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Board's Adoption of a Plan of Dissolution Held Not to Be a Breach of the Directors' Fiduciary Duties

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In *The Huff Energy Fund, L.P. v. Gershen*, C.A. No. 11116-VCS (Del. Ch. Sept. 29, 2016), the Delaware Court of Chancery dealt with the issue of whether a company's decision, approved by its board of directors and its stockholders, to dissolve the company following the sale of a significant portion of its assets breached the directors' fiduciary duties. The court held that it did not.

The plaintiff, The Huff Energy Fund, L.P. ("Huff") initiated an action to challenge Longview Energy Company's ("Longview's") decision to dissolve itself. The complaint alleges, among other things, that the Board breached the Shareholders Agreement ("Agreement") and breached its fiduciary duties by adopting a plan of dissolution without exploring more favorable alternatives in violation of *Revlon* and as an unreasonable response to a perceived threat in violation of *Unocal*. Huff, an oil and gas company, was Longview's largest stockholder, holding approximately 40 percent of Longview's outstanding common stock.

Prior to the dispute, Huff and Longview entered into an Agreement that provided that "any transfer by Huff of its Longview stock was subject to a right of first offer to Longview." The Agreement also provided that "a unanimous vote of the Board was required for any act or omission that would have a material adverse effect on the rights of any Shareholder *as set forth* in this Agreement."

Relevant to the dispute, following the 2008 financial crises, the Board recognized that Longview's chances of achieving a liquidity event were hindered. As such, the Board began to explore transactions to sell some of Longview's properties. In September 2014, Longview was anticipating a sale of its California assets for $43.1 million, but the buyer elected to withdraw its purchase a month later when oil prices collapsed and the value of the assets tumbled. Notwithstanding the low oil prices, Longview continued to seek a buyer and consummated a deal for the sale of the California assets for $28 million. Following the sale, the Board sought stockholder approval, which it obtained, to dissolve Longview.

Huff alleged that Longview breached the Agreement because the dissolution had "a material adverse effect" on its right to transfer its Longview stock to Longview. Furthermore, Huff argued that because the dissolution would have a material adverse effect on its right, the Board's vote was subject to unanimous approval.

In analyzing the defendant directors and company's motion to dismiss Huff's complaint, the court held that the director defendants cannot be liable for the alleged breach of the Agreement. The court reasoned that "***under Delaware law, officers of a corporation are not liable on corporate contracts as long as they do not purport to bind themselves individually.***" The court further states that while it is true that some of the directors signed the Agreement, it was clear on the face of the document that they did so in a representative, not individual, capacity.

Secondly, the court held that Huff failed to plead breach of contract against any of the defendants. Huff argued that the Board's adoption of the plan of dissolution violated the provision in the Agreement which required unanimous Board approval: "any action or omission that would have a material adverse effect on the rights of any Shareholder, as set forth in this Agreement." Huff argues that the Agreement "sets forth a right of transferability" and that the Board's adoption of the plan of dissolution materially and adversely affected that right. In analyzing this claim, the court turned to the construction of the phrase "set forth" and stated that if "set forth" means "created," then the purported "right of transferability" would escape the unanimity requirement because the right was not created by the contract. However, if "set forth" means that the unanimity requirement would apply to any act or omission that has a materially adverse effect on any right that is merely "referenced" in the contract, then Huff's interpretation might prevail.

However, the court found that Huff's interpretation contradicted common sense and the business realities of the parties' relationship as reflected in the Agreement. Huff's interpretation would unreasonably subject all extra-contractual "rights" to the unanimity requirement, solely because they were referenced in relation to another right actually created by the Agreement. Therefore, because the Agreement did not create a right of transferability for Huff, but instead allowed Longview the right of first offer, the court rejected Huff's argument that the dissolution vote violated the Agreement.

Next, Huff unsuccessfully argued that because the Agreement provided that Longview "shall continue to exist and shall remain in good standing under the laws of its state of incorporation," the dissolution violated the Agreement for Longview to "continue to exist." As the court noted, the provision in question was merely a commitment to remain in good standing as a Delaware corporation, and not a "commitment to exist 'come what may,'" as Huff ascribed to it.

Next, the court found that there was no breach of the directors' fiduciary duties in approving the transaction. In holding so, the court stated that Huff failed to rebut the business judgment presumption that the Board acted with loyalty and care. In attempting to rebut the presumption, Huff argued that two of the directors who were also officers were going to receive severance payments upon a change-in-control. Also, Huff argued that Longview's CEO had prior business relationships with other members of the Board. The court addressed each argument in turn and stated that the "***possibility of receiving change-in-control benefits pursuant to pre-existing employment agreements does not create a disqualifying interest as a matter of law***." Secondly, allegations regarding the CEO's former and then-current business relationships with other members of the Board, in the absence of any allegation that the CEO either controlled or was controlled by any other member, fail to create a reasonable inference of a disqualifying conflict. As the court noted, under Delaware law, "***personal friendships, without more; outside business relationships, without more; and approving of or acquiescing in the challenged transaction, without more, are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment.***"

As a result, the court concluded that Huff failed to plead that a majority of the Board that approved the transaction were not independent. Thus, entire fairness did not apply.

The court next turned to Huff's *Revlon* and *Unocal* arguments. The court held that the Board's plan of dissolution in no way implicated the policy concerns expressed in *Revlon*. Specifically, the adoption of the plan did not constitute a "final stage" transaction or effect a "change of control that fundamentally altered ownership rights." Similarly, *Unocal* did not apply. The court noted that Huff "cite[d] no cases…indicating either that (1) the adoption or filing of a certificate of dissolution or (2) the board's 'perception' that a shareholder posed a threat to any individual director's 'power' over the corporation implicates the 'omnipresent specter' lingering in those instances where *Unocal* scrutiny has been invoked."

Lastly, the court addressed the stockholders' approval of the Board's plan of dissolution. The court stated that even if it were to agree with Huff's arguments, the approval by Longview's stockholders "cleansed the transaction," thereby ensuring the applicability of the business judgment rule. As stated by the Delaware Supreme Court, "***Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests.***"

Key Takeaways

This case has a few noteworthy takeaways for practitioners and boards alike:

- When the Board takes action that may implicate the director's fiduciary duty obligations, it may make sense to seek stockholder approval as a mechanism of cleansing a transaction which otherwise would be subject to an exacting standard of director scrutiny.
- A director-officer who may receive change-in-control benefits pursuant to a preexisting employment agreement does not by itself rebut the presumption that the director acted with loyalty and care.
- Lastly, unless a shareholder specifically negotiates for specific provisions requiring certain board actions to be subject to unanimous approval, a court may limit its interpretation of an agreement to not unreasonably subject all extra-contractual rights to the unanimity requirement.