FIDUCIARY DUTIES OF A BUYER'S BOARD

By Ryan Thomas

2009 was an active year for litigation focused on the fiduciary duties of public company directors. Fortunately for the directors, the Delaware courts remained protective of the business judgment rule and maintained a high bar to findings of bad faith and personal liability. This year too is likely to bring considerable litigation in the areas of director fiduciary duties and oversight responsibilities.

By early in the year, there had already been one notable Delaware Chancery Court opinion in this area: In re Dow Chemical Company Derivative Litigation, regarding breach of fiduciary duty claims against the buyer's board in connection with a merger transaction. While many of last year's merger-related cases were focused on the fiduciary duties of a seller's board of directors, particularly so-called Revlon duties, the Dow opinion was a rare opportunity for the courts to review and comment on the duties of the board of an acquiring company.

From the Dow opinion, boards can take some comfort in the fact that the Delaware Chancery Court again confirmed the broad protections of the business judgment rule, even in a "bet-the-company" context. The court also confirmed the high bar to a finding of "bad faith" expressed in last year's Lyondell opinion.

In the Dow case (January 11 of this year), the Delaware Chancery Court dismissed breach of fiduciary duty claims brought by shareholders against the Dow Chemical Company board of directors in relation to the company's decision to acquire Rohm & Hass Company in an $18.8 billion cash merger. The merger agreement provided Rohm and Hass 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 its 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 joint venture with a Kuwaiti chemicals company that Dow was relying on for a significant portion of the merger financing, Dow was, in fact, unable to obtain the financing to complete the merger on the agreed-to terms.

Dow shareholders subsequently brought a derivative action alleging breaches of 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."

In dismissing the shareholders' claims, the court said 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. Referring 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, plaintiffs must show "that defendants completely and 'utterly failed' to even attempt to meet their duties."

Moreover, the Lyondell court noted that, in a transactional context, an "extreme set of facts" would be required to sustain a bad faith claim premised on the notion that a disinterested board of directors had intentionally disregarded its fiduciary duties.

These recent Delaware Chancery Court opinions confirm 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 the 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 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 and disinterested decisions, but will not (absent an "utter failure") review the merits of the acquisition decision itself.

However, notwithstanding Dow's 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 decision. This process should 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 itself second guessed by a court.

A good decision-making process will include appropriate steps to adequately inform board members regarding:

- The valuation (potentially to include a fairness opinion or other third party valuation).
- Strategic fit and need, and the related messaging to the market.
- Potential diligence concerns.
- Potential regulatory and integration issues.
- Competition for the target.
- Execution risks relative to consummation of the transaction (including those related to financing or any requisite buyer shareholder approvals).
- The potential for a topping bidder and/or shareholder activism, and the related deal protections.
- The specific transactional terms relative to current "market" deal terms and the relative bargaining power of the parties, including those terms relating to acquisition financing, termination, closing conditions and each party's remedies. Particularly with a highly leveraged transaction, a buyer's board should be informed of the consequences of a failure to obtain the requisite financing.

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.

BOARD MEMBERS SHOULD TAKE COMFORT IN RECENT DELAWARE CHANCERY COURT OPINIONS CONFIRMING THE BUSINESS JUDGMENT RULE PROTECTION IN THE CONTEXT OF ACQUISITIONS AND OTHER MATERIAL BUSINESS TRANSACTIONS.

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 percent of the buyer's shares).

Finally, and perhaps most importantly from a potential liability standpoint, the board process and approvals should be conducted in a good faith and disinterested manner, free of any potential conflicts.

If a board follows a sound process, in the honest belief that a transaction is appropriate and in the best interests of its shareholders, it 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.

Ryan D. Thomas is a partner in the Corporate and Securities Practice Area at Bass, Berry & Sims PLC. He counsels boards and companies on corporate governance, M&A, shareholder activism, and securities matters.

John Fuller and Brandi Holland, associates in the Corporate and Securities Practice Area at Bass, Berry & Sims PLC, assisted in this article.