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In This Issue...

Featured Article

Stockholder Ratification: A Review of the Benefits and Burdens
Contributed by Mark J. Gentile, John Mark Zeberkiewicz and Megan R. Wischmeier, Richards, Layton & Finger, P.A. 1

Directors & Officers

Delaware Supreme Court Affirms Dismissal of Stockholder Suit against Viacom Board for Breaches of Fiduciary Duties in Blockbuster Spin-Off 6

Public Companies

SEC Adopts Final Rules on Interactive Data to Improve Financial Reporting 7

Shareholder Derivative Actions

Second Circuit Affirms Dismissal of Pfizer Shareholder Derivative Suit for Failure to Adequately Plead Demand Futility 8

Shares & Shareholders

Delaware Chancery Court Denies Preferred Shareholders' Request for Temporary Restraining Order to Preserve Investment in Closely-Held Corporation; Orders Parties to Negotiate a Status Quo Order 9

Featured Article

Stockholder Ratification: A Review of the Benefits and Burdens

Contributed by:
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Few doctrines of Delaware corporate law have been called to serve as many distinct functions as the common law doctrine of stockholder ratification. Over the years, the doctrine has been proffered to remove the taint of voidability from unauthorized corporate acts,[1] to moot claims of waste,[2] and to revive the presumption of the business judgment rule in transactions that, due to disabling conflicts, would otherwise have been reviewed under the rigorous entire fairness standard.[3] Whether as a result of the same term being used to describe conceptually distinct notions,[4] or as a result of zealous advocates pushing the doctrine beyond its intended bounds, the doctrine has generated a great deal of confusion.[5]

Recently, in *Gantler v. Stephens*, the Delaware Supreme Court, in an effort "[t]o restore coherence and clarity" to the doctrine of stockholder ratification, held that the doctrine "must be limited to its so-called 'classic' form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective."[6] This holding, though seemingly straightforward, presents a number of complicated issues for corporate practitioners and their clients. Chief among these issues is what form, post-*Gantler*, a "stockholder ratification" vote must take and whether the benefit that any such vote might confer upon those seeking it is outweighed by the risk it entails.

"Classic" Ratification

The concept of "classic ratification," as articulated by the Supreme Court in *Gantler*, cannot be properly understood without reference to the (now-overturned) concept of ratification as applied in the lower court's opinion. *Gantler* involved an action for breach of fiduciary duty against the directors and officers of First Niles Financial, Inc. ("First Niles") for their decision to effect a reclassification of common stock held by holders of 300 or fewer shares into non-voting preferred stock with senior dividend rights.[7] The effect of the reclassification was to shift full voting power to First Niles' large stockholders, who remained the sole holders of common stock following the reclassification, and to facilitate First Niles' deregistration as a reporting company under the federal securities laws.[8] The reclassification was approved by a five-person board consisting of two "inside directors," both of whom defendants "implicitly concede[d]" were neither disinterested nor independent; one director who was found to be beholden to the CEO and therefore not independent; and two directors found to be disinterested and independent.[9] The Chancery Court found that plaintiffs had alleged facts sufficient to demonstrate that a majority of the board was not disinterested or independent, which ordinarily would have rebutted the presumption of the deferential business judgment rule and triggered a review under the more exacting entire fairness standard.[10] But the Chancery Court never reached that stage of the process.

Rather than applying the entire fairness standard, the Chancery Court looked to the stockholder vote approving the reclassification—which, because it was effected through a charter amendment, required for its approval the affirmative vote of a majority of the outstanding shares of common

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stock—and determined that it was sufficient to "'revive[] the powerful presumptions of the business judgment rule as the applicable standard of review for the challenged conduct.'"[11] To benefit from this change in the applicable review standard, defendants were required to demonstrate that "all material facts relevant to the transaction were fully disclosed" and that the transaction was approved by a majority of the outstanding unaffiliated shares entitled to vote.[12] On these points, the Chancery Court found that the disclosure in the proxy statement was adequate and that the reclassification had been approved by the vote of 50.28 percent of the unaffiliated shares eligible to vote.[13] Thus, "because there was adequate disclosure, the unaffiliated shareholders' ratification of the Reclassification [was] valid," and, in the Chancery Court's view, that ratification brought "the Board's decision to effect the Reclassification back within the business judgment presumption."[14] And plaintiffs' claims were so dismissed.[15]

In reviewing the Chancery Court's rulings, the Supreme Court found that the lower court had erred in finding that First Niles' disclosure was not materially misleading.[16] Based on that finding, the Supreme Court could have found the business judgment rule inapplicable (since the reclassification would not have been approved by a *fully informed* vote of the unaffiliated stockholders) and thereby sidestepped the Chancery Court's ruling on the effect of the ratification vote. But the Supreme Court decided instead to use the occasion to bring doctrinal clarity to an area of law riddled with conflicting interpretations and uncertain applications.[17] Noting prior decisions alluding to the uncertainty caused by the doctrine's "compartmentalization" into distinct areas,[18] the Supreme Court sought to cut back the various powers and functions that had been ascribed to the doctrine over the years and to confirm that its proper application is found in its "classic" form. In this framework, stockholder ratification exists, and serves a function, where it involves the voluntary submission of a matter to stockholders for approval thereby in a situation where the stockholders' affirmative vote is not required by law to authorize the matter.[19] Thus, the stockholder "ratification" at issue in the Chancery Court's *Gantler* opinion could not have revived the application of the business judgment rule, because the sole vote that was sought and obtained—namely, the vote required under Section 242 of the General Corporation Law of the State of Delaware ("DGCL") to effect the charter amendment—was *legally* required to authorize the transaction.

Read literally, the Supreme Court's articulation of "classic ratification" could lead to the conclusion that the doctrine of stockholder ratification is inapplicable in *any* case where the board is seeking stockholder approval as to a matter that by law requires for its authorization an affirmative stockholder vote.[20] But that conclusion would be inconsistent with the gloss the Supreme Court provided on its own formulation of "classic" ratification. In clarifying the concept, the Supreme Court noted that "the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve"[21] and cited to its opinion in *In re Santa Fe*,[22] where it had reversed the lower court's ruling that a "ratifying" stockholder vote on a merger had "extinguished" plaintiffs' breach of fiduciary duty claims arising from the defendant-board's adoption of defensive measures. In that case, the Supreme Court held that the doctrine was inapplicable because Santa Fe's stockholders "merely voted in favor of the merger and not the defensive measures."[23]

What the Supreme Court in *Gantler* did not say, however, is that matters that are *ancillary* to the principal transaction for which stockholder authorization is legally required are incapable of being ratified when voluntarily submitted to stockholders.[24] For example, if a majority of the directors are receiving a special benefit from a merger, such as golden parachute payments, there is no reason why the board could not submit the merger agreement to the stockholders for adoption thereby as required by law[25] and *request* that the stockholders specifically approve the special benefit, which would be fully disclosed in the proxy statement and appear as a separate item on the proxy card. In fact, the Supreme Court's opinion suggests not only that this additional, voluntarily-requested vote is within the bounds of "classic" ratification, but that the disinterested stockholders' approval of the matter would revive the presumption of the business judgment rule.[26] Thus, in its discussion of "director action or conduct" that stockholders are "specifically asked to approve," the Supreme Court noted that "[w]ith one exception, the 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether."[27] This further amplification demonstrates the application of the doctrine of stockholder ratification that the Supreme Court found objectionable: namely, "springing" ratification, or the attempt by defendants, *post hoc*, to transform the vote that they were legally required to obtain to authorize the challenged transaction into a vote to authorize the transaction *and* to approve any and all conduct and factors that would otherwise call into question the directors' disinterestedness and independence.

Practical Implications

The principal question for corporate practitioners, post-*Gantler*, is when, if ever, is it appropriate to seek a ratification vote on a matter *ancillary* to the matter for which stockholder approval is legally required. Practical considerations will likely dictate the answer—and in most cases would militate against seeking the additional, voluntary ratification vote. Even if the board becomes aware of factors that could result in a rebuttal of the presumption of the business judgment rule, it may be reluctant to seek a separate ratification vote as to those factors, since doing so could be seen as a tacit concession that the directors are neither disinterested nor independent.[28] In addition, the board, in seeking any such separate vote, would essentially be pleading for the stockholders' grace, since any effort to provide stockholders with an incentive to vote in favor of the ratification proposal, including conditioning the approval of the transaction on the approval of the ratification vote, could be found to be "coercive" and therefore impermissible.[29] Finally, even if the board is willing to risk seeking a separate ratification vote on its disabling interests, it does so with little guidance regarding how the vote should be conducted or which matters must be ratified. As noted above, *Gantler* instructs that "the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve."[30] But the board can never be certain that it will have adequately anticipated all of the conduct and interests that a potential plaintiff could challenge. And in light of the Supreme Court's reference in its opinion to *Santa Fe*,[31] it is unclear whether the board could seek a single vote from stockholders to ratify all of its actions and interests or whether it must seek a separate vote on each decision, act, interest, conflict or other factor that would conceivably require ratification.

Given the risks attendant to seeking a "classic" ratification vote as to one or more ancillary matters—and considering that the Supreme Court in *Gantler* foreclosed any defense based on the "ratification" vote on the principal matter at issue—it would seem that any board, when faced with potentially disabling conflicts, would likely opt to use a special committee of independent, disinterested directors to negotiate the transaction and, if necessary, to make a recommendation to the full board with regard to the transaction.[32] In the absence of a controlling stockholder, the use of a properly comprised and functioning special committee[33] generally will have the effect of restoring the presumption of the business judgment rule.[34] Thus, unless there are no directors who would qualify as "disinterested" and "independent" and could easily comprise a special committee, there would seem to be little comparative advantage to seeking the "classic" ratification vote on the matter giving rise to the potentially disabling conflict.

An additional question stemming from *Gantler* is what impact, if any, the Supreme Court's analysis of the doctrine of stockholder ratification has on the continued viability of using the majority-of-minority vote as a cleansing mechanism in a transaction involving a controlling stockholder. Put simply, *Gantler* should have no impact on the viability of that cleansing mechanism. Since the Supreme Court's decision in *Kahn v. Lynch*,[35] the exclusive standard of review for transactions involving a controlling stockholder is entire fairness,[36] and the use of a cleansing mechanism, such as the majority-of-minority vote, only shifts the burden of proof on the issue of fairness from the controlling stockholder to the plaintiff.[37] The purpose of this vote is not to legally authorize the transaction but to provide minority stockholders the power to reject the proposed transaction[38] and, in this manner, compensate for the loss in bargaining power and provide some assurance that the controlling stockholder will not use its position to treat the minority stockholders unfairly.[39] This is categorically different from the stockholder ratification concept at issue in *Gantler—i.e.*, the *post hoc* use of the statutorily required vote to provide cover for the board's otherwise disabling conflict. The Supreme Court's observation that "the 'cleansing' effect of such a [classic] ratifying shareholder vote is to subject the challenged director action to business judgment review" supports this conclusion.[40] To wit: in the case of a merger involving a controlling stockholder, a "ratifying" vote is incapable, under the Supreme Court's opinion in *Kahn v. Lynch*, of restoring the presumption of the business judgment rule. From this, it may be inferred that the Supreme Court was not referring to the majority-of-minority vote, and to conclude otherwise would be to suggest that the Supreme Court, without specific reference to *Kahn*, overruled its prior precedent.[41]

Conclusion

The Delaware Supreme Court's clarification of the doctrine of stockholder ratification effectively prevents defendants from claiming that the requisite vote of the unaffiliated stockholders on a matter that legally requires stockholder approval for its authorization (as opposed to the vote of such stockholders on a matter that has been separately and voluntarily submitted to such stockholders) has the effect of restoring the presumption of the business judgment rule in cases where that presumption would otherwise be rebutted due to disabling conflicts. The Supreme Court's opinion should not be read to hold that the board may not seek a ratification vote on matters that are *ancillary* to a matter that legally requires stockholder approval. Nonetheless, given the elimination of the stockholder ratification defense in its pre-*Gantler* incarnation, deal planners would be well advised to consider using a special committee of disinterested, independent directors in connection with any transaction in which the directors could be alleged to have a disabling conflict. This will help to minimize the impact of any potential conflicts and to preserve the presumption of the business judgment rule. Finally, although the Supreme Court seemed to whittle the doctrine of stockholder ratification down to its "classic" form, the opinion should not be read as eliminating the use of a majority-of-minority vote as a cleansing mechanism in a transaction involving a controlling stockholder to shift the burden of proving entire fairness.

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[1] *See Michelson v. Duncan*, 407 A.2d 211, 218-19 (Del. 1979) (stating that "voidable acts are susceptible to cure by shareholder approval").

[2] *See Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 897-98 (Del. Ch. 1999).

[3] *See Lewis v. Vogelstein*, 699 A.2d 327, 335 (Del. Ch. 1997) ("In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.").

[4] *See Williams v. Geier*, 671 A.2d 1368, 1379 n.24 (Del. 1996) ("The term 'ratification' is, in the dictionary sense, a generic term connoting official approval, confirmation or sanction. Thus, it is not

incorrect to consider broadly that stockholder approval in either sense may be called 'ratification.'") (internal citation omitted); *Huizenga*, 751 A.2d at 900, n.78 ("In using the word ratification in this opinion, I am keenly aware that 'classic ratification' involves the 'voluntary addition of an independent layer of shareholder approval in circumstances where such approval is not legally required.' Indeed, my colleague Vice Chancellor Steele recently noted that it was oxymoronical [sic] to call a necessary stockholders' vote in advance of a transaction's consummation 'advance ratification.' For want of better nomenclature, I use the term as describing a stockholder vote sufficient to invoke the business judgment rule standard of review.") (internal citations omitted).

[5] *See, e.g., Solomon v. Armstrong*, 747 A.2d 1098, 1114-15 (Del. Ch. 1999) ("The legal effect of shareholder ratification, as it relates to alleged breaches of the duty of loyalty, may be one of the most tortured areas of Delaware law. A different rule exists for every permutation of facts that fall under the broad umbrella of 'duty of loyalty' claims.").

[6] *Gantler v. Stephens*, 2009 BL 18055, at 35-36 (Del. Jan. 27, 2009) (emphasis in original). The Supreme Court's opinion in *Gantler* contains several other noteworthy findings and holdings, including that officers owe fiduciary duties that are identical to those owed by corporate directors, that a board's decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework, and that enhanced scrutiny under the so-called *Unocal* test did not apply to the claim that the officers and directors "sabotaged" the due diligence process and rejected a merger offer, given that the claim sounded in disloyalty rather than improper defensive conduct. The Supreme Court also made several significant observations regarding the directors' duty of disclosure, including in the context of partial disclosure. These topics, however, are outside the scope of this article and are not addressed herein.

[7] *Gantler v. Stephens*, 2008 BL 30308, at 7-8 (Del. Ch. Feb. 14, 2008).

[8] *Id.* at 8-9.

[9] *Id.* at 34-35.

[10] As the Chancery Court noted: "The business judgment rule presumption the Board acted loyally regarding the Reclassification is rebuttable by facts establishing the Board was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the Reclassification was in the best interest of the Company and its shareholders." *Id.* at 32.

[11] *Id.* at 40 (citing *Sample v. Morgan*, 914 A.2d 647, 664 (Del. Ch. 2007)). This formulation of "ratification" has, in recent years, found support in several Delaware cases. *See*, *e.g.*, *In re PNB Holding Co. S'holders Litig.*, Consol. C.A. No. 28-N, slip op. at 32, n.70 (Del. Ch. Aug. 18, 2006) ("[T]he fact that the shareholder vote was required to give legal significance to the Merger does not affect whether or not the vote itself has ratification effect."); *see also Huizenga*, 751 A.2d at 900, n.78.

[12] *Gantler*, 2008 BL 30308, at 41. The Court noted that, because the reclassification required for its approval the vote of a majority of the outstanding stock entitled to vote under Section 242 of the DGCL, it was appropriate to require the ratification vote to be a majority of the unaffiliated shares outstanding. "The court in *PNB Holding*, in the context of a ratification of a merger approved by interested directors, held that the appropriate vote should be a majority of the unaffiliated stockholders' shares eligible to vote, and not merely a majority of the unaffiliated shares that were actually voted. An unreturned proxy vote is akin to passive dissent; to not include a dissenting vote would contravene 8 *Del. C.* § 242, which requires a vote of a 'majority of the outstanding stock of the corporation entitled to vote' for charter amendment approval. Thus, for purposes of ratifying an amendment to a charter, Defendants must show that a majority of the unaffiliated shares eligible to vote voted in favor of the Reclassification." *Id.* (footnotes omitted). The Court accordingly determined that the requisite ratification vote could be derived through a "simple ratio" that it expressed as follows: "The denominator is the number of outstanding shares at the time of the vote minus the number of affiliated shares eligible to vote. The numerator is the total number of shares voted in favor of the Reclassification minus the total number of affiliated shares entitled to vote." *Id.* at 42.

[13] *Id.* at 44.

[14] *Id.* at 58.

[15] *Id.* As is often the case, the Court's decision not to apply entire fairness led to a dismissal of the claims. *See, e.g.*, *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) (noting that "[i]t is often of critical importance whether a particular decision is one to which the business judgment rule applies or if the entire fairness rule applies"); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.").

[16] *See Gantler*, 2009 BL 18055, at 28-29 ("We conclude that the Proxy disclosures concerning the Board's deliberations about the First Place bid were materially misleading. Because we reverse the dismissal of Count II on that basis, we do not reach the plaintiffs' remaining disclosure claims.").

[17] *See id.* at 35 ("Under current Delaware case law, the scope and effect of the common law doctrine of shareholder ratification is unclear, making it difficult to apply that doctrine in a coherent manner.").

[18] *See id.* The Supreme Court quoted *In re Wheelabrator Technologies, Inc., S'holder Litig.*, 663 A.2d 1194, 1201 (Del. Ch. 1995), for the proposition that the doctrine "might be thought to lack coherence because the decisions addressing the effect of shareholder 'ratification' have fragmented that subject into three distinct compartments."

[19] *See Gantler*, 2009 BL 18055, at 35.

[20] It is unclear whether the Supreme Court intended its holding to apply to those situations where a stockholder vote is "statutorily" required, such as under Sections 242, 251 and 271 of the DGCL, or, more broadly, to any circumstance where stockholder approval is "legally" required to authorize the matter. *Compare* "the ratification doctrine does not apply to transactions where shareholder approval is statutorily required" (*Gantler*, 2009 BL 18055, at 37) and "'ratification' . . . describes only corporate action where stockholder approval is not statutorily required for its effectuation" (*id.* at 37, n.55), *with* "circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective" (*id.* at 36). *See also id.* at 37 ("Here, the Reclassification could not become legally effective without a statutorily mandated shareholder vote approving the amendment to First Niles' certificate of incorporation."). Reading the opinion to stand for the latter proposition would raise additional issues with respect to the effect on the standard of review for votes that are not required under the DGCL but are otherwise required by applicable law. For example, under Section 280G of the Internal Revenue Code of 1986, as amended, stockholder approval of "parachute payments" to "disqualified individuals" is required under certain circumstances to avoid adverse tax consequences. *See* I.R.C. § 280G. Thus, the 280G vote, in one sense, is "legally" required to obtain the favorable tax treatment being sought. But the board authorizing the "parachute payments" could have a disabling

conflict. It is unclear, then, whether the 280G vote itself would be sufficient to cure the disabling conflict, or whether the board would be required to seek an additional, voluntary "cleansing" vote to revive the application of the business judgment rule.

[21] *Gantler*, 2009 BL 18055, at 36.

[22] *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 68 (Del.1995).

[23] *Id.*

[24] In addition, the opinion does not appear to alter the principle of stockholder ratification, articulated in *In re General Motors (Hughes) S'holder Litig.*, No. Civ. A. 20269 (Del. Ch. Mar. 4, 2005), *aff'd* 897 A.2d 162 (Del. 2006), relating to the effect of a special vote of stockholders of a particular group or class that may have interests that diverge from those of other stockholders. In that case, the former holders of General Motors' Class H Stock—a tracking stock designed to represent the financial performance of Hughes Electronics Corporation, a wholly-owned subsidiary of General Motors—challenged the split-off transaction pursuant to which General Motors sold a significant stake in Hughes to The News Corporation and exchanged each Class H share for one share of Hughes' common stock. The Class H holders alleged that GM's directors breached their duty of loyalty in failing to deal fairly with, and failing to adequately compensate, the Class H holders in the split-off. *Id.* Noting that the split-off transactions were approved by a majority of the outstanding unaffiliated Class H shares and that the relevant disclosure document sufficiently described the effect of stockholder ratification, the Court found that such approval was sufficient to maintain the presumption of the business judgment rule. *Id.*

[25] *See* 8 *Del. C.* § 251.

[26] *See Gantler*, 2009 BL 18055, at 37.

[27] *Id.* The "one exception" is that stockholder ratification "can validly extinguish . . . a claim that the directors lacked the authority to take action that was later ratified." *Id.* at 36, n.54. The Supreme Court was careful to note that it did not intend to suggest that acts that are void, *ultra vires*, gifts or waste could be ratified by less than unanimous stockholder approval. *Id.* Moreover, the Supreme Court specifically stated that its clarifications in the opinion applied only to the common law doctrine of stockholder ratification and were not intended to alter the established jurisprudence regarding the effect of a stockholder obtained under Section 144 of the DGCL. For a discussion of the effect of Section 144, *see generally* Blake Rohrbacher, John Mark Zeberkiewicz & Thomas Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719 (2008).

[28] Moreover, the disclosure that would be required to ensure that the ratifying stockholder vote is "fully informed" would likely rise to the level of self-flagellation. Any plaintiff attacking stockholder ratification of a board's actions will challenge the disclosures made in connection with the ratification vote. Nonetheless, the board "must meet [the] affirmative 'burden of demonstrating full and fair disclosure.'" *See Sample*, 914 A.2d at 655 (Del. Ch. 2007) (quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 140-41 (Del. 1977)). And, as the Chancery Court has stated, "it is noteworthy that Delaware law does not make it easy for a board of directors to obtain 'ratification effect' from a stockholder vote. The burden to prove that the vote was fair, uncoerced, and fully informed falls squarely on the board. Given the fact that Delaware law imposes no heightened pleading standards on plaintiffs alleging material nondisclosures or voting coercion and given the pro-plaintiff bias inherent in Rule 12(b)(6), it is difficult for a board to prove ratification at the pleading stage. If the board cannot prevail on a motion to dismiss, the defendant directors will be required to submit to discovery and possibly to a trial." *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 899 (Del. Ch. 1999).

[29] The Delaware courts have held that stockholder ratification is only effective if it is not "coerced." *See Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278-79 (Del. Ch. 1986) (finding that the stockholder vote was fatally flawed by the implied and expressed threats that, unless the proposed amendments were authorized, the stockholder-officer-director would oppose future transactions that the board of directors might determine to be in the best interests of all stockholders); *see also Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1061 (Del. Ch. 1987).

[30] *Gantler*, 2009 BL 188828, at 36.

[31] *Id.*

[32] Under Section 141(c) of the DGCL, a board committee does not have the authority to approve or recommend to stockholders any action that requires for its approval stockholder authorization under the DGCL. *See* 8 *Del. C.* § 141(c). This includes, for example, the approval of virtually any merger, any charter amendment, any sale of all or substantially all of the corporation's assets, and any dissolution of the corporation.

[33] For a court to grant deference to a special committee's decision, the committee members must be disinterested in, and must have broad authority with respect to, the transaction at issue. This includes, among other things, whether the committee has the "power to say no." *In re First Boston, Inc. S'holders Litig.*, C.A. No. 10338, slip op. at 15 (Del. Ch. June 7, 1990).

[34] *See In re Western Nat'l Corp. S'holders Litig.*, C.A. No. 15927, slip op. at 68-69 (Del. Ch. May 22, 2000) ("[B]ecause the absence of a controlling shareholder removes the prospect of retaliation, the business judgment rule should apply to an independent special committee's good faith and fully informed recommendation.").

[35] C.A. No. 8748 (Del. Ch. July 9, 1993), *rev'd*, 638 A.2d 1110 (Del. 1994), *on remand*, C.A. No. 8748 (Del. Ch. Apr. 17, 1995), *aff'd*, 669 A.2d 79 (Del. 1995).

[36] *See Huizenga*, 751 A.2d at 900-01 ("Indeed, it appears that a corporation with a controlling or majority stockholder may, under current Delaware law, never escape the exacting entire fairness standard through a stockholder vote, even one expressly conditioned on approval by a 'majority of the minority.' Because of sensitivity about the structural coercion that might be thought to exist in such circumstances, our law limits an otherwise fully informed, uncoerced vote in such circumstances to having the effect of making the plaintiffs prove that the transaction was unfair.").

[37] *See id.*; *see also In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 643-44 (Del. Ch. 2005). In *Cox*, the Court suggested that, should a controlling stockholder merger be "subject from inception to negotiation and approval of the merger by an independent special committee and [approval by the majority of disinterested stockholders], the business judgment rule should presumptively apply." *Id.* Also, in *In re Pure Res., Inc., S'holders Litig.*, 808 A.2d 421, 444 n.43 (Del. Ch. 2002), the Court noted that a "tailoring [of the *Lynch* rule] could include providing business judgment protection to mergers negotiated by a special committee and subject to majority of the minority protection," but in *In re PNB Holding Co. S'holders Litig.*, Consol. C.A. 28-N, slip op. at 19 (Del. Ch. Aug. 18, 2006), the Court noted that the use of both of the procedural protections would not yet ensure application of the business judgment rule, stating: "[a]bsent clarifying guidance from our Supreme Court, after *Lynch*, it is difficult for this court to subject such a merger to anything but entire fairness review, regardless of whether the proponents of the transaction employed all the procedural protections necessary to replicate an arms-length merger, by negotiating the transaction with a special committee of independent directors and conditioning the transaction on a non-waivable majority-of-the-minority vote."

[38] The Court of Chancery has held that the majority-of-minority vote will only be an effective cleansing mechanism if the transaction is expressly contingent upon approval by the majority of the disinterested shares. *See Rabkin v. Olin Corp.*, C.A. No. 7547, slip op. at 13 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990) (TABLE).

[39] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983).

[40] *Gantler* 2009 BL 18055, at 36.

[41] In the past, when the Supreme Court has overturned a prominent case (or portions thereof), it has called attention to the effect of its holding. *See*, *e.g.*, *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). This is evidenced in *Gantler* itself. *See id.* at 36 & n.54 (after holding that a "classic" ratification vote subjects the challenged action to business judgment review but does not "extinguish" the claim, the Supreme Court noted: "To the extent that *Smith v. Van Gorkom* holds otherwise, it is overruled").

Directors & Officers

Fiduciary Duties

Delaware Supreme Court Affirms Dismissal of Stockholder Suit against Viacom Board for Breaches of Fiduciary Duties in Blockbuster Spin-Off

Pfeffer v. Redstone, No. 115, 2008, 2009 BL 14710 (Del. Jan. 23, 2009)

The Delaware Supreme Court recently affirmed dismissal, by the Delaware Chancery Court, of a stockholder suit against the board of directors of Viacom, Inc. and affiliated defendants relating to Viacom's spin-off of Blockbuster, Inc. The court held that the transaction was not subject to entire fairness review and that the Chancery Court did not err in ruling that the plaintiff failed to state a claim with respect to alleged breaches of fiduciary duties.

The Blockbuster Special Dividend and Spin-Off

In 2004, Viacom divested its 82.3 percent interest in Blockbuster through a special dividend and spin-off. Blockbuster issued a $5 per share dividend to its stockholders, including Viacom. Following the issuance of the special dividend, Viacom spun off Blockbuster by an exchange offer pursuant to which each tendered Viacom share was exchanged for 5.15 Blockbuster shares. Significantly, neither Viacom's then-CEO Sumner Redstone nor National Amusements, Inc. (NAI), which held 71 percent of Viacom and was controlled by Redstone, participated in the exchange offer.

The exchange offer prospectus disclosed, among other things, that NAI would not participate in the exchange offer; Blockbuster's ability to operate may be impaired by the increased debt incurred to pay the special dividend; a special committee of Blockbuster's independent directors had recommended approval of both the special dividend and exchange offer to the entire board; and neither Viacom nor Blockbuster made a recommendation to stockholders about the exchange offer. The prospectus did not disclose the names of the Blockbuster directors on the special committee.

Following the exchange offer, Blockbuster's business faltered and, in 2006, Blockbuster restated its cash flows for 2003 through 2005. Beverly Pfeffer, a former Viacom stockholder who tendered her shares in the exchange offer, filed a class action suit in the Delaware Chancery Court on behalf of all Viacom stockholders who tendered their shares and Blockbuster stockholders who held shares on the record date for the special dividend. Pfeffer asserted breach of fiduciary duty claims against the Viacom board, NAI, and other defendants. The Chancery Court dismissed Pfeffer's claims with prejudice for failure to state a claim under Chancery Court Rule 12(b)(6). *See Delaware Chancery Court Dismisses Breach of Fiduciary Duty and Disclosure Claims Arising out of Viacom Spin-Off of Blockbuster*, Bloomberg Law Reports, Mergers & Acquisitions, Vol. 2, No. 3 (Mar. 2008).

Pfeffer appealed the dismissal of only the first four counts of her complaint. Those counts alleged that the Viacom directors breached their fiduciary duties of loyalty, care, and disclosure, and NAI, as Viacom's majority stockholder, breached its duty of loyalty, by making material misstatements and omissions with respect to the special dividend and exchange offer. Pfeffer argued that these counts should have been reviewed under an entire fairness standard because of Redstone's and NAI's financial interests in the transactions.

Entire Fairness Review Not Required

On appeal, the Delaware Supreme Court first concluded that the special dividend and exchange offer were not subject to entire fairness review. NAI, as Viacom's controlling stockholder, had no duty of entire fairness under Delaware law in making what was a non-coercive exchange offer. The Viacom directors did have a duty to structure the exchange offer to be non-coercive and disclose all material facts relating to the exchange offer. The Supreme Court agreed with the Chancery Court that the Viacom directors met this duty.

Duty of Disclosure Claims Legally Insufficient

Pfeffer challenged the dismissal of her duty of disclosure claims for four reasons. First, she claimed that she adequately pleaded that the prospectus disclosures regarding Blockbuster's cash flow were material. Second, she argued that she adequately pleaded that the Viacom board knew, or should have known, that Blockbuster would have a cash flow problem after the spin-off. Third, she maintained that the Chancery Court erred in finding that the Viacom board's method for determining the exchange ratio was not material. Fourth, she claimed that the Chancery Court erred in finding that the composition of the Blockbuster special committee was not material.

The Supreme Court rejected all four reasons for appeal. It agreed with the Chancery Court that Pfeffer's complaint failed to allege how the cash flow disclosure was a material misstatement, since the subsequent restatement of cash flow in 2006 merely reclassified certain numbers without affecting the total, and the restatement did not affect Blockbuster's stock price. The court also concluded that Pfeffer failed to sufficiently plead that certain cash flow calculations prepared before the exchange offer were made available to the Viacom directors or were the type of information routinely provided to directors. Regarding the determination of the exchange ratio, the court held that such information was not material, and therefore was not required to be disclosed, because Viacom did not make any representation in the prospectus that the value implied by the exchange ratio was fair. Finally, the court concluded that omission of the identities of the special committee members was not material because the prospectus did not suggest that the special committee took any action that could not have been taken by the entire board.

Viacom Directors and NAI Did Not Breach Duty of Loyalty

The Supreme Court also rejected Pfeffer's assertion that she stated claims against the Viacom directors and NAI for breaches of the duty of loyalty. According to the court, Pfeffer's claim against the Viacom directors was insufficient because she did not plead that the directors stood on both sides of the exchange offer or that they received a benefit from the transaction not enjoyed by Viacom stockholders generally. Pfeffer's claim against NAI also failed because she failed to allege that NAI orchestrated the special dividend or the exchange offer. Accordingly, the court affirmed the Chancery Court's dismissal of Pfeffer's claims.

Public Companies

Disclosure & Reporting

SEC Adopts Final Rules on Interactive Data to Improve Financial Reporting

SEC Release Nos. 33-9002; 34-59324; 39-2461; 1C-28609; File No. S7-11-08 (Jan. 30, 2009)

The Securities and Exchange Commission adopted final rules requiring companies to provide financial statements to the SEC in an interactive data format using the eXtensible Business Reporting Language (XBRL). Building upon a voluntary program for the submission of interactive data begun in 2005, the new rules require filers to attach standardized tags to items contained in financial statements thereby allowing the information to be directly downloaded to spreadsheets, analyzed using commercial software, or used in investment models. The new rules will be phased-in over a three-year period. According to the SEC, the new rules will make financial data easier for investors to use, assist in automating regulatory filings and business information processing, and reduce costs associated with financial disclosure.

Interactive Data Financial Statements

The SEC explained that the new rules will not change the disclosure requirements under the federal securities laws and regulations, and companies will still be required to use the ASCII and HTML electronic formats for filings. Under the new rules, however, in addition to the ASCII or HTML filing format, companies will also have to submit their financial statements in an interactive data format using XBRL as an exhibit to periodic and current reports and registration statements. The use of interactive data will be required for the entire financial statement, including footnotes and financial statement schedules, but not for Management's Discussions and Analysis, executive compensation, or other financial, statistical, or narrative disclosures. According to the SEC, new Rule 405 of Regulation S-T sets forth the basic tagging and posting requirements for XBRL data, while the EDGAR Filer Manual contains detailed tagging requirements.

As the SEC explained, a primary difference between its voluntary program for submitting interactive data and the new rules is the requirement that footnotes in financial statements be tagged using XBRL. The new rules will require four levels of detail for footnote data tagging: (1) a single block text tag for each full footnote; (2) a single block text tag for each significant accounting policy within a footnote; (3) a single block text tag for each table in a footnote; and (4) a tag for each monetary value, percentage, number, or other amount within a footnote. Only the first level of tagging will be required for a filer's first year of interactive reporting. Thereafter, all four levels will be required, but a filer will have a 30-day grace period in the second year to submit the interactive data.

Phase-In of the New Rules

According to the SEC, the new rules will be phased-in over three years. Domestic and foreign large accelerated filers using U.S. generally accepted accounting principles (GAAP) that have a worldwide public common equity float above $5 billion will be required to provide interactive data for fiscal periods ending on or after June 15, 2009. All other large accelerated filers will begin providing interactive data for fiscal periods ending on or after June 15, 2010. Finally, all remaining U.S. GAAP filers, and foreign filers using international financial reporting standards (IFRS), will begin filing interactive data for fiscal periods ending on or after June 15, 2011. The SEC explained that the multi-year phase-in is designed to (1) allow companies to plan and implement data tagging with the benefit of the experience of the first year filers, (2) allow the SEC to monitor implementation of the rules and make any necessary adjustments, and (3) allow additional time to develop IFRS data tags. In the first year of XBRL submission, companies will have a 30-day grace period and will be permitted to submit their interactive data as an amendment to a filing.

Covered Reports

As the SEC explained, the new rules on interactive data apply to financial statements contained in periodic reports filed under the Securities Exchange Act of 1934 (Exchange Act) on Forms 10-Q, 10-K, and 20-F, the Form 40-F annual report, and Forms 8-K and 6-K that contain revised or updated financial statements. In addition, filers will be required to provide interactive data for financial statements in transition reports on Forms 10-Q, 10-K, or 20-F. Registration statements filed under the Securities Act of 1933 (Securities Act) will be required to include interactive data when financial statements are included directly in the registration statement. The new rules, however, will only require filers to submit interactive data after a price or price range has been determined and any time thereafter when the financial statements are changed. Interactive data will not be required for initial public offerings or for financial statements contained in registration statements filed under Exchange Act Forms 10-K, 10-Q, 20-F, and 40-F.

The SEC noted that interactive data will not be required for officer certifications in periodic reports under Exchange Act Rules 13a-14 and 15d-14, explaining that excluding such certifications balances avoiding unnecessary costs with encouraging accuracy. The SEC further stated that as it monitors implementation of the new rules it may make changes regarding officer certifications.

Website Posting

The new rules will require that by the end of the calendar day on the date of filing, companies post to their corporate website the same interactive data they provided to the SEC. According to the SEC, making this information available on the company's website will further encourage the widespread dissemination of information and help lower access costs for users by making data available directly from the issuer rather than from third-party sources that may charge a fee. The new rules also require that the Web posting not be a hyperlink to the SEC's website and that the information be posted for 12 months.

Liability for Interactive Data Files

Interactive data files submitted within 24 months of a filer's first submission will be subject to the federal securities laws in a modified manner pursuant to new Rule 406T. During this period, interactive data will not be deemed part of a registration statement or prospectus for the purposes of Sections 11 and 12 of the Securities Act or deemed filed for purposes of Section 18 of the Exchange Act or Section 34(b) of the Investment Company Act of 1940. In addition, interactive data files will not be subject to liability under the foregoing sections. However, interactive data files will be subject to the anti-fraud provisions of the federal securities laws, except with respect to a failure to comply with tagging requirements that occurs despite a good faith effort to comply and is promptly corrected after the filer learns of the failure. Finally, under the modified liability rules, interactive data will be deemed filed for purposes of Rule 103 under Regulation S-T, giving filers the benefit of Rule 103's safe harbor for electronic transmission errors that are promptly corrected. According to the SEC, the modified application of the federal securities laws balances avoiding unnecessary costs and expenses with encouraging accuracy by allowing issuers and service providers time to become comfortable with the tagging requirements. The limitations on liability will be phased-out by October 31, 2014.

In discussing liability for interactive data files, the SEC explained that new Rule 406T omits any reference to interactive data in viewable form. The SEC stated that interactive data in viewable form as displayed on the SEC's website should be treated in the same manner as the related interactive data file. However, the SEC noted that interactive data in viewable form displayed on other websites is subject to the general anti-fraud principles applicable to republication of a person's statements.

Shareholder Derivative Actions

Demand on the Board

Second Circuit Affirms Dismissal of Pfizer Shareholder Derivative Suit for Failure to Adequately Plead Demand Futility

In re Pfizer, Inc. Derivative Securities Litig., No. 07-cv-3547, 2009 BL 14760 (2d Cir. Jan. 27, 2009)

The United States Court of Appeals for the Second Circuit recently affirmed the dismissal of a shareholder derivative lawsuit against Pfizer, Inc. for failure to adequately allege demand futility under Federal Rule of Civil Procedure (FRCP) 23.1. In an unpublished opinion guided by applicable Delaware law, the court held that the bases asserted by plaintiffs for demand futility were not sufficient to establish a reasonable doubt that a majority of Pfizer's board of directors either lacked independence or were not disinterested.

Shareholders Allege Directors and Officers Knew or Should Have Known About Damaging Side Effects of Pfizer's Arthritis Drugs

Plaintiff shareholders alleged that defendants, all former Pfizer directors and officers, were or should have been aware of the significant cardiovascular risks associated with two of Pfizer's most successful arthritis drugs—Celebrex and Bextra. Plaintiffs claimed that defendants permitted Pfizer to market and sell these drugs even after becoming aware of their risks. As a result of defendants' actions or failure to act, plaintiffs alleged that Pfizer was forced to defend hundreds of product liability and consumer fraud lawsuits and suffered significant losses in market capitalization. The present derivative lawsuit asserted several theories of liability, including breach of fiduciary duty, gross mismanagement and waste of corporate assets. The district court dismissed the suit for failure to allege sufficient facts to establish demand futility and plaintiffs appealed.

Directors' Personal Liability Limited in Accordance with DGCL

At the outset, the court noted that Pfizer's shareholders had limited directors' monetary liability by exculpating directors for breaches of the duty of care as permitted by Delaware General Corporation Law § 102(b)(7). As a result, the defendants could only be held personally liable for a breach of their duties of good faith or loyalty. The threshold of proof for these types of breach was generally higher than for a breach of the duty of care and, in the court's view, was not met by plaintiffs' allegations.

Court of Appeals Refuses to Presume Knowledge by Pfizer Board Members of Drugs' Risks

Plaintiffs argued that defendants had knowledge of the cardiovascular risks associated with Pfizer's drugs because (1) there were several sources available to defendants, including several published studies and an internal Pfizer clinical study, that suggested such risks and called for an assessment by drug companies and (2) a number of lawsuits relating to these cardiovascular risks had been brought against Pfizer between 2001 and 2005. Plaintiffs claimed that even if defendants did not have first hand knowledge of these risks, the court should presume or infer such knowledge because it related to Pfizer's "core activity." To support its argument, plaintiffs cited cases where courts have presumed knowledge or information relating to a corporation's core activities. This knowledge, plaintiffs further alleged, made the directors "interested" for demand futility purposes because it exposed them to potential personal liability arising from a breach of fiduciary duty.

In finding that plaintiffs had not sufficiently alleged demand futility, the court found no legal basis for plaintiffs' conclusion that the mere existence of scientific studies, without more, permitted a court to infer that directors had knowledge of their existence and relevance, especially given the innumerable studies Pfizer would likely have conducted. The court rejected cases cited by plaintiff, observing that these cases involved information of a "far greater magnitude" than the information presented by the drug studies at issue in the current case. *Pfizer* at 5.

Requirements For Pleading Demand Futility Not Analogous to Proof of Scienter in Securities Fraud Class Actions; Judgment Affirmed

In arguing that the court should presume the defendants' knowledge of the studies and risks associated with the drugs, plaintiffs cited cases arising not in demand futility claims but rather in securities fraud class actions where an inference of scienter was required to maintain the claim. The court observed that demand futility inquiries were different from inquiries involving scienter and fraud. In the court's view, scienter required a showing of knowledge alone, while demand futility claims required not only knowledge but also that such knowledge created an affirmative duty to act that was consciously ignored.

The court concluded that plaintiffs' pleaded facts did not show that defendants had the requisite actual knowledge and that, even if the court permitted knowledge to be presumed, plaintiffs failed to show how the information gave rise to a duty to act that was consciously ignored by defendants. In reaching this conclusion, the court also dismissed as insufficient claims that members of Pfizers' audit committee were not disinterested because their knowledge of the drugs' risks rendered the financial statements misleading. Finally, the court observed that plaintiffs' allegations of insider trading, with the exception of certain trades that defendants conceded were interested, were not pled with the requisite particularity.

In affirming the dismissal of the action, the court also found that the district court's refusal to grant plaintiffs leave to amend the complaint was not an abuse of discretion because any new allegations to be proposed were simply variations of those that had been previously rejected by the court.

Shares & Shareholders

Shareholder Rights

Delaware Chancery Court Denies Preferred Shareholders' Request for Temporary Restraining Order to Preserve Investment in Closely-Held Corporation; Orders Parties to Negotiate a Status Quo Order

Topspin Partners, L.P. v. Rock Solid Systems, Inc., C.A. No. 4275-VCL, 2009 BL 13549 (Del. Ch. Jan. 21, 2009)

The Delaware Chancery Court recently denied a request for a temporary restraining order (TRO) by certain preferred shareholders of RockSolid Systems, Inc., a closely-held software company. Plaintiffs sought the TRO to prevent RockSolid from spending the remainder of plaintiffs' $1.25 million investment in contravention of the terms of a letter agreement between plaintiffs and RockSolid. In a letter opinion responding to plaintiffs' expedited request, Vice Chancellor Stephen P. Lamb was persuaded that plaintiffs' delay in seeking relief made it inequitable for the court to grant the TRO. Although plaintiffs' request was denied, the court ordered the parties to negotiate a status quo order to protect the interests of all parties going forward.

Plaintiffs' Rights Governed by Modified Stockholders' Agreement

Under the terms of a stockholders' agreement, RockSolid was obligated to deposit the proceeds from its sale of $1.25 million of Series A Preferred Stock into a segregated account and these funds could not be disbursed without the approval of RockSolid's board of directors, including the consent of plaintiffs' board representatives. If the funds were not approved for disbursement by March 1, 2008, plaintiffs were permitted to request that the shares be redeemed for the purchase price paid. However, the defendants failed to carry out the terms of the shareholders' agreement. RockSolid never set up a segregated account and its officers used, and continued to use, the funds for general corporate purposes without board approval while plaintiffs did not request a redemption of their shares. Defendants indicated that less than $300,000 of the original $1.25 million remained.

Plaintiffs, concerned that if the funds were depleted they could not recover their investment, brought the present action seeking, aside from the TRO, the dissolution of RockSolid, the appointment of a receiver to oversee the dissolution and redemption of their preferred shares.

Court Balances the Equities and Denies TRO; Status Quo Order to be Negotiated

To successfully obtain a TRO under Delaware law, a party was required to prove a threat of imminent, irreparable injury. If proven, a court could issue the TRO unless it was shown that (1) there was no colorable claim; (2) the risk of harm in granting the TRO was greater than the risk to plaintiff of denying it; or (3) the plaintiff did not proceed as promptly as it should have and "therefore contributed to the emergency nature of the application and [was] guilty of laches." *Topspin* at 3.

Plaintiffs argued that the threatened dissipation of corporate assets constituted irreparable harm for purposes of a TRO because plaintiffs held preferred shares with enforceable redemption rights and the funds in question were designated as the source from which their stock would be redeemed. Proceeding on the assumption that plaintiffs had met their burden of imminent, irreparable harm, Vice Chancellor Lamb initially observed that plaintiffs satisfied the low burden of demonstrating a colorable claim for breach of contract, and the defendants admitted a contractual right had been violated. However, the court denied the TRO, finding evidence of the two remaining factors, which the court viewed as interrelated.

Because the TRO would have effectively put RockSolid out of business and prevented it from completing the software product that was the focus of the company, the court was persuaded that the harm in imposing the TRO was greater than the risk to plaintiffs in denying their request. The court was swayed by defendants' claim that their product was near completion and the TRO would result in the loss of a great deal of value. Furthermore, plaintiffs' delay in bringing the action made the court wary of their motives. Plaintiffs had not taken any prior actions to enforce their rights under the stockholders' agreement, nor had they taken any steps to satisfy their redemption rights. Although the court refused to rule on defendants' accusation that plaintiffs hoped to steal RockSolid's near-completed software product by means of the lawsuit and keep the potential profits for themselves, the court agreed that plaintiffs' slowness in bringing a claim made defendants' accusations of laches at least plausible.

Although the court denied plaintiffs' request for a TRO, it did order that the parties negotiate a status quo order to preserve intact as much of RockSolid's business as possible while also limiting the use of the disputed funds. The order must require that any expenditures over a set dollar amount require the agreement of the parties or a court order.

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