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406 – Advising Your Independent Directors: Help Them to Help You

LaFleur Browne
Vice President & Assistant Corporate Secretary
SLM Corp. (Sallie Mae)

Richard Renck
Director
Ashby & Geddes, P.A.

Alexander Simpson
Vice President, General Counsel & Corporate Secretary
Reis, Inc.

Brad Stein
Vice President-Legal & Assistant Secretary
Forestar Group Inc.

Faculty Biographies

LaFleur Browne
Vice President & Assistant Corporate Secretary
SLM Corp. (Sallie Mae)

Richard Renck

Richard L. Renck is a director of Ashby & Geddes, P.A. in Wilmington, DE. His responsibilities include representing companies, controlling stockholders, as well as directors in various proceedings in the Court of Chancery, including litigation involving corporate mergers and acquisitions and shareholder class and derivative actions. Richard has also advised special committees of directors, company's involved in proxy contests, as well as companies engaged in complex commercial litigation.

Prior to joining Ashby & Geddes, P.A., Mr. Renck served as a clerk for the Court of Chancery of the State of Delaware. In recent years, he has been appointed co-vice chair of the American Bar Association business law section's Business Courts Subcommittee and appointed by Delaware's Court of Chancery as a special master and receiver in order to gather the books and records of a Delaware corporation, determine its rightful stockholders and convene an annual meeting for the election of directors.

Mr. Renck received a BS from Presbyterian College in Clinton, SC and is a graduate of the University of South Carolina School of Law.

Alexander Simpson

Alexander Simpson is vice president, general counsel and corporate secretary of Reis, Inc., a Nasdaq-listed business information (commercial real estate data) company. He is responsible for all legal matters affecting Reis, including corporate governance, SEC disclosure, litigation management, employment and intellectual property matters.

Prior to joining Reis, Mr. Simpson was associated with Davis Polk & Wardwell and later a partner at King & Spalding, both in New York City. In private practice, he advised issuers and underwriters in connection with a wide range of securities offerings, and also provided advice on general corporate matters, including corporate governance.

He a member of the ACC's Greater New York Chapter, and been a member of the board of directors since 2010, is president of the board of his cooperative apartment building, and is an officer of Ever Green Boat Club (a Dartmouth alumni rowing club).

Mr. Simpson received a BA from Dartmouth College and is a graduate of the Duke University School of Law, where he was managing editor of the *Duke Law Journal*.

Brad Stein

Brad Stein is vice president and assistant secretary of Forestar Group Inc. (NYSE: FOR), a real estate and natural resources company located in Austin, TX. At Forestar, he advises the company regarding its transactions and operations, manages litigation, is closely involved in governance and risk oversight functions, and counsels management, the board of directors and board committees.

Prior to joining Forestar, Mr. Stein worked in the legal department of Temple-Inland Inc., a Fortune 500 company then spun-off Forestar in 2007. Before working in-house, Mr. Stein practiced law at Brown McCarroll in Austin, TX and Paul Hastings in Los Angeles, CA.

In Austin, Mr. Stein has created a pro bono legal aid organization and also provides pro bono legal services and consultation to music and entertainment related businesses. He serves on the board of several nonprofit organizations, including Make A Wish Foundation, Any Baby Can, Austin Music Foundation and Austin Music People.

Mr. Stein graduated from the University of Michigan and received his law degree as dean's scholar from the St. Louis University School of Law.

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I. Required Independence of Majority of Board by NYSE/NASDAQ

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I. Required Independence of Majority of Board by NYSE/NASDAQ

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C. Company Related Party Policy
D. Proxy Advisory Firm Definitions, Roles, Issues
E. Judicial Oversight

A. Definitions of Independence

- **SEC**
  - Requires disclosure of independence determinations – refers to applicable listing standards (Regulation S-K Item 407)

Source: Regulation S-K Item 407

- **NYSE**
  - Subjective: The Board must "affirmatively determine" that there is "no material relationship with the listed company"
  - Objective: A director will fail to qualify as independent if:
    - The director (or an immediate family member) has been employed by the subject company within the last 3 years
    - The director (or an immediate family member) has received more than $120,000 in compensation from the company during any 12-month period during the previous 3 years
      - exempts board fees and deferred compensation for prior services
    - The director (or an immediate family member) is related to a firm that is serving as an auditor to the company
    - The director (or an immediate family member) is, or within the last 3 years has been, employed as an executive officer of another company where any of the subject company's present executive officers also served on the other company's compensation committee—the "I'll scratch your back if you scratch mine" clause
    - The director (or an immediate family member) is affiliated with a company that has made payments to or received payments from the subject company that exceed the greater of $1 million or 2% of the other company's gross revenues in any of the last 3 fiscal years.

Source: NYSE Listed Company Manual, § 303A.02

A. Definitions of Independence (cont.)

- **NASDAQ**
- Defined generally as: "[A] person other than an Executive officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."
- The following traits disqualify a director from being independent:
  - The director was employed by the company within the last 3 years
  - The director (or a defined Family Member) accepted over $120,000 in compensation from the company for any 12-month period during the 3 previous years
    - board fees and certain retirement benefits are exempted
  - The director is the Family Member of a person who has served as an Executive Officer of the company in the previous 3 years
  - The director is (or has a Family Member who is) a partner in, or a controlling Shareholder or and Executive Officer of an entity that has made to, or received from, the Company payments that exceed $200,000 or 5% of that firm's consolidated gross revenues for the year (certain payments are exempt)
  - The director is (or has a Family Member who is) an Executive Officer of another entity where (at any time during the previous 3 years) any of the Executive Officers of the listed company served on the compensation committee of the other entity
  - The director is (or has a Family Member who is) a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during the previous 3 years

Source: The NASDAQ Listing Rules, § 5605(a)(2).

A. Definitions of Independence (cont.)

State Law Standard for Independence

"The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."

Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004)

B. Required Independence of 3 Board Committees

SarbOx requires that the Audit, Compensation and Nominating/Governance Committees be comprised solely of independent directors (with limited exceptions), and imposes additional independence requirements on Audit Committee members (See Exchange Act Rule 10A-3(b)(1)). Dodd-Frank adds further independence requirements as it relates to committee advisors.

C. Company Related Party Policy

A company policy should ensure compliance with SEC rules and disclosure requirements, exchange (NYSE, NASDAQ) rules, and other company policies. There should be a process for monitoring related party transactions. Governance Committee/Board must make a determination as to independence of directors.

D. Proxy Advisory Firm Definitions, Roles, Issues

- Proxy Advisory Firms often have their own definitions and rules regarding independence that can be stricter than NYSE rules (*i.e.*, years since a director has served as an officer)
- Proxy Advisors can take punitive measures in their voting recommendations if they determine that a director is not independent
- Importance of anticipating Proxy Advisory Firms' recommendations
  - Many investors cannot (or do not) do their own analysis – they will follow the Proxy Advisors' recommendations

E. Judicial Oversight

- After the fact, a court may review independence (with the benefit of 20/20 hindsight) in a way that is more restrictive than SEC or listing rules dictate
  - Healthsouth
  - Barnes & Noble

II. Independent Director Oversight Considerations

A. Internal Controls
B. Compliance
C. Risk Assessment
D. Executive Compensation
E. Succession Planning

A. Internal Controls

Board and Audit Committee involvement in Internal Control over Financial Reporting (ICFR) process and results

- Disclosure Controls/Disclosure Committee
- Management assessment of ICFR
- CEO/CFO certification on SEC Reports
- NYSE affirmation

B. Compliance

- Oversight of Compliance involves
  - Having an effective compliance program
  - Reporting (hotline/incidents)
  - Training
  - NYSE requires independent directors to approve any waiver of corporate code of conduct
  - Whistleblower complaints/protections
  - See Risk Assessment

C. Risk Assessment

- Board/Audit Committee should oversee the process to ensure that it is designed to <u>identify potential events</u> that may affect the entity, <u>manage risks</u>, and provide reasonable assurance regarding the <u>achievement of entity objectives.</u> (SEC Regulation S-K Item 407(h) requires disclosure of the Board's role in risk oversight)

- Establish rigorous, documented procedures, with proper "tone from the top" and ownership/buy-in from senior management

- Risk assessment should include risk identification, risk evaluation, and risk mitigation

C. Risk Assessment (cont.)

- Risks related to compensation are a hot topic. SEC requires disclosure of the company's compensation policies and practices as they relate to the company's risk management (Regulation S-K Item 402(s)).
- A company shall review compensation policies and practices for all employees to determine if they create risks that are reasonably likely to have a *material adverse effect* on the company.
- The company should engage in a systematic process involving participants from its legal, finance, human resources, operations and other departments, in which it:
  - identifies company incentive compensation plans
  - assesses the plans to determine if they create undesired or unintentional risk of a material nature, taking into account any mitigating factors, and
  - documents the process and conclusions.

D. Executive Compensation

- Executive compensation should be set by an independent compensation committee.
  - Listing requirements/SEC disclosure
  - IRS Section 162(m) – performance compensation
- Increased investor focus (and benchmarking by Proxy Advisors) – important to have periodic benchmarking and to anticipate the Proxy Advisors' reactions.
  - Shareholders "Say on Pay" and "Say on Pay Frequency"

E. Succession Planning

- The Board has ultimate responsibility for succession planning.
- Three types of succession planning:
  - "Name in the envelope"—the person the Board has waiting in the wings if the CEO is incapacitated or dies suddenly,
  - The "targeted retirement," where a CEO makes known to the Board his or her departure date, allowing the board to start an orderly process to find a successor, and
  - The "deteriorating situation," where it becomes clear over a period of months that the Board must change the CEO sooner than planned because business is faltering.
- To accomplish this:
  - The Board must ensure that it has more than cursory exposure to senior management.
  - Boards should benchmark potential leadership. This task is often given to executive search firms.
  - A Board starting point should be a specification for a CEO who reflects the strategy and context of a company's future, not its present.

III. Legal Representation Issues

A. Who Does In-House Counsel Represent?
B. Hiring Independent Counsel
C. Special Independent Committees

A. Who Does In-House Counsel Represent?

- Answer – The Company
- Discuss – Relationship with Board
  - Importance of maintaining independence
  - Must be "independent broker"
- Discuss Penn State (Freeh report)
  - Failure to keep Board apprised of risks

B. Hiring Independent Counsel

- Board (and/or Committees) should have the ability to hire its own counsel (or other advisors) as circumstances warrant

C. Special Independent Committees

- Special Litigation Committees
  - Used when a shareholder has filed derivative litigation
  - Committee formed to review the claims
    - Committee may pick up and prosecute the claims (rare); or
    - Committee may seek dismissal of the claims
- Special Transactional Committees
  - Used when the company is faced with a conflict transaction
    - Common types: MBO, transaction with controlling stockholder, etc.
  - Use of a properly formed and charged committee should shift burden to a plaintiff challenging a transaction to show that the deal was not "entirely fair" rather than the company bearing the burden to show that it was.
    - Make-up of the committee critical
    - Should be given clear authority to negotiate, evaluate, and accept or reject
    - Should take "ownership" of the transaction

IV. Miscellaneous Issues in Representing Independent Directors

A. Public Access to Independent Directors
B. Meeting Tips/Executive Sessions
C. Minutes
D. Third Party Reports
E. Director Education

A. Public Access to Independent Directors

- NYSE requires oversight of public comments by independent directors
- Annual proxy statement must disclose how a shareholder can contact presiding director
- Although not widespread, Lead Directors and/or Board Chairs are engaging more with shareholders and may serve as shareholders' point of contact.
  - Allows Boards to develop a relationship of trust with shareholders
  - Allows the Board to tell the company's story directly when issues arise
  - However, a balance must be struck between what a Director can say versus what management can say
    - Directors may not be on top of latest developments.
    - Need to ensure consistent disclosure.
- Companies where the lead director or Chair is the shareholders' point of contact include: Boeing, Occidental Petroleum, Bed Bath & Beyond, PG&E, Merck and Dow Chemical

B. Meeting Tips/Executive Sessions

- Periodic executive sessions of independent directors without management are required.
- Any consensus in an executive session needs to be deliberated by the Board reflected in the minutes.
- Meeting books or Board portals include reports and backup materials
- Policy on retention of Board materials, notes, emails and memos among directors, etc.

C. Minutes

- Minutes should reflect
  - written record of the agenda items
  - the decision-making process
  - specific action taken or voted upon
- Careful consideration of how much detail of discussion items to include in the minutes
- Note *Disney* case for importance of a court or regulatory agency in judging Board conduct

D. Third Party Reports

- Directors are protected when they rely in good faith on reports of management and reports of experts, a standard from *Caremark*

E. Director Education

- Your role in keeping directors up to date on developments
  - Subscribe to law firm updates
- Consider focusing on one governance/education topic per meeting
- Offer directors access to education
  - NACD, etc.

ADVISING YOUR INDEPENDENT DIRECTORS: HELP THEM TO HELP YOU

RECENT CASE LAW FROM DELAWARE:

How The Failure To Effectively Deploy And Utilize Your Independent Directors Can Lead To Expensive Litigation Pitfalls

In 2011 and early 2012, the Court of Chancery of the State of Delaware issued several decisions that garnered the attention of the press and the blogosphere—primarily for their indictment of the behavior of controlling persons and/or the financial advisors in the consideration, negotiation, and approval of certain transactions. For purposes of this panel, however, these cases also provide lessons to in-house counsel on ways they might better use the skills (and cleansing effects) that the independent directors on their board might bring to similar situations. Here, we summarize four of those cases, and at the end of each provide some "food for thought" about how the independent directors in those cases might have been better able to assist their boards and their companies.

In re Del Monte Foods Co. S'holders Litig., C.A. 6027-VCL, 2011 WL 1677458 (Del. Ch. Feb. 14, 2011)

In this action for a preliminary injunction, plaintiff-stockholders sought to postpone the stockholder vote approving the planned merger between Del Monte Foods Company and Blue Acquisition Group, Inc. The latter entity was comprised of three private equity firms: Kohlberg, Kravis, Roberts &Co. ("KKR"), Centerview Partners, and Vestar Capital Partners ("Vestar"). Plaintiffs grounded their request in the Del Monte board of director's failure to oversee adequately Barclays Capital's actions as financial advisor in connection with the sale process. Plaintiffs' alleged that Barclays Capital ("Barclays") positioned itself to profit from the sale process by utilizing its position as financial advisor for Del Monte to facilitate a sale that would allow it to also provide buy-side financing for the transaction. The court granted the injunction and stayed the vote for a period of 20 days in light of the plaintiffs' reasonable likelihood of success on their breach of fiduciary duty and aiding and abetting breach of fiduciary duty claims.

In late 2009, Barclays began meeting with LBO firms, including KKR, with whom it had a close business relationship in order to discuss a potential acquisition of Del Monte. Barclays subsequently advised Del Monte that it knew many interested buyers and was accordingly well positioned to advise Del Monte in a potential sale process. Barclays, however, did not reveal its plan from the outset to seek to provide the buy-side financing of any potential transaction. Intending to assume a role in the buy-side financing, Barclays recommended that the board pursue a targeted, non-public bidding process that would improve its chances of securing this role and identified five LBO firms that that were invited submit indications of interest. Despite Del Monte's intention that the bidding process remain private, word of the bidding process spread and Vestar and Campbell's Soup asked to be included. A total of six firms, including Vestar and KKR, subsequently entered into confidentiality agreements with Del Monte that included no-teaming provisions. The firms then submitted their indications of interest, the highest being Vestar's bid of $17.50 per share. The directors considered the indications of interest, but concluded that an acquisition was not in the best interests of the company and instructed Barclays to shut down the bidding process.

Although directed to halt the bidding process, Barclays continued to meet with KKR about the prospect of acquiring Del Monte, and KKR continued to reach out to Del Monte toward this end. Six months later, in September of 2010, Barclays met with Vestar and suggested that KKR would serve as an ideal partner in the proposed acquisition. Despite its awareness of KKR and Vestar's binding confidentiality agreements with Del Monte—which prohibited any arrangement, understanding, or discussion that would lead to a teaming agreement—Barclays thus paired the two highest bidders, reducing the prospect of competition for any renewed process and improving its odds of providing buy-side financing. Agreeing to keep Vestar's participation a secret, KKR extended an unsolicited indication of interest of $17.50 per share in October of 2010. Although this amount was lower in real terms than the March 2010 bids, the board met to consider the offer. With the support of interested members of management who would profit from the sale and not knowing that Vestar was a secret partner, the board concluded that no pre-signing market check was needed and adopted a single-bidder strategy. The board was swayed toward this decision by its belief that no other bidders were lurking (the previous high bidder, Vestar, needed a partner) and its concern that a renewed process would negatively affect the stock price and employees' perception of the company's future.

Barclays served as the principle point of contact for Del Monte during the negotiations it orchestrated with KKR and continued to keep Vestar's participation a secret. As it was moving toward an agreement with Del Monte, KKR formally approached Barclays to request that Del Monte allow Vestar to become an additional member of the sponsor group. In doing so, neither KKR nor Barclays suggested that Vestar's addition was necessary or that Vestar had been an intended member of the sponsor group for months. The board summarily approved the pairing and did not consider enforcing the confidentiality agreement or inviting Vestar to participate with a different sponsor to generate competition. Continuing its series of alleged errors, the board approved Barclays request to provide buy-side financing before Del Monte and KKR agreed on a price. Barclays' interests therefore became directly adverse to those of Del Monte, necessitating a second fairness opinion from Perella Weinberg before the merger was ultimately approved at a sale price of $19 per share. The Merger Agreement provided for a 45 day post-signing go-shop period that the Del Monte board allowed Barclays to oversee despite its direct financial conflict as buy-side financer with the emergence of another bidder.

Because of Barclays' lack of candor with the board, many of the Jan. 12, 2011 proxy statement disclosures about the transaction proved false and misleading and Del Monte issued a proxy supplement on Feb. 4 to moot the plaintiffs' disclosure claims. These disclosures included the revelation that Barclays intended to provide buy-side financing from the beginning; other financing sources could have provided sufficient financing without Barclays; Barclays had routine business development discussions with KKR and Vestar; and KKR and Vestar had discussions about working together on an indication of interest including adding Vestar as an acquisition partner at a later point in the negotiation process

In granting the plaintiffs' motion for preliminary injunction, the court found that the plaintiffs sufficiently demonstrated (i) a reasonable probability of success on the merits of their breach of fiduciary duty and aiding and abetting breach of fiduciary duty claims, (ii) that plaintiffs would suffer irreparable injury if an injunction was not granted, and (iii) that a balance of the equities favored the injunction. Most relevant of these determinations was the court's analysis of the likelihood of success on the breach of fiduciary duty claims. In evaluating the viability of these claims, the court applied enhanced scrutiny because of the "subtle situational conflicts" that arose but were not sufficient to trigger entire fairness review. Under enhanced scrutiny review in the Merger context, directors bear the burden of demonstrating that they sought to secure the transaction that offered the best value reasonably available to the stockholders. In light of the critical role financial advisors play with respect to protection of shareholder interests during the consideration of a takeover bid, the court noted that Delaware courts have required full disclosure of investment banker compensation and potential conflicts and have "examined conflicts closely to determine whether they tainted the directors' process." The court further emphasized the core requirement under Delaware law that the board assume an "active and direct role in the sale process." The court subsequently found that the plaintiffs demonstrated a reasonable probability of success on their breach of fiduciary duty claims, emphasizing that, while Barclays was certainly deceptive, the directors compounded the perverse effects of this deception by granting Barclays' request to provide buy-side financing and allowing Barclays to taint the go-shop process.

Lessons Learned: When directors rely in good faith on experts "selected with reasonable care," their decisions "will not be disturbed;" but, "when a board is deceived by those who will gain from such misconduct, the protections girding the decision itself vanish." The role of independent directors can become "particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management…may not necessarily be impartial." Here, Del Monte's independent directors should have exercised greater oversight over the conflicting interests of its financial advisor, Barclays. Although the directors were not themselves conflicted, they had a duty to ensure that those from whom they sought counsel were providing objective guidance. Prior to this decision, independent directors (and the boards they sit on) may have been content in the assumption that experienced advisors such as those here would have notified them of such conflicts—that assumption is no longer safe. This obligation to really understand an advisor's potentially conflicting loyalties is firmly grounded in directors' duty to take an active and direct role in the sale process. Although here

Barclays appears to have willfully manipulated the sale process, the Del Monte Board, through greater oversight, could have abated this manipulation when relevant facts were revealed. In-house counsel can best utilize their independent directors in situations such as this by making sure that they are always attuned to potentially conflicting situations, and if such suspicions arise, they probe until they are satisfied that the suspicions were unfounded. Ultimately, as the court points out in *Del Monte*, "the buck stops with the board" and the independent board members must therefore ensure that their independent decision making process is not tainted by the conflicts of others.

***In re El Paso Corporation S'holder Litig.*, 41 A.3d 432 (Del. Ch. Feb. 29, 2012).**

In this action, the stockholder-plaintiffs of El Paso sought to enjoin the stockholder vote on a proposed merger between El Paso Corporation and Kinder Morgan, Inc. The plaintiffs alleged that the board's reliance on its conflicted CEO and conflicted financial advisor, Goldman Sachs, tainted the transaction with disloyalty.

El Paso, an energy company composed of a pipeline business and an Exploration & Production ("E&P") business, announced in May of 2011 that it was planning to spin off its E&P business. In order to preempt any market competition for El Paso's pipeline business after the spin-off, Kinder Morgan sought to acquire El Paso in whole. Accordingly, in August of 2011, Kinder Morgan offered El Paso $25.50 per share in cash and stock. When the El Paso board rejected this offer, Kinder Morgan threatened to go public with its interest in acquiring El Paso and the Board capitulated, entering into negotiations. The two companies reached an agreement in principle for the acquisition of El Paso at $27.55 per share, but Kinder Morgan later reneged on this agreement, and El Paso backed down, ultimately agreeing to a package valued at $26.87 as of the signing of the Merger agreement. Although this amount was still a substantial premium to market value, the plaintiffs alleged that the agreement was nevertheless the product of the selfish motivations of El Paso's CEO and Goldman Sachs.

Throughout the negotiation process, the board entrusted all key price negotiations to the company's CEO, Doug Foshee. Foshee, however, was aware of Kinder Morgan's intent to sell off El Paso's E&P segment upon acquisition of El Paso and had spoken with other senior management about approaching Kinder Morgan with a management bid for the E&P assets. Accordingly, throughout the negotiation process, Foshee was not only motivated to effect the acquisition, but was also incentivized to approve a lower price, as this would translate into a lower price for the E&P assets and – likely – a greater willingness of Kinder Morgan to work with Foshee. Foshee kept this motive a secret from the Board throughout the negotiations and, after the Board approved the Merger agreement, Foshee approached Kinder Morgan's CEO on two occasions to suggest a management bid.

Compounding the Board's problematic reliance on Foshee, the Board sought financial and strategic advice from Goldman Sachs, who proved inarguably conflicted. Not only did Goldman Sachs own 19% of Kinder Morgan and control two of the Kinder Morgan board seats, the lead Goldman banker advising El Paso personally owned approximately $340,000 of Kinder Morgan stock, a fact that he did not disclose. Although the institutional conflict was known by the Board, which brought in Morgan Stanley to advise El Paso with respect to the Merger, Goldman continued as primary financial advisor to El Paso for the spin-off and was asked to continue to provide financial updates to the Board comparing the spin-off to the Merger. Amplifying the impact of this role, the Board was evaluating the attractiveness of the Merger only in relation to the spin-off, as it had decided not to test the market for other potential buyers of either or both of its two business segments. Accordingly, Goldman had the capacity and incentive to skew its valuation of the spin-off downward and thereby directly affect the relative valuation of the Merger. The potential skewing effect of this incentive structure was augmented by the failure of Goldman's lead banker to disclose his personal ownership of Kinder Morgan stock—"a very troubling failure that tend[ed] to undercut the credibility of his testimony and of the strategic advice he gave." Perhaps most perniciously, Goldman tainted the cleansing effect of Morgan Stanley by clinging to its contract as exclusive advisor on the spin-off and refusing to allow El Paso to pay Morgan Stanley anything if the Board chose the spin-off rather than the Merger agreement. Goldman thus ensured that Morgan Stanley would face a choice either to approve the acquisition by Kinder Morgan and get $35 million or advise the board to opt for the spin-off and receive nothing. Finally, despite claiming it did not advise El Paso on the Merger, Goldman asked for and received a $20 million fee for its work on the Merger.

In order to achieve the requested injunction, plaintiffs were charged with demonstrating (i) a reasonable probability of success on the merits, (ii) that they would suffer irreparable harm without an injunction, and (iii) that the balance of the equities favored an injunction. In light of the interests of Foshee and Goldman Sachs in the transaction and the their "furtive behavior that engenders legitimate concern and distrust," the court found it "difficult to conclude that the board's less than aggressive negotiating strategy and its failure to test Kinder Morgan's bid actively in the market … were not compromised by…conflicting financial incentives." The court emphasized that "businessmen and investment bankers … like Foshee and [Goldman's lead banker] get paid the big money because they are masters of economic incentives, and keenly aware of them at all times" and therefore can rarely effectively assert that the conflicts of interest they concealed did not cross their plane of awareness with respect to the particular transaction. The court noted that "[w]hen anyone conceals his self-interest … it is far harder to credit that person's assertion that that self-interest did not influence his actions." Accordingly, the court readily found that the plaintiffs had a reasonable probability of succeeding on their breach of fiduciary duty claims. The court further found that the likely insufficiency of potential monetary damages counseled that the stockholders would suffer irreparable harm without an injunction. However, the court did not find that the balance of harms weighed in favor of an injunction because there was no other bid on the table and the stockholders of El Paso would have an opportunity to reject the Merger themselves. In declining to grant the injunction, the court expressed "frustration that the traditional tools of equity may not provide the kind of fine instrument that enables optimal protection stockholder in this context" and was troubled by the wealth shifting behavior of the insiders in the case.

Lessons Learned: The admonitions of the court in *El Paso* reveal a number of ways in-house counsel can curb the likelihood of litigation, or at least be better positioned to seek its early dismissal. First, as is clear from the facts above, it is important for in-house counsel to ensure that its board (and especially the independent directors) takes reasonable steps to understand where conflicts may lie, and if conflicts involving management exist, exerts sufficient oversight over transaction negotiations such that they are not unduly influenced by the conflicted cast members. In particular, the board should exercise caution before entrusting negotiations exclusively to management without any oversight by a legal advisor or independent director. While these persons are often (perhaps most often) the best positioned to handle negotiations, should they have any materially conflicting interest, that negotiation job should pass to someone else—often a special committee of independent directors. Second, with regard to conflicted bankers, counsel should ensure that the board circumscribes narrowly the role of a banker it identifies as conflicted and limits any possible tangential effect the banker could have on a particular transaction. Although Goldman was appropriately removed from its advisory position with respect to the Merger, it was still considered capable of affecting the relative valuation of the Merger in its role as advisor to the potential spin-off.

In re Goldman Sachs Group, Inc., S'holder Litig., C.A. No. 5215-VCG, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011).

Even though the court ultimately dismissed the plaintiffs' claims for failure to make a pre-suit demand, *In re Goldman Sachs* also provides substantial insight into best practices when utilizing independent directors. The plaintiffs, two institutional stockholders, alleged that Goldman's compensation structure incentivized Goldman employees to maximize short-term profits and increase their bonuses and to hedge Goldman's investments, taking positions opposite to clients it was investing with, advising, and financing. Accordingly, the plaintiffs alleged that the Director Defendants breached their fiduciary duties by approving the compensation structure, committing corporate waste, and failing to satisfy their oversight responsibilities with respect to the compensation structure.

Because the plaintiffs did not make a demand before bringing their derivative claims, they were charged with establishing demand futility. With respect to the challenged approval of the compensation structure, the plaintiffs were charged with showing particularized facts that created a reasonable doubt that either (i) the directors were disinterested and independent or (ii) the challenged actions were otherwise the product of a valid exercise of business judgment. In evaluating the first prong of this requirement, the court sought to determine the extent to which the board was conflicted. The plaintiffs argued that six of the directors were interested because the Goldman Sachs Foundation had made contributions to charitable organizations with which the directors were affiliated. The court concluded that, even if the Goldman Sachs Foundation was dominated or controlled by Goldman Sachs, a director's connection as trustee, board member, or even president of a charity to which the company donates does not, without more, foreclose independence. The court emphasized that plaintiffs must show how the donations would likely be material and affect the decision making of the directors. With respect to each of the allegedly interested directors, the plaintiffs never demonstrated the donations resulted from active solicitation by the allegedly interested director, what the ratio of the Goldman Foundation donation to overall donations was, or any other information establishing that the amount would materially affect the charity. Even with respect to the Goldman Sachs director who earned her living as President of Brown University, and whose livelihood accordingly depended on her fundraising ability, the plaintiffs failed to demonstrate that she actively solicited the contribution or establish that the amount donated by the Goldman Sachs Foundation was material; accordingly, plaintiffs could not "raise the inference that [she felt] obligated to the foundation or other Goldman management." Plaintiffs also alleged that three other directors were interested in light of their financial transactions with Goldman Sachs, but failed to allege that the directors relied on their transactions with Goldman Sachs or that the transactions were material to their employment.

Having failed to show that the majority of directors were not independent, in order to establish demand futility the plaintiffs needed to demonstrate that the approval of the compensation package was not otherwise the product of a valid exercise of business judgment. To successfully plead demand futility under this prong, plaintiffs were required to "allege particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision." In finding that the plaintiffs failed to do so, the court emphasized that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment." The court further found that the board reasonably informed itself before making its decision and that it is not obligated to consider every conceivable alternative. Accordingly, the court held that the plaintiffs did not sufficiently plead demand futility with respect to their challenge of the board's approval of the compensation package

With regard to the plaintiffs' waste claim, without "specific allegations of unconscionable transactions and details regarding who was paid and for what reasons they were paid," the plaintiffs similarly failed to establish demand futility. Finally, with respect to the plaintiffs' allegations of the directors' failure to exercise sufficient oversight, in order to establish demand futility, the plaintiffs were required to allege facts that created "a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to a demand." To face a substantial likelihood of personal liability sufficient to be deemed interested, the director-defendants must have either "utterly failed to implement any reporting or information system or controls," or, "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." In this case, only the latter condition applied and the plaintiffs were accordingly required to show a "sustained or systematic failure" to exercise oversight in order to establish lack of good faith.

The plaintiffs argued that the oversight failures related both to oversight of legal compliance and to oversight of business risk. With respect to unlawful conduct, the court concluded that the unethical conduct alleged by the plaintiffs—securitizing high risk mortgages, shorting the mortgage market, using naked credit default swaps, and magnifying risk through synthetic CDOs—is not the type of illegal conduct envisaged by *Caremark*. In other words, risky conduct does not equate to illegal conduct. With respect to oversight of business risk, the court concluded that the plaintiffs must show bad faith to establish personal liability for excessive risk-taking. If this onerous burden did not exist and plaintiffs could avoid the requirement of bad faith "by twisting their duty of care claims into *Caremark* loyalty claims, such a scenario would eviscerate the purpose of exculpation and could potentially chill the service of qualified directors." In finding that the plaintiffs failed to plead facts suggesting bad faith, the court emphasized that Delaware law is not designed to subject directors to personal liability for failing to properly evaluate business risk.

Lessons Learned: The lessons from this case are more positive in nature, as they show how independent directors might find their actual independence challenged but survive. From *In re Goldman Sachs*, corporate counsel can take comfort in the ability of their independent directors to take risks in exercising their duties as members of the board. Moreover, counsel need not question the independence of their directors based on their involvement in charitable organizations as long as the board members do not actively solicit donations from the company and as long as the company's donations do not materially affect the charity's sustainability or that of a particular project. It does, however, provide a cautionary lesson in that in house counsel should have in place a system to monitor certain affiliations their independent directors have in their daily lives so that potential conflicts can be readily identified and neutralized so that the entire benefit flowing from such independence is compromised or lost. Here, as is usually the case, where the independent directors have some relationship with the person or entity on the other side of the table, whether business, social, or charitable, that director's ability to remain "independent" in the eyes of the Delaware court will hinge almost entirely on the question of whether the connection is so material (socially or financially) that the director cannot be expected to completely disregard that interest in favor of his fealty to the company he serves.

***N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888 (Sept. 30, 2011)**

In this case, the Court of Chancery declined to dismiss the plaintiff's breach of duty of loyalty claims, finding that the plaintiff sufficiently alleged that the Merger agreement enabling the acquisition of *info*GROUP by CCMP Capital Advisors was the product of the directors' breach of their fiduciary duty of loyalty. The plaintiff alleged that Vinod Gupta—the founder, former CEO and chairman of the board, and largest stockholder of the company (owning 37%)—controlled the other board members through "a pattern of threats aimed at other Board members and unpredictable, seemingly irrational actions that made managing the company difficult and holding the position of director undesirable." Through this control, Gupta allegedly forced the merger at an inopportune time and through a deficient sales process so that he could obtain liquidity. As a result of the inadequate sales process—which Gupta allegedly disrupted by influencing the list of potential bidders, conducting unsupervised negotiations, and leaking confidential information about the sale to various parties—the Company's shareholders received an unfair price of $8.00 per share, which was below the market price of $8.16 at the time the Merger was announced.

One way to overcome the presumption of the Business Judgment Rule is to allege facts establishing that a majority of the individual board members had a financial interest in the transaction *or* were dominated or controlled by a materially interested director. In order to demonstrate that Gupta was a materially interested director, the plaintiff was charged with pleading sufficient facts to allege that Gupta received a material, personal, and financial benefit from the merger that was not equally shared by the other stockholders. The plaintiff asserted that Gupta had a clear need for liquidity in light of a number of converging factors. At the time the Complaint was filed, Gupta owed over $12 million stemming from prior derivative claim settlements and bore an additional $13 million of debt. Gupta also needed liquidity because of his intended launch of a new business. The plaintiff alleged, moreover, that Gupta had no other investments or income providing meaningful cash. Because the size of Gupta's 37 % share rendered it relatively illiquid, and because Gupta was ultimately unable to obtain sufficient financing to purchase the company, the sale of *info*GROUP to a third party was Gupta's only option to achieve the liquidity he needed.

The court recognized liquidity as a benefit that may lead directors to breach their fiduciary duties and declined to conclude as a matter of law that the $100 million of liquidity Gupta received from the merger was not material to him. The court further found that the plaintiff sufficiently pled that this material financial benefit was unique to Gupta because the other shareholders held 6% or less of the company and their shares were therefore already relatively liquid prior to the merger.

Gupta's conflict, without more, would prove insufficient to establish that the transaction was not approved by a disinterested majority of the board of directors, because of his minority stake in the company. The plaintiff, however, sufficiently alleged that the other, ostensibly independent, board members knew of Gupta's liquidity needs and were effectively dominated and controlled with respect to the Merger vote. In the months leading up to the Merger, Gupta issued a press release without authorization encouraging the sale of the company and generally proved disruptive, at one point denigrating and calling for the firing of the company's management. More directly, Gupta repeatedly threatened the other board members with lawsuits if they did not take action to sell the company and informed the board he had uncovered evidence of financial fraud. The court concluded, from the facts alleged, and in the plaintiff-friendly posture of a motion to dismiss, that it was reasonable to infer that Gupta dominated the board defendants through a pattern of intimidating threats that rendered them not independent with respect to the Merger approval.

Lessons Learned: This fact pattern is actually not that uncommon—a founder who eventually went to the public well for investment, who continued to manage the business as if it were still a private company. It is in these types of scenarios where the protections of vigorous, independent directors can most benefit their company and its shareholders. As one reads this opinion, you read of emails or testimony that indicated these otherwise independent directors had been worn down by Mr. Gupta's domineering ways, and unfortunately, appear to have been willing to bend to his desires just to complete a transaction and be rid of him. It is precisely in these types of situations, however, where the stockholders most rely on the protections truly independent directors can provide. In situations such as this, the Company will likely fare much better if in-house counsel has fostered a true sense of independence in his or her independent directors—perhaps that is blanket authorization for a lead independent director to retain his own counsel to advise the independent directors on any issue they believe warrants it, perhaps it is through constantly reinforced guidance that all directors loyalties lie to the company, not to the persons occupying senior management?