TEXAS BUSINESS LITIGATION JOURNAL

Fiduciary Duty Law and Business Torts

SPRING 2012 ▪ Volume 34 ▪ Number 2

TABLE ▪ OF ▪ CONTENTS

SECTION OFFICERS and COUNCIL MEMBERS

▪ Chair ▪
Wallis M. Hampton
Skadden Arps Slate Meagher & Flom LLP
1000 Louisiana, Suite 6800
Houston, Texas 77002
(713) 655-5116
(888) 329-0756 (Fax)

▪ Chair-Elect ▪
L. James Berglund II
Thompson & Knight LLP
1722 Routh Sweet, Suite 1500
Dallas, Texas 75201
(214) 969-1385
(214) 880-3104 (Fax)

▪ Secretary-Treasurer ▪
W. Frank Carroll
Cox Smith Matthews Inc.
1201 Elm Street, Suite 3300
Dallas, Texas 75270
(214) 698-7828
(214) 698-7899 (Fax)

▪ Assistant Secretary-Treasurer ▪
Thomas R. Jackson
Jones Day
2727 N. Harwood Street
Dallas, Texas 75201
(214) 969-2978
(214) 969-5100 (Fax)

▪ Council Members (terms expire 2014) ▪
L. James Berglund, II, Dallas
Barry M. Golden, Dallas
Brian E. Robison, Dallas
Rick Milvenan, Austin
Wallis Hampton, Houston
Darryl Anderson, Houston
Kennerth Held, Houston
Ken Carroll, Dallas

▪ Council Members (terms expire 2013) ▪
William F. Carroll, Dallas
David S. Coale, Dallas
Danielle S. Murray Fitzpatrick, Austin
Thomas R. Jackson, Dallas
Bruce McDonald, Houston
John T. Prud'homme, Round Rock
Michael D. Rubenstein, Houston
Charles W. Schwartz, Houston

▪ Council Members (terms expire 2012) ▪
Todd Murray, Dallas
Carrie Huff, Dallas
Mark Bayer, Dallas
Scott Kidwell, Midland
Nicole Williams, Dallas
John Shoemaker, Houston

▪ Ex-Officio Council Members ▪
James E. ("Jim") Elliott, Dallas

▪ Section Past Chairs ▪
Stephen D. Susman - 1976-77
James E. Coleman, Jr. - 1977-78
J. Burleson Smith - 1978-79
B. J. Bradshaw - 1979-80
Charles T. Newton - 1980-81
Jack N. Price - 1981-82
Robin P. Hartmann - 1982-83
Gary V. McGowan - 1983-84
Keith E. Kaiser - 1984-85
Barry F. McNeil - 1985-86
Richard N. Carrell - 1986-87
W. Royal Furgeson, Jr. - 1987-88
Ernest R. Higginbotham - 1988-89
Max Hendrick, III - 1989-90
A. Michael Ferrill - 1990-91
Gregory S. C. Huffman - 1991-92
Layne E. Kruse - 1992-93
Allene D. Evans - 1993-94
Robert M. Cohan - 1994-95
Kenneth E. McNeil - 1995-96
Jorge C. Rangel - 1996-97
Karen B. Willcutts - 1997-98
Rufus W. Oliver, III - 1998-99
Karl S. Stern - 1999-2000
N. Henry Simpson III - 2000-01
Curtis L. Frisbie, Jr. - 2001-02
James K. Spivey - 2002-03
Lin Hughes - 2003-04
Kathleen M. LaValle - 2004-05
Larry A. Gaydos - 2005-06
Justice Jim Moseley - 2006-07
Randy D. Gordon - 2007-08
William M. Katz, Jr. - 2008-09
Leslie Sara Hyman - 2009-10
Michael D. Rubenstein - 2010-11

▪ Journal Editor ▪
A. Michael Ferrill, San Antonio

▪ Contributing Editors ▪
Leslie Hyman, San Antonio
Gerard G. Pecht, Houston
William M. Katz, Jr., Dallas
Mark Bayer, Dallas
Todd Murray, Dallas
Peter A. Stokes, Austin
Wallis Hampton, Houston
Peter Loh, Dallas
Jay Nelson, Houston
Barry Golden, Dallas
Amy Stewart, Dallas
Andrew Wooley, Houston
Danielle Fitzpatrick, Austin
Heather Lohman, Houston

▪ Webmaster ▪
Hon. James Moseley, Dallas

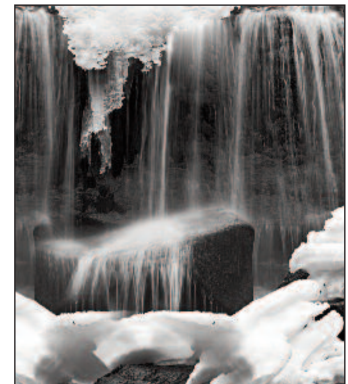
Letter from the Section Chair. 2

From the Editor 3

Developments

Update of Delaware Decisions from 2011 Impacting Fiduciary Duty Law
By Todd A. Murray 4

Business Torts Update – Spring 2012
By William M. Katz, Jr. and Megan H. Schmid 21



COVER: "Spring Thaw, Eastern Sierras, California." Photograph by Larry Gustafson, Dallas.

Publication Layout - State Bar of Texas Graphics Department

▪ FROM THE SECTION CHAIR ▪

Dear Section Members:

This issue of the *Journal* contains two of our annual surveys. Todd Murray has prepared our 2012 survey of Delaware fiduciary duty law while Bill Katz and Megan Schmid have reviewed developments in business torts. As always, the Council wants to thank Mike Ferrill for his editorial work and Larry Gustafson for his cover photograph of the Eastern Sierras. We are always on the lookout for interesting articles concerning business litigation topics. If you are interested in submitting an article for publication, please contact Mike Ferrill (amferrill@coxsmith.com or 210-554-5282).

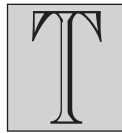
Our annual meeting at the State Bar Convention in June was a tremendous success. We sponsored a two-hour CLE on class action litigation. Our panelists included the Honorable W. Royal Furgeson, Jr. of the Northern District of Texas, the Honorable Vanessa Gilmore of the Southern District of Texas, the Honorable Xavier Rodriguez of the Western District of Texas, Frank Carroll of Cox Smith Matthews, Danielle Fitzpatrick of King & Spalding, and Daniel Gold of Haynes and Boone. Haynes and Boone's Carrie Huff was the moderator. We also presented this year's Distinguished Counselor award to Gary McGowan. Gary truly has had a distinguished career. He was Chair of the Section in the early 1980s, helped found Susman Godfrey & McGowan, and has been one of the leading mediators in Texas for over 20 years.

As my term as Chair comes to an end, I want to thank several people whose assistance allowed me to survive the last year. My successor James Berglund, our secretary-treasurer Frank Carroll, and our assistant secretary-treasurer Tom Jackson all made my job much easier. Michael Rubenstein, my immediate predecessor, also helped navigate me through many issues that arose over the year. Finally, I want to thank our friends at the State Bar—in particular, Tracy Nuckols, Lily Hewgley, Michelle Schweitzer, and Emily Bouquet—for all that they do for the Section.

Of course, if you have any questions or comments, please feel free to call me or James Berglund.

Regards,

Wallis Hampton
Section Chair
713-655-5116
wallis.hampton@skadden.com



This issue of the Journal features the annual survey articles on Delaware fiduciary duty law and business torts.

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), amferrill@coxsmith.com.

A. Michael Ferrill
Editor

Update of Delaware Decisions from 2011 Impacting Fiduciary Duty Law

By Todd A. Murray[1]

This survey examines significant business torts decisions by Texas courts for the period from May 2011 through February 2012. "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 application of the discovery rule and fraudulent concealment doctrine, when publicly available documents bear on the defendant's conduct; (2) when and under what circumstances an actionable DTPA representation may be implied based on conduct; (3) how to contractually limit claims for fraud and fraudulent inducement; and (4) whether a non-Texas resident who uses interactive local websites to allegedly defame a Texas resident is subject to personal jurisdiction in Texas.

Application of the Discovery Rule and Fraudulent Concealment Doctrine when Publicly Available Documents Contradict the Defendant's Representations

Last year was a particularly interesting and active year for both the Delaware Supreme Court and the Delaware Chancery Courts, which issued many interesting and notable decisions.

***Kahn v. Kolberg Kravis Roberts & Co., L.P.,* 23 A.3d 831 (Del. 2011)**

Primedia, Inc., is a Delaware corporation whose main executive offices are located in New York City. Primedia's business involves ownership of media properties and brands that "connect buyers and sellers through print publications, websites, events, newsletters, and video programs." Its common stock actively trades on the New York Stock Exchange. Defendant (Appellee) Kohlberg Kravis Roberts & Co. L.P. ("KKR") is an investment partnership that specializes in management buyouts of business entities. KKR indirectly controlled a majority of the common stock of Primedia.[2]

On December 19, 2001, Primedia's board of directors approved a plan for Primedia to acquire up to $100 million of its preferred shares, at 50% to 60% of redemption value, in exchange for common stock. As of December 19, 2001, KKR controlled approximately 60% of Primedia's outstanding stock and had three of its designees on Primedia's board. At the May 16, 2002 board meeting, Primedia's directors authorized an additional $100 million in buybacks of its preferred shares. On May 21, 2002, Primedia's KKR directors authored an advisory memo to KKR's Investment Committee and Portfolio Committee containing an update on Primedia's second quarter performance and advocating the purchase of Primedia's preferred shares. The May 21 memo contained nonpublic information about Primedia.[3]

On July 2, 2002, Primedia director and General Counsel Beverley Chell circulated the unanimous written consent to the disinterested directors. The written consent stated, in part, that KKR's purchase of up to $50 million in Primedia preferred stock was acceptable and not a usurpation of a corporate opportunity. The board purportedly executed the written consent on July 8, 2002, without any serious deliberations. On July 3, 2002, KKR formed ABRA III LLC as an investment vehicle to purchase Primedia's preferred shares, and ABRA began purchasing preferred shares on July 8, 2002.

On September 26, 2002, Primedia's board of directors met and approved the sale of one of its biggest assets, the American Baby Group. Primedia did not publicly disclose the American Baby Group sale until November 4, 2002. Between September 26 and November 4, 2002, KKR spent $39 million to acquire Primedia's preferred stock. On November 5, 2002, Primedia's board of directors decided to explore repurchasing Primedia preferred shares. ABRA made its last purchase of Primedia's preferred shares on November 5, 2002.[4]

The plaintiffs originally filed a derivative action on November 29, 2005. The Second Amended Complaint alleged that KKR had engineered Primedia's plans to restructure and redeem the preferred stock, and then formed ABRA "as a vehicle to buy the exact same Series D Stock, Series F Stock, and Series H Stock that were the

subject of Primedia's buyback."[5] The Second Amended Complaint also challenged the Board's written consent approval of ABRA's purchases.

On July 13, 2007, the Special Litigation Committee ("SLC") moved to stay the action pending its investigation and report. The court granted the stay, and on February 28, 2008, the SLC submitted its report and moved to dismiss the action. On January 11, 2008, after the SLC's investigation concluded, the plaintiffs presented a new claim to the SLC's counsel. The plaintiffs claimed that the KKR defendants breached their fiduciary duty to the Company by purchasing the preferred stock at a time when they possessed material, non-public information. The allegations supporting the "*Brophy*" claim did not appear in the Second Amended Complaint, because the plaintiffs had purportedly uncovered the information while reviewing materials after they filed the Second Amended Complaint.[6]

The SLC's counsel contended that the transaction's closing would moot the plaintiffs' case. The Delaware Supreme Court found that this case fell within the public importance exception because other litigants had raised the *Brophy* issue in actions now pending before the Court of Chancery. For that reason, the supreme court resolved the legal issue concerning available disgorgement remedies for a *Brophy* claim.[7]

The court reviewed the trial judge's legal conclusions *de novo*. The Vice Chancellor's analysis had focused on the SLC's investigation of three issues: (1) the *Brophy* claim based on the May 21 Insider Information Memo; (2) the *Brophy* claim based on the agreement to sell American Baby Group; and (3) the breach of contract claim based on the backdated written consent and the $50 million restriction. The Vice Chancellor had found that the SLC had met its burden under the first prong of *Zapata Corp. v. Maldonado*,[8] but rather than granting the motion to dismiss immediately, the Vice Chancellor addressed *Zapata's* discretionary second prong.

The Vice Chancellor started from "the proposition that there is a *Brophy* claim. . .that would blow by a motion to dismiss on failure to state a claim."[9] Then the Vice Chancellor held that under the law, as explained in *Pfeiffer v. Toll*,[10] disgorgement was not an available remedy for most of the *Brophy* claims. But the Supreme Court held that this was error because *Pfeiffer's* holding—which requires a plaintiff to show that the corporation suffered actual harm before bringing a *Brophy* claim—was not a correct statement of Delaware law.[11]

The court noted that, in equity, "when the breach of confidential relation by an employee is relied on and an accounting for any resulting profit is sought, loss to the corporation need not be charged in the complaint.... Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss."[12] Thus, actual harm to the corporation is not required for a plaintiff to state a claim under *Brophy*. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit.

The court also noted that, *In re Oracle Corp. Deriv. Litig.*,[13] it had affirmed the Court of Chancery's articulation of the elements essential for a plaintiff to prevail on a *Brophy* claim. The plaintiff must show that: "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information."[14] It then expressly declined to adopt *Pfeiffer's* thoughtful, but unduly narrow, interpretation of *Brophy* and its progeny. It went on to disagree with the *Pfeiffer* court's conclusion that the purpose of *Brophy* is to "remedy harm to the corporation." In fact, *Brophy* explicitly held that the corporation did not need to suffer an actual loss for there to be a viable claim. Importantly, *Brophy* focused on preventing a fiduciary wrongdoer from being unjustly enriched. Moreover, the court noted, "we have found no cases requiring that the corporation suffer actual harm for a plaintiff to bring a *Brophy* claim. To read *Brophy* as applying only where the corporation has suffered actual harm improperly limits its holding."[15]

Finding it could not ascertain whether the Vice Chancellor had analyzed the SLC's motion to dismiss without improperly relying on *Pfeiffer*, and so it was forced to reverse and remand.[16]

***King v. VeriFone Holdings, Inc.*, 12 A.3d 1140 (Del. 2011)**

The sole issue on this appeal was whether a stockholder-plaintiff who had brought a stockholder's derivative action without first prosecuting an action to inspect books and records under 8 *Del. C.* § 220 is legally precluded from prosecuting a later-filed section 220 proceeding.[17]

VeriFone, a Delaware corporation whose principal place of business is in San Jose, California, designs, markets, and services electronic payment transaction systems.

On December 3, 2007, VeriFone publicly announced that it would restate its reported earnings and net income for the prior three fiscal quarters. Both sets of numbers had been materially overstated due to accounting and valuation errors made while its inventory systems were being integrated with those of another company it had acquired. After that restatement announcement, VeriFone's stock price dropped over 45%. On October 31, 2008, shareholder Charles King filed a consolidated amended derivative complaint in the Northern District of California, claiming that various VeriFone officers and directors had committed breaches of fiduciary duty and corporate waste.[18]

VeriFone moved to dismiss King's consolidated complaint for failure to make a pre-suit demand upon its Board, as required by Federal Rule of Civil Procedure (FRCP) 23.1(b)(3). On May 26,

2009, the court granted VeriFone's motion, holding that King's consolidated complaint failed to allege particularized facts that would excuse a pre-suit demand. That dismissal was without prejudice. In granting leave to amend the complaint, the court suggested that King first "engage in further investigation to assert additional particularized facts" by filing a section 220 action in Delaware.[19]

On June 9, 2009, King submitted to VeriFone a written demand to inspect specified categories of documents. Unable to resolve the dispute through mediation, on November 6, 2009, King filed this section 220 action in the Court of Chancery for an order permitting him to inspect the Audit Report and any documents relied upon in its preparation. VeriFone moved to dismiss the section 220 complaint under Court of Chancery Rule 12(b)(6), claiming that King had "initiated this litigation backwards" by first filing his derivative suit in California. Citing an earlier Court of Chancery decision, *Beiser v. PMC–Sierra, Inc.*,[20] VeriFone argued that King's section 220 action violated the longstanding public policy-based rule that derivative plaintiffs should utilize the section 220 inspection process before commencing a derivative action. The Court of Chancery granted the motion, finding that King lacked a proper purpose because by electing to file before conducting a pre-suit investigation. The Delarware Supreme Court reviewed the trial court's conclusions of law *de novo*.

The court found that section 220 expressly grants a stockholder of a Delaware corporation the right to inspect that corporation's books and records. It then noted that Delaware courts had strongly encouraged stockholder-plaintiffs to utilize section 220 before filing a derivative action, in order to satisfy the heightened demand futility pleading requirements of Court of Chancery Rule 23.1. Nevertheless, it held that "a failure to proceed in that specific sequence, however, although ill-advised, has not heretofore been regarded as fatal."[21]

The court then explained that Delaware cases that reached a contrary outcome involved two sets of circumstances, neither of which was present here. In the first, a stockholder-plaintiff's plenary derivative complaint was still pending and the plenary court had not granted the plaintiff leave to amend. In the second, the plenary court had dismissed the derivative complaint with prejudice and, specifically, without leave to amend. In both circumstances, the Court of Chancery dismissed the later-filed section 220 actions for lack of a proper purpose.[22]

The court noted that the "result we reach here reaffirms long-standing Delaware precedent which recognizes that it is a proper purpose under section 220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, where the earlier-filed plenary complaint was dismissed on demand futility-related grounds without prejudice and with leave to amend."[23]

The court then offered guidance on those situations when the premature filing of a plenary derivative action may be a potential abuse. If, as the Court of Chancery indicated, the premature filing of a derivative action is motivated by a "rush[ ] to the courthouse" to position the plaintiff to be named "lead plaintiff," appropriate remedies are available in the plenary court. Being the "first to file" does not automatically confer lead plaintiff status. Both Delaware and federal courts generally consider various factors when selecting lead plaintiff (and lead counsel), the goal being to appoint the representative who will best serve the interests of the corporation and its shareholders and most effectively prosecute the litigation. One possible remedy for a prematurely filed derivative action might be for the plenary court to deny the plaintiff "lead plaintiff" status in such circumstances. Another (although more drastic) remedy for a derivative complaint brought prematurely and without prior investigation of facts that would excuse a pre-suit demand, would be for the plenary court to dismiss the derivative complaint with prejudice and without leave to amend as to the named plaintiff. A third possible remedy would be for the plenary court to grant leave to amend one time, conditioned on the plaintiff paying the defendants' attorneys' fees incurred on the initial motion to dismiss.[24]

***CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011)**

JetDirect Aviation Holdings, a private jet management and charter company, was a Delaware LLC. Beginning in 2005, JetDirect began acquiring other small charter companies. In 2006, the company's board of managers discovered deficiencies in its accounting processes and internal controls that eventually caused Ernst & Young, its auditor, to refuse to complete its audit. The board consolidated its billing, accounting, and other operations, which only exacerbated those deficiencies. The board approved four more major acquisitions in late 2007.[25]

In April 2007, CML became a junior secured lender after loaning JetDirect $26 million; the parties later increased the loan to $34 million. Two months later, JetDirect defaulted on its loan and was insolvent by the beginning of 2008.[26]

CML sued JetDirect's managers derivatively, claiming that (1) they had breached their duty of care by approving the late 2007 acquisitions without informing themselves of JetDirect's true financial condition, (2) they had acted in bad faith by failing to adequately implement and monitor their internal controls, and (3) certain defendants had breached their duty of loyalty by benefitting from self-interested asset sales when JetDirect underwent liquidation. CML claimed that if JetDirect's managers had possessed accurate financial information, they would have known that JetDirect would not have approved the late 2007 acquisitions. CML also claimed that certain senior managers hid adverse information from the board. Lastly, it claimed that when JetDirect began liquidating its assets to reduce its debt, the board approved asset sales to entities controlled by some of the managers, without adequate review. The Chancery Court dismissed the claims, holding that CML, as a creditor, lacked standing to sue derivatively, and CML appealed.[27]

On appeal, CML argued that Delaware's Limited Liability

Company Act grants creditors derivative standing on behalf of insolvent LLCs, in the same manner as a creditor would have in the case of an insolvent corporation.[28] The Delaware Supreme Court disagreed, holding that "[t]he LLC Act, by its plain language, exclusively limits derivative standing to 'member[s]' or 'assignee[s],' and that exclusive limitation is constitutional." The court noted that the statute in question, 6 Del. C. § 18-1002, reads in pertinent part: "In a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action…."[29] CML argued that the preceding statutory section, 6 Del. C. § 18-1001, had permissive language allowing LLC members or assignees to sue derivatively. CML contended that the sections therefore guaranteed the right to derivative standing to members or assignees, but did not limit it only to them. CML also argued that reading the two sections together demonstrated that the General Assembly intended simply to rephrase the language of the Delaware laws granting derivative standing to creditors of insolvent corporations.[30] Noting that a statute is ambiguous only if it is "susceptible to two reasonable interpretations" or would "lead to an unreasonable or absurd result," the supreme court held that the text was unambiguous and that it "must apply the plain language without any extraneous contemplation of, or intellectually stimulating musings about, the General Assembly's intent."[31]

CML next argued that this yielded an absurd result because there should not be a difference between LLCs and corporations given the policy underlying derivative standing. It argued that, without derivative standing on behalf of insolvent LLCs, there would be no stakeholders with any incentive to enforce fiduciary duties of the LLC's managers through legal action. The supreme court agreed that this might be the case and that "creditors become the ultimate risk bearers in LLCs" in the case of insolvency. However, it noted that the General Assembly was free to choose different limitations on corporate and LLC derivative standing, and the courts were required to honor that policy choice: "Ultimately, LLCs and corporations are different; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights."[32]

***Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 34 A.3d 1074 (Del. 2011)**

Sagarra was a Spanish corporation, and a minority shareholder of another Spanish corporation, Uniland. CPV, also a Spanish corporation, was the majority shareholder in Uniland, and was also the majority shareholder in Giant Cement Holdings, Inc. CPV sold Giant to Uniland through a Delaware corporation, UAC, created as a wholly-owned subsidiary of Uniland solely for the purpose of acquiring Giant. Sagarra sued derivatively on behalf of UAC to rescind the sale, claiming that the transaction was unfair and the result of self-dealing and, therefore, a breach of fiduciary duty by UAC's directors, CPV, and Uniland. Sagarra failed to satisfy the demand requirements set forth by Spanish law, and the Court of Chancery therefore granted the defendants' motion to dismiss, holding that Spanish law governed.[33]

Before the Delaware Supreme Court, Sagarra argued that the Court of Chancery erred in determining that Spanish law governed the applicable derivative standing requirements, and that the Court of Chancery should have applied Delaware law. In particular, Sagarra argued that the trial court should have applied Delaware's demand futility doctrine. In support of this argument, Sagarra contended it was suing to enforce the rights of UAC, which was a Delaware corporation. Sagarra conceded that UAC was a third-level subsidiary of Uniland, the company in which Sagarra actually held shares. Sagarra also argued that the internal affairs doctrine required the application of Delaware's derivative standing rules, because the right it sought to enforce arose when Uniland incorporated UAC in Delaware and UAC's directors breached their fiduciary duties.[34]

The Delaware Supreme Court noted that Delaware law recognizes "double derivative" suits, in which a shareholder of a parent corporation brings suit derivatively to enforce the claim of a wholly-owned corporate subsidiary when the controlling parent company refuses to enforce the subsidiary's claim directly. Here however, the court noted that the case went one step beyond a normal double derivative suit, and that "Sagarra's standing to sue derivatively on behalf of UAC must necessarily derive from its ownership of shares of Uniland, because Uniland is the only corporation in which Sagarra owns shares. Without that ownership stake, Sagarra would have no basis to claim standing to sue on behalf of any entity within the Uniland corporate hierarchy."[35] The court noted that in order to enforce a claim belonging to the subsidiary on a parent company's behalf, a shareholder must first establish its standing to proceed derivatively at the parent level. Therefore, "Sagarra's standing to sue derivatively, including its presuit demand obligations, is governed by the derivative standing rules that apply at the parent (Uniland) level."[36]

The court then considered whether Delaware or Spanish law applied to the parent company level, noting the rule that the internal affairs doctrine "requires that the law of the state (or, in this particular case, the sovereign nation) of incorporation must govern those relationships." It noted that a requirement of presuit demand "is quintessentially an 'internal affair'" that falls within the scope of that doctrine, as it allocates the right to sue on behalf of the corporation between shareholders and directors. Spanish law therefore applied to the demand requirement.[37]

Sagarra lastly attempted to argue that the court should set aside the rule for policy reasons, contending that Delaware had an interest in preventing its corporations from being used for abusive purposes, like the one alleged here. The court held that, although the argument was "correct in the abstract," Delaware courts are not free to police fiduciary breaches unless their power to act is properly invoked: "A Delaware court has no power to intervene unless and until the plaintiff's standing to invoke its jurisdiction is established. For this Court to disrupt the internal affairs of a Spanish corporation by displacing Spanish derivative standing rules with those of Delaware, would serve no legitimate Delaware interest and would violate the principle of comity."[38] The court thus affirmed the Court of Chancery's judgment.

***Seven Investments, LLC v. AD Capital, LLC,* 32 A.2d 391 (Del. Ch. 2011)**

Seven Investments, LLC and AD Capital, LLC, both investment management companies, agreed to combine their operations into a single firm to be known as Canvas Companies, LLC. Shortly after executing the merger agreement, Mark Robbins, the manager of Seven Investments, discovered that Abraxis Discala, the manager of AD Capital, had misrepresented at least two critical facts: (1) that AD Capital was able to contribute the amount of capital it had promised, and (2) that Discala had an established network of investors from which he could raise more capital. Robbins learned that AD Capital's assets were pledged to secure other debts, that Discala had no investor network, and that Discala and AD Capital were being investigated for fraud by federal authorities. After learning this, Seven Investments terminated the arrangement in accordance with terms in the merger agreement. In a formal termination agreement, Seven Investments agreed to pay particular expenses, and the parties granted each other expansive releases. Additionally, the parties acknowledged in the termination agreement that they each intended "to give a full and complete release and discharge of the Released Claims," even though "they may be unaware of or may discover facts in addition to or different from those which they now know or believe to be true related to or concerning the Released Claims or the Released Persons."[39]

Two years after the termination agreement, Seven Investments sued AD Capital and Discala. It alleged that the expenses Seven Investments agreed to pay on behalf of Canvas were fraudulent because they had been incurred by Discala and AD Capital in their use of the joint venture as a front for their fraud, rather than by legitimate operations of Canvas. The complaint sought a declaration that Seven Investments' obligations pursuant to the Termination Agreement were excused due the fraud by AD Capital and Discala, or, alternatively, that the merger agreement and other agreements relating to Canvas were null and void. The complaint also asserted a claim for common law fraud based on Discala's misrepresentations of his ability to bring capital and investors to the table, as well as a claim for unjust enrichment. Finally, the complaint sought to recover for Discala's breach of his fiduciary duties as a manager of Canvas.[40] The defendants moved to dismiss, relying on the general release in the termination agreement.

The Court of Chancery noted that the defendants' motion depended on whether the general release encompassed the claims asserted by Seven Investments. The court then proceeded to analyze the release, noting that, in making such a determination, "the intent of the parties as to its scope and effect are controlling, and the court will attempt to ascertain their intent from the overall language of the document."[41] It noted that, if "the claim falls within the plain language of the release, then the claim should be dismissed." The court held that, because Seven Investments claimed the release itself was induced by the defendants' fraud, the defendants bore the burden of proving that the released claim "was within the contemplation of the releasing party."[42] The court noted that the release explicitly extinguished "all claims, known or unknown" arising from or related to the merger agreement or other agreements related to Canvas. It particularly emphasized that "the parties took pains to express affirmatively (albeit redundantly) their intention to extinguish all claims," and found that, on its face at least, the release's language was "broad and unambiguous" and encompassed the claims asserted by Seven Investments.[43] The court held that the release clearly defeated the complaint's request for declaratory relief.

Turning to the fraud count, the court noted that these claims were also covered by the language in the general release, even if Seven Investments believed that the alleged fraudulent expenses were legitimate at the time. The court noted, however, that Robbins and Seven Investments had alleged that one of the reasons for terminating the merger agreement was that they suspected Discala of fraud, as the complaint stated that they became concerned Discala "was misusing Canvas Companies as a front to raise money to pay off his own personal debts, including gambling and other debts." The court held that Seven Investments was therefore on notice at the time it entered into the termination agreement that the disputed expenses were possibly fraudulent, and, in crafting the termination agreement, it "accepted that risk under the terms that were negotiated, and released its right to pursue that claim as part of the package of consideration exchanged by the parties."[44] The court therefore dismissed the fraud and unjust enrichment claims. It also dismissed "Seven Investments' effort to repackage all of its claims under a breach of fiduciary duty theory."[45]

The court noted that its dismissal of the claims based on the release squared with the Delaware Supreme Court's holding in *DuPont*.[46] In that case, the Delaware Supreme Court had held that the complaint's allegations stated a cause of action for fraud in the inducement that could void the release in question. DuPont had settled with the plaintiffs in exchange for a general release. Four years later, however, the plaintiffs sued DuPont again, alleging that they had been fraudulently induced into settling because DuPont had withheld vital information.[47] The Chancery Court distinguished that case, noting that the essence of the fraud there was separate conduct DuPont had entered into after the litigation had commenced. The court held that *DuPont* did not preclude general releases of claims for fraud or fraudulent inducement, "particularly where the party granting the release is on notice of potential fraud claims."[48] The court noted that Seven Investments had agreed to pay expenses that it already suspected might be fraudulent, and the agreement "was part of the negotiated resolution of a business dispute by sophisticated parties, acting with the advice of separate counsel." The alleged fraud here, unlike in *DuPont*, was not separate from the fraud that was the subject of the settlement in the first place. Therefore, the court dismissed the complaint.[49]

***Klig v. Deloitte LLP*, C.A. No. 4993-VCL, 2011 WL 5925085, —A.3d — (Del. Ch. 2011)**

Steven Klig was a partner in both Deloitte LLP ("Deloitte U.S.") and Deloitte Tax, both organized as LLPs under Delaware law. Each company was governed by a partnership agreement ("MOA") that, in contrast with the traditional concept of a partnership as a flat organization, established a hierarchical, corporate-type governing structure with a board of directors and CEO.[50] In January 2009, Klig was arrested for allegedly stalking and harassing an ex-lover. After Deloitte management learned of Klig's arrest, one of its managing partners spoke with Klig, who agreed to take an unpaid leave of absence. The managing partner informed the board of directors, which ratified the arrangement. Two weeks later, Klig spoke with the managing partner again, allegedly stating he wished to return to work. In September, Klig emailed the outgoing and new managing partner handling his mater, expressing dissatisfaction with his continued unpaid leave of absence because it might still be months before he would go to trial. He then insisted that Deloitte either allow him to return to work on October 1, agree to his permanent retirement on disability, or submit his expulsion to a vote of the partners before October 1. The outgoing and incoming managing partners requested that he resign, and he refused, stating that he intended to return to work. The managing partners took steps to deny Klig access to Deloitte's offices and recommended that his expulsion be submitted for a vote. Deloitte's CEO, however, believed that expulsion would be too harsh at this point, given that Klig had not yet been proven guilty. Deloitte's general counsel recommended that, if Klig were not expelled, then Deloitte should reinstate his pay retroactive to when Klig had tried to return to work, which the company did, while stating he would continue on leave until Deloitte allowed him to return or until his association was severed in accordance with the partnership agreement.[51]

On May 24, 2010, Klig pled guilty in his criminal case to a misdemeanor count that essentially charged him with electronic stalking. After his guilty plea, Deloitte proceeded with an expulsion vote on the recommendation of the Deloitte board and management. Klig was expelled by a vote of 99% of voting partners.[52]

Klig filed suit, contending that, first, Deloitte management wrongfully placed him on an unpaid leave of absence, and that they recognized their error by reinstating his salary but continued to deny him his right to participate in Deloitte's business until his expulsion. He also claimed that his expulsion was wrongful. The complaint alleged wrongful dissociation from Deloitte and Deloitte Tax, breach of contract by Deloitte Tax, breach of the implied covenant of good faith and fair dealing, breach of the Delaware Wage Payment and Collection Act, and breach of the duty of loyalty. Klig requested an order requiring Deloitte to reinstate him his former position.[53]

The Court of Chancery noted that Klig's chief complaint was that Deloitte management breached the partnership agreements when it placed Klig on unpaid leave, when it kept him on unpaid leave after he asked to return, and when it placed him on paid leave, but did not allow him to return to work. The parties disputed whether Deloitte's management had actual authority to address Klig's situation, but the court held that management's actions were subsequently ratified by the boards of both partnerships and thus were valid. It held that a context-specific inquiry applied as to whether ratification is valid, and that "[v]alid ratification does not inherently require a blow-by-blow description immediately preceding the directors' vote." Rather, the board could rely on the judgment of management in responding to sensitive personnel issues.[54] The court held that the ratification votes by the boards of Deloitte and Deloitte Tax were proper, as resolutions and detailed letters describing the facts were circulated prior to the meeting, and the boards engaged in a "robust discussion" of the issue.[55]

Klig argued that the ratification was nonetheless invalid, because the boards were not permitted to ratify what he alleged amounted to a material breach of the partnership agreements. The court noted, first, that Klig had not actually established a breach of the partnership agreements. Regardless, it held, "an alleged breach centered on lack of management authority is precisely the type of breach that is curable through ratification."[56] In other words, if management acted beyond the scope of its authority under the partnership agreement, the entire purpose of ratification by the board is to endorse those actions and authorize them in accordance with the board's authority under the agreement—as the court noted, the "quintessential scenario for effective ratification."[57]

Klig also contended that the directors were interested in the ratification because, if they did not ratify management's decision, the boards would have exposed Deloitte to a heightened risk of loss in this litigation that would have adversely affected the board members. The court held that these "interests" of which King complained were in fact appropriate, as they "heightened the directors' sensitivity to their fiduciary responsibility" because their interests here were in line with Deloitte's interests. The court therefore granted summary judgment on Klig's claim for breach of the partnership agreements.[58]

The court also rejected Klig's claim for wrongful dissociation on the same basis, as the Delaware statute on which he relied only provides for a cause of action if the dissociation is "in breach of an express provision of the partnership agreement."[59] Because the court had found no breach, it rejected this claim as well. The court dismissed the count for breach of the implied covenant of good faith and fair dealing, noting the rule that a party acts in good faith when its actions are consistent with the parties' expectations when entering the contract. In light of that, the court held, "[i]t is inconceivable to me that during original-position bargaining over the terms of the partnership agreements, the parties would have decided that Deloitte U.S. and Deloitte Tax could not place on unpaid leave a partner who had been indicted for the types of shocking criminal charges that were spelled out in glaring detail in the Indictment and supported with documentary

evidence and a report from the investigating officer."[60] Finally, in dismissing Klig's claim for breach of the duty of loyalty, the court noted that this duty, as set forth in the Deloitte U.S. partnership agreement, was only owed by other Deloitte partners, not by the entity as a whole. Because King had sued only the entities and not any partners, there was no duty owed and therefore no duty breached, so summary judgment was appropriate on that count as well. [61]

***In re Del Monte Foods Company Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011)**

On November 24, 2010, Del Monte Foods Company ("Del Monte" or the "Company") entered into an agreement and plan of merger with Blue Acquisition Group, Inc. and its wholly owned acquisition subsidiary, Blue Merger Sub Inc. (the "Merger Agreement" or "MA"). Blue Acquisition Group is owned by three private equity firms: Kohlberg, Kravis, Roberts & Co. ("KKR"), Centerview Partners ("Centerview"), and Vestar Capital Partners ("Vestar"). Because KKR was the lead firm, "KKR" as used herein generally refers to the sponsor group.[62]

The stockholders of Del Monte were scheduled to vote on the merger on February 15, 2011. The plaintiffs sought a preliminary injunction postponing the vote. They originally asserted that the individual defendants, who comprised the Del Monte board of directors (the "Board"), breached their fiduciary duties in two separate ways: first by failing to act reasonably to pursue the best transaction reasonably available, and second by disseminating false and misleading information and omitting material facts in connection with the stockholder vote. The defendants mooted the disclosure claims through an extensive proxy supplement released during the afternoon of February 4, 2011 (the "Proxy Supplement").[63]

The court's factual recitation is worthy of a detailed summary. Barclays has a strong presence in the consumer food and pet product sectors where Del Monte operates. Barclays understood that it was one of Del Monte's principal investment banks. Del Monte's stable businesses threw off large amounts of cash, a critical attribute for debt-fueled LBOs. Over the past two years, KKR had paid Barclays over $66 million in fees. Barclays had worked with KKR on half a dozen projects in the consumer and retail space, including a large transaction where Barclays acted as both sell-side advisor and provided buy-side financing for KKR. On December 17, 2009, Moses and other Barclays bankers met with KKR to present various opportunities, including an acquisition of Del Monte. Moses made similar pitches during the same time period to other private equity firms, including Apollo Management.[64]

Apollo sent Del Monte a written expression of interest in an acquisition at $14 to $15 per share. After receiving the letter, Del Monte reached out to Barclays. Moses believed that Del Monte was also reaching out to other banks, including Goldman Sachs, a firm that ran an earlier process for the Company. Moses told Del Monte that Barclays was well-positioned to advise Del Monte because Barclays "knew many of the entities that might be an interested buyer."[65] Moses did not mention that he personally had been pitching Apollo, KKR, and other private equity firms on acquiring Del Monte. The Board did not learn of Moses' efforts to stir up the initial LBO bid until discovery in this litigation. Moses also did not mention that Barclays planned from the outset to seek a role in providing buy-side financing.

Moses recommended that the Del Monte Board pursue a targeted, non-public process that tracked precisely what Moses had previewed with KKR and the other private equity firms. Barclays then identified the five LBO shops that would be invited to submit expressions of interest: KKR, Apollo, The Carlyle Group, CVC Partners, and the Blackstone Group. The Board adopted Barclays' recommendation. Each of the participants agreed not to discuss the confidential information they obtained from Del Monte or their bids with anyone, including each other. Absent Company consent, the signatories could not discuss potential financing with any source other than Barclays.[66]

During its regularly scheduled meeting on March 18, 2010, the Board considered the five indications of interest. The Board decided that the Company's stand-alone growth prospects were sufficiently strong that it was not in the stockholders' best interests to proceed further with the process. The directors also concluded that Barclays had pushed too far, too fast, and that Barclays had not been hired to actually sell the company. The Board specifically instructed Barclays "to shut [the] process down and let buyers know the company is not for sale."[67] But Barclays did not do so.

In September 2010, Moses sensed that the timing was right to put the Del Monte LBO back together. Moses had lunch with Brian Ratzan of Vestar. Moses suggested that it might be "an interesting time to make another approach to [Del Monte]" and that, if Vestar were interested, "the ideal partner would be KKR."[68] At the time, both Vestar and KKR were bound by their confidentiality agreements with Del Monte. Vestar and KKR did not have "prior written consent" from Del Monte. Nor did Barclays. In fact, Barclays was not authorized at that time to do anything on behalf of Del Monte.

By pairing Vestar with KKR, Barclays put together the two highest bidders from March 2010, thereby reducing the prospect of real competition in any renewed process. On October 11, 2010, KKR delivered a written indication of interest from KKR and Centerview to acquire Del Monte for $17.50 in cash. The price represented a 28.7% premium over the closing price of Del Monte's common stock on the previous trading day. While nominally higher than the $17 offered in March, it was a step back given intervening market developments. Del Monte and Barclays calculated that an equivalent bid would have been $18.32. The KKR letter did not mention Vestar, and Vestar representatives did not attend the meeting. In preparing for the meeting, KKR and Vestar agreed not to disclose Vestar's participation because "it's just another thing" that would have to be explained. After the October 11, 2010, meeting, Barclays worked with KKR to conceal Vestar's participation.[69]

After deciding this time to pursue discussions with KKR, the Board considered whether to conduct a pre-signing market check. The Board concluded that none was needed. At the time, the Board did not know that Barclays had teamed Vestar with KKR. The Board ultimately decided to adopt a single-bidder strategy of negotiating only with KKR. During the meeting, the Board formally authorized the Company to "re-engage" Barclays as its financial advisor.

On November 8, 2010, news of a potential Del Monte LBO leaked when the London Evening Standard reported that KKR had offered to acquire the Company for $18.50 per share. Later in the day, KKR contacted the Board and raised its offer to $18.50 with a request for exclusivity. The Board declined to grant formal exclusivity, but did not reach out to any other bidders. The Board also declined to approve a transaction at $18.50 per share.[70]

With momentum building towards a deal, the time had come for the repeat M & A players to hit up the Board with two unsavory requests. First, during the week of November 8, 2010, KKR "formally approached Barclays Capital to request that the Company allow KKR/Centerview to include Vestar in the deal as an additional member of the sponsor group."[71] The second unsavory request was when Barclays finally asked Del Monte if it could provide buy-side financing, as Barclays had been planning to do since at least January 2010. On November 12, Brown reported to his KKR colleagues that "Barclays has been cleared to be a financing bank." On November 23, 2010, Del Monte executed a letter agreement that formally authorized Barclays to provide financing to KKR. In contrast to the Barclays witnesses, who reluctantly admitted when pressed that providing buy-side financing might create the appearance of a potential conflict, the November 23 letter acknowledged that Barclays' relationship became adverse to Del Monte and that if push came to shove, Barclays would look out for itself. Because of the conflict of interest, Barclays insisted in the letter agreement that Del Monte obtain a second fairness opinion. Not only did Del Monte fail to secure any benefits for itself or its stockholders as the price of Barclays' buy-side participation, but Del Monte actually incurred an additional $3 million for a second financial advisor.[72]

Between November 19 and 22, 2010, at the same time it was working with KKR to provide financing for the deal, Barclays ostensibly negotiated with KKR over the price. The Board decided to let Barclays run the go-shop. In carrying out this assignment, Barclays had a direct financial conflict. Goldman Sachs had a prior relationship with Del Monte and independently approached Del Monte about managing the go-shop. Upon learning of Goldman's interest, Barclays told KKR that Goldman was trying to "scare up competition." Brown of KKR told Barclays that he would "manage it" directly with Goldman. He solved the problem by letting Goldman participate in 5% of the syndication rights for the acquisition financing, which "squared things away there." After that, Goldman dropped its efforts to conduct the go shop. During the go-shop period, Barclays contacted fifty-three parties, including thirty strategic buyers. Three requested and were provided with confidentiality agreements. Two parties from the early 2010 process re-engaged. No one expressed interest.[73]

On January 12, 2011, Del Monte issued its definitive proxy statement on Schedule 14A. Many of the disclosures about the background of the transaction were false and misleading, in part because Barclays hid its behind-the-scenes activities from the Board. On February 4, after the completion of discovery in connection with the preliminary injunction application, Del Monte issued the Proxy Supplement to moot the plaintiffs' disclosure claims. The Proxy Supplement disclosed that the Company learned significant facts about Barclays' role and interactions with KKR only as a result of this litigation.[74]

The court applied the enhanced scrutiny test to the director's conduct, which has both subjective and objective components. Initially, the directors "bear the burden of persuasion to show that their motivations were proper and not selfish."[75] The record did not reflect meaningful Board consideration or informed decision making with respect to the Vestar pairing. In considering Barclays' request, the court found, the Board failed to act reasonably. The Board did not ask whether KKR could fund the deal without Barclays' involvement, and Del Monte did not learn until this litigation that Barclays was not needed on the buy-side. If the Board had refused Barclays' request, then Del Monte could have had a non-conflicted (or at least not directly conflicted) negotiator bargain with KKR. Without some justification reasonably related to advancing stockholder interests, it was unreasonable for the Board to permit Barclays to take on a direct conflict when still negotiating price. It is impossible to know how the negotiations would have turned out if handled by a representative that did not have a direct conflict. The burden of that uncertainty must rest with the fiduciaries who created it.[76] The court then found that Barclays' conflict tainted the go-shop process: "What Barclays did looks good on the surface, but the 'who' is as important as the 'what.' . . . 'body language' can be critical."[77] The court concluded that that the plaintiffs established a reasonable likelihood of success on the merits of their claim that the director defendants failed to act reasonably in connection with the sale process. The court also found that the plaintiffs had established a reasonable likelihood of success on the merits of their claim that KKR aided and abetted the breaches of fiduciary duty that resulted from Barclays' misconduct. The court also found that the plaintiffs had shown the necessary threat of irreparable harm.[78]

The court then enjoined the merger vote for a period of only 20 days (shorter than requested by the plaintiffs), which it found provided ample time for a serious and motivated bidder to emerge. Interestingly, in reaching its decision, the court also enjoined KKR from enforcing any deal protection measures. When a party aids and abets a breach of fiduciary duty, the court noted, the contract rights that the aider and abetter secures as a result of the interaction must give way to the superior equitable rights and interests of the beneficiaries.[79] The court considered whether a preliminary injunction of this nature would give KKR the right to terminate the Merger Agreement. It found that, if the Merger Agreement was not consummated by May 22, 2011, then the parties could walk away under the terms of the agreement. Prior to that drop-dead date, each party was obligated to

use its reasonable best efforts to consummate the merger. The injunction was to lift in twenty days, over two months before the drop-dead date. It also found that the preliminary injunction would not cause the deal to fail because a closing condition could not be met by the drop-dead date. The Merger Agreement provided as a condition to closing that "[n]o court or other Government Entity of competent jurisdiction shall have enacted, issued, promulgated, enforced or entered any law (whether temporary, preliminary or permanent) that is in effect and restrains, enjoins or otherwise prohibits consummation of the Merger." Thus, the preliminary injunction would not, the court found, give either party the right to terminate. Neither would the injunction allow the parties to invoke the Merger Agreement section that provided that either party could terminate the agreement if "any Order permanently restraining, enjoining or otherwise prohibiting consummation of the Merger shall become final and non-appealable."[80]

The court then held that the plaintiffs established a reasonable probability of success on the merits of a claim for breach of fiduciary duty against the individual defendants, aided and abetted by KKR. By failing to provide the serious oversight that would have checked Barclays' misconduct, the court held that the directors had breached their fiduciary duties in a manner reminiscent of *Mills Acquisition Co. v. Macmillan, Inc.*[81] The court noted that holding that the Del Monte directors breached their fiduciary duties for purposes of granting injunctive relief did not suggest that the directors faced a meaningful threat of monetary liability. On the preliminary record, the court noted that it appeared that the Board had sought in good faith to fulfill its fiduciary duties, but had failed because it was misled by Barclays. The same cannot be said for the self-interested aiders and abetters, the court noted. But while the directors might face little threat of liability, they could not escape the ramifications of Barclays' misconduct. For purposes of equitable relief, the Board was responsible.[82]

***Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442 (Del. Ch. 2011)**

Hazelett Strip–Casting manufactures casting machines for the production of aluminum, zinc, lead, and copper strip and related products. A strip-casting machine is a major capital investment costing up to $16 million. From 1956 until December 27, 1994, Bill and Dick Hazelett were Hazelett Strip–Casting's only stockholders. Bill owned 800 shares, giving him 69.57% of the equity. Dick owned 350 shares, giving him 30.43%. At the time of the decisions relating to a reverse stock split, Hazelett Strip–Casting's board of directors consisted of Bill, his son David, and company employees Raymond Clavelle, Craig Snyder and Richard Hayden. Bill served as Chairman, President, and Chief Executive Officer, having held these positions from the founding of the company until he passed away during the pendency of this case. Dick died on July 23, 2002. In his will, he bequeathed his 350 shares to 169 individuals, consisting primarily of past and present company employees, and named plaintiff Ginette Reis and Janet Patterson as executors for the Estate.[83]

On October 25, 2004, Hazelett Strip–Casting offered to purchase the Estate's 350 shares for $1,500 per share. Bill set the price unilaterally. When questioned about the price in his deposition, Bill said he "just pulled it out of the air." While the executrices were resisting the stock sale and seeming to hold out for a higher price, the Estate's attorney suggested to the company's probate counsel that a reverse stock split could be used to bypass the executrices and achieve the same result as a purchase. On October 25, 2005, the directors acted by unanimous consent to approve a reverse split and recommend it to the stockholders. In the reverse split, every outstanding share would become a 1/400 fractional interest. After the split, the Estate would hold 350/400 of a share, and Stave Island would hold two shares. The board did not set a value that the Estate would receive. It resolved that Hazelett Strip–Casting would "arrange for the disposition of the fractional interest that will be held by the Estate" or "pay in cash the fair value of such fraction of a share," and "such arrangement for disposition shall be made, or such fair value shall be paid, promptly following the corporation's receipt of a stock valuation study."[84]

On November 29, 2005, the reverse split was presented at a special meeting of stockholders. The only stockholder present was Stave Island, which voted to approve the reverse split. On December 13, 2005, the board met and voted to amend Hazelett Strip–Casting's certificate of incorporation to add Article Thirteenth, which provided "The Corporation shall not issue or permit to be outstanding fractions of a share." The charter amendment did not otherwise implement the reverse split. It was filed with the Delaware Secretary of State on December 23, 2005. With this filing, the defendants, incorrectly the court noted, believed that they had completed the reverse split.

To determine the value the Estate would receive, the board retained Sheldrick, McGehee & Kohler, LLC ("SMK"), a valuation firm. SMK opined that, as of September 30, 2005, the aggregate equity of Hazelett Strip–Casting was worth $1,834,443, making each 1/400 fractional interest worth $1,595.17. On March 20, 2006, the board approved a cash payment of $558,309.50 to compensate the Estate for its 350/400 of a share.

Reis and Patterson refused to accept the check on behalf of the Estate. Hazelett Strip–Casting and the Estate's lawyer then asked the probate court to remove them as the executors of the Estate. By order dated May 16, 2006, the probate court removed Reis and Patterson, and appointed a local attorney, Albert Cicchetti, as administrator. He accepted the check on behalf of the Estate and deposited it in an interest-bearing account while reserving the right to contest the adequacy of the amount. The board acted via unanimous consent dated January 15, 2008, to approve a further amendment to the company's charter that actually would implement the reverse split. The charter amendment was filed on January 28, 2008, finally implementing the reverse split as of that date. Reis appealed the decree. She also filed this action, in which she challenged the reverse split as a breach of the defendants' fiduciary duties and as violating section 155(2) of the Delaware General Corporation Law.[85]

The court noted that section 262 authorizes a specialized proceeding in the Court of Chancery through which stockholders may obtain a judicial determination of the fair value of their shares after a merger. Because the appraisal statute allocates the valuation determination in the first instance to the Court of Chancery, the resulting proceeding differs from traditional litigation in which wrongdoing has been alleged. A stockholder need not plead or prove any wrongdoing to obtain the fair value determination.[86] However, the court then noted that section 155(2) does not contain anything remotely similar to the mechanisms found in section 262, and it therefore does not authorize an appraisal-style proceeding to obtain "fair value" for fractional shares.[87] Section 155(2) provides instead that if a corporation opts to buy out fractional interests, the corporation "shall ... pay in cash the fair value" of those interests. Responsibility for determining fair value is allocated to the corporation.[88]

The court found that, because stock split was used to freeze out minority interests, the Directors' decision to implement a reverse stock split would be reviewed under the entire fairness standard with the burden on the defendants.[89] In this case, the court noted, Bill controlled Hazelett Strip–Casting. In 2005, he directly controlled Stave Island, which was the company's controlling stockholder with nearly 70% of its outstanding common stock. The court found that the other four directors were beholden to him. Each was an employee of Hazelett Strip–Casting, and David was both an employee and Bill's son. Without adding new directors to the board, an independent committee could not have been appointed, and there was no majority-of-the-minority vote.

The court then noted that, in *Applebaum*, the Delaware Supreme Court opined that "'fair value' in Section 155[has] a meaning independent of the definition of 'fair value' in Section 262 of the Delaware General Corporation Law."[90] The fair price and fair value standards called for equivalent economic inquiries. The court noted that *Sterling v. Mayflower Hotel Corp.*,[91] implicitly equated the economic inquiry in an entire fairness case and an appraisal proceeding. *Weinberger v. UOP, Inc.*,[92] distinguished between the valuation standard to be applied in the fairness inquiry—which is identical—and the potential remedy available—which could be quite different. Based on this reasoning, the court held that it had complete power to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.[93]

The court then found that there had been no dealing in this case that could be called "fair." Procedural protections were not implemented, and no one bargained for the minority. Reis and Patterson, who were acting as fiduciaries for the Estate, were not given the chance. Having failed to implement a fair process, the defendants did not serendipitously arrive at a fair price. The fair price analysis is part of the entire fairness standard of review; it is not itself a remedial calculation. In an entire fairness case, the matter only proceeds to the remedial phase if the transaction fails the test of fairness. At that point, the remedy could well be a damages award equal to the fair value that would have been awarded in an appraisal, but "the measure of any recoverable loss ... under an entire fairness standard of review is not necessarily limited to the difference between the price offered and the 'true' value as determined under appraisal proceedings."[94]

The court then held that the case did not call for a remedy other than an award of fair value. The defendants did not set out to extract value rapaciously from the minority, nor did they freeze out the minority to capture the value of opportunities that the corporation was on the verge of achieving and in which the minority otherwise would have shared. In cases like this one, where the fair price analysis and remedial determination coincide, the court declined to review fair price twice, first as a range for purposes of the entire fairness standard and later as a point figure for purposes of the remedial calculation.

The court then determined the fair value of the shares, laying out its reasoning in detail.[95] It relied on two methods: capitalized earnings and book value. In doing so, it rejected the plaintiff's comparable companies and capitalized free cash flow methods. Both SMK valuations employed a single methodology: capitalized earnings. But the court noted that both SMK valuations exhibited flaws that enabled SMK to reach an unfair result conveniently close to the $1,500 price that Bill unilaterally set in October 2004. The court then used the SMK trial valuation as a starting point and made significant corrections. The record was devoid of projections for Hazelett Strip–Casting.

Both the plaintiff's and the defendants' experts looked to historical results, so the court did so as well. Looking to the Delaware Block Method, the court adopted a five-year period as the norm. The earnings figures used to derive the earnings base were then adjusted to eliminate non-recurring gains and losses. SMK failed to make any normalizing adjustments. The court found that the "Marine Division" was a tax-efficient way for Bill to indulge his love of sailing, adjusting the company's historical figures to remove the expenses associated with the Marine Division. The "Beach and Boat Motel" had historically operated at a modest profit, so the court gave the minority stockholders the benefit of those returns.

Using the build-up method, SMK had calculated a cost of equity of 21%. Also using the build-up method, plaintiffs' expert Willamette Management Associates ("WMA") had calculated a cost of equity of 18%. SMK's build-up method included a healthy company-specific risk premium of 6%. WMA included a company-specific risk premium of 2%. If SMK had used WMA's company-specific risk premium, its cost of equity would have been 17%. Replacing SMK's 6% factor with WMA's 2% generated a cost of equity of 17%. Unlike WMA, however, SMK had spoken directly with management and, the court found, should have had a more accurate view of the company's growth. A higher growth factor generates a higher appraised value, giving SMK a reason to be conservative. The court therefore adopted SMK's figure. Dividing the earnings base of $283,327 by this capitalization factor produced an equity value of $2,248,627 for the operating business. The final step in the court's analysis was to add

the value of non-operating assets. Real estate had been appraised at $951,000. A net operating loss ("NOL"), which could be used to offset the company's future earnings for tax purposes, was $258,000. The sum of the capitalized earnings valuation ($2,248,627) plus the real estate ($951,000) plus the NOL ($258,000) produced an aggregate value of $3,457,627.

The court then noted that book value could be an appropriate valuation method for a business that derives significant value from its physical assets. As of December 31, 2007, Hazelett Strip–Casting's books reflected owner's equity of $7,718,469, which had remained relatively stable during the five years leading up to the valuation date. The capitalized earnings method produces an aggregate equity value of $3,457,627. The wide disparity troubled the court, and reinforced its concern that the company's earnings have been depressed because the owners had taken their returns in the form of compensation and equipment lease payments, thereby suppressing an income-based valuation. As a result, the court ultimately valued Hazelett Strip–Casting using a blended average that afforded 80% weight to capitalized earnings value and 20% weight to book value. The resulting fair value of equity was $4,421,457. Dividing by 1,150 yielded a fair value per fractional interest of $3,845.

The defendants made two additional arguments, which the court likened to "Hail Mary" passes—incomplete ones. First, the defendants claimed that they did not owe fiduciary duties to Reis or the other beneficiaries of the Estate because, at the time of the reverse split, those individuals were not yet stockholders. This argument failed because a plaintiff who had been bequeathed shares in a corporation is an "equitable owner" to whom fiduciary duties are owed and who has standing to sue for breach of fiduciary duty directly or derivatively.[96] Second, the defendants argued that Reis was estopped from challenging the reverse split because she initially supported the idea as a way to get cash for the legatees. But Reis only indicated support for a mechanism by which Dick's beneficiaries could receive cash, not a specific price.[97]

***Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011)**

This decision begins by answering the question of whether a board can "*just* say no" to a tender offer. The answer, the court found, is "no." Under Delaware law, the board must pass through two prongs of exacting judicial scrutiny by a judge who will evaluate the actions taken by, and the motives of, the board.

This case concerned a takeover battle between Air Products & Chemicals, Inc. and Airgas, Inc. Air Products and the shareholder plaintiffs asked the court to order Airgas to redeem its poison pill and other defenses that were stopping Air Products from moving forward with its hostile offer, and to allow Airgas's stockholders to decide for themselves whether they wanted to tender into Air Products' $70 "best and final" offer, which the Airgas Board contended was inadequate.[98]

The takeover battle began in mid-October 2009 when John McGlade, President and CEO of Air Products, privately approached Peter McCausland, founder and CEO of Airgas, about a potential acquisition or combination. After McGlade's private advances were rebuffed, Air Products went hostile in February 2010, launching a public tender offer for all outstanding Airgas shares.[99]

On December 21, 2010, the Airgas board met to consider Air Products' "best and final" offer of $70 per share. Management kicked off the meeting by presenting an updated five-year plan to the board. McCausland gave an overview of the refreshed plan, and then McLaughlin addressed key financial highlights. This was followed by presentations by three financial advisors. Both Bank of America Merrill Lynch and Goldman Sachs, which Airgas had retained, "were of the opinion that the Air Products' $70 offer was inadequate from a financial point of view." Credit Suisse, also retained, noted that Air Products' offer "was only slightly above what [Airgas] should trade at, was below most selected transactions and was well below the value of the Company on the basis of a DCF analysis, which was the analysis to which Credit Suisse gave the most weight." Thus, Credit Suisse "easily concluded that the $70 offer was inadequate from a financial point of view." The Airgas Board then voted to reject the $70 offer. Interestingly, the Air Products Nominees were some of the most vocal opponents to the $70 offer.[100]

The next day, December 22, 2010, Airgas filed another amendment to its 14D–9, announcing the board's unanimous rejection of Air Products' $70 offer as "clearly inadequate" and recommending that Airgas stockholders not tender their shares. The board reiterated that the value of Airgas in a sale is at least $78 per share.[101]

Because of the "omnipresent specter" of entrenchment in takeover situations, it is well-settled that when a poison pill is being maintained as a defensive measure and a board is faced with a request to redeem the rights, the *Unocal* standard of enhanced judicial scrutiny applies. The poison pill was born "as an attempt to address the flaw (as some would see it) in the corporation law" giving boards a critical role to play in the merger context but no role to play in tender offers.[102] In *Moran v. Household International, Inc.*,[103] written shortly after the *Unocal* decision in 1985, the Delaware Supreme Court first upheld the legality of the poison pill as a valid takeover defense. Specifically, in *Moran*, the Household board of directors "react[ed] to what it perceived to be the threat in the market place of coercive two-tier tender offers" by adopting a stockholder rights plan that would allow the corporation to protect stockholders by issuing securities as a way to ward off a hostile bidder presenting a structurally coercive offer.[104] The court noted that *TW Services, Inc. v. SWT Acquisition Corp.*[105] appeared to support the view that a well-informed board acting in good faith in response to a reasonably perceived threat may, in fact, be able to "just say no" to a hostile tender offer.

Examining the defendants' actions under this first prong of *Unocal*, the court found that "the presence of a majority of outside independent directors coupled with a showing of reliance on advice

by legal and financial advisors, 'constitute[s] a prima facie showing of good faith and reasonable investigation.'"[106] Here, the court found, the Airgas board met this test. First, it was currently comprised of a majority of outside independent directors—including interestingly the three recently-elected insurgent directors who were nominated to the board by Air Products. Second, the Airgas board relied on not one, not two, but three outside independent financial advisors in reaching its conclusion.

The first part of *Unocal* review, the court noted, requires more than that; it requires the board to show that its good faith and reasonable investigation ultimately gave the board "grounds for concluding that a threat to the corporate enterprise existed." The only threat that the board discussed—the threat that has been the central issue since the beginning of this case—is the inadequate price of Air Products' offer. In the end, it really is "All About Value."[107]

The court did not perceive Air Products' offer as structurally coercive. However, the Delaware Supreme Court has recognized other "threats" that can be posed by an inadequately priced offer. One such potential continuing threat has been termed "opportunity loss," which appears to be a time-based threat.[108] As such, Air Products' offer posed no threat of opportunity loss. Inadequate price and the concept of substantive coercion are inextricably related. Airgas's argument was that "the substantial ownership of Airgas stock by these short-term, deal-driven investors poses a threat to the company and its shareholders"—the threat that, because it is likely that the "arbs" would support the $70 offer, "shareholders will be coerced into tendering into an inadequate offer." The threat that merger "arbs" will tender into an inadequately priced offer is only a legitimate threat if the offer is indeed inadequate. The court found some evidence in the record suggesting that this risk may be real.[109]

Ultimately, the court found it came down to the Delaware Supreme Court's holdings in *Paramount* and *Unitrin*. In *Unitrin*, the court held: "[T]he directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan." When a company is not in *Revlon* mode, a board of directors "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[110] The court, therefore, found that the Airgas board acted in good faith and relied on the advice of its financial and legal advisors in coming to the conclusion that Air Products' offer was inadequate. It noted that, as the supreme court has held, a board that in good faith believes that a hostile offer is inadequate may "properly employ[ ] a poison pill as a proportionate defensive response to protect its stockholders from a 'low ball' bid."[111] The court also noted that "the 'inadequate value' of an all cash for all shares offer is a 'legally cognizable threat.'" Moreover, "[t]he fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders."[112]

Turning next to the second part of the *Unocal* test, the court examined whether the Airgas board's defensive measures were a proportionate response to the threat posed by Air Products' offer. Where the defensive measures "are inextricably related, the principles of *Unocal* require that [they] be scrutinized collectively as a unitary response to the perceived threat." Defendants bear the burden of showing that their defenses are not preclusive or coercive, and if neither, that they fall within a "range of reasonableness." Thus, the real issue posed was whether defensive measures are "preclusive" if they make gaining control of the board realistically unattainable in the short term (but still realistically attainable sometime in the future), or if "preclusive" actually means "preclusive"—*i.e.*, forever unattainable.[113]

The court noted that this precise question was asked and answered in *Versata Enterprises, Inc. v. Selectica, Inc.*[114] There, Trilogy (the hostile acquiror) argued that in order for the target's defensive measures not to be preclusive: (1) a successful proxy contest must be realistically attainable, and (2) the successful proxy contest must result in gaining control of the board at the next election. The Delaware Supreme Court rejected this argument, stating that "[i]f that preclusivity argument is correct, then it would apply whenever a corporation has both a classified board and a Rights Plan.... *[W]e hold that the combination of a classified board and a Rights Plan do not constitute a preclusive defense.*"[115] Thus, the court found it was bound by this clear precedent to proceed on the assumption that Airgas's defensive measures were not preclusive if they delayed Air Products from obtaining control of the Airgas board (even if that delay was significant) so long as obtaining control at some point in the future was realistically attainable. Even if Air Products was unable to achieve the 67% supermajority vote of the outstanding shares necessary to remove the board in a special meeting, it would only need a simple majority of the voting stockholders to obtain control of the board at next year's annual meeting. Air Products had stated its unwillingness to wait around for another eight months until Airgas's 2011 annual meeting. If Air Products was unwilling to wait another eight months to run another slate of nominees, the court held, that was a business decision of the Air Products board, but as the supreme court has held, waiting until the next annual meeting "delay[s]—but [does] not prevent—[Air Products] from obtaining control of the board."[116]

***Johnston v. Pedersen*, 28 A.3d 1079 (Del. Ch. 2011)**

Xurex was an early-stage company engaged in the development and sale of protective coatings derived from nano-technology invented by Bo Gimvang. Only one company had been able to develop a functional product from Xurex's technology: DuraSeal Pipe Coatings Company. DuraSeal remained Xurex's only customer and was responsible for 99% of Xurex's sales. As a result of private placements, prior to the issuance of the Series B Preferred challenged in this action, Xurex had outstanding 32,046,313 shares of common stock and 15,069,850 shares of Series A Preferred Stock. The Series A Preferred carried one vote per share and voted with the common stock on an as-converted basis.[117]

In 2009, Gimvang and Bob Bishop, the former CEO, faced shareholder discontent. Rex Powers, Robert Clifford, and Ken Pendersen were elected to the board. To stabilize the company, Powers, Pedersen, and Clifford offered DuraSeal a new licensing deal. In an agreement ultimately executed on January 13, 2010, DuraSeal received exclusive rights to market and sell all Xurex products (past, present, and future) to the North American oil and gas industry until October 1, 2018.

On January 11, 2010, the board distributed to stockholders the procedures for the mail-in election. On January 12, an investor named Richard Fox arrived with proxies purportedly representing a majority. The critical proxy came from Gimvang, who alone controlled 43.5% of the company's voting power through his ownership of common stock. Clifford reviewed the proxies, concluded that they represented at most 49% of the company's voting power, and accepted only 48% as valid. Clifford also informed Gimvang about the long-term license deal with DuraSeal. Gimvang withdrew his support from Fox, and Fox exited. The deadline for the mail-in election was February 5, 2010. On January 25, Powers, Pedersen, and Clifford sent a letter to stockholders announcing the long-term license agreement and summarizing the company's historic struggles. When the mail-in ballots were counted, Powers, Pedersen, Clifford, defendant Jay McGarrigle, and plaintiff Dietmar Rose had received the most votes.[118]

Thereafter, disagreements arose between Powers and Rose, and Rose resigned. Gimvang and Bishop still controlled a majority of the voting power. Thus, the court noted, Powers, Pendersen, and Clifford had ample reason not to want another control contest. In March 2010, they attempted to both raise capital through a new equity issuance and dilute the Bishop/Gimvang block. Although their individual perspectives inevitably influenced their perceptions, the court found that Pedersen and Clifford subjectively believed that a personally beneficial course of action optimally served the company and its stockholders.[119]

On April 16, 2010, the Xurex board notified all stockholders of the opportunity to participate in the bridge loan. The deadline for receiving $300,000 in commitments was Friday, April 23. Within this timeframe, investors were expected to decide whether or not to invest in a bridge loan convertible into an undefined preferred security. Pedersen told certain investors that the preferred stock would include some kind of "super vote right" to protect against an unwanted change of control from the then-current board. Pedersen selectively disclosed this information to certain stockholders. The directors never made similar disclosures to other stockholders.

Sometime in July 2010, Pedersen and Clifford held a brainstorming session with counsel to decide how to structure the Series B Preferred. Like the Series A Preferred, the Series B Preferred carried one vote per share and votes with the common stock on an as-converted basis. Unlike the Series A Preferred, it carried the following additional class voting right:

> [T]he affirmative vote or written consent of the holders of a majority of the outstanding shares of Series B Preferred, voting separately as a single class, shall be required for the approval of any matter that is subject to a vote of the Corporation's stockholders, whether or not a class vote is required by law.[120]

The Series B Preferred offering closed on September 10, 2010. It raised approximately $443,152. Of that amount, $269,597 came from converted principal and interest from the bridge loan. The board's chosen structure for issuing the Series B Preferred resulted in a small group of stockholders controlling the class vote feature.

The court then held that the evidence established "clearly and convincingly that the defendants successfully placed the Series B Preferred with friendly stockholders who are either (i) members of the board, (ii) family or friends of board members, or (iii) belong to investor groups led by individuals like Duncan who support incumbent management."[121]

Ironically, the threat to the incumbent board did not come directly from Gimvang or Bishop, but rather from an unexpected quarter — DuraSeal. In April 2011, DuraSeal began soliciting proxies from Xurex stockholders to remove the incumbent Xurex directors and elect a new board. In May, the Xurex board learned of the solicitation and began a counter-solicitation. At the time, Xurex's annual meeting of stockholders was scheduled for June 25, 2011.

On June 14, 2011, the plaintiffs delivered written consents to Xurex's registered agent in Delaware and principal place of business in Albuquerque. The written consents purported to remove the defendants as Xurex directors, fix the number of directors on the board at five, and elect five new directors. Also on June 14, 2011, the plaintiffs initiated this action seeking an order pursuant to 8 *Del. C.* § 225 declaring that the written consents were valid and effective. The plaintiffs contended that the written consents represented approximately 69% of the outstanding common stock, 51% of the outstanding Series A Preferred Stock, and 13% of the outstanding Series B Preferred Stock. The defendants thereafter conceded that the consents represented a majority of Xurex's outstanding voting power and would be effective but for the class vote provision in the Series B Preferred. The court was called upon to determine whether the written consents could be given effect without the affirmative vote of holders of a majority of the Series B Preferred.[122]

The court began its analysis by citing *Aprahamian v. HBD & Co.*,[123] for the principle that, when a board of directors takes action that affects the stockholder franchise, the board must justify its action under the enhanced scrutiny test. Directors facing a proxy contest face an inherent positional conflict: "A candidate for office, whether as an elected official or as a director of a corporation, is likely to prefer to be elected rather than defeated. He therefore has a personal interest in the outcome of the election even if the interest is not financial and he seeks to serve from the best of motives."[124]

When tailored for reviewing director action affecting a stockholder vote, the court noted, enhanced scrutiny requires that the defendant fiduciaries bear the burden of persuading the court that their motivations were proper and not selfish, that they did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way, and that the directors' actions were reasonably related to a legitimate objective.[125]

The court held that the record established that the defendant directors adopted the class vote provision in the Series B Preferred for the specific purpose of preventing holders of a majority of Xurex's common stock and Series A Preferred from electing a new board. Assuming for the sake of discussion that the directors subjectively intended only to raise capital, the court's view was that this goal was not a sufficiently compelling justification for issuing the Series B Preferred with a class vote on any issue that could be submitted to the corporation's stockholders.[126] Accordingly, although the bridge loan and Series B Preferred issuance were structured in a manner nominally open to all stockholders, in reality the offerings delivered control of the class vote into friendly hands. To the extent this was a collateral consequence of a capital raise, the price paid by stockholders in the coin of voting rights was too high. Therefore, The defendant directors, the court held, breached their duty of loyalty by issuing the Series B Preferred. As a result, the court held that the written consents submitted by the plaintiffs and other Xurex stockholders were effective to remove the defendant directors from office and replace them with the new directors.[127]

***In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, C.A. No. 961-CS, 2011 WL 6440761, —A.3d— (Del. Ch. 2011)**

The court here dealt with "something that is indicative of the mindset that too often afflicts even good faith fiduciaries trying to address a controller. Having been empowered only to evaluate what the controller put on the table and perceiving that other options were off the menu because of the controller's own objectives, the special committee put itself in a world where there was only one strategic option to consider, the one proposed by the controller."[128]

Southern Peru was an NYSE-listed mining company that was majority owned by Grupo Mexico, S.A.B. de C.V. Grupo Mexico also owned a non-publicly traded Mexican mining company, Minera Mexico. Grupo Mexico proposed to Southern Peru's board of directors that Southern Peru purchase its interest Minera Mexico, in exchange for approximately $3.1 billion worth of Southern Peru's stock. Because Grupo Mexico was self-interested in the transaction, Southern Peru's board formed a special committee of disinterested directors, which retained Goldman Sachs as its financial advisor. After eight months of back-and-forth over the terms of the deal, the special committee, and then the board, approved the merger. By the time the merger was approved, the value of stock Southern Peru tendered in the transaction had grown to $3.75 billion. Contending that the transaction was unfair, several minority shareholders brought this derivative suit, arguing that "Grupo Mexico received something demonstrably worth more than $3 billion (67.2 million shares of Southern Peru stock) in exchange for something that was not worth nearly that much (99.15% of Minera)."[129]

The plaintiffs' complaint centered around the fact that, in setting the values of Southern Peru and Minera, the special committee overvalued Minera and undervalued Southern Peru. The initial analysis that Goldman presented to the committee, on June 11, 2004, showed a maximum equity value for Minera of $1.3 billion, compared to the market value of Southern Peru's stock, which was $3.1 billion. This presentation demonstrated that Goldman "could not get the get anywhere near the give."[130] Following that presentation, Goldman and the committee ceased focusing on Southern Peru's market value, and focused instead on a relative value analysis, relying on discounted cash flow metrics. However, in order to bring the values closer together, Goldman's analysis used assumptions and discount rates that were less favorable to Southern Peru, and more favorable to Minera. Even under these methods, however, the highest equity value for Minera was still short of the asking price.[131]

The court noted that, instead of engaging in this contorted analysis, "a third party in the Special Committee's position might have sold at the top of the market, or returned cash to the Southern Peru stockholders by declaring a special dividend," or, if the directors thought the merger made long-term sense, simply demanded a premium from Grupo Mexico in exchange for the transaction.[132]

The special committee did make a counterproposal to Grupo Mexico, offering stock with a market value of $2.095 million, although this proposal was never mentioned in Southern Peru's proxy statement describing the merger. The special committee also proposed implementation of a fixed, rather than a floating, exchange ratio that would set the number of Southern Peru shares issued in the transaction because it was uncomfortable with having to issue a variable number of shares; thus, the dollar value at the time of closing would vary depending on Southern Peru's stock price. Grupo Mexico initially rejected the offer, but then on August 21, 2004, it counteroffered, asking for 67 million shares—at the time, worth about $2.76 billion. By the time the offer was considered by the special committee, that value had risen to $3.06 billion. Goldman then made another presentation to the committee, basing its valuation methods on different EBITDA multiples. In doing so, it based Minera's value on Southern Peru's projected EBITDA.[133]

On October 5, 2004, the special committee and Grupo Mexico arrived at a final deal, in which the special committee agreed to pay 67 million shares, which they justified paying "through a series of economic contortions. . . . by decreasing Minera's debt cap by another $105 million, and by getting Grupo Mexico to cause Southern Peru to issue a special dividend of $100 million, which had the effect of decreasing the value of Southern Peru's stock."[134]

Additionally, rather than require a majority-of-the-minority vote to approve the merger, the committee agreed to require only a

two-thirds vote of Southern Peru's common stock. This meant that the deal would be approved if either of Southern Peru's largest minority shareholders—Cerro or Phelps Dodge—voted in favor along with Grupo Mexico. The court noted that this presented an issue because one of the special committee members, Handelsman, represented Cerro, and Cerro wanted to monetize its shares and get out of its investment in Southern Peru. Because the merger deal would also provide for registration of unregistered shares—which Cerro, as a founding stockholder, held—the court noted that Handelsman would thus be inclined to see the merger through, although at the most favorable price possible. The court was not prepared to find that Handelsman consciously agreed to a suboptimal deal simply to achieve liquidity for Cerro, but it found little doubt that the situation influenced his approach: "That does not mean he consciously gave in, but it does means that he was less than ideally situated to press hard. Perhaps most important, Cerro's desires when considered alongside the Special Committee's actions illustrate the tendency of control to result in odd behavior."[135]

Goldman provided a written fairness opinion, based again on relative discounted cash flow analyses, with no standalone equity value given for Minera. The Special Committee then voted 3–0 to recommend the merger to the full board. At the last-minute suggestion of Goldman, Handelsman abstained in order to remove any appearance of conflict based on his participation in the negotiation of Cerro's registration rights, although he had been heavily involved in the negotiations. The Board then unanimously approved the merger and Southern Peru entered into the merger agreement. The shareholder vote took place nearly five months later, but the special committee did not ask Goldman to update its fairness opinion, which the court found "curious"—first, because Southern Peru's stock price had gone up substantially since the merger was announced, and second, because Southern Peru had exceeded the 2004 EBITDA estimates that had been used in Goldman's analysis by some 37%. The court was particularly concerned with this because Cerro had agreed to vote against the merger if the special committee changed its recommendation.[136] Southern Peru's shareholders approved the merger on March 28, 2005.

At trial, both sides agreed that the merger was subject to entire fairness review, which included both process ("fair dealing") and price ("fair price"). The court concluded that, under the Delaware Supreme Court's decision in *Kahn v. Tremont Corp.,*[137] it was required to engage in a factual look at the actual effectiveness of the special committee before shifting the burden of persuasion on fairness from the defendants to the plaintiffs.[138] It determined that the burden of persuasion remained with the defendants, because the Special Committee was not "well functioning." However, it also held that, regardless of who bore the burden, it would still find the merger unfair, because the process by which the merger was negotiated and approved was not fair and did not result in the payment of a fair price.[139]

The court began its fairness discussion by noting that there was no issue as to the independence of the members of the special committee. However, it noted problems with the committee's process: "From the get-go, the Special Committee extracted a narrow mandate, to "evaluate" a transaction suggested by the majority stockholder." Although committee did in fact go further and engage in negotiations, "its approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate."[140] The court held that the committee had fallen victim to "a controlled mindset," through which it allowed Grupo Mexico to dictate the merger's terms. It failed to insist on looking at alternatives, but instead accepted that its only options were to approve or disapprove a purchase of Minera, taking off the table other options that would have given it negotiating leverage, thus enabling it to rationalize what was a suboptimal deal. It opined that "the Special Committee was trapped in the controlled mindset, where the only options to be considered are those proposed by the controlling stockholder. When a special committee confines itself to this world, it engages in the self-defeating practice of negotiating with itself—perhaps without even realizing it—through which it nixes certain options before even putting them on the table."[141] Thus, the committee failed to consider options such as proposing Grupo Mexico buy out the shareholders of Southern Peru who were seeking to monetize their shares, and it failed to engage in meaningful back-and-forth with the controlling shareholder. Rather, their focus, and Goldman's focus, was on finding a way to get the terms of the merger structure to make sense, rather than on questioning the assumption that the merger was a good idea in the first place.[142]

The court noted that this mindset led to several faulty analyses of the merger's value, pointing out that the committee was never able to justify the merger based on Minera's standalone value, as opposed to the relative valuation methods, which the court held were faulty because of their underlying assumptions. It also held that the committee should not have discounted Southern Peru's market value in focusing on these other valuation methods, and it roundly criticized the special committee for failing to update its fairness analysis after Southern Peru's vast gain in stock price and vastly exceeding its EBITDA projections.[143] Therefore, the court held that the merger was unfair and rendered judgment for the plaintiffs.

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 former president of the Dallas Chapter of the Federal Bar Association, and is a past-Chair of the Dallas Bar Association's Securities Section. Mr. Murray has experience in a wide range of complex business litigation, with a focus on director and officer defense, oil and gas, and technology-related matters, and he is on the list of Panel Counsels of Chartis for the State of Texas. He also has litigated shareholder derivative actions representing the special litigation committee, the dissident shareholder, the target company, and the alleged interested directors. And he has represented corporate officers and other individuals in SEC and Self Regulatory Organization investigations and enforcement actions, and in Department of Justice investigations. The author thanks Chris Hodge for his assistance in drafting this article.

2 *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 833 (Del. 2011).

3 *Id.* at 834.

4 *Id.*

5 *Id.* at 834–35.

6 *Id.* at 835 (citing *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949)).

7 *Id.* at 836.

8 430 A.2d 770 (Del. 1981).

9 23 A.3d at 836–37 (citing *In re Primedia Inc. Derivative Litig.*, C.A. No. 1808, at 58–59, 62–64 (Del. Ch. Jun. 14, 2010)).

10 989 A.2d 683 (Del. Ch. 2010).

11 23 A.3d at 837 (citing *Pfeiffer v. Toll*, 989 A.2d 683 (Del. Ch. 2010)).

12 *Id.* (quoting *Brophy*, 70 A.2d at 8).

13 867 A.2d 904 (Del. Ch. 2004), *aff'd*, 872 A. 2d 960 (Del. 2005).

14 23 A.3d at 838 (quoting *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904 (Del. Ch. 2004), *aff'd* 872 A.2d 960 (Del. 2005)).

15 *Id.* at 838–40.

16 *Id.* at 842.

17 *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1141 (Del. 2011).

18 *Id.* at 1142.

19 *Id.* at 1142–43 (citing *In re VeriFone Holdings, Inc. S'holder Derivative Litig.*, 2009 WL 1458233, at *13 (N.D. Cal. Aug. 26, 2010)).

20 2009 WL 483321 (Del. Ch. Feb. 26, 2009).

21 *King*, 12 A.3d at 1145–46.

22 *Id.* at 1146–48.

23 *Id.* at 1150.

24 *Id.* at 1151–52.

25 *CML V, LLC v. Bax*, 28 A.3d 1037, 1039 (Del. 2011).

26 *Id.*

27 *Id.* at 1040.

28 *Id.* at 1040–41.

29 *Id.* at 1041 (quoting 6 Del. C. § 18-1002).

30 *Id.* at 1041–42.

31 *Id.*

32 *Id.* at 1043.

33 *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 34 A.3d 1074, 1075–77 (Del. 2011).

34 *Id.* at 1078.

35 *Id.* at 1080.

36 *Id.* at 1080–81 (citing Lambrecht v. O'Neal, 3 A.3d 277, 288–91 (Del. 2010)).

37 *Id.* at 1081–82.

38 *Id.* at 1083.

39 *Seven Investments, LLC v. AD Capital, LLC*, 32 A.2d 391, 393–95 (Del. Ch. 2011).

40 *Id.* at 395–96.

41 *Id.* 396 (quoting *Corporate Prop. Assocs. 6 v. Hallwood Gp. Inc.*, 817 A.2d 777, 779 (Del.2003)).

42 *Id.*

43 *Id.* at 397.

44 *Id.* at 398.

45 *Id.*

46 *Id.* at 399 (citing *E.I. DuPont de Nemours & Co. v. Fla. Evergreen Foliage*, 744 A.2d 457 (Del. 1999)).

47 *Id.* (citing *DuPont*, 744 A.2d at 458–59).

48 *Id.*

49 *Id.* at 400–01.

50 *Klig v. Deloitte LLP*, C.A. No. 4993-VCL, 2011 WL 5925085, at *1–2, — A.3d — (Del. Ch. Nov. 21, 2011).

51 *Id.* at *3–5.

52 *Id.* at *6.

53 *Id.* at *5.

54 *Id.* at *8.

55 *Id.* at *8–9.

56 *Id.* at *9 (citing *Lewis v. Vogelstein*, 699 A.2d 327, 334 (Del. Ch. 1997)).

57 *Id.*

58 *Id.* at *10.

59 *Id.* (citing 6 Del. C. § 15-602).

60 *Id.* at *11.

61 *Id.* at *14.

62 *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 817 (Del. Ch. 2011).

63 *Id.*

64 *Id.* at 819–20.

65 *Id.* at 820.

66 *Id.* at 820–21.

67 *Id.* at 822.

68 *Id.* at 823.

69 *Id.* at 823–24.

70 *Id.* at 825.

71 *Id.*

72 *Id.* at 825–26.

73 *Id.* at 826–27.

74 *Id.* at 828–29.

75 *Id.* at 830 (citing *Mercier v. Inter–Tel (Del.), Inc.*, 929 A.2d 786, 810 (Del.Ch.2007)).

76 *Id*. at 833–34.

77 *Id*. at 835 (citing *In re Netsmart Techs., Inc. S'holder Litig.*, 924 A.2d 171, 188 (Del.Ch.2007)).

78 *Id*. at 837–38.

79 *Id*. at 840–41.

80 *Id*. at 842–43.

81 *Id*. at 836 (citing *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del.1989)).

82 *Id*. at 818.

83 Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 450–51 (Del.Ch. 2011).

84 *Id*. at 452–53.

85 *Id*. at 453–54.

86 *Id*. at 455–56 (citing *Andra v. Blount*, 772 A.2d 183, 192 n. 22 (Del. Ch. 2000)).

87 *Id*. at 456 (citing *Applebaum v. Avaya, Inc.,* 812 A.2d 880, 893 (Del. 2002)).

88 *Id*. (citing 8 Del. C. § 155(2)).

89 *Id*. at 460 (citing *Metro. Life Ins. Co. v. Aramark Corp.*, 1998 WL 34302067, at *3 (Del. Ch. Nov. 20, 1990)).

90 *Id*. at 461 (citing *Applebaum*, 812 A.2d at 892).

91 93 A.2d 107 (Del. 1952).

92 457 A.2d 701 (Del. 1983).

93 28 A.3d at 461–64.

94 *Id*. at 464–66.

95 *Id*. at 468–78.

96 *Id*. at 478.

97 *Id*. at 479.

98 Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48, 55–56 (Del. Ch. 2011)

99 *Id*. at 55.

100 *Id*. at 88–89.

101 *Id*. at 90.

102 *Id*. at 95 (citing *TW Servs., Inc. v. SWT Acquisition Corp.*, 1989 WL 20920, at *10 (Del. Ch. Mar. 2, 1989)).

103 500 A. 2d 1346, 1356 (Del. 1985).

104 16 A.3d at 95 (citing *Moran v. Household Int'l, Inc.,* 500 A.2d 1346, 1356 (Del. 1985)).

105 1989 WL 20920 (Del. Ch. Mar. 2, 1989).

106 16 A.3d at 103.

107 *Id*. at 104–06.

108 *Id*. at 107.

109 *Id*. at 108–09.

110 *Id*. at 112 (quoting *Unitirin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1376 (Del. 1995)).

111 *Id*. (quoting *Paramount Commc'ns, Inc. v. Time, Inc.,* 571 A.2d 1140, 1150 (Del. 1990)).

112 *Id*. at 124 (quoting *Unitirin*, 651 A.2d at 1384).

113 *Id*. at 113.

114 5 A.3d 586 (Del. 2010).

115 *Id*. at 604 (citing *Versata,* 5 A.3d 586, 604 (Del. 2010)).

116 16 A.3d at 121 (quoting *Versata*, 5 A.3d at 604).

117 *Johnston v. Pedersen*, 28 A.3d 1079, 1081–82 (Del. Ch. 2011).

118 *Id*. at 1082–83.

119 *Id*. at 1084–85.

120 *Id*. at 1086–87.

121 *Id*. at 1088.

122 *Id*. at 1089.

123 531 A.2d 1204 (Del. Ch. 1987).

124 28 A.3d at 1090 (quoting *Aprahamian*, 531 A.2d at 1206).

125 *Id*.

126 *Id*. at 1090–91.

127 *Id*. at 1092–93.

128 *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, C.A. No. 961-CS, 2011 WL 6440761, at *1, —A.3d— (Del. Ch. 2011)

129 *Id*. at *3.

130 *Id*. at *7–8.

131 *Id*. at *8–10.

132 *Id*. at *9.

133 *Id*. at *10–11.

134 *Id*. at *12.

135 *Id*. at *13–14.

136 *Id*. at 16–17.

137 694 A.2d 422 (Del. 1997).

138 2011 WL 6460761 at 20 (citing *Kahn v. Tremont Corp.*, 694 A.2d 422, 428–29 (Del. 1997)).

139 *Id*. at 23, 26.

140 *Id*. at 26.

141 *Id*. at 26–28.

142 *Id*. at 29.

143 *Id*. at 29–37.

Business Torts Update – Spring 2012

By William M. Katz, Jr. and Megan H. Schmid[1]

William M. Katz

Megan H. Schmid

This survey examines significant business torts decisions by Texas courts for the period from May 2011 through February 2012. "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 application of the discovery rule and fraudulent concealment doctrine, when publicly available documents bear on the defendant's conduct; (2) when and under what circumstances an actionable DTPA representation may be implied based on conduct; (3) how to contractually limit claims for fraud and fraudulent inducement; and (4) whether a non-Texas resident who uses interactive local websites to allegedly defame a Texas resident is subject to personal jurisdiction in Texas.

Application of the Discovery Rule and Fraudulent Concealment Doctrine When Publicly Available Documents Contradict the Defendant's Representations

In *BP Am. Prod. Co. v. Marshall*,[2] the Texas Supreme Court held that neither the discovery rule nor fraudulent concealment extended the statute of limitations on the plaintiff royalty owners' fraud claims, because the royalty owners' injury was not inherently undiscoverable and BP's fraudulent representations could have been discovered with reasonable diligence through available public records.

The Marshalls owned and leased mineral interests in South Texas to ARCO, BP's predecessor. The leases contained a standard sixty-day savings clause that would extend the term of the leases past their expiration dates as long as BP engaged in good faith drilling or reworking operations designed to produce oil or gas in paying quantities with no cessation of operations for more than sixty days. Two weeks before the leases' primary terms were to expire in 1980, BP drilled a well. When the Marshalls failed to see any production from the well, they contacted BP. In response, BP sent them a letter purporting to set forth the activities conducted on the well as documentation that operations were continuing in good faith. Satisfied with the response, the Marshalls did not investigate further. In March 1981, BP decided to plug the well and another operator took over. It was undisputed that there have been continuous operations on the lease since the new operator took over and drilled a productive well in April 1981. Through a series of assignments, Wagner Oil Company eventually became the operator on the lease.

In 1997, other mineral interest owners on the lease sued Wagner and BP for breach of implied covenants to reasonably develop and market hydrocarbons. During the course of discovery, the other mineral interest owners concluded that the original lease had terminated in January 1981, when BP stopped making good faith efforts to rework the well. In 2001, the Marshalls intervened in the suit against BP and Wagner, asserting that their lease had terminated in 1981 and that BP had defrauded them by purposefully concealing facts and circumstances showing that the lease had already terminated. The Marshalls contended that the four-year statute of limitations for fraud had been extended until June 2000—when BP released internal documents allowing them to discover the fraud.

At trial, the jury found in favor of the Marshalls, resulting in (1) a declaration that the lease had been terminated and that BP's property interest had reverted to the Marshalls; (2) an accounting and transfer of an overriding royalty interest; and (3) damages for fraud, plus interest and attorney's fees. The court of appeals upheld the jury's finding of fraud.

On appeal, the supreme court considered whether the statute of limitations barred the Marshalls' fraud claim against BP.[3] First, the court analyzed the discovery rule and held that it did not delay the accrual of the Marshalls' cause of action against BP, because the Marshalls' injury was not inherently undiscoverable. The court emphasized that the Marshalls had a duty to exercise reasonable diligence to protect their mineral interests and that the information disclosing BP's failure to continue good faith efforts to develop the oil and gas lease was available in public records, including the well log and plugging report filed by BP with the Texas Railroad Commission. The court found that while the information in the well log was highly technical information, it was still publicly available to the Marshalls. The court reached its conclusion despite the fact that the

Marshalls needed an expert to interpret the well log and plugging report in the litigation.

Applying a similar analysis, the court next addressed the doctrine of fraudulent concealment, holding that the Marshalls' claims were barred by the statute of limitations, because "as a matter of law, the Marshalls would have been able to discover BP's fraud through the use of reasonable diligence." Despite BP's oral and written representations to the Marshalls in 1980 that continuous operations were ongoing, the court found that the Marshalls had an affirmative obligation to perform an additional investigation to protect their interests. The court reasoned that by failing to investigate public records available within the limitations period, the Marshalls "did not exercise reasonable diligence in relying on BP's representations and limitations barred their claim." The court noted that Stanley Marshall "was a sophisticated lessor who subscribed to industry publications, worked as a driller when he was younger, and thus understood the oil and gas industry." Accordingly, the court reversed and rendered judgment in favor of BP.

Implied Representations under the DTPA Based on Conduct

In *Red Roof Inns, Inc. v. Jolly*,[4] the Fourteenth Court of Appeals held that an actionable representation under the Texas DTPA may be implied solely based on conduct, but all three justices disagreed on when and under what circumstances such a representation may be implied.

The plaintiffs/guests traveled to Houston to visit a relative in the hospital when they checked into a Red Roof Inn at 2:30 a.m. When they checked in, the guests noted that: (1) the front desk clerk informed them (after inquiry) that safes were not available for guest use; (2) a security guard was on duty in the lobby; and (3) they received a card key to gain entry to their room. Unfortunately, during their stay, unknown suspects burglarized their motel room and stole jewelry valued at $50,000.00 that had been left on the nightstand.

The guests sued Red Roof Inn for negligence and violations of the DTPA. Specifically, the guests alleged that Red Roof Inn engaged in a false, misleading, or deceptive act or practice in leasing the motel room by (1) representing the motel was "a safe, secure, and monitored property," when the motel was actually "a crime-afflicted property that was not operated or monitored in a secure manner," and (2) failing to disclose facts regarding the safety and security of the motel in an effort to induce them into staying there. The jury found that Red Roof Inn was negligent, but was only five percent responsible for the theft. The jury also found in favor of the guests on their DTPA claims, but did not find that Red Roof Inn had acted knowingly. The guests elected to recover under their DTPA claims, and the trial court awarded damages, interest, attorney's fees, and court costs.

On appeal, the court of appeals considered whether the evidence was legally and factually sufficient to support the jury's finding that Red Roof Inn violated the DTPA and whether the trial court erred by not applying the five percent responsibility found by the jury to the DTPA claim. The panel agreed that an actionable representation under the DTPA may be implied solely based on conduct—an issue of first impression for the Fourteenth Court of Appeals and an issue not yet addressed by the Texas Supreme Court. The panel disagreed, however, on when and under what circumstances such a representation may be implied. The majority held the evidence to be legally insufficient to support the DTPA claim, and reversed and rendered a take-nothing judgment in favor of Red Roof Inn. The concurring justice agreed with the majority's conclusions, but disagreed with the majority's analysis. And the dissenting justice would have held that the evidence was legally and factually sufficient to support the jury's DTPA finding.

Justice Frost, writing for the majority, found that research did not disclose any case law addressing "whether and when a representation should be implied under the DTPA based upon a party's conduct." Accordingly, Justice Frost began her analysis by looking at how Texas "courts view implied statements in other contexts," such as implied covenants in contracts. Finding that Texas law does not favor implied covenants, Justice Frost held that a "representation should be implied from conduct only when, under the circumstances at the time the party engaged in that conduct, the only reasonable interpretation of that conduct is that the party meant to convey the representation in question." Applying this analysis to the facts, Justice Frost found that even if it were reasonable to interpret either the security guard's presence or the issuance of a card key as a representation that Red Roof Inn was safe, secure, and monitored, that would not be the only reasonable interpretation of this conduct. "To qualify as an implied representation, the representation must be so obvious that it did not need to be stated." Justice Frost also reasoned that it would be inconsistent with Texas Supreme Court precedent regarding landowner's duties under premises liability law to hold that the presence of a security guard and the issuance of a card key imply a representation that the motel was secure. Finally, Justice Frost held that there was no evidence that Red Roof Inn withheld any information from the guests to induce them into leasing a motel room.

Justice Jamison, concurring, agreed that with the majority's disposition of the case, but disagreed with the reasoning. Specifically, Justice Jamison did "not believe it [was] necessary for the court to create a new test, based on contract law, to recognize implied representations under the DTPA, or to invoke the . . . factors for a landowner's duty under premises-liability negligence principles. . . ." Justice Jamison reasoned that the DTPA was a statute intended to be liberally construed to protect consumers from the unilateral conduct of one party, unlike an implied covenant based on the mutual agreement of contracting parties. Instead, Justice Jamison would have analyzed the case the same way other sister courts have done—applying only the legal sufficiency standard.

Justice McCally, writing in dissent, disagreed with the majority's contractual analysis and its decision to reverse and render judgment

in favor of Red Roof Inn. Rather, "the proper analysis [was] to uphold the jury's determination that such direct evidence of the existence of a security guard at check in and the provision of a secure key gives rise to an implied representation that Red Roof employed full-time security measures against unauthorized access." Therefore, Justice McCally would have held that the evidence was legally and factually sufficient to support the jury's DTPA finding.

Contractually Limiting Claims for Fraud and Fraudulent Inducement

In *Allen v. Devon Energy Holdings, L.L.C.*,[5] the First Court of Appeals held that a redemption agreement containing an independent investigation clause, mutual release, and merger clause did not bar the plaintiff's fraudulent inducement and fraud claims.

Robert Allen held a minority interest in Chief Holdings, LLC, a closely-held natural gas exploration and development company. Trevor Rees-Jones was Chief's manager and majority owner. In November 2003, Chief offered to redeem Allen's stock in the company and sent him a letter explaining the terms of the redemption offer and including a "pessimistic assessment of a number of facts and events that could negatively impact Chief's value in the future." The letter also enclosed two other documents: (1) an opinion on Chief's market value prepared by Phalon George Capital Advisors and (2) an appraisal of Chief's existing gas reserves. In June 2004, Chief gave Allen three days to review and sign the written redemption agreement. Between November 2003 and June 2004, however, a number of events occurred that Allen now claims would have materially impacted his decision to redeem his interest had Rees-Jones and Chief disclosed them to him. Generally, these events revolved around Rees-Jones' discovery that a competitor had successfully horizontally-drilled into the Barnett Shale and the development of plans for Chief to expand its activities in the area with horizontal drilling. The June 2004 redemption agreement contained an "Independent Investigation" clause, a general "Mutual Release," and a merger clause, and priced Allen's redemption based on the November 2003 appraisals "regardless of any subsequent change in value." Allen redeemed his interest and two years later Chief sold for substantially more than his redemption sales price.

Allen sued Rees-Jones and Chief's successor-in-interest Devon Energy Holdings, L.L.C. for fraud, breach of fiduciary duty, violations of the Texas Securities Act, and shareholder oppression. Rees-Jones and Devon filed traditional motions for summary judgment, which the trial court granted. The court of appeals reversed and remanded the case, holding that the trial court erred in granting summary judgment on Allen's claims of fraudulent nondisclosure, fraudulent misrepresentation, breach of fiduciary duty, and violations of the Texas Securities Act, but properly granted summary judgment on his common law fraud claim and shareholder oppression claim.

On appeal, the court of appeals considered the following factors identified by the Texas Supreme Court in *Forest Oil Corp. v. McAllen,*[6] to determine if a contract bars a fraudulent inducement claim as a matter of law: (1) whether the contract's terms were negotiated or boilerplate; (2) whether the complaining party was represented by counsel; (3) whether the parties dealt with each other at arm's length; and (4) whether the parties were knowledgeable in business matters. In *Forest Oil*, the court also affirmed its previous holding in *Schlumberger Tech Corp. v. Swanson*,[7] that "a release that clearly expresses the parties' intent to waive fraudulent inducement claims, or one that disclaims reliance on representations about specific matters in dispute, can preclude a claim of fraudulent inducement." Accordingly, Texas Supreme Court precedent teaches that a fraudulent inducement claim is not contractually barred or waived unless there is "an expressed clear and unequivocal intent to disclaim reliance or waive a claim for fraudulent inducement."

In *Allen*, however, the court of appeals found that "[e]ven a clear and unequivocal disclaimer of reliance may not bar a fraudulent inducement claim under certain circumstances." The appellate court determined that it must look to the *Forest Oil* factors even if it first found that the disclaimer of reliance was clear and unequivocal, concluding that "(1) if all four factors are conclusively established (and the requirement of precise language is satisfied), the disclaimer precludes fraudulent inducement as a matter of law, (2) if none of the other four factors are satisfied the disclaimer does not bar a fraudulent inducement claim even if it is clear and unequivocal, and (3) if the parties are sophisticated and represented by counsel, it is also necessary to demonstrate at least one of the other two factors (either negotiated terms or an arm's length transaction)."

Applying the above analysis to the facts of *Allen*, the court of appeals held that the redemption agreement did not bar Allen's fraud claims, because there was no clear and unequivocal disclaimer or waiver of reliance. The court reasoned that the redemption agreement did not: "(1) state that the only representations that had been made were those set forth in the agreement; (2) contain a broad disclaimer that any extra-contractual representations had been made and that no duty existed to make any disclosures; (3) provide that Allen had not relied on any representations or omissions by Chief; or (4) include a specific 'no liability' clause stating that the party providing certain information will not be liable for any other person's use of the information."

Addressing the independent investigation clause, the court found that it did not clearly and unequivocally negate the possibility that Allen, in addition to his own independent investigation, also relied on information obtained from Chief and Rees-Jones. In other words, it did not clearly disclaim reliance on the information given to him by Chief. The independent investigation clause also included a mutual release from "any claims that might arise as a result of any determination that the value of [Chief] . . . was more or less than" the agreed redemption price at the time of the closing. The court found that this mutual release released the parties only from claims that arose from a determination that the redemption price did not reflect Devon's value at closing. According to the court, it did *not* release Allen's claims regarding alleged misrepresentations and omissions concerning Devon's *future* prospects.

Furthermore, the court found that the separate mutual release provision, releasing "all claims, demands, rights, liabilities, and causes of action of any kind or nature," did not bar Allen's fraudulent inducement claim, because it did not address fraud claims in clear and explicit language.

Finally, the court followed the Texas Supreme Court's holding in *Italian Cowboy*,[8] and found that the "generic merger clause by itself [was] insufficient to negate the element of reliance in a fraudulent inducement claim."

Despite the court's finding of no clear and unequivocal disclaimer of reliance, the court proceeded to consider the *Forest Oil* factors as "additional reasons why summary judgment was inappropriate." The court concluded that Devon and Rees-Jones established factors two and four—that Allen was an attorney who represented himself and that he was knowledgeable in the oil and gas industry. But the court found that a fact issue existed as to factors one and three—whether the terms of the contract were negotiated and whether the parties dealt with each other at arm's length. Accordingly, summary judgment was inappropriate and the court reversed and remanded Allen's fraud claims to the district court.

Personal Jurisdiction in a Defamation Case Based on Interactive Local Websites

In *Wilkerson v. RSL Funding, L.L.C.*,[9] the First Court of Appeals held that Texas courts did not have personal jurisdiction over a non-Texas resident who posted alleged defamatory comments about a Texas business on interactive, local websites for Houston, Texas.

Plaintiff RSL Funding, L.L.C. offers to pay lottery winners lump sums in exchange for a portion of their future lottery payments. Defendant Jerry Wilkerson resides in California with his daughter, a lottery winner who was solicited by RSL and had a bad experience with the company. Wilkerson decided to express his dissatisfaction with RSL by posting his review of the company on the internet. After searching the internet for RSL, Wilkerson found two third-party websites (local Yahoo! for Houston and Yelp for Houston) containing RSL's basic business information, including its location in Houston, Texas. He posted multiple comments on both websites complaining about RSL and specific RSL personnel.

RSL sued Wilkerson asserting claims of defamation, libel, and business disparagement. Wilkerson filed a special appearance objecting to the trial court's jurisdiction over him. RSL responded that Wilkerson published his statements specifically aimed at RSL, a Texas company, on "www.local.yahoo.com" and "www.yelp.com" for Houston—interactive websites that "use geographic location as the key to their respective search options." The trial court overruled the special appearance and Wilkerson appealed.

As a matter of first impression, the court of appeals considered whether a non-Texas resident who uses interactive local websites to allegedly defame a Texas resident is subject to the same jurisdictional standards as a non-Texas resident who uses local print media to allegedly defame a resident. First, the court found that Wilkerson negated RSL's jurisdictional claims by claiming his postings were not directed at Texas, thereby placing the burden back on RSL to "respond with evidence affirming its allegations." The court then analyzed the sufficiency of the evidence presented by RSL. Both Wilkerson and RSL requested that the court apply the "sliding scale" analysis "often used to evaluate whether jurisdiction may be exercised over a nonresident defendant based on the relative interactivity of its website." The court declined to do so, however, because the defendant did not own and operate the websites on which he posted his comments. Instead, the court applied the constitutional standard of purposeful availment, and found that none of the evidence presented by RSL was factually sufficient to exercise personal jurisdiction over Wilkerson. The court reasoned that it could not impute the unilateral activities of the website operators to Wilkerson, including the website operators' decisions to "use geographic location to facilitate searches by other users unrelated to this dispute." Therefore, the court reversed the judgment of the trial court and rendered a judgment of dismissal without prejudice for lack of personal jurisdiction.

Justice Keyes dissented and would have held that by using interactive local websites for Houston to post allegedly defamatory comments about a local Houston, Texas-based business, the defendant subjected himself to the long-arm jurisdiction of Texas. Justice Keyes criticized the majority for "derail[ing] an important case of first impression" by erroneously shifting the burden of proof to the plaintiff to prove jurisdiction and declining to apply the sliding-scale analysis to determine personal jurisdiction over a user of the Internet, because that user did not own or operate the websites at issue.

ENDNOTES

1 Mr. Katz is a partner in the Dallas office and Mrs. Schmid is an associate in the Houston office of Thompson & Knight LLP.

2 342 S.W.3d 59 (Tex. 2011).

3 The court also addressed whether the other mineral interest owners' lost title by adverse possession.

4 No. 14-10-00344-CV, 2011 WL 6288147 (Tex. App.—Houston [14th Dist.] Dec. 15, 2011, no pet h.).

5 — S.W.3d —, No. 01-09-00643-CV, 2011 WL 3208234 (Tex. App.—Houston [1st Dist.] July 28, 2011, no pet. h.).

6 268 S.W.3d 51 (Tex. 2008).

7 959 S.W.2d 171 (Tex. 1997).

8 *Italian Cowboy Partners, Ltd. v. Prudential Insurance Co. of Am.*, 341 S.W.3d 323 (Tex. 2011).

9 — S.W.3d —, No. 01-10-01001-CV, 2011 WL 3516147 (Tex. App.—Houston [1st Dist.] Aug. 11, 2011, no pet. h.)

▪ NOTES ▪

State Bar of Texas
Antitrust & Business Litigation Section
P.O. Box 12487
Austin, TX 78711-2487

NON PROFIT ORGANIZATION
U.S. POSTAGE
PAID
PERMIT NO. 1804
AUSTIN, TEXAS