved and it came time to raise money to fund the transaction, the chief financial officer of Dr. Pepper Bottling ran two sets of numbers: one based on the 3% volume growth rate, and another based on a 4% growth rate.[133] The numbers based on the 3% rate were given to lenders and disclosed to shareholders in the merger proxy statement; the numbers based on the 4% rate were propounded to potential investors.[134] The disparity between these numbers formed the basis of the plaintiffs' breach of fiduciary duty claim: they argued that Turner actually believed the 4% volume growth rate to be accurate, but reported a 3% projection to his shareholders so that the merger price appeared to be a reasonable value when in fact it was not.[135]

After recounting and evaluating at length the testimony of Turner and others involved with the merger, the court concluded that Turner in fact believed the 3% projections to be accurate: "His projection of 3% was based on his knowledge of the market, his expertise in the bottling industry, and his experience. That estimate was a truthful estimate and a reasonable estimate." [136] Thus, the court ruled that "Turner exercised faithfully his fiduciary duties."[137]

Some plaintiffs in this case also sought appraisal of their shares in order to obtain fair value for them. After an extensive valuation analysis, the court determined that the fair value of each share of Dr. Pepper Bottling common stock as of the date of the merger was $32.31.[138]

ENDNOTES

1 Todd A. Murray is a partner at Carrington, Coleman, Sloman & Blumenthal L.L.P. in Dallas Texas. He is on the Council for the Texas State Bar's Antitrust and Business Litigation Section, is a Co-Chair of the Corporate Investigations Subcommittee of the ABA Section of Litigation Securities Committee, and is the Treasurer of the Dallas Bar Association's Securities Section.

2 2007 WL 1453705 (Del. May 18, 2007).

3 *Id*. at *1.

4 *Id*. at *1.

5 *Id*. at *1 (Personal jurisdiction over the defendants was based on 10 Del. C. § 3114, which subjects Delaware corporation's directors to personal jurisdiction in the Court of Chancery. NACEPF waived any basis it had to pursue the claims derivatively in the Court of Chancery and in its appeal to the Supreme Court.).

6 *Id*. at *3.

7 *Id*. at *4-7.

8 *Id*. at *6.

9 *Id*. at *6.

10 *Id*. at *7.

11 *Id*. at *9.

12 925 A.2d 1265 (Del. 2007).

13 *Id*. at 1268-69.

14 *Id*.

15 *Id*. at 1269. One of these vacancies was filled by Ponsoldt's son.

16 *Id*.

17 *Id*.

18 *Id*.

19 *Id*.

20 *Id*.

21 *Id*.

22 *Id*. at 1270.

23 *Id*.

24 *Id*.

25 *Id*.

26 *Id*.

27 *Id*. at 1269.

28 *Id*. at 1270.

29 *Id*. at 1270-71.

30 *Id*. at 1271.

31 *Id*.

32 *Id*.

33 *Id*. at 1272.

34 *Id*.

35 *Id*.

36 *Id*.

37 *Id*.

38 *Id*. at 1273.

39 *Id*.

40 *Id*.

41 *Id*. at 1267.

42 *In re Tri-Star Pictures, Inc.*, 634 A.2d 319 (Del. 1993).

43 *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006).

44 925 A.2d at 1277-78.

45 *Id*. at 1278 (quoting *Gentile v. Rossette, supra* note __, at 100).

46 *Id*. at 1278-79.

47 *Id*. at 1279.

48 *Id*. at 1279-80.

49 *Id*. at 1280.

50 *Id*.

51 *Id*. at 1281.

52 2007 WL 2058736 (Del. Ch. July 11, 2007).

53 *Id*. at *2.

54 *Id*. at *2.

55 *Id*. at *2.

56 *Id*. at *2-3.

57 *Id*. at *3.

58 *Id*. at *3.

59 *Id*. at *4.

60 *Id*. at *4 (quoting *Tooley v. Donaldson,Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004)).

61 *Id*.

62 *Id*. at *5 (citing *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006)).

63 *Id*. at *5 (quoting *Gentile v. Rossette*, 906 A.2d 91, 99-100 (Del. 2006)).

64 *Id*. at *5 (The Court dismissed Rhodes and Van de Groep's claims for breach of oral agreement, violation of the North Carolina trade practices statute, slander per say, and breach of stockholders agreement (against all but one defendant)).

65 926 A.2d 94 (Del. Ch. June 15, 2007).

66 *Id*. at 99.

67 *Id*. at 99-100.

68 *Id*. at 99.

69 *Id*. at 101.

70 *Id*. at 102.

71 *Id*. at 102.

72 *Id*. at 104-05.

73 *Id*. at 108-09.

74 *Id*. at 110.

75 *Id*. at 110.

76 *Id*. at 110-114.

77 *Id*. at 113.

78 *Id*. at 114.

79 *Id*. at 114-15.

80 *Id*. at 115-23.

81 *Id*. at 117.

82 *Id*. at 117.

83 *Id*. at 118.

84 *Id*. at 121.

85 *Id*. at 123.

86 926 A.2d 58 (Del. Ch. 2007).

87 *Id*. at 60.

88 *Id*. at 61.

89 *Id*.

90 *Id*.

91 *Id*. at 68.

92 *Id*.

93 *Id*. at 61.

94 *Id*. at 69.

95 *Id*. at 61.

96 *Id*.

97 *Id*. at 68.

98 *Id*. at 61.

99 *Id*. at 69.

100 *Id*. at 61.

101 *Id*.

102 *Id*. at 70.

103 *Id*. at 61.

104 *Id*. at 62.

105 *Id*.

106 *Id*.

107 *Id*. at 71.

108 *Id*.

109 *Id*. at 72.

110 *Id*. at 62.

111 *Id*.

112 *Id*.

113 *Id*. at 66.

114 *Id*. at 63.

115 *Id*. at 74.

116 *Id*. at 76-77.

117 *Id*. at 77-78.

118 *Id*. at 78.

119 *Id*.

120 *Id*. at 85-87.

121 *Id*. at 87-91.

122 *Id*. at 92-93.

123 *Id*. at 93.

124 2007 WL 1342263 (Del. Ch. May 2, 2007).

125 *Id*. at *1.

126 *Id*.

127 *Id*.

128 *Id*. at *2.

129 *Id*.

130 *Id*.

131 *Id*. at *3.

132 *Id*.

133 *Id*.

134 *Id*.

135 *Id*. at n.16.

136 *Id*. at *9.

137 *Id*.

138 *Id*. at *15.

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