DELAWARE CHANCERY COURT LIMITS DAMAGES FOR DUTY-OF-DISCLOSURE CLAIMS; DISMISSES CLAIMS AGAINST DIRECTORS FOR BREACH OF FIDUCIARY DUTY

On June 19, 2008, the Delaware Chancery Court granted summary judgment in favor of three outside directors of Transkaryotic Therapies, Inc. ("TKT") in connection with breach-of-fiduciary duty claims arising out of the 2005 acquisition of TKT by Shire Pharmaceuticals Group ("Shire"). The Court also dismissed plaintiffs' duty-of-disclosure claims holding that (a) plaintiffs were without an equitable injunction remedy for these claims three years after the merger had been consummated and (b) monetary damages were unavailable because there was no evidence of disloyalty or bad faith on the part of the directors who authorized the disclosures.

- From a practitioner's perspective, the most likely result of the TKT decision is that future plaintiffs will be more likely to pursue injunctive relief for disclosure claims, because the failure to do so will leave them without an effective remedy absent a showing of bad faith or breach of the duty of loyalty. This may result in increased litigation between signing and closing.

- Further, it is heartening to note that the decision reinforced the concepts that directors who are (or are designees of) large shareholders are not conflicted in their advocacy of a transaction simply as a result of such shareholdings, and that their attempts to garner shareholder support of a board-approved transaction are not in conflict with their roles as directors, but are in fact as the Court noted "consistent with -- rather than at odds with --" their fiduciary duties.

Facts

Warburg Pincus, a private equity firm, owned about 15% of TKT, and had a representative on the TKT board, Jonathan Leff. Wayne Yetter, a pharmaceutical executive who had worked with the then current CEO of Shire in at least two prior jobs, was also on the TKT board. In February 2005, Shire made a formal offer to purchase TKT for $31 per share, which was rejected by the TKT board. After further negotiations, TKT and Shire finally settled on the price of $37 per share, and Shire and TKT entered into a merger agreement in April 2005. The merger was approved by a 5 to 2 vote of the TKT board, and the CEO of TKT thereafter resigned in protest. The merger was approved by a slim majority of the shares outstanding, and closed in July 2005.

In what originally began as an appraisal action in the summer of 2005, certain TKT shareholders brought a suit in 2007 against four TKT directors, including Wayne Yetter and Jonathan Leff, as well as Shire and TKT. Plaintiffs made three claims: (1) the TKT director defendants had breached their fiduciary duty to disclose and their duty of loyalty; (2) Shire had aided and abetted the TKT directors in breaching their fiduciary duty; and (3) TKT had entered into an unlawful merger. All the defendants, except for one of the directors, moved for summary judgment. The Court granted summary judgment in favor of all the defendants on plaintiffs' failure-to-disclose claim, and in favor of the director defendants on plaintiffs' breach-of-loyalty claims. The Court also granted summary judgment dismissing plaintiffs' claim that Shire had aided and abetted the three directors who moved for summary judgment, but denied summary judgment on whether Shire had aided and abetted the fourth director (who did not move for summary judgment) in allegedly breaching his duty of loyalty. The Court denied summary judgment on TKT's unlawful-merger claim, finding that plaintiffs had established a genuine issue of fact for trial. The Court observed, however, that the claims remaining for trial narrowly escaped summary judgment, and cautioned plaintiffs that they bore a heavy burden in establishing their claims at trial.

Breach of Fiduciary Duty

Plaintiffs claimed that the defendant directors had breached their fiduciary duties to the TKT shareholders by (1) failing to disclose material information before the shareholders voted on the merger; and (2) voting affirmatively for the merger, influenced by some personal benefit or interest.

While the Court's analysis as to each of the defendants was fact-specific, the Court's views as to Messrs. Leff and Yetter are noteworthy.

As one of Warburg's representatives on TKT's board, Leff allegedly had divided loyalties between TKT and Warburg. Because TKT had lost FDA approval for another product candidate and its stock had dropped significantly, plaintiffs claimed that Warburg wanted a way out of its investment in TKT. According to plaintiffs, Leff, on behalf of Warburg, aggressively pushed for the prompt sale of TKT at an unfairly low price because Warburg wanted to sell its interest. Plaintiffs pointed to Leff's aggressive attempts to encourage the board vote in favor of the merger, noting that Leff had micromanaged the valuation process and lobbied for shareholder votes after the merger was announced. Specifically, according to plaintiffs, Leff breached his fiduciary duty by soliciting so-called "empty votes" (votes relating to shares that were owned by shareholders on the record date but thereafter were sold).

After reviewing plaintiffs' case, the Court held that their evidence illustrated only that Leff was an employee of Warburg, that Warburg had some concerns over its investment in TKT, and that Leff was enthusiastic and engaged in the TKT-Shire merger negotiations. The Court rejected plaintiffs' argument that Leff had pushed for the sale of TKT at an unfairly low price so Warburg could sell its interest in TKT. On the contrary, because Warburg was TKT's largest investor, Warburg stood to lose the most if TKT was sold at an unfairly low price. Thus, contrary to plaintiffs' argument, Leff, as Warburg's representative and TKT's director, had powerful incentives to get the best available deal. The Court stated: "[I]n fact, '[a] director who is also a shareholder of his corporation is more likely to have interests that are aligned with the other shareholders of that corporation as it is in his best interest, as a shareholder, to negotiate a transaction that will result in the largest return for all shareholders.' [Warburg's] substantial stake gave Leff 'powerful economic (and psychological) incentives to get the best available deal.'" Plaintiffs also failed to prove that Warburg wanted to "get rid" of its investment in TKT. The Court found that, at most, Warburg was concerned and evaluated its investment periodically, which "is what private equity firms are supposed to do." As to the "empty vote" issue, the Court noted that the concept is "rhetorically appealing but legally unavailing; Delaware law explicitly provides for record-date voting." Leff's advocacy of the merger transaction was "consistent with -- rather than at odds with -- his fiduciary duties." The Court granted summary judgment on all of plaintiffs' breach-of-loyalty claims against Leff.

Plaintiffs based their breach-of-loyalty claim against Yetter, in part, on Yetter's previous business relationship with Emmens, the CEO of Shire, alleging that Yetter depended on Emmens for employment, and sold his seat to secure a positive job reference. In granting summary judgment in favor of Yetter, the Court held that business relationships or friendships alone do not indicate a conflict of loyalty unless these relationships are of a "bias-producing nature." Here, the Court found that plaintiffs' allegation that Yetter sold his vote in exchange for a positive job reference was unsupported by evidence. Although Yetter listed Emmens as a reference on his application for a position with a new employer, the Court found no evidence demonstrating that Emmens was contacted or even knew that he was listed as a reference. Furthermore, Yetter voted affirmatively to reject Shire's initial offer of $31 per share, and thus, if Yetter had been willing to sell his vote, he would have sold it then.

Duty to Disclose

Plaintiffs also claimed that the defendant directors failed to disclose (a) Warburg's influence on Leff and another director, Rod Moorhead (a former Warburg Pincus partner), (b) Yetter's and Emmens's previous employment relationship, and (c) the existence of and circumstances surrounding certain other transactions to the TKT shareholders before the shareholder vote in July 2005. As a result, plaintiffs claimed that these TKT directors breached their fiduciary responsibility to "disclose fully and fairly all material information within the board's control when it seeks shareholder action."

In analyzing the duty-to-disclose claims, the Court reiterated that the duty to disclose is not a separate, independent fiduciary duty but rather a specific application of the fiduciary duties of care and loyalty. As a result, damages may vary depending on which fiduciary duty the disclosure claim is based on. In failure-to-disclose cases where directors do not breach their duty of loyalty by acting in bad faith or self-interest, Delaware's statutory exculpatory provision, section § 102(b)(7), bars plaintiffs from recovering monetary damages. Here, the Court found no evidence that the TKT directors had acted in bad faith or self-interest. As to injunctive or other relief, the Court found that because the TKT-Shire merger took place three years ago, "an injunctive order requiring supplemental, corrective disclosures at this stage would be an exercise in futility and frivolity."

Unlawful Merger

According to plaintiffs, the TKT shareholder votes were incorrectly tabulated and, therefore, there was a question as to whether the TKT-Shire merger was actually approved in accordance with Delaware law. TKT urged the Court to rely on 8 Del C. section § 105, which provides that a certificate of merger filed with the Delaware Secretary of State constitutes *prima facie* evidence that shareholders have approved a merger. The Court agreed with TKT that plaintiffs must rebut this presumption, but held that plaintiffs had done so by demonstrating that, at the very least, the number of votes by which the merger passed was called into question. The Court held that TKT had failed to produce any evidence rebutting plaintiffs' proffer of evidence and therefore concluded that plaintiffs raised a genuine issue of material fact for trial. Accordingly, the Court denied TKT's motion for summary judgment on plaintiffs' unlawful-merger claim.

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If you have any questions about this decision, please contact the authors of this memorandum, Steven J. Gartner (212-728-8222, sgartner@willkie.com), William H. Gump (212-728-8285, wgump@willkie.com), Roger Netzer (212-728-8249, rnetzer@willkie.com) and Steven A. Seidman (212-728-8763, sseidman@willkie.com), or the attorney with whom you regularly work.

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