

CORPORATE AND SECURITIES LAW ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

Fiduciary Duties of a Buyer's Board; Implications of Conflicting D&O Indemnification Provisions

February 16, 2010

In our 2009 client alert [*The Path Ahead: Corporate Law Trends and Forecasts for 2010*](#), we noted that 2009 had been an active year for litigation focused on the fiduciary duties of public company directors. Fortunately, the Delaware Courts remained protective of the "business judgment rule" and maintained a high bar to findings of "bad faith" and personal liability of directors. At that time we anticipated 2010 to be equally active for litigation in the areas of director fiduciary duties and oversight responsibilities.

True to this prediction, there has already been a notable Delaware Chancery Court opinion in this area, the *In re Dow Chemical Company Derivative Litigation*.¹ While many of the cases in 2009 were focused on the duties of a seller's board of directors, the *Dow* opinion was a rare opportunity for the courts to review and comment on the duties of the board of an acquiring company. In the *Dow* opinion, as described below, boards should take note and comfort that the Delaware Chancery Court again confirmed the broad protections of the "business judgment rule." The court also confirmed the high bar to a finding of "bad faith" expressed in last year's *Lyondell* opinion. Additionally, in an important ancillary matter for directors and officers, the Delaware Chancery Court recently issued an opinion addressing the implication of conflicting advancement and indemnification rights flowing from multiple organizational documents.

Delaware Chancery Court Clarifies Duties of Boards of Acquiring Companies

On January 11, 2010, the Delaware Chancery Court dismissed breach of fiduciary duty claims brought by shareholders against the board of directors of Dow Chemical Company related to its decision to acquire Rohm & Haas Company in an \$18.8 billion cash merger. The merger agreement provided the target a right of specific performance in addition to monetary penalties for any delay or failure to close but did not contain a financing condition. While public company acquisition agreements typically have specific performance clauses, in recent years highly leveraged transactions have frequently included so-called "reverse break-up fees" which allow the buyer to limit their exposure to a small percentage of the deal price if the financing falls through. Given the size of the transaction and requisite financing, an order of specific performance (or commensurate damages) against *Dow* could have been catastrophic if financing was not available. As a result of unexpected economic conditions and the loss of a significant anticipated business venture, *Dow* was, in fact, unable to obtain the financing to complete the merger on the agreed-to terms.² *Dow* shareholders subsequently brought a derivative action alleging breaches of

¹ *In re Dow Chemical Company Derivative Litigation*, C.A. No. 4349-CC, 2010 WL 66769 (Del. Ch. Jan. 11, 2010).

² Parallel with the company's pursuit of Rohm & Haas, *Dow* had entered into a joint venture agreement with a Kuwaiti chemicals company. The joint venture was expected to close on January 2, 2009 and *Dow* anticipated up to \$9 billion in proceeds from the transaction. On December 28, 2008, the Kuwaiti government rescinded its approval of the joint venture.

fiduciary duties, including approving the transaction without a financing condition under the circumstances and placing the company in a “precarious position, facing potential financial ruin.”

The Court dismissed the shareholders’ claims stating that the directors’ decision to enter into the merger agreement was a proper exercise of business judgment that could not be challenged by plaintiffs merely unhappy with the outcome. The Court noted that the plaintiffs appeared to focus principally on the “substantive content of the directors’ decision” rather than the decision making process. Making reference to its 2009 *Citigroup* decision, the Court stated that “substantive second-guessing of the merits of a business decision, like what the plaintiffs ask the Court to do here, is precisely the kind of inquiry that the business judgment rule prohibits.” In addition, the Court made clear that there is no heightened scrutiny standard of business judgment applicable to “bet-the-company” decisions.

The Court also reiterated that directors are entitled to protection of the business judgment rule unless a plaintiff shows that directors acted in bad faith. Citing the Delaware Supreme Court’s decision in *Lyondell*, the Court stated that in order to demonstrate that a board acted in bad faith, “[p]laintiffs must show that defendants completely and ‘utterly failed’ to even attempt to meet their duties.” Moreover, the *Lyondell* court noted that an “extreme set of facts” would be required to sustain a bad faith claim, in a transactional context, premised on the notion that a disinterested board of directors had intentionally disregarded its fiduciary duties.

Board members should take comfort in these recent opinions of the Delaware Chancery Court confirming the business judgment rule protection in the context of acquisitions and other material business transactions, and that heightened scrutiny of director decision making will not typically apply to good faith decisions made by a majority of disinterested directors -- regardless of the size or importance of the transactions, or its potential impact on the buyer and its shareholders if the deal falls apart. This should be welcome relief for boards and companies that have been hesitant to make acquisitions in the wake of recent failed deals and the current economic conditions for fear of enhanced personal exposure. *Dow* confirms that courts will look at the process and whether the board made good faith, informed decisions, but will not (absent an “utter failure” to make such a decision) review the merits of the acquisition decision itself.

Key Take-Aways:

Notwithstanding *Dow*’s welcomed reaffirmation of the business judgment rule, directors must continue to be mindful of good process in fulfilling their fiduciary duties in the context of an acquisition or other significant business agreement or decision. This process should typically include, as appropriate, seeking the advice of experienced counsel and, where relevant, financial advisors. Without a defensible, informed and good faith decision-making process, a board may find themselves second guessed by a court -- even approving terms similar to that in the *Dow* case. A good decision-making process will include appropriate steps to adequately inform themselves of the valuation, strategic fit and need, potential diligence, regulatory and integration issues, current “market” deal terms and the relative bargaining power of the parties, competition for the target, and the specific transactional terms, including those relating to acquisition financing, termination, closing conditions and each party’s remedies. Additionally, when approving deal protections affecting a buyer, as in a mutual no-shop provision or covenants restricting a buyer’s operational or strategic flexibility in a stock-for-stock deal, the buyer’s directors should be fully informed regarding the potential impact of these provisions and the relative value exchanged for these protections, as a buyer’s board also has continuing fiduciary duties to its shareholders after a deal is announced.³ Particularly with a highly leveraged transaction, a buyer’s board

³ Indeed, as with a target’s board, a buyer’s board must consider the possibility of heightened scrutiny of its agreement to no-shop or other deal protections affecting its actions or ability to terminate—especially where the buyer’s shareholder vote and corresponding board recommendation is required (i.e., pursuant to stock exchange rules where consideration in the form of shares of a buyer’s common stock exceeds 20% of the buyer’s shares).

should be informed of the consequences of a failure to obtain the requisite financing. Finally, as with any board action, the board process and approvals should be conducted in a disinterested manner, free of any potential conflicts.

If a board follows a sound process and acts in a disinterested manner and in good faith in the honest belief that a transaction is appropriate and in the best interests of its shareholders, the board should be able to approve an acquisition or other significant transaction -- even a potentially risky transaction -- with confidence and without fear of judicial second guessing.

Delaware Chancery Court Addresses the Implication of Conflicting D&O Indemnification Provisions

Recently, the Delaware Chancery Court issued an opinion that addressed an issue that can arise when a director's advancement and indemnification rights flow from multiple organizational documents in its *Xu Hong Bin v. Heckmann Corp.* decision.⁴ Historically, the general assumption has been that when the bylaws conflict with the certificate of incorporation, the bylaws are invalidated to the extent of the conflict. However, in the *Heckmann* case, the Court ruled that if a corporation's current certificate of incorporation and bylaws were simultaneously adopted, then the courts would make every effort to reconcile conflicting provisions of the certificate of incorporation and bylaws, rather than invalidating the conflicting provision of the bylaws -- based, in part, on the practical assumption that the drafters did not intend for these documents to conflict. Therefore, contrary to traditional expectations for conflicting organizational documents, the Court concluded that Heckmann's bylaws effectively limited the provision providing for mandatory advancement of legal expenses in its certificate of incorporation and, therefore, allowed Heckmann to impose reasonable terms and conditions on the director's right to advancement of legal expenses as set forth in the certificate of incorporation.

Key Take-Aways For Companies:

Companies should consider whether their intentions and policies regarding advancement and indemnification rights will be most effectively preserved if they flow from a single, carefully drafted source and whether that source should be the company's certificate of incorporation or bylaws. If the advancement and indemnification rights provided by a company are currently set forth in more than one document, including in separate indemnification agreements, the documents should be carefully reviewed together to ensure that they consistently express the intent of the company -- with consideration to amending these documents where necessary.⁵

As a related best practice, a company's indemnification documents should also be reviewed periodically by the company and qualified legal counsel to ensure that they adequately address recent developments in the law, include state-of-the-art indemnification concepts and provide the breadth of protection intended by the company and in light of the circumstances of the company.

Key Take-Aways for Directors:

Prior to accepting an appointment, directors (as potential indemnitees) should review the various organizational documents to ensure there are no potentially conflicting provisions that could limit a director's advancement or indemnification rights. Indeed, courts may not be sympathetic to directors who do not do so. For example, the Court in *Heckmann* indicated that it would typically assume a director had indeed reviewed such provisions prior to accepting a directorship given their critical importance to directors generally. Incumbent directors also have a strong personal interest in reviewing

⁴ *Xu Hong Bin v. Heckmann Corp.*, C.A. No. 4802-CC, 2010 WL 187018 (Del. Ch. Jan. 8, 2010).

⁵ Public companies will need to consider potential shareholder vote and disclosure issues with respect to the feasibility of any amendments to its charter or bylaws.

the documents of the companies on which he or she serves in order to assess if there is a potential adverse conflict.

At the end of the day, it is in the interest of both companies and directors to ensure that the advancement and indemnification protection offered to directors and officers is both clearly drafted and consistent with mutual expectations and best practices.

Bass, Berry & Sims PLC's Fiduciary Duties Subgroup monitors and advises on developments in the area of director and executive fiduciary duties. If you have any questions regarding the issues addressed in this alert, please feel free to communicate with your regular contacts in our Corporate and Securities Group, or attorneys in our Fiduciary Duties Subgroup, including those responsible for this alert listed below.

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