

message from partner in charge

In this issue, we see how boards of directors have fared in the courts, amid all the financial market losses. Albert Manwaring and Matt Kaplan discuss a Chancery Court decision that may aid boards facing fiduciary scrutiny. And Matt Greenberg and Greg Brabec relate another state Supreme Court decision: if boards' intentions are good, their decisions about the sale price of their company, even if disappointing to their shareholders, also aren't a willful fiduciary failing.

And under ARRA, new funding is available to housing authorities for public housing; we give the details on page 7.

In cyberspace, a Pepper webinar relates how employers can prepare for the proposed Employee Free Choice Act, and a Peppercast offers issues to consider before filing for bankruptcy.

We welcome comments, questions and suggestions about this newsletter.

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Delaware Chancery Court Dismisses Fiduciary Duty Claims Against Citigroup Board Arising from Subprime Losses

A group of shareholders of Citigroup, Inc. brought a derivative action in the Delaware Court of Chancery against Citigroup's board of directors, alleging that the board failed to properly oversee and monitor the risk involved in Citigroup's subprime mortgage investments. In the action, *In re Citigroup Shareholder Derivative Litig.* (C.A. No. 3338-CC), the plaintiffs claimed that the board ignored multiple "red flags" that should have put the director defendants on notice of the mounting problems in the real estate and credit markets, which led to the substantial subprime mortgage losses at Citigroup. The plaintiffs also alleged that Citigroup's board committed waste by approving a generous retirement package for Citigroup's outgoing CEO, who was at the helm of Citigroup when the company sustained its subprime mortgage losses. The defendants moved to dismiss the complaint for failure to plead demand futility and to state a claim under Rules 23.1 and 12(b)(6), respectively, of the Court of Chancery Rules.

Chancellor William B. Chandler III's opinion in the Chancery Court should allay the fears of boards of directors over the potential of personal liability for breach of fiduciary duties arising from corporate losses tied to the collapse of the subprime mortgage market. Chancellor Chandler dismissed the plaintiffs' oversight claims under *Caremark* on the grounds that oversight duties under Delaware law are not designed to subject directors to personal liability for the failure to properly evaluate business investment risk, and that the business judgment rule prohibits just this type of judicial second-guessing even when corporate losses are substantial. Accordingly, Chancellor Chandler held that shareholder demand on Citigroup's board of directors to

bring suit on the *Caremark* claims was not futile, demand was not excused, and these claims were dismissed.

The only claim that survived the defendants' motion to dismiss was their claim that Citigroup's board committed waste by authorizing a retirement package to the outgoing CEO so disproportionately large, in light of the substantial subprime mortgage losses, that the package was beyond the board's "outer limit" of discretion, and thus constituted waste. The chancellor's admonition to directors that the board's discretion in setting executive compensation is not unlimited comports with the heightened scrutiny executive compensation issues are receiving from the Securities and Exchange Commission and disappointed investors.

Background

Over the last few years, factors including the nationwide decline in real estate values and the scheduled increase in monthly payments on adjustable rate mortgages caused a wave of residential foreclosures and inflicted heavy losses on the subprime mortgage industry. The plaintiffs alleged that Citigroup was heavily invested in the subprime mortgage market through its purchase of collateralized debt obligations (CDOs) that depended on cash flows from consumer payments on subprime mortgages. Once these payments began to dry up, these CDOs lost value, and by late 2007, Citigroup faced a potential direct loss of \$55 billion dollars. Further compounding Citigroup's troubles, in December of 2007, the company was forced to bail out \$49 billion dollars worth of structured investment vehicles (SIVs) that, according to the plaintiffs, were invested in home equity loans – a riskier type of asset than is typically used in SIVs.

The *Caremark* Claims

To survive a motion to dismiss, the plaintiffs' allegations, that the board committed "an unconsidered failure to act" in connection with their oversight of the risk in Citigroup's subprime mortgage investments, must rise to a level of "sustained or systemic failure of the board to exercise oversight." This is the legal standard to demonstrate bad faith under *Caremark* that the chancellor found was required to avoid the proscription of Delaware's business judgment rule and the exculpatory provision under 8 *Del. C.* § 102(b)(7) in Citigroup's certificate of incorporation, insulating the board from liability for breaches of the duty of care.

Chancellor Chandler characterized as conclusory the plaintiffs' allegations that the defendants ignored "red flags" that would have enabled the board to prevent the subprime mortgage losses.

Chancellor Chandler found that the plaintiffs' allegations against Citigroup differed from typical duty of oversight claims under *Caremark*. Instead of alleging that the defendants failed to adequately oversee improper director or officer action, the complaint against Citigroup was based on an "alleged failure to monitor Citigroup's *business risk*" in the subprime mortgage market, and sought to impose director liability for business decisions that, in hindsight, caused the company to sustain substantial losses.

After explaining that the business judgment rule proscribes judicial second-guessing of informed business decisions that turn out poorly, Chancellor Chandler ruled that to meet the bad faith standard, a plaintiff was required to plead particularized facts that the directors acted with *scienter*, or knowledge of the impropriety of their conduct, and quoted *Caremark* for the proposition that director liability premised on the failure of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." Chancellor Chandler emphasized that the nature of business risk necessarily implicates a risk of loss that must be accepted to achieve most significant investment gains.

The plaintiffs' allegations fell short of meeting the standard of bad faith under *Caremark*. Chancellor Chandler characterized as conclusory the plaintiffs' allegations that the defendants ignored "red flags" that would have enabled the board to prevent the subprime mortgage losses. He pointed out that Citigroup had procedures and controls in place to monitor risk, and that the plaintiffs had failed to explain how the procedures Citigroup had in place were inadequate. In discussing the alleged warning signals arising from the Enron scandal, Chancellor Chandler reasoned that the Enron scandal differed substantially from the current subprime mortgage crisis, and held that Citigroup's board was not required to have heightened sensibilities as a result of unrelated wrongdoing.

Finally, the chancellor distinguished the recent AIG case that had survived a motion to dismiss. The AIG complaint contained “well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG,” over which the AIG defendants allegedly failed to exercise proper oversight. The chancellor distinguished the well-pled claims of widespread criminal wrongdoing in AIG from the allegations of poorly managed business risk against Citigroup. Chancellor Chandler concluded that the plaintiffs had not similarly alleged any such bad faith conduct against Citigroup’s board, and that therefore, the Citigroup board was entitled to the protection of the business judgment rule.

Waste Claims

The plaintiffs asserted that Citigroup’s board committed waste by approving an agreement between Citigroup and its outgoing CEO that provided him with a generous retirement package. The chancellor emphasized the difficulty a plaintiff faces under Delaware law in pressing a successful claim for corporate waste – the exchange must be so one-sided that “no business person of ordinary, good, sound judgment could conclude that the corporation has received adequate consideration.”

Chancellor Chandler reasoned, however, that the Delaware Supreme Court had recognized an “outer limit” at which executive compensation becomes unconscionable and constitutes waste, but that he had insufficient information to measure the outgoing CEO’s compensation relative to the performance of the corporation against this standard. Thus, taking the allegations in the complaint as true, as he was required in a motion to dismiss, Chancellor Chandler found that demand was excused for this waste claim under Court of Chancery Rule 23.1, and held that this claim also stated a claim for relief under Court of Chancery Rule 12(b)(6).

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Webinar: Are You Prepared for the EFCA?

Wednesday, June 3
11:00 A.M. - Noon (EDT)

If the Employee Free Choice Act (EFCA) is passed, it would be dramatically easier for unions to organize workers and obtain favorable terms in a first collective bargaining agreement.

Make no mistake: the EFCA is a major threat to employers now. The EFCA was always intended to end up in a compromise, and that won’t change. With the Democratic party in control of the Senate, the House, and the presidency, expect dramatic legal changes that will make organizing easier, and be very punitive for employers.

Join us for a free, one-hour online seminar where you will learn:

- where the debate on the proposed legislation currently stands and where it is likely to end up
- steps that employers can take now to prepare themselves for the proposed legislation
- why this may be the wrong time to be conducting EFCA training for non-supervisory employees
- how to evaluate the health of employee relations
- what systems to have in place whether EFCA passes or not
- how to win card-check/petition or “quickie” secret ballot elections.

Speakers

- *Reggie Hockenberry*, principal, HR Connect
- *Jonathan Kane*, partner and chairman, Labor and Employment Group, Pepper Hamilton LLP
- *Bill Kirby*, president, W.P. Kirby Associates, Inc.
- *Amy G. McAndrew*, of counsel, Labor and Employment Group, Pepper Hamilton LLP

Register online for this complimentary seminar at <http://www.regonline.com/Checkin.asp?EventId=727216>.

Contact Bernadette Romano at 215.981.4775 or romanob@pepperlaw.com if you have any questions.

Delaware Supreme Court Reaffirms Director Protections and Clarifies *Revlon* Duties in Sale Transactions

In an *en banc* decision, the Delaware Supreme Court in *Lyondell Chemical Company v. Ryan*, C.A. No. 401, 2008 (Del. Mar. 25, 2009) recently reversed the Delaware Court of Chancery and granted summary judgment to Lyondell's directors. The Supreme Court's decision clarifies directors' duties in the context of a sale transaction. Specifically, the decision provides guidance that:

- *Revlon* duties, which require a company's board to obtain the best price for stockholders at the sale of a company, arise at the time a company embarks on a transaction either by its own initiative or in response to an unsolicited offer that will result in a change of control of the company. *Revlon* duties do not arise simply because a company is "in play" as a result of a third party's actions.
- Given the unique combination of circumstances faced by directors in fulfilling their *Revlon* duties in pursuing a change of control transaction, there are no prescribed steps or blueprints that directors must follow. Rather, directors must be "reasonable" in carrying out their duties to obtain the best price.
- Exculpatory provisions for breaches of the duty of care (such as in Lyondell's certificate of incorporation and which are customarily included in certificates of Delaware corporations) provide independent and disinterested directors significant protection from monetary damages. While it may have been a triable issue of fact as to whether the Lyondell directors breached their duty of due care, the exculpatory provision afforded them protection from personal liability. The Supreme Court went on to reinforce that a bad faith breach of loyalty in the sale context is very hard to prove and "an extreme set of facts is required to sustain a disloyalty claim." Directors do not breach their duty of loyalty by failing to act in good faith without a showing of intent to do harm or an intentional dereliction of duty.

Background

As early as April 2006, Basell AF expressed an ongoing interest in acquiring Lyondell Chemical Company. Lyondell believed the offering price of \$26.50-\$28.50 per share proposed by Basell was inadequate, and responded that it was not interested in selling the company. In May

The Supreme Court held that directors' decisions must be "reasonable, not perfect" and only if the disinterested directors had knowingly and completely failed to undertake their responsibilities to attempt to obtain the best price would they breach their duty of loyalty.

2007, an affiliate of Basell filed a Schedule 13D with the SEC, disclosing its continuing interest to acquire Lyondell. Immediately upon this disclosure, the Lyondell board convened a special meeting and decided to take a "wait and see" approach. On July 9, 2007, Basell's owner met with Lyondell's chairman and CEO to discuss a deal that, after negotiations, resulted in a written offer by Basell of \$48 per share with no financing contingency, but that required a \$400 million break-up fee and an executed merger agreement within seven days. The Lyondell board, all disinterested and independent directors, met twice in the following two days to review the valuation materials that were prepared for an upcoming regular board meeting and to discuss the Basell offer. The Lyondell board determined that it was interested and authorized the retention of a financial advisor and management to conduct additional negotiations with Basell.

The parties negotiated in the interim while the financial advisor prepared a "fairness" opinion. The board again met and instructed management to try to negotiate better terms, including (i) a higher price, (ii) a go-shop provision, and (iii) a reduction in the break-up fee. Basell responded that it had put forth its best offer and agreed only to lower the break-up fee by \$15 million.

The Lyondell board met again on July 16 to consider the Basell merger agreement and review the legal and financial advisor presentations. The board received an opinion by its financial advisor that the merger price was "fair" and the price offered by Basell was described by a managing direc-

tor of its financial advisor as “an absolute home run.” The board’s legal advisors advised the board that even though management had been unsuccessful in negotiating a “go-shop” clause, the merger agreement contained a “fiduciary out” provision that would afford directors the ability to exercise their fiduciary duties and consider any superior proposals. The Lyondell board voted to approve the merger, which was subsequently approved by more than 99 percent of the voted shares.

A shareholder class action was filed in the Court of Chancery claiming the Lyondell board failed in performing its fiduciary duties with regard to the merger transaction. Specifically, the claim alleged that the merger price was grossly insufficient, the directors were motivated by self-interest, the negotiation process was flawed, the directors agreed to unreasonable deal protection provisions, and the preliminary proxy statement omitted numerous material facts. The Court of Chancery rejected all claims except with respect to whether the directors had acted in good faith in fulfilling their *Revlon* duties and whether the deal protection measures were preclusive.

Supreme Court Decision

In an interlocutory appeal by the directors, the Supreme Court rejected the Chancery Court’s decision denying summary judgment. Because the Lyondell board was independent and disinterested, the issue before the Supreme Court was whether the directors breached their fiduciary duty of loyalty by failing to act in good faith. The Supreme Court cited three factors in holding that the Chancery

Court approached the record from “a mistaken view of applicable law.”

Timing when *Revlon* Duties Attach: The Chancery Court imposed *Revlon* duties on the Lyondell directors prematurely. The Chancery Court cited the two months of inactivity by Lyondell directors between the filing of the Schedule 13D as critical to its analysis of their good faith. The Supreme Court, however stated that the *Revlon* duties do not arise merely when a company is “in play,” but rather when a company “embarks on a transaction, either of its own accord or in response to an unsolicited offer, that will result in a change of control.” Though the Schedule 13D may have put the public and the directors on notice, the time for action under *Revlon* did not begin until the directors began negotiating the sale of Lyondell on July 10, 2007. The directors’ “wait and see” approach was an entirely appropriate exercise of the board’s business judgment. The Supreme Court held that it was not until July 10, the date the board decided to engage in a sale transaction, that its *Revlon* duties commenced. The Chancery Court had acknowledged that the directors’ conduct during those seven days might not demonstrate anything more than a lack of due care, which would not survive summary judgment in light of the exculpatory provision.

Board Is Not Required to Follow Specific Steps in the Sale Process: The Chancery Court read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process. The Supreme Court made clear however that “there is only one *Revlon* duty – to get the best price for the stockholders at a sale of the company.” The \$48



Peppercast: Ten Issues to Consider Before Filing for Bankruptcy

The key to a successful Chapter 11 case is pre-bankruptcy planning. In this podcast with Evelyn Meltzer, an attorney in Pepper Hamilton’s Corporate Restructuring and Bankruptcy Practice Group, she focuses on ten issues to consider before filing for bankruptcy.

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per share price amounted to a 45 percent premium over the closing share price on the last trading day before the filing of the Schedule D and a 20 percent premium over Lyondell's closing price on July 16, 2007, the day before the merger was announced. The Supreme Court noted that courts cannot tell directors exactly how to accomplish their goal of obtaining the highest price for stockholders due to the multitude of circumstances that directors may face in the sale transaction context, many of which will be outside of their control. The Supreme Court cited the director's reliance on financial and legal advisors, the substantial premium paid by Basell and statements made to the board regarding the purchase price in concluding that the directors did not consciously disregard their duties and violate their duty of good faith in conducting the sale process.

Standard for Reviewing a Disinterested Board's Actions in a Sale Transaction: The Chancery Court incorrectly equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith. The Supreme Court stated that the proper inquiry was not if the directors had done everything they should have, but whether the disinterested and independent directors "utterly failed" to attempt to obtain the best sales price. The Supreme Court concluded that there is a "vast difference" between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties. The Supreme Court held that directors' decisions must be "reasonable, not perfect" and only if the disinterested directors had knowingly and completely failed to undertake their responsibilities to attempt to obtain the best price would they breach their duty of loyalty.

In reviewing the record, the Supreme Court determined that the board met several times to consider the offer; were generally aware of the value of Lyondell; solicited and followed the advice of their financial and legal advisors; attempted to negotiate a higher offer even though the evidence indicated that Basell had offered a "blowout" price; and ultimately approved the merger agreement because it was simply too good not to be passed along to stockholders for their consideration. As such, the record clearly established that the directors did not breach their duty of loyalty by failing to act in good faith and reversed the Chancery Court's decision and remanded the case for entry of judgment in favor of the Lyondell directors.

The Delaware Supreme Court's decision reaffirms the deference afforded to decisions of independent and disinterested directors in the context of a sale transaction and holds that directors will receive broad protection from personal liability under exculpation clauses so long as they do not consciously disregard their fiduciary duties.

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The American Recovery and Reinvestment Act of 2009 Public Housing Capital Fund Allocations

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the Recovery Act or ARRA). Among its provisions, the Recovery Act included extraordinary grants of direct funding and tax incentives targeted to support preservation and development of affordable multifamily housing. No sector of the affordable housing industry received greater immediate funding authorization than public housing.

Eight days later, on February 25, 2009, the U.S. Department of Housing and Urban Development (HUD) allocated 75 percent of all ARRA funds authorized for HUD administration, and nearly \$3 billion of newly available Public Housing Capital Funds. Time constraints imposed by an expedited allocation and obligation schedule require immediate consideration by public housing agencies.

We have discussed below capital funding allocation/obligation details specifically concerning public housing. Additional Housing Updates are available, which address the broad spectrum of affordable housing stimulus in ARRA. The entire text of ARRA can be found at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.1.enr>. Information about the Recovery Act's HUD-administered funding programs can be found at <http://www.hud.gov/recovery/phcfund.cfm>.

Public Housing Capital Fund Allocations

The Recovery Act provides \$4 billion in additional Capital Funds for use in modernization and development of public housing and mixed finance projects. On February 25, HUD released its allocation schedule for \$3 billion of this funding, distributed among the nation's 3,100 public housing authorities (PHAs), based on 2008 Capital Funding formulas. An additional \$1 billion authorized by the ARRA will be allocated on a competitive basis in coming months. HUD has published the amount of noncompetitive Public Housing Funds that each PHA will receive at the following Web site: <http://www.hud.gov/recovery/phcfund.cfm>.

Deadlines. Also, on February 25, each PHA should have received an e-mail from the Office of Capital

Each PHA (i) must obligate 100 percent of its ARRA Capital Funds within one year of the date on which funds become available to the agency for obligation, (ii) must spend 60 percent of funds within two years of that date, and (iii) must spend its entire allocation within three years.

Improvements (the OCI Notice), which provided information on how the non-competitive Public Housing Funds will be allocated and obligated. The OCI Notice includes two very important dates: (1) ACC Amendments (attached to the OCI Notice in form) must be submitted to the appropriate local HUD field office no later than March 9, 2009; and (2) each PHA must provide, no later than April 10, 2009, an annual statement to HUD describing how obligated funds will be expended.

Priority Use. The OCI Notice encourages PHAs to give priority to capital projects that can begin within 120 days, and, as recited in the Recovery Act, to (i) rehabilitation of vacant units and (ii) capital projects that have begun or are included in each PHA's five-year plan. Once the executed ACC Amendment, Annual Plan and Board Resolutions (required with the annual plan) have been submitted, starting on March 23, 2009, each PHA's allocation will be available in the LOCCS system for draw in accordance with normal procedures.

Competitive Round. HUD is required to distribute the remaining \$1 billion of competitive Public Housing Capital Funds by September 30, 2009. Although criteria for competitive awards have not yet been established, PHAs can expect priority for demonstrated need and use for rehabilitation of vacant rental units, capital projects

already underway and those that are otherwise part of each PHA's five-year plan.

Restrictions on Use. It should be noted that the Public Housing Capital Funds may not be used for operating expenses or rental assistance commitments. Typical restrictions against using federal funds for replacement housing, however, shall not apply to the Recovery Act Capital Funds. The ARRA requires HUD to develop an oversight system insuring that Public Housing Capital Funds are used to supplement and not supplant other sources of funding obligated by and available to the PHA.

Obligation and Expenditure Deadlines. Each PHA (i) must obligate 100 percent of its ARRA Capital Funds within one year of the date on which funds become available to the agency for obligation, (ii) must spend 60 percent of funds within two years of that date, and (iii) must spend its entire allocation within three years. If any PHA fails to abide by the first benchmark, remaining funds shall be recaptured by HUD. If either the two- or three-year benchmarks are not met, then the balance of funds shall be recaptured by HUD. Any recaptured funds shall be allocated by HUD to PHAs in compliance with the spending requirements.

The Recovery Act states that HUD may waive or specify alternative requirements for any provision of any statute or regulation in connection with the use of these funds (except for fair housing, environmental, labor standards and discrimination). HUD also may direct that requirements relating to the procurement of goods and services arising under state and local laws and regulations not apply to ARRA Capital Funds.

This is one of a series of articles published by members of Pepper Hamilton LLP discussing issues arising out of the American Recovery and Reinvestment Act of 2009. For our other publications, please refer to our firm's Web site at www.pepperlaw.com.

If you have any questions or comments on this topic or any matter concerning the ARRA and affordable housing preservation or development, please feel free to contact the following individuals or any other member of our Finance, Real Estate, Affordable Housing, Tax, or Low Income Housing Tax Credit practice groups.

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