FIDICIARY DUTIES OF DIRECTORS IN M&A TRANSACTIONS

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State Bar of Texas
15th ANNUAL
ADVANCED BUSINESS LAW
November 9-10, 2017
Houston

CHAPTER 4

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November 10, 2017

Agenda

- (1) Overview of a Director's Fiduciary Duties
  - Duty of Obedience
  - Duty of Care
  - Duty of Loyalty
- (2) The Business Judgment Rule
- (3) The Entire Fairness Doctrine
- (4) Recent Developments

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Overview: Fiduciary Duty of Texas Directors

- In fulfilling managerial responsibilities, directors of Texas corporations are charged with a fiduciary obligation to both the corporation and its shareholders.
- Under Texas law three duties stem from the fiduciary status of corporate directors:
  - (1) Duty of obedience
  - (2) Duty of care
  - (3) Duty of loyalty
- In Texas, these duties have been developed through case law rather than codification in the Texas Business Organizations Code (BOC).
- Statute of Limitations = 4 years (Tex. Civ. Prac. & Rem. Code Ann. § 16.004(a)(5)).

Breaking Down the Duty of Obedience

- Forbids *ultra vires* acts
- Traditional Texas directors duty implicated in key Texas case, *Gearhart*
- Rarely implicated in the modern context given expansive corporate powers and broadly defined purpose clauses in certificates of formation permitted by the Texas Business Organizations Code

Breaking Down the Duty of Care

- Directors must execute corporate duties with such care as "an ordinarily prudent man would use under similar circumstances." (*McCollum v. Dollar*)
- Standard of review: gross negligence
- Corporations may adopt provisions exculpating the duty of care under their corporate charters (*See* BOC §§ 7.001(b),(c)(2),(c)(3), & (c)(4))
- Thus, modern breach of fiduciary duty cases have shifted focus predominantly to duty of loyalty issues.

Breaking Down the Duty of Loyalty

- Two parts:
  - (1) Loyalty (i.e. put corporation/shareholder interests ahead of personal interests)
  - (2) Good faith
- The methods "for the determination of honesty, good faith, and loyal conduct are many and varied, and no hard and fast rule can be formulated." (*Imperial Group (Texas), Inc. v. Scholnick*)
- Generally prevents directors from:
  - usurping corporate opportunities;
  - engaging in interested director transactions (self-dealing) to the detriment of the corporation; or
  - otherwise taking unfair advantage of the corporation to benefit themselves.

Directors' Duties in Relation to M&A Transactions

- Landmark Cases:
  - *Smith v. Van Gorkom (1985)*
  - *Unocal Corp. v. Mesa Petroleum Co. (1985)*
  - *Unitrin, Inc. v. American General Corp. (1995)*
  - *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (1986)*
- Key Recent Developments:
  - *In Re Rural/Metro Corp. Stockholders Litigation (2014)*
  - *Kahn v. M&F Worldwide (2014)*
  - *Corwin v. KKR Financial Holdings (2015)*
  - *In Re Trulia, Inc. Stockholder Litigation (2016)*
  - *In Re MeadWestvaco Stockholders Litigation (2017)*
  - *In re Massey Energy Co Derivative & Class Action Litigation (2017)*
- Consistent Theme: The Business Judgment Rule

The Business Judgment Rule (BJR)

- A presumption in favor of the decisions of the board of directors so long as certain prerequisites are met:
  - (1) good faith
  - (2) with the care that a reasonably prudent person would use
  - (3) with the reasonable belief that they're acting in the best interest of the corporation
- It functions as a defense to breach of fiduciary duty claims, and the burden of proof is on the plaintiff.
- Goal: keep judiciary from second-guessing business decisions
- BJR does not protect against:
  - Grossly negligent acts
  - Ultra vires acts
  - Fraudulent acts
  - Self-dealing
  - Failure to exercise any judgment at all
  - Uninformed decisions

The Entire Fairness Doctrine

- This heightened standard of review comes into play only in cases where BJR is defeated. This is the most exacting standard of judicial review in Delawre.
- Burden of Proof: The burden shifts to the defendant directors to prove that the transaction was entirely fair, both as to:
  - (1) Fair Price (substantive fairness); and
  - (2) Fair Dealing (procedural fairness)
- Safeguards: The burden will not shift to the directors as described above if the company duly made use of:
  - (1) A Special committee; and/or
  - (2) Approval of a majority of the minority shareholders

Enhanced Scrutiny Under *Unocal*

FACTS

- Mesa Petroleum (Plaintiff), led by a well-known corporate raider, made a two-tier hostile bid for Unocal Corporation (Defendant) in which the front end was $54 in cash, and the back end of the deal was $54 in junk bonds.
- Since most shareholders preferred cash over the bonds, Unocal feared shareholders might rush to sell their shares, even if they did not think it was a fair price.
- Unocal's directors hatched a plan to repurchase their own shares at $72 each, excluding the Mesa shares.
- The lower court held that Unocal could not exclude a shareholder from a tender offer; Unocal appealed.

Enhanced Scrutiny Under *Unocal*

LAW

- Directors have a duty to protect the corporation from injury by third parties and other shareholders, which grants directors the power to exclude some shareholders from stock repurchases.
- However, the directors' decision is subject to "enhanced scrutiny" where there is a natural conflict (Here, the directors were excluding a party from acquiring a majority control).
- A board of directors may only try to prevent a takeover where it can be shown that there was a threat to corporate policy and the defensive measure adopted was proportional and reasonable given the nature of the threat.

Enhanced Scrutiny Under *Unocal*

TAKEAWAYS

- Enhanced Scrutiny Test (aka the "Unocal Test")
  - Used to assess whether the BJR applies to a target board's decisions during a takeover
  - Two Prongs: (1) Reasonableness and (2) Proportionality
- In the takeover context, the burden of proof is on the directors to establish that their actions were reasonable and proportional before they may be shielded by BJR. Otherwise, enhanced scrutiny will apply in a court's review of the directors' action.
- Later modified in *Unitrin*, which required the tactics to be "coercive" or "preclusive" before the court would step in.

Enhanced Scrutiny Under *Revlon*

FACTS

- Pantry Pride's CEO approached Revlon's CEO with an offer: either (A) $40-42/share for Revlon; or (B) $45/share hostile takeover.
- Revlon's directors adopted a poison pill plan to repurchase five million Revlon shares, but Pantry Pride countered. Ultimately, Revlon sought another buyer, Forstmann Little & Co.
- The agreement with Forstmann was subject to restrictions such as a twenty-five million dollar cancellation fee for Forstmann and a no-shop provision.
- MacAndrews & Forbes Holdings, Inc. (Plaintiffs) sought to enjoin Revlon's agreement with Forstmann, as not in the best interest of the shareholders.
- The lower court held for Plaintiffs. Revlon and its directors appealed.

13 | Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506, A.2d 173 (Del. 1986).

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Enhanced Scrutiny Under *Revlon*

LAW

- When a takeover is inevitable, the directors' duty is to achieve the best price for the shareholder.
- Court held that when the board decided to "sell the company," its duty "changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the shareholders benefit."
- Ultimately, because the defensive measures undertaken by Revlon's board prevented Revlon's shareholders from accepting Pantry Pride's superior offer, the Revlon board's actions were inconsistent with the board's duty to maximize the immediate value of their shares.

14 | Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506, A.2d 173 (Del. 1986).

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Enhanced Scrutiny Under *Revlon*

TAKEAWAYS

- The *Unocal* doctrine no longer extends to a corporation in a takeover situation once it is determined that the corporation will be sold.
  - At that point, the board's fiduciary duties should no longer focus on the long-term interests of the corporation, but rather the short-term interests of the shareholders in achieving a transaction that will maximize the immediate value of their shares.
  - If the board's performance of these duties is challenged, the court, rather than defer to the board's business judgment, will review the decision with "enhanced scrutiny."
- Price is not the only relevant factor. Other factors include:
  - (i) proposed or actual financing;
  - (ii) questions of illegality;
  - (iii) risk of nonconsummation;
  - (iv) bidder's prior business experiences; and
  - (v) bidder's business plans and their effect on the shareholders.

15 | Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506, A.2d 173 (Del. 1986).

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Directors' Duties in Relation to M&A Transactions

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- Consistent Theme: The Business Judgment Rule

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Recent Developments: *Rural/Metro Corp.*

- FACTS: Special committee formed to handle sale of company lacked independence and had narrow charter that did not include negotiating the sale of the company, and board failed for months to supervise the special committee. In addition, the financial advisor failed to disclose conflicts of interest.
- HOLDING: The board breached its duty of care under Revlon by failing to act within a range of reasonableness in managing the company's sale process.
- TAKEAWAY: The cost to a financial advisor that induced a breach of fiduciary duty is severe. In many cases, whether as a result of the exclusion of exculpated parties from joint tortfeasor status or a court's allocation, damages will fall disproportionately on those without the benefit of exculpation—officers and advisors.

17 | In Re Rural/Metro Corp. Stockholders Litigation (2014).

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Recent Developments: *Kahn v. M&F Worldwide*

- FACTS: Going-private merger with a parent company owned by **controlling** (43%) shareholder.
- HOLDING: The BJR standard applied where the merger was conditioned on the approval of both:
  - special committee of independent and disinterested directors.
  - A **majority of the minority** shareholders.
- TAKEAWAY: Reliance on dual procedural protections affords minority shareholders greater protection, and courts will apply the more deferential BJR standard of review to encourage controlling shareholders to rely on this dual procedural protection.

18 | Kahn v. M&F Worldwide Corp., 2014 WL 996270 (Del. March 14, 2014).

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Recent Developments: *Corwin*

- FACTS: Plaintiffs challenged KKR's acquisition of KKR Financial in a stock-for-stock deal, at 35% premium to KKR Financial's market price, arguing that even though KKR only owned 1%, it was a controlling shareholder because of its unique relationship with KKR Financial (LBO financing for KKR + mgmt. services agreement w/ KKR affiliate).
- HOLDING: BJR applies to M&A not involving a controlling shareholder if transaction is approved by a fully informed, uncoerced majority of disinterested shareholders.
- TAKEAWAY: There is increased deference to director action when there is shareholder approval. It doesn't matter if the "cleansing" stockholder vote was already required by statute – it still functions to cleanse.
- NOTE: 2016 Delaware Chancery Court case, *Volcano*, extends *Corwin* to M&A completed by tender offer.

19 | Corwin v. KKR Financial Holdings LLC, 125 A.3d 304, 308-14 (Del. 2015).

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Recent Developments: *Trulia*

- FACTS: Plaintiffs challenged Zillow's acquisition of Trulia in a stock-for-stock merger valued at approx. $3.5 billion.
- HOLDING: The proposed settlement was neither fair nor reasonable because the company would be providing its stockholders with useless and immaterial supplemental disclosures that did not justify a broad release of claims. Further, the court specifically warned that, Delaware courts will no longer approve disclosure-only settlements unless:
  - (1) the supplemental disclosures meet "plainly material" standard; and
  - (2) the proposed release is sufficiently narrow.
- TAKEAWAY: *Trulia* follows a series of recent decisions in which Delaware courts show a growing unwillingness to approve disclosure-based settlements of merger litigation.

20 | In Re Trulia, Inc. Stockholder Litigation (2016)

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Recent Developments: *Mead/Westvaco*

- FACTS: MeadWestvaco Corporation and Rock-Tenn Company combined in 2015 in a $9 billion stock-for-stock merger of equals. The merger was approved by 98 percent of the stockholders. The plaintiffs alleged that the directors, "flying blind" and "doing virtually nothing to meet their fiduciary duties," entered into the transaction in reaction to a threatened proxy contest by an activist investor and left $3 billion of value on the table.
- HOLDING: Plaintiffs' allegations did not support a reasonable inference of bad faith and dismissed the case.
- TAKEAWAY: The standards of waste and bad faith are essentially equivalent, and each is virtually impossible to meet:
  - (i) an extreme set of facts establishing that disinterested directors intentionally disregarded their duties or
  - (ii) the decision under attack is so far beyond the bounds of reasonable judgment that it is inexplicable on any ground other besides bad faith.

21 | In Re MeadWestvaco Stockholders Litigation (2017).

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Recent Developments: *Massey*

- FACTS: Massey faced multiple derivative and class actions, both relating to (i) willful failure to comply with safety regulations; and (ii) sale of company. Directors argued that under Corwin, the BJR protected their activities leading up to sale of company to Alpha.
- HOLDING: BJR is not a magic eraser. stockholders voted solely on the Massey-Alpha merger, not on the board's decision-making process or the fiduciary conduct leading up to that transaction. Indeed, the fiduciary misconduct alleged—a business plan to consciously disregard safety laws—preceded the merger by several years.
- TAKEAWAY: The vote to cleanse must have a proximate relationship to the alleged breaches of fiduciary duties.

22 | In re Massey Energy Co Derivative & Class Action Litig., No. 5430-CB, 2017 WL 1739201 (Del. Ch. May 4, 2017).

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Recent Developments: *Other Cases*

- Comstock (2016): Court rejected plaintiff's "tell me more" type disclosure claims that the Delaware courts have consistently held are inadequate to state a colorable disclosure claim. "Delaware law does not require disclosure of a play-by-play of negotiations leading to a transaction or of potential offers that a board has determined were not worth pursuing" and that "quibbles with a financial advisor's work simply cannot be the basis of a disclosure claim."
- Larkin (2016): The court expressly rejected the plaintiffs' "rigorously literal reading" of Corwin that "all transactions subject to entire fairness for any reason cannot be cleansed under Corwin" (emphasis in original). Instead, the court agreed with the defendants that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving controlling stockholders."

Recent Developments: *Other Cases*

- Columbia Pipeline (2017): Court found that the defendants' motivation to generate change-in-control benefits from a spinoff was sufficiently disclosed to shareholders. Applying *Corwin*, the Court found that stockholders had approved the transaction in an informed, uncoerced vote.
- In re Saba Software (2017): the Court held that Revlon, not BJR, applied with respect to the acquisition of Saba because "the stockholder vote approving the transaction was neither fully informed nor uncoerced."

Conclusion

- Directors using both (1) a bona fide independent board process and (2) proper shareholder voting is almost certain to get the benefit of the business judgment rule.

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