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PUBLIC COMPANY M&A ACADEMY PART II: BUSINESS JUDGMENT RULE-PROCESS, BOARD AND RISK ISSUES

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Why Are We Here?

- The vast majority of acquisitions of U.S. public companies attract litigation.
- For reasons discussed later, the risk of litigation may be declining; however, one should still assume that a transaction and the process that led to it will be tested in litigation.
- The central claim in most of these actions is a claim that the directors of the target company, in deciding to enter into the transaction at issue, breached their fiduciary duties to the company's stockholders.
- Due to the large volume of case law, the focus of this presentation will be on Delaware, although we will occasionally detour to compare and contrast other jurisdictions.
- Both the target board and the buyer are, to a certain extent, aligned on these issues, because the buyer inherits the fact pattern of the process.
- Process matters.

Fiduciary Duties Generally

- Duty of Care
 - The duty of care requires that directors act on an informed basis after due consideration of relevant information, including the input of legal and financial experts -- this means that directors should act only after they believe that they have obtained all necessary information, and have had the opportunity and time to deliberate fully.
 - To demonstrate that a director has not met his or her duty of care, a plaintiff generally would need to prove that the director was grossly negligent in his or her consideration of a proposed transaction or matter.
 - Directors' personal liability for breaches of the duty of care (but not the duty of loyalty) may be exculpated under DGCL § 102(b)(7).

Fiduciary Duties Generally

- Duty of Loyalty
 - The duty of loyalty requires that directors act in good faith in a disinterested manner.
 - Good faith contemplates that an action is intended to be taken for the best interest of the corporation and its stockholders and for a rational business purpose.
 - Disinterestedness means that a director has no material personal or financial interest in a transaction that is not shared by stockholders generally.
 - The conflict of interest between the director and the company or its stockholders must be substantial, actual and imminent, and not speculative and remote, for it to result in the director being considered to be interested.
- Duty of candor
 - The duty of candor is generally viewed as a facet of the duty of loyalty. Directors have a fiduciary duty to disclose to the stockholders the available material facts that would enable them to make an informed decision with respect to a transaction.

The Business Judgment Rule

- The business judgment rule is important because it limits judicial scrutiny of the directors' decisions if they acted with due care, in good faith and in a disinterested manner.
- Where the business judgment rule applies, courts will not substitute their own notions of what might constitute sound business judgment for the decisions made by the directors. The business judgment rule, therefore, offers directors a level of protection from liability.
- The business judgment rule also provides a legal presumption in favor of the directors -- under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.
- In instances where the business judgment rule applies, a plaintiff alleging breach of fiduciary duty has the burden of rebutting this presumption. Directors' decisions are protected unless the plaintiff is able to meet its burden of proof in showing that directors have not satisfied their duty of care or duty of loyalty or that the board's decision was not based on a rational business purpose.

Conflict Transactions

- There is no automatic need to create a special committee or layer on separate advisors (legal / financial) in every instance where there may potentially be conflicts. As considerations regarding a potential sale of control evolve, the need for a special committee may change – importantly, the board should be fully and promptly advised of conflict issues as they develop.
- The mere presence of a single conflicted director does not necessarily deprive the entire board of the business judgment rule’s presumption of loyalty unless a challenging plaintiff can show that the self-interested director either (a) constituted a majority of the board, (b) controlled and dominated the entire board, or (c) failed to disclose his or her interest in the transaction to the whole board and “a reasonable board member would have regarded the existence of [such other board member’s] material interests as a significant fact in the evaluation of the proposed transaction.”
- If a majority of directors are “disinterested” and “independent,” the board can function as a board, rather than as a committee, on a conflict transaction, particularly if it does so in a deliberate and informed manner, but the board’s activities and role in the negotiations of the transaction will be carefully scrutinized.
 - “Disinterestedness” means, in this context, that a director does not appear on both sides of a transaction, nor will gain any personal financial benefit from a transaction that is not shared with stockholders generally.

Conflict Transactions

- The meaning of “Independent” in this context is a somewhat amorphous concept that involves determining whether a director is beholden to an interested party to a transaction or is otherwise handicapped from exercising independent judgment. Evaluations of “independence” in this context are fact/context specific and take into account various matters that could compromise independence such as familial relationships or a strong, domineering personality of another interested director.
- Even if “disinterested” and “independent” directors constitute a majority of the board, conflicts involving management, in particular the chairman and CEO (e.g., the quintessential example of a management buyout transaction), could make consideration of forming a special committee of “disinterested” and “independent” directors advisable for several reasons, including the fact that:
 - as a practical matter, the special committee will bear increased burdens to review critically information and recommendations from management (at least those who are interested in the transaction), and
 - a special committee comprised of a smaller group of directors than all of the independent directors is typically better able to function in the face of and negotiate a transaction than the full board.

Special Committees

- In a conflict transaction, a properly formed and functioning special committee will shift the burden of proof so that the person challenging the transaction will have the burden of proving that the transaction was not fair rather than the directors having to prove entire fairness.
- Through myriad decisions, the courts have identified numerous deficiencies in special committee processes and, as a result, a reasonably good roadmap for a solid special committee process has emerged that includes the following key guidelines:
 - Timing – a special committee should be formed early enough in the transaction process to afford a reasonable opportunity to review and consider a proposed transaction and to actively participate in the negotiations;
 - Composition – potential members of the committee should be (a) as “independent” and “disinterested” as possible - past and current affiliations and arrangements of the members should be considered to ensure that no member could reasonably be viewed as insufficiently independent or having a self-interest in a potential transaction, and (b) and willing to perform their responsibilities - the members should be prepared to be active, vigorous participants in the process and to keep themselves fully informed of all material information about the negotiations and alternatives to a proposed transaction.

Special Committees

- **Mandate** – a clear, written mandate should be embodied in resolutions (and/or a charter) adopted by the board giving the special committee all of the authority responsibilities it needs to discharge its functions appropriately. Such authority and responsibilities should clarify the special committee's power to:
 - retain its own advisors (legal / financial),
 - fully evaluate a potential transaction and the critical power to say "no" to the transaction,
 - negotiate the terms of the transaction, and
 - consider alternatives to the transaction, including by contacting one or more potential bidders, or even conduct a full auction, if it considers these actions to be appropriate.
- **Separate Advisors** – the special committee should select its own legal and financial or other advisors (without the influence of the interested party) as it sees fit, which advisors should be free from relationships that could compromise independence.

Special Committees

- Importance of Vigorous Negotiation – Court decisions make it clear that a properly functioning special committee cannot be a rubber stamp but rather must aggressively seek to promote and protect public stockholders' interests.
- Exercise of Due Care – Like the board generally, the special committee should seek to manage process and negotiations to ensure adequate time to become appropriately informed and exercise thoughtful deliberations.
- Documentation – meetings and deliberations should be carefully documented in current and accurate minutes.
- Compensation – meaningful compensation arrangements should be established in connection with the formation of a special committee.

Enhanced Scrutiny

- There are limited situations in which Delaware courts will not defer to board conduct under the application of the business judgment rule and will instead exercise “enhanced scrutiny” to determine if the directors breached their fiduciary duties. These arise primarily in three areas:
 - adoption of a defensive mechanism in response to an alleged threat to corporate control or policy (the “*Unocal* standard”);
 - approval of a transaction involving a sale of control and/or a break up of the company (“*Revlon* duties”); and
 - one or more of the directors having a conflict of interest that compromised the actions or decision making process of the board (“entire fairness”).
- When a court determines that either *Revlon* duties or the *Unocal* standard has been implicated, a court will scrutinize the reasonableness of the board’s actions and its decision-making process.
- When a court determines that the entire fairness standard applies, it will scrutinize the fairness of both the price and the process.
- In addition, unlike under the deferential business judgment rule, the directors bear the burden of proving that their process and conduct satisfy the court’s enhanced standard of review.

Unocal Standard

- The *Unocal* standard requires that the board satisfy the two-prong burden of demonstrating that (a) the directors had a reasonable belief that there was a legitimate threat to corporate control or policy, and (b) there was a reasonable relationship between the threat and the defensive tactics employed or action (or inaction) taken.
- The *Unocal* case involved a board's defense against a hostile tender offer, and the *Unocal* standard has since been the general standard of review for the adoption of stockholder rights plans (or "poison pills") and other defensive measures.
- However, it has also been applied to deal protection provisions, even in cases where *Revlon* was not implicated, if the deal protection provisions have the effect of precluding competing offers (e.g., *Omnicare*).

Revlon Duties – When Do They Apply?

- When they apply
 - When a company initiates an active bidding process to sell itself; or
 - When a company, or its own or in response to a bidder's offer, abandons its long-term strategy and seeks an alternative transaction involving a breakup of the company.
- When they do not apply
 - Merely because a company is "in play"
 - Stock-for-stock merger with a non-controlled buyer – *Paramount Communications v. Time*
 - But a stock-for-stock merger with controlled buyer can trigger *Revlon* duties – *Paramount Communications v. QVC*
- When they might apply
 - Mixed consideration deals, where target company stockholders receive a combination of buyer stock and cash.
 - Delaware decisions have gone both ways, and the Delaware Supreme Court has not ruled on the issue.

Revlon Duties – How Do They Apply?

- The duty of the directors, in the context of a sale of corporate control, has been variously characterized as a duty to obtain the highest value reasonably attainable for the stockholders, or to act as an auctioneer to maximize stockholder value.
- Courts have made clear that there is “no single blueprint” to maximizing stockholder value, and what is reasonable depends on the circumstances.
- A pre-execution market check is not always required (*C&J Energy Services, Open Lane*).
- Revlon is not a guaranty that stockholders receive the highest price; directors can rationally determine that a proposal with a lower price is preferable to a proposal with a higher price that presents other issues (e.g., antitrust risk, financing uncertainty).

Fairness Opinions

- There is no obligation under state corporate or Federal securities laws for a board of either a target company or a buyer to obtain a fairness opinion in a corporate merger or acquisition transaction.
- The directors of a Delaware corporation have a fiduciary duty of care to inform themselves by all reasonable means before making decisions. Absent misconduct or breach of fiduciary duties, courts will accord boards tremendous deference under the business judgment rule.
- A board may obtain a fairness opinion in an acquisition transaction for two principal reasons:
 - First, a board is entitled to rely on the expert advice of the company's investment bankers as part of the board's effort to gather all reasonably available information in fulfilling its fiduciary duty of care in evaluating the transaction.
 - Second, from a practical standpoint fairness opinions also provide evidence that the board used reasonable business judgment in approving the transaction. Since *Smith v. Van Gorkom* in 1985, fairness opinions have become a regular feature of corporate transactions. The court in *Van Gorkom* found that the board breached its duty of care by approving a merger without adequate information on the value of the company and the fairness of the price. The board could show no independent evidence that the price was fair.

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Investment Banker Conflicts

- A trio of Delaware cases from the first half of this decade – *Del Monte Foods Co.*, *El Paso Corp.* and *Rural Metro Corp.* – highlighted the challenges for boards in dealing with investment banker conflicts in situations where *Revlon* duties applied.
- In these and other cases, bankers advising target companies engaged in various bad acts:
 - Failing to disclose to board that the bank sought to provide buy-side financing since beginning of process
 - Pairing bidders in a manner that limited price competition and advantaged a bidder that was also a client of the bank
 - Failing to disclose the lead banker's significant stake in the acquirer
- In some cases boards enabled conflict situations by not examining more critically disclosed conflicts (e.g., a bank's \$4 billion stake in the buyer).
- Process matters. In many ways the process begins with the negotiation of the engagement letter with the bank.

Entire Fairness

- If a plaintiff can prove that one or more of the directors have a conflict of interest that compromised the actions or decision-making process of the board, the board risks losing the presumption of loyalty under the business judgment rule and a court will analyze a transaction under the “entire fairness standard,” which is the highest level of judicial scrutiny in Delaware.
- Under the entire fairness standard:
 - a court will analyze (a) the process followed by the board of directors in considering the transaction (“fair dealing”) and (b) the price agreed to in the transaction (“fair price”); and
 - the burden shifts to the directors to prove fair dealing and fair price.
- In analyzing whether the transaction resulted from fair dealing, the court will examine the directors’ decision-making process, the quality of the result and the quality of disclosures.
- In determining the fairness of the price, the court will examine, among other things, the company’s assets, market values, future prospects, earnings and other factors that affect the intrinsic value of the transaction.

The New Landscape – *Kahn v. M&F Worldwide*

- Recent cases have provided a blueprint for structuring transactions that might otherwise be subject to some form of enhanced scrutiny in such a way as to give the directors the benefit of the business judgment rule.
- *Kahn v. M&F Worldwide* involved a merger between a controlling stockholder and its subsidiary, and normally might have been expected to be reviewed under the *Revlon* or even the entire fairness standard.
- In *M&F Worldwide*, the parties agreed to the following structure, which allowed application of the business judgment rule:
 - the controlling stockholder conditions the deal, from the beginning, on approval by a special committee and a vote of a majority of the minority stockholders;
 - the special committee is independent;
 - the special committee is fully empowered to select and engage advisors and to negotiate a transaction or refuse to proceed with a transaction;
 - the special committee meets its duty of care in negotiating a fair price;
 - the vote of minority stockholders is informed; and
 - the vote of the minority stockholders is uncoerced.

The New Landscape – *Corwin*

- *Corwin* involved a merger that was subject to review under *Revlon*.
- The Delaware Supreme Court held that even if a transaction subject to *Revlon* would be reviewed under the business judgment rule after being approved by a majority of fully informed and uncoerced stockholders.
- Subsequent Delaware decisions have continued to define the scope of *Corwin*, including by extending it to two-step transactions in which a majority of the stockholders tender their shares in the first-step tender offer (*Volcano Corp.*) and making clear that plaintiffs bear the initial burden of showing that the stockholder vote was inadequately informed (*Merge Healthcare*).
- But *Corwin* is not without its limits. In *Saba Software*, the Court of Chancery held that the plaintiffs stated both a disclosure claim due to the lack of explanation of why the company had missed an SEC deadline to restate its financials, and a claim that the stockholder vote was coerced because stockholders were forced to choose between a sale at a depressed price or holding potentially worthless stock.
- Case law in this area will continue to develop.

The New Landscape – *Trulia*

- The vast majority of stockholder suits in the context of M&A transactions have historically been settled on the basis of additional disclosures to stockholders in exchange for a broad “intergalactic” release of claims.
- In *Trulia*, the Delaware Court of Chancery rejected a proposed settlement and held that, going forward, supplemental disclosures supporting a settlement must be “plainly material”; i.e., addressing a plainly material misrepresentation or omission.
- The court stated that the determination of whether a disclosure is plainly material “should not be a close call”.
- In addition, the scope of the release must be narrowly circumscribed to encompass nothing more than the disclosure and fiduciary duty claims in connection with the sale process.

The New Landscape – Appraisal Actions

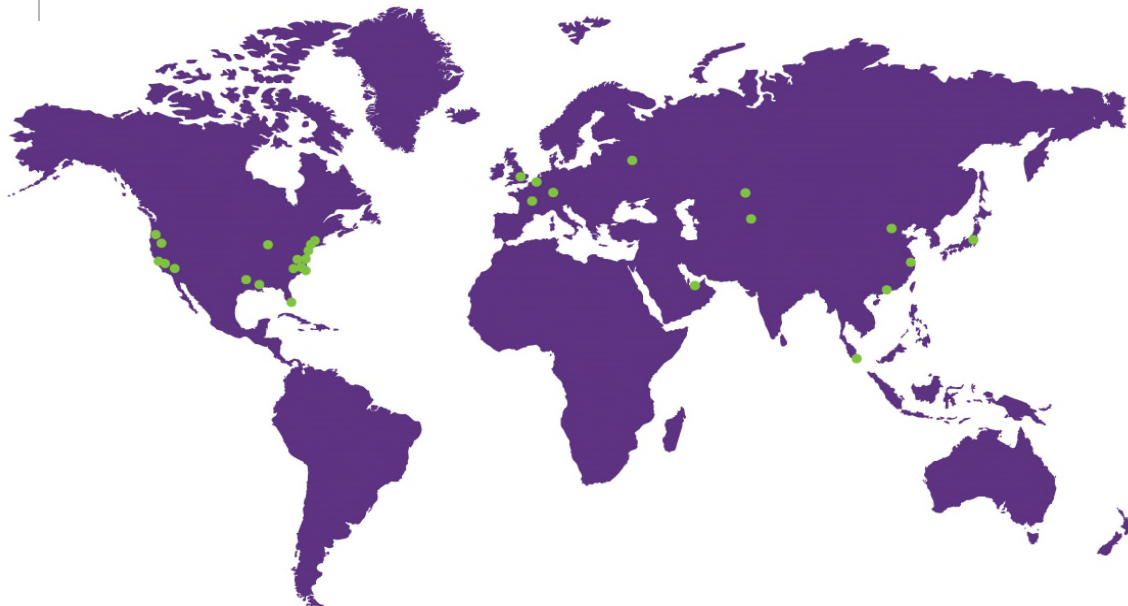
- Presumably at least in part as a result of the decisions in the *M&F Worldwide*, *Corwin* and *Trulia*, appraisal actions have been on the rise in Delaware.
- Stockholders who object to a merger have a statutory right to have a court determine the “fair value” of their shares.
- The court is required to consider “all relevant factors” in determining fair value.
- There has been some ambiguity as to how deal price should be taken into account along with discounted cash flow, comparable company and comparable transaction analyses, but since 2010 it has been clear the deal price could at least be a factor in the analysis.
- Decisions in 2016, most particularly in the *Dell* case, called into question the role of deal price in the analysis; the court in *Dell* gave no weight to either the pre-transaction stock price or the deal price and arrived at a fair value that was 28% higher than the deal price.
- In December of 2017, however, the Delaware Supreme Court reversed and remanded the Court of Chancery’s decision.

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