October 29, 2013

Delaware Court of Chancery Holds That Board Did Not Breach Fiduciary Duties or Create an Unfair Election in Proxy Contest

In *Red Oak Fund, L.P.* v. *Digirad Corp.*, the Delaware Court of Chancery held that the Digirad board of directors did not breach its fiduciary duties or create an unfair election process where: (i) preliminary election results that showed the incumbents in the lead were accidentally disclosed to a large stockholder; (ii) certain preliminary proxy reports inaccurately reported a large lead by management; (iii) the company delayed disclosure of negative financial results until after the election; and (iv) management proxy materials did not disclose that the board was considering a stockholder rights plan (a "poison pill").

Plaintiff, owner of 5.6% of Digirad's outstanding common stock, nominated a slate of five directors to replace the company's incumbent board, but lost the ensuing proxy contest. Plaintiff filed suit, alleging that the incumbent directors breached their fiduciary duties and created an unfair election process.

The court found no breach of fiduciary duties and no valid claim of an unfair election process, holding that:

- *Disclosure of informal preliminary vote tallies was not materially misleading* – The company's proxy solicitor, erroneously believing that an analyst was an agent of the company, shared informal estimates of vote predictions with the analyst, who then shared the information with a large stockholder. The plaintiff alleged that this action improperly swayed the election, particularly since Digirad is a microcap company. The court found these disclosures immaterial and not intended to mislead stockholders since the proxy solicitor had no indication that the information would be shared with stockholders.[1]

- *No duty to correct third party proxy report* – The company mistakenly voted treasury stock held in the company's name for the incumbents, resulting in inaccurate third party proxy reports. The plaintiff contended that had it known of the mistake, it would have changed its strategy because, in fact, the vote was much closer. The court found that the board had not created an unfair election process because the voting was accidental and the plaintiff failed to show that the information would have been material to a reasonable stockholder.

- *No duty to disclose preliminary quarterly financial results showing declining performance* – Although the board knew before the election that impending financial results were negative, the court held that the board did not have an affirmative duty to finalize the quarterly financial statements or release preliminary information before required to do so by the federal securities laws.

[1] The decision did not address the question of whether the disclosure of the preliminary proxy results could be viewed as a violation of Rule 14a-9, which identifies "Claims made prior to a meeting regarding the results of a solicitation" as potentially misleading statements within the meaning of that provision (although the determination that the disclosure was not material argues against such a finding).

- *No duty to disclose contemplation of a poison pill* - Even if the board began to consider implementing a poison pill before the election, this information was the "kind of inner workings and day-to-day functioning that are not the proper subject of disclosure."

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Justin G. Hamill
212-373-3189
jhamill@paulweiss.com

Stephen P. Lamb
302-655-4411
slamb@paulweiss.com

Jeffrey D. Marell
212-373-3105
jmarell@paulweiss.com

Robert B. Schumer
212-373-3097
rschumer@paulweiss.com

Steven J. Williams
212-373-3257
swilliams@paulweiss.com

Frances F. Mi
212-373-3185
fmi@paulweiss.com

Joseph Christensen and Justin A. Shuler contributed to this memorandum.