MERGERS AND ACQUISITIONS — DEALING WITH DIFFICULT ISSUES

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1. INTRODUCTION

1.1 Scope of Outline. This outline focuses on five difficult areas that corporate lawyers often struggle over when advising their clients in merger and acquisition transactions: (i) using special committees of independent directors in acquisitions involving conflicts of interests with officers, directors and/or controlling stockholders, (ii) making timely disclosure of acquisition negotiations, (iii) choosing among competing bids, (iv) the emergence of a third-party interloper who makes a bid after an acquisition agreement has been executed, and (v) walking away from an executed acquisition agreement due to a "material adverse change" in the target. These kinds of matters can be problematic due to the time pressures under which critical legal decisions must be made and due to the fact that these matters present the participants with exposure to substantial risks of personal liability. To top that, the clients will expect legal counsel to safeguard them against later legal challenges while at the same time insisting that counsel not "kill the deal" by being too conservative in the giving of legal advice. In that regard, allegations of breaches of corporate fiduciary duties and the duty of full disclosure under federal securities laws are likely to be basis for subsequent legal challenges. This outline will discuss the pertinent legal issues and their ramifications as well as the steps that counsel may take in advising the client.

1.2 Role of Legal Counsel. In dealing with difficult problems in mergers and acquisitions, legal counsel must prepare the client in advance for issues that may arise. The goal of corporate lawyers will be to manage the legal issues in a manner that best protects the deal and insulates the client from liability under the circumstances. Shepherding management, boards of directors and controlling stockholders through the problems discussed below is not an easy role for counsel to play.

1.3 Delaware Law. With respect to corporate fiduciary duties, this outline focuses primarily on the application of Delaware corporate law since it is the most developed of all the states. Indeed, it is common for the courts of other jurisdictions to look to Delaware law for guidance. For an analysis of fiduciary duties under Texas corporate law, see *Beck, Fiduciary Duties of Controlling Interest Shareholders*, 35 Tex. J. Bus. L. 16 (Spring 1998).

2. THE USE OF SPECIAL COMMITTEES IN CONFLICT OF INTEREST TRANSACTIONS

2.1 Overview.

2.1.1 Duty of Care. Section 141(a) of the Delaware General Corporation Law lays out the fundamental concept that a corporation is to be managed by its directors rather than by its stockholders. This delegation of authority carries with it certain fiduciary duties which directors owe to the corporation and its stockholders. Most notably is the duty of care which requires directors to act in good faith, on a fully informed basis and in a considered manner in making decisions for the corporation. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

2.1.2 Duty of Loyalty. Directors also owe a duty of loyalty to their corporation and its stockholders. Under this duty, directors are required to act in the best interests of the corporation and to refrain from doing anything that would injure the corporation or deny it some benefit. Moreover, the duty of loyalty frowns on conduct that amounts to self-dealing with the corporation. Accordingly, as between the interests of the corporation and a fiduciary, the interests of the corporation must always come first. The Delaware Supreme Court in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) observed:

> "[The duty of loyalty] that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest. *Guth v. Loft, Inc.* 5 A.2d 503, 510 (Del. 1939) . . . Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling stockholder and not shared by the stockholders generally." 634 A.2d at 360-61.

A part of the duty of loyalty is the obligation of a corporate fiduciary to make other directors and the corporation aware of any conflicts of interest that such person may have with respect to any matter involving the corporation before any action is taken on that matter. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985). Because the courts view self-dealing transactions with great skepticism, the courts historically have given heightened scrutiny to such transactions when they are challenged by minority stockholders.

2.2 Controlling Stockholders. Corporate fiduciary duties usually are discussed in terms of the duties of directors and officers. However, in cases involving self-dealing, the courts have recognized that controlling stockholders also owe fiduciary duties to the corporation and its stockholders. But, who is a controlling stockholder for the purposes of state corporate law? The Delaware courts are of the view that a stockholder is a "controlling stockholder" when that stockholder (i) owns more than 50% of the corporation or (ii) exercises control over the business affairs of the corporation. See *Ivanhoe Partners v. Newmont Mining Corp.* 535 A.2d 1324, 1344 (Del. 1987). Thus, a stockholder with less than 50% ownership will be deemed a controlling stockholder if it actually exercises control over the corporation. See *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1113 (Del. 1994) (a 43.3% stockholder was deemed a controlling stockholder because it exercised control over the corporation through its board representation and its general conduct displayed toward the corporation). Interestingly, the most notable Delaware cases on the use of special committees pertain to self-dealing transactions involving controlling stockholders.

2.3 Interested Transactions. The law books are full of cases in which corporate fiduciaries have been sued over transactions between them and their corporation. In the context of mergers and acquisitions, three classic examples of a conflict of interest transaction ("interested transaction"or "self-dealing") are (i) where a director purchases from, or sells to, the corporation certain business assets, (ii) an affiliate of a controlling stockholder receives a loan from the corporation in connection with an acquisition transaction, or (iii) in the case of going private transactions, a parent corporation (i.e. controlling stockholder) engages in a merger transaction with a corporation in which it owns less than 100% of the stock. Since corporate fiduciaries are vulnerable to attack when they engage in self-dealing transactions, legal counsel is charged with establishing procedural safeguards in these transactions to insulate the client from potential liability and to protect the transaction in the case of a subsequent legal challenge. The use of special committees of independent (disinterested) directors to negotiate and approve an interested transaction has become the most common method of safeguarding a transaction.

2.4 Standard of Judicial Review in Breach of Duty of Loyalty Cases. In discussing the legal risks associated with carrying out an interested transaction, the starting point must be with the standard of review by which the courts will judge whether there has been a breach of the duty of loyalty.

2.4.1 General. The standard of review utilized by Delaware courts to determine whether a defendant's conduct is sufficient to impose liability or grant injunctive relief is critical to the outcome of any lawsuit alleging a breach of fiduciary duties by officers, directors and/or controlling stockholders. *Clark, Kahn v. Lynch Communication System, Inc.: A Major Step Toward Clarifying the Role of Independent Committees*, 20 Del. J. Corp. Law. 564, 564 (1995); *Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437, 437 (1993). With regard to a legal challenge to the propriety of an interested transaction, the Delaware courts have had to decide whether the standard of entire fairness or the less onerous standard known as the business judgment rule is the most appropriate test to be applied in judging liability. As will be seen below, the business judgment rule is the more favorable standard of review from the standpoint of successfully defending directors in the courtroom.

2.4.2 Business Judgment Rule. The courts historically have given judicial deference to the decision making of directors. The reluctance of courts to second-guess the business decisions of boards is based on the belief that boards are more qualified than courts to make such decisions. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). Also, there is a belief that to expose directors to liability for ordinary mistakes in judgment would discourage qualified individuals from serving as directors.

In keeping with this policy of judicial deference to boards of directors, courts in most jurisdictions have granted directors protection by establishing what has become known as the business judgment rule. This rule essentially says that in the courtroom, defendant directors will have the benefit of the presumption that they acted (i) on an informed basis, (ii) in good faith and (iii) in the honest belief that the challenged transaction was in the best interest of the corporation. See *Unocal Corp. v. Mesa Petroleum Co.* 493 A2.d 946, 954 (Del. 1985) *Citron v. E.I. DuPont de Nemours & Co.*, 504 A.2d 490, 499 (Del. Ch. 1990). The rule also imposes upon the plaintiff the burden of proof in rebutting this presumption.

Practically speaking, the business judgment rule has largely come to mean that a plaintiff must demonstrate that the directors were guilty of gross negligence or fraud in order for the directors to be found culpable. If the rule is rebutted, the courts will then examine the actual fairness of the challenged transaction and the defendant directors will have the burden of proving that the challenged transaction was fair to, and in the best interests of, the corporation and its stockholders.

In summary, the business judgment rule may be appropriately described as a rule about process in the boardroom. In that regard, the judicial inquiry into the conduct of directors will focus on how the directors informed themselves, evaluated the issues and deliberated in reaching a business decision. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Most importantly, under the business judgment rule, a court will not review the substantive aspects of a challenged transaction. So, even if directors make a bad decision, they will, at least in theory, still be insulated from liability so long as they can demonstrate that they utilized a reasonable process in reaching an informed decision. By reason of this protection afforded by the business judgment rule, there are relatively few cases involving an allegation of a breach of the duty of care that have resulted in liability to directors. The same is not true of cases involving an alleged breach of the duty of loyalty (i.e. conflict of interest transactions) since in those cases, the standard of entire fairness is applied to determine culpability rather the less onerous business judgment rule.

2.4.3 Entire Fairness Standard. In cases involving an interested transaction, the courts will apply the entire fairness standard in determining whether there has been a breach of the duty of loyalty. (See Section 2.5.1(C) below for a discussion of the application of the business judgment rule where a majority of a board is disinterested with respect to a challenged transaction involving other members of the board.) As explained below, the entire fairness standard requires that the courts actually examine the merits of the challenged transaction.

(A) The Business Judgment Rule Not Applied in Judicial Review of Self-Dealing Transactions. The Delaware courts have long held that where a challenged transaction involves an alleged breach of the duty of loyalty, the business judgment rule is not the applicable standard of review. Instead, the substantive legal standard applied by the courts is entire fairness with the burden of proving such fairness being placed upon the defendants. The application of the entire fairness standard calls for a court to focus on two aspects of the challenged transaction: (i) whether there was "fair dealing" between the defendants and the corporation and (ii) whether a "fair price" was received by the corporation and its stockholders. See *Weinberger v. UOP Inc.*, 457 A.2d 701, 701 (Del. 1983).

(B) "Fair Dealing" and "Fair Price." "Fair dealing" pertains to whether the corporation was treated fairly in connection with the negotiations of the challenged transaction. Was the transaction negotiated on a simulated arms length basis and were the corporation and its directors and disinterested stockholders adequately represented in protecting their interests? How did the timing, structure and negotiation of the transaction affect the interests of the corporation and its stockholders? These are the kinds of questions that are asked in determining the presence or absence of fair dealing. The concept of "fair dealing" contemplates that the corporation had the ability to bargain on an arms length basis and that the conflicted parties did not take advantage of the corporation through their position of control.

On the other hand, the "fair price" element involves an evaluation of the economic realities of the challenged transaction for the purpose of determining whether the corporation and its disinterested stockholders received full value in the transaction taking into account all relevant factors like comparable values, market conditions and future prospects. See *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (Del. 1997) and *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 940 (Del. 1985). In short, "entire fairness" essentially requires that when the evidence concerning "fair dealing" and "fair price" is considered together, a trier of the facts will conclude that the negotiated transaction produced a fair transaction to the corporation and its disinterested stockholders.

2.4.4 Demonstrating Fair Dealing: Transaction Approval by Special Committee of Independent Directors or Minority Stockholder Vote. In the case of a self-dealing transaction, interested parties usually seek to demonstrate fair dealing by conditioning the closing of the transaction on the prior approval of independent directors and/or a majority of the disinterested minority stockholders.

(A) Special Committee Approval. The court in the *Weinberger* case indicated that satisfying the requirement of fair dealing would have been helped if the

corporation had established "an independent negotiating committee of outside directors to deal . . . at arms length." 457 A.2d at 706 n.7. Based on that observation, corporate lawyers began thereafter to use special committees of disinterested directors to negotiate interested transactions on behalf of the interests of a corporation and its stockholders hoping that this step would help safeguard the transaction in case of subsequent legal challenges.

(B) Disinterested Stockholder Approval. Some interested transactions are conditioned upon the approval by a majority of the disinterested stockholders because where there is an approval by informed (disinterested) stockholders, the Delaware courts will shift the burden to the plaintiffs of proving the unfairness of the challenged transaction. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 1117 (Del. 1993) and *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990). In the *Citron* case, the closing of the interested transaction was conditioned on the approval of a special committee as well as the affirmative vote of a majority of the disinterested stockholders.

Seeking disinterested stockholder approval has advantages and disadvantages. In the case of public companies, obtaining stockholder approval must occur through a proxy solicitation that will involve considerable time and expense to complete. Also, there is the risk that the transaction could be disapproved. Moreover, even if stockholder approval is obtained, the transaction is still subject to legal challenge. Importantly, however, the burden of proving the that transaction was entirely unfair will have been shifted to the plaintiff.

Parallel to the above methods of having a neutral decision-making body approve an interested transaction for purposes of satisfying the duty of loyalty are the requirements of Section 144(a) of the Delaware General Corporation Law which pertain to preventing an interested transaction from being voided on the grounds of director conflicts. This statutory provision "protects corporate actions from invalidation on the grounds of director self-interest if such interest is (1) disclosed to and approved by a majority of disinterested directors; (2) disclosed to and approved by the shareholders; or (3) the contract or transaction is found to be fair as to the corporation." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993). Although an embodiment of common law, Section 144(a) speaks only to director conflicts and the voidability of interested contracts, and does not address the entire fairness standard for reviewing duty of loyalty cases. See, Note, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 Del. J. Corp. L. 981 (1986).

2.4.5 Effect of a Special Committee on the Choice of Judicial Standards in the Review of an Interested Transaction. There was some confusion after the *Weinberger* decision as to whether the use of a special committee would affect the standard of judicial review. As a result, in the case of *In re Trans World Airlines Inc., Shareholders Litigation*, No. 9844, slip op. at 15-16 (Del. Ch. 1988), the chancellor held that if a special committee is utilized, the business judgment rule would be the applicable standard for judicial review instead of the entire fairness standard. But, subsequently, in *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 500-02 (Del. Ch. 1990), the contrary view was adopted by a different Chancery Court. In rejecting the *Trans World* holding, the *Citron* court concluded that the inherent

dangers in interested transactions called for maintaining the entire fairness rule as the standard of judicial review regardless of the use of a special committee or the obtaining of shareholder ratification.

2.4.6 Entire Fairness Standard Is Applicable to All Interested Transactions Notwithstanding a Special Committee. The split in the Delaware courts over the standard of review applicable to interested transactions was settled in 1994 by the Delaware Supreme Court's decision in *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1116 (Del. 1994). There the court held that the business judgment rule is not applicable in reviewing self-dealing transactions. Thus, directors who approve an interested party transaction will not be brought within the protections afforded by the business judgment rule. Instead, the "exclusive standard of judicial review is . . . entire fairness. . . . Entire fairness remains applicable even when an independent committee is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny." See *Kahn v. Tremont Corporation*, 694 A.2d 422, 427 (Del. 1997). For a more complete analysis of *Kahn v. Lynch Communication Systems, Inc.*, see *Clark, Kahn v. Lynch Communication Systems Inc.: A Major Step Toward Clarifying the Role of Independent Committees*, 20 Del. J. Corp. L. 564 (1995). The bottom line, with respect to a challenged interested transaction, is that courts will examine the transaction to see if, in fact, it was fair to the corporation and its stockholders. This means that judicial deference will not be given to director decisions involving an interested transaction.

2.4.7 Shifting the Burden of Proof: The Benefit of Using Special Committees After Kahn v. Lynch Communications Systems, Inc. Notwithstanding its strict application of the entire fairness standard in cases involving self-dealing transactions, the Delaware Supreme Court in *Kahn v. Lynch Communications Systems, Inc.* granted a major procedural advantage to the defendants where it was demonstrated that a special committee was properly organized and utilized to negotiate an interested transaction. The court ruled that, as in the case where disinterested stockholder approval is obtained, use of a special committee will shift to the plaintiff the burden of proving that the challenged transaction was "entirely unfair" to the corporation and its stockholders. Because of this benefit, special committee use is prevalent in conflict of interest transactions. However, as discussed below, improper establishment and/or operation of a special committee can cause this procedural advantage to be lost.

2.5 Legal Requirements in Establishing and Operating a Special Committee. Set forth below are certain factors that the courts have focused on when determining whether a special committee has been properly organized and has properly functioned in order to shift the burden of proof to the plaintiff. For a complete analysis of the use of special committees, see *Uarallo, McErlean and Silberglied, From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53 Bus. Lawyer 397 (1998).

2.5.1 General.

(A) Fully Functioning Committee. In the case of interested transactions, the best practice obviously is to adopt as many procedural safeguards as possible, especially if counsel expects litigation challenging the transaction. Accordingly, the use of special committees in negotiating and approving an interested transaction has become the rule rather than the exception. Of course, the mere existence of a special committee "does not itself shift the

burden of proof." See *Rabkin v. Olin Corp.*, C.A. No. 7547 (Del. Ch. 1990) aff'd 586 A.2d 1202 (Del. 1990) and *Rabkin v. Philip A. Hunt Chem.*, 498 A.2d 1099, 1107 (Del. 1985). The committee's formation and operation must, in fact, reflect integrity, true independence and real bargaining power in negotiating the transaction on an arms length basis. Otherwise, the courts will not shift the burden of proof to the plaintiff.

As to whether a special committee properly functioned, the Delaware Supreme Court in *Kahn v. Lynch Communications Systems, Inc.* reduced it to the following: the special committee must "(i) [be] truly independent, (ii) [be] fully informed and (iii) [have] the freedom to negotiate at arms length." 638 A.2d at 1120. This means that the conduct of the special committee must reflect that the conflicted parties did not dictate terms, but that in fact, the committee had full bargaining power in negotiating the transaction. Likewise, the facts should demonstrate that the members of the committee were "fully informed and active [in] appropriately simulating an arms length transaction." *Kahn v. Tremont Corporation*, 694 A.2d 422, 428 (Del. 1997). There the court concluded that a three-member committee did not function properly in part because one member never attended any meetings of the committee, another one missed two critical meetings and the third member and the only truly active member had a significant business relationship with the controlling stockholder. In sum, if a special committee is to be credible, its members must demonstrate that they took their responsibilities seriously because "it is . . . the case attention, and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence." *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984)

(B) Failure to Have a Special Committee. It should be noted that while the use of a special committee is not legally mandated, the courts are more likely to find the presence of "fair dealing" if a special committee is used to negotiate and approve an interested transaction. Indeed, the courts have acknowledged that the establishment of an independent bargaining structure through the use of a special committee "while not conclusive, is strong evidence of the fairness" of the challenged transaction. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, at 938, n.7 (Del. 1985). More specifically, the chancery court in *Seagraves v. Urstadt Property Co.*, C.A. No. 10307, slip op. at 11 (Del. Ch. 1996) noted that the failure to use a special committee "evidences the absence of fair dealing." From an evidentiary standpoint, therefore, the absence of a special committee can be harmful to a defendant's case.

(C) Caveat: Approval by a Disinterested Majority of Directors is Preferable to Using a Special Committee of Disinterested Directors. Appointing a special committee is generally not advisable if a majority of the directors are disinterested parties. The reason is that under those circumstances, the action of a disinterested majority will be covered by the business judgment rule rather than the more onerous standard of entire fairness. In *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971), the challenged transaction had been approved by five of the nine-member board of directors. All five directors were found to be independent and there was no showing that the controlling stockholder dominated this five-person majority of the board or dictated the terms of the deal. As a result, the court applied the business

judgment rule. See *Sparks, The Whys and Hows of Special Committees*, The M&A J. 44 (March, 1998).

Where there is a disinterested majority of the directors, "fair dealing" can be enhanced by having the interested directors excuse themselves from board deliberations on the subject transaction. Furthermore, a subset of the disinterested directors can be delegated the responsibility of negotiating on behalf of the corporation and periodically reporting back to all the disinterested directors. While this subset would not be a special committee in the sense contemplated by this outline, these steps would be a demonstration of the good faith effort by the disinterested directors to act independently in negotiations with the conflicted parties. This is important because a disinterested majority of directors will not be viewed as a neutral decision-making body if the evidence shows that they were dominated or otherwise influenced by the conflicted parties in connection with their decision to authorize the interested transaction.

2.5.2 Independence of Committee Members. A fundamental requirement in establishing a special committee is that its members be independent from the interested parties. Absent that fact, the work of the committee will be vulnerable to attack regarding its objectivity and impartiality in dealing with the conflicted parties.

(A) Determining Independence. The question of "independence" is a fact intensive issue which must be decided on a case by case basis. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993). However, generally speaking, a director will be deemed to be disinterested if such director "neither appear[s] on both sides of a transaction nor expect[s] to derive any benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all of its stockholders." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Furthermore, "independence" means that a director is "not dominated or otherwise controlled by an individual or entity interested in the subject transaction." *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988). The burden of proof with respect to the issue of a director's independence rests upon the party challenging the transaction. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1989).

(B) Materiality of Self-Interests. Since independence is critical to the credibility of a special committee, selecting only the most pristine directors is the best practice to follow when a board establishes the committee. However, some boards may find that all of its directors have varying degrees of existing or prior business or close social relationships with the conflicted parties. Under these circumstances, the selection of committee members will necessarily include some directors that have some benefit flowing from the challenged transaction or some relationship with the interested parties. Even so, such a committee member may still be deemed to be independent for the purposes of representing the interests of the corporation and its disinterested stockholders. In that regard, in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), the Delaware Supreme Court observed:

> "We have generally defined a director as being independent only when the director's decision is based

entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations . . . By contrast, a director who receives a <u>substantial benefit</u> from supporting a transaction cannot be objectively viewed as disinterested or independent." 634 A.2d at 361 (emphasis added).

Based upon the foregoing, the Delaware courts have concluded that a benefit must be <u>material</u> to a committee member before it will cause that member to be viewed as not being independent. For instance, in *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489 (Del. Ch. 1996), one member of a two-member committee had a consulting agreement with the corporation. The court recognized that because the continuation of that arrangement depended upon the goodwill of the conflicted directors, the independence of the member was subject to challenge. But, in doing so, the court said that his independence must turn on whether the value of the consulting agreement was "<u>so de minimus</u> that it could not have influenced [his] ability to consider the [challenged transaction] impartially." (emphasis added) <u>Id</u>.

In the case where there are no "independent" directors, one alternative is to appoint additional directors to the board who are independent and who will constitute the special committee. See *Carlton Investments v. TLC Beatrice International Holdings, Inc.*, C.A. No. 17950 (Del. Ch. 1997) (two independent directors added to a board of directors to act as special committee).

(C) <u>Effect of Material Benefits from Prior Relationships With Special Conflicted Parties</u>. In reviewing the conduct of a special committee, the court in *Kahn v. Tremont Corp.*, 694 A.2d 422, 426 (Del. 1997) strongly criticized the prior business relationships that several committee members had had with the controlling stockholder. Likewise, in *In re MAXXAM, Inc., Shareholders Litig.*, C.A. No. 12111 (Del. Ch. 1997), the court found that a special committee had not shifted the burden of proof in part because all of its members had significant financial and business relationships with the conflicted parties.

(D) <u>Non-disqualifying Benefits</u>. The Delaware courts have recognized that a director's receipt of customary director fees or the receipt of pension benefits, standing alone, will not constitute a disqualifying financial interest (see *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) and *Parnes v. Bally Entertainment Corp.*, C.A. No. 15192, slip op. (Del. Ch. 1997)) and a director's right to indemnification from the corporation will not be a disqualifying interest (*In Re Sea Land Corp. Shareholders Litig.*, 642 A.2d 792 (Del. Ch. 1992).

(E) <u>Effect of a Committee Member Not Being Found to be Independent</u>. What is the impact if, in a subsequent legal challenge, some committee members are found by a court not to have been independent? In the *Kahn v. Dairy Mart Convenience Stores, Inc.* case, the Chancery Court downplayed the significance of having found that only one of the two committee members was independent in carrying out the functions of the special committee. The court said: "While that fact, standing alone, is not fatal to the

defendant's position, it does call for careful judicial scrutiny. As [another Chancellor has noted] 'if a single member committee is to be used, the member should, like Caesar's wife, be above reproach.' *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)." *Kahn v. Dairy Mart Convenience Stores, Inc.* C.A. No. 12489, slip op. In a similar vein, the chancery court in *In Re MAXXAM Shareholders Litig.*, 659 A.2d 260 (Dec. Ch. 1995) indicated that a committee of five would continue to be viable if at least three members were found to be independent. In sum, it appears that the courts will not find that a lack of independence on the part of one or more committee members will in some way taint the independence of the remaining committee members so long as a majority continues to be independent.

(F) One Person Committee. While appearance-wise it may not be desirable, a one person committee has found acceptance by the Delaware Courts. See *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985). And, as noted above, the court in *Kahn v. Dairy Mart Convenience Stores, Inc.* indicated that the lack of independence of one member of a two-person committee would not be fatal in itself.

2.5.3 Independence of Advisors to the Committee. Much like the requisite independence of the members of a special committee, a lack of independence on the part of the advisors to the committee also will jeopardize the credibility of the committee. In that regard, prior relationships between an investment banking firm or legal counsel and the conflicted parties can be expected to be looked upon with much disfavor by the courts in deciding if there was "fair dealing." For instance, in the case of *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997), the court strongly criticized the retention of a financial advisor which had lucrative past dealings with the controlling stockholder and his affiliates. Likewise, legal counsel to the committee had previously represented an affiliate of the controlling stockholder.

2.5.4 Committee Not Influenced by Interested Parties. To demonstrate that it functioned properly, a special committee must act independently. This means that it must be free of the influence of the interested parties. Most assuredly, the conflicted party cannot dictate the terms of the challenged transaction. *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985).

2.5.5 Committee Has the Power to Negotiate at Arms Length and to Say No.

(A) Freedom to Walk Away. For a special committee to be properly functioning, the committee must have total freedom to negotiate on an arms length basis. Accordingly, a special committee should be under no compulsion to reach any agreement with the conflicted parties. In *First Boston, Inc. Shareholders Litig.* C.A. No. 10338, slip op. 68 (Del. Ch. 1990), the court said:

> "It is the duty of directors serving on a [special] committee to approve only a transaction that is in the best interest of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such direction to achieve the best price that a fiduciary will pay if that price is not a fair price. Nor is it sufficient to get a price

that falls within a range of 'fair value' somehow defined, if the fiduciary [or someone else] would pay more."

And, in *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994), the court similarly noted that:

> "The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price." 638 A.2d at 1119. (emphasis added)

(B) Effect of Threats Made Against a Special Committee. The interested parties must not engage in any conduct that would effectively undermine the ability of the special committee to negotiate freely or to walk away from the proposed transaction. Below are three cases in which such conduct was fatal to the defendant's case.

A controlling stockholder's threat to a special committee that it would veto any proposal other than its own was viewed as effectively taking away the bargaining power of the committee. The committee had no ability to "shop" the deal for a better offer. *Kahn v. Dairy Mart Convenience Stores, Inc.*, C. A. No. 12489 (Del. Ch. 1996).

A controlling stockholder's threat to a special committee to launch a hostile tender offer at a price less than what was then being offered by the controlling stockholder in a proposed merger was viewed as depriving the special committee of the "power to say no." "Blackmailing" a committee can be fatal to the claim of "fair dealing." *Kahn v. Lynch Communication Systems, Inc.* 638 A.2d at 1120.

A controlling stockholder used an ultimatum to a special committee that it would proceed with a transaction without the committee's input if the committee did not accept the offer that was then being offered by the controlling stockholder in merger negotiations. The court viewed this as having caused the committee to lose its ability to negotiate on an arms length basis since it had in effect no other choices to pursue. See *American General Corp. v. Texas Air Corp.* C.A. No. 8390 (Del. Ch. 1988).

2.5.6 Manner of Selecting Advisors to the Committee. The special committee should select its own advisors. The selection of advisors can be flawed if the selections are based on the recommendations or direction of the interested parties. See *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, n. 6 (Del. Ch. 1996); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997); *Fort Howard Corp. Shareholders Litig.* C.A. No. 9991, slip op. at 30 (Del. Ch. 1988). While special circumstances may call for additional advisors, a special committee will normally retain its own legal counsel and financial advisor. The conflicted parties should not participate in discussions with the advisors to the committee. See *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261, 1279-80 (Del. 1989).

2.6 Key Procedural Steps in Setting Up a Special Committee by a Board. Set forth below are some of the steps that a board should consider in establishing a special committee that will stand the test of judicial scrutiny.

2.6.1 Board Should Grant Appropriate Authority to Committee.

(A) To Negotiate on Behalf of the Corporation and Its Disinterested Stockholders.

(B) To Make a Recommendation to Board with Respect to the Proposed Transaction.

(C) To Retain For the Committee Whatever Advisors That the Committee Believes Are Needed.

Illustration of Board Resolutions Granting Committee Authority: "to consider the merger proposal from DuPont . . . to retain on behalf of the minority stockholders such advisor or advisors as . . . [the committee] may deem prudent, and as promptly as may be reasonable to report their findings to the full board." *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 493 (Del. Ch. 1990).

2.6.2 Board and Company Counsel Should Verify Independence of Members Selected and Their Time Availability to Carry-out Their Charge.

2.6.3 Board Minutes Should be Drafted to Adequately Reflect the Action of Board in Establishing the Committee.

2.6.4 Board Should Make Available to the Committee Those Members of Management Needed to Assist the Committee in an Analysis of the Proposed Transaction.

2.7 Key Procedural Steps in the Operation of a Special Committee. For an illustration on how a special committee should consider operating, see *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990). And for an illustration of how not to operate, see *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997). Set forth below are some operating guidelines that a special committee should consider:

2.7.1 Initial Organizational Meeting.

(A) Should Elect Chairperson.

(B) Should Decide Method of Selecting Legal Counsel and a Financial Advisor Free of the Influence of the Conflicted Parties.

2.7.2 Should Retain Legal Counsel and Financial Advisor.

(A) Interviews of Prospective Advisors May Be Appropriate.

(B) Should Verify Independence of Advisors Before Hiring.

2.7.3 Should Clearly Understand the Committee's Role in Representing the Corporation and its Minority Stockholders.

(A) Legal Counsel Should Advise Committee on the Business Judgment Rule Versus the Entire Fairness Standard and the Case Law Regarding Favorable and Unfavorable Conduct of Special Committees.

(B) Legal Counsel Should be Consulted Whenever There is an Issue as to What is Proper Conduct.

2.7.4 Should Establish Appropriate Operating Policies.

(A) Should Keep Minutes of Committee Meetings.

(B) Should Keep Confidential From the Conflicted Parties the Activities, Strategies and Thinking of the Special Committee.

(C) Should Become Fully Informed on the Issues.

(D) Should be Willing to Reject the Proposed Interested Transaction (i.e. exercise bargaining power and feel no compulsion to reach any agreement)

(E) Should take adequate time to deliberate and investigate the issues.

(F) Should Rely Upon the Fairness Opinion of its Own Financial Advisor.

(G) Should Keep an Adequate Record of the Negotiating History to Demonstrate the Exercise of Real Bargaining Power.

2.8 Advising the Special Committee. Counsel to a special committee should explain to its members their role in the proposed transaction and should outline the primary duties of the members including:

2.8.1 Become Fully Informed on the Issues Involving the Proposed Transaction.

2.8.2 Do Not Discuss with the Conflicted Parties the Negotiation Deliberations or Strategies of the Committee.

2.8.3 Act Independently of the Conflict Parties.

2.8.4 Strive to Participate in All Meetings.

2.8.5 Be Prepared to Say No to the Proposed Transaction.

2.8.6 Be Motivated to Represent the Corporation and its Minority Stockholders.

2.9 Advising the Conflicted Parties. Counsel to the conflicted parties should explain how a special committee is to operate if it is to have credibility and what the conduct of the conflicted parties should be with respect to the work of the special committee. Of course, the conflicted parties should be advised on the front-end that a special committee should not be established unless the conflicted parties are prepared to negotiate at arms length with the committee and to even receive a negative response from the committee regarding the terms of the proposed transaction. Set forth below is some common sense advice that interested parties should follow:

2.9.1 Keep a Distance from the Committee and its Advisors (i.e. Do Not Attempt to Influence the Committee).

2.9.2 Make No Threats or Demands on the Committee.

2.9.3 Do Not Place Limitations on the Committee's Ability to Function Properly.

2.9.4 Be Prepared for the Consequences of a Rejection of the Proposal by the Committee.

3. THE TIMELY DISCLOSURE OF ACQUISITION NEGOTIATIONS

3.1 Overview. A common goal in negotiating an acquisition transaction is to avoid having to publicly disclose such negotiations prior to the execution of a definitive agreement. The motivations behind this goal are usually based on legitimate business reasons. In the first place, the potential acquiror does not want to lose a deal to a third-party bidder as a result of a public disclosure prior to obtaining a signed agreement. A public announcement may have the effect of putting the target into "play" among would-be suitors. Also, news of merger negotiations may drive the market price of the target company's stock beyond the strike price proposed by the potential acquiror. On the other hand, a target company does not want to disclose negotiations for fear that the parties may never reach an agreement to do the deal. In that case, the prior disclosure of negotiations may result in the target company being looked upon as "damaged merchandise" especially if it appears that the potential acquiror walked away from the deal. For these kinds of reasons, the parties will aim to carefully manage all events that could precipitate a forced public disclosure on an untimely basis. Unfortunately, the desire to maintain secrecy about negotiations can conflict with the duty of full disclosure. Set forth is a discussion of the relevant issues and some guidelines for addressing these kinds of disclosure problems.

3.2 Duty to Disclose Acquisition Negotiations.

3.2.1 Basic v. Levinson.

(A) Mandatory Disclosure of Negotiations Prior to an Agreement in Principle. It has been ten years since the United States Supreme Court handed down its landmark decision in *Basic Inc. v. Levinson*, 485 U.S., 224 (1988). The Court held that merger negotiations can be a material fact requiring disclosure under the federal securities laws. Prior to this decision, the prevalent view in merger and acquisition circles was that the duty of disclosure would not be triggered until such time as the parties had at least reached an agreement in principle on price and deal structure. Suffice it to say, the *Basic* case initially sent shock waves through the merger and acquisition legal fraternity.

(B) Materiality Test For Merger Negotiations. The Court in Basic adopted a "probability/magnitude" test for deciding when merger negotiations constituted a "material fact" requiring public disclosure. In essence, the Court concluded that the triggering of the duty of disclosure turned on the "probability" of the proposed transaction actually occurring balanced against the magnitude of the event to the corporation.

3.2.2 Key Points From Basic In Considering Whether the Duty of Disclosing Merger Negotiations Has Been Triggered. The decision in Basic provided the following understandings regarding the duty to disclose merger negotiations:

(A) Must be "Material Facts" to Trigger Duty to Disclose. There is no general duty to disclose merger negotiations just because they are occurring. However, the *Basic* decision concluded that merger negotiations can become "material facts" requiring disclosure even if the parties have not yet reached an agreement in principle as to price and deal structure.

(B) Material Facts Judged on Case-by-Case Basis. There are no "hard and fast" rules as to what point in time merger negotiations become "material facts" requiring public disclosure. Thus, the issue must be determined on a "case-by-case" basis.

(C) Right to Remain Silent. As a general rule, a company has the right for business reasons to remain silent about its corporate activities. Thus, even though merger negotiations may be taking place, a statement of "no comment" in answer to inquiries about merger negotiations is permissible so long as there is then no other existing factor (e.g. the existence of insider trading or a duty to correct a prior disclosure) that would require disclosure. See *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981).

(D) Any Statement Made About Merger Negotiations Must be Accurate. In the absence of a decision to remain silent about merger negotiations, a company must carefully consider any disclosure that might touch on the subject. In that regard, the courts are clear that whenever a statement (whether in an SEC filing, a press release or some other media channel) is made by a company about the existence or status of merger negotiations, the statement must be accurate. Thus, press releases that report that there are currently no "material corporate developments" or "no major activities are presently underway" can be considered misleading if in fact, the company is then engaged in some form of merger negotiations/discussions.

3.2.3 Subsequent Cases. While the *Basic* case created concern initially, it appears that subsequent cases have largely applied the holdings in *Basic* in a manner consistent with the concepts of "materiality" and "timely disclosure" that were followed by the securities bar prior to *Basic*.

(A) *In re Columbia Securities Litigation*, 747 F. Supp. 237 (S.D.N.Y. 1990). The defendant argued that the "probability/magnitude" test of *Basic* met that the duty to disclose merger negotiations was triggered only when the probability of the deal occurring was "more likely than not." The court rejected that standard on the basis that *Basic* did not limit its "materiality" concept to a rigid standard of probability.

(B) *SEC v. Boreman*, Civ. Act. 91-0567 (D.D.C. 1991). The defendant CEO issued a press release in response to an inquiry by the New York Stock Exchange about trading activity in the company's securities. The company stated that it was aware of the recent trading activity in its stock but knew of no reason for such activity. In fact, the CEO had recently expressed

willingness to enter into merger discussions with a potential suitor. The SEC charged the defendant with issuing a false and misleading press release.

(C) *Taylor v. First Union Corporation of South Carolina*, 857 F2d 240 (4th Cir. 1988). Certain stockholders in a bank sold their shares to a potential acquiror of the bank. However, the stockholders were not told prior to the sale that the acquiror and the bank had discussed merger if interstate banking became legalized. Because the discussions were considered too preliminary and contingent, the court concluded that the discussions were not "material facts" requiring disclosure to the selling stockholders. Some commentators have suggested that the decision in this case could have easily been the reverse on the basis that there was a substantial likelihood that a stockholder's decision to sell his stock in the bank would have been affected if the stockholder knew about the merger discussions even if they were contingent on the interstate banking laws being changed.

(D) *Jackrony v. RIHT Financial Corporation*, 873 F.2d 411 (1st Cir. 1989). The court concluded that disclosure of a company's vulnerability to being acquired in a hostile takeover and management's internal discussions about a possible merger are not generally required to be disclosed. The company was not engaged in any merger discussions with a potential acquiror.

3.3 Secondary Events That Can Trigger a Duty to Disclose Merger Negotiations. Since there is a right to remain silent ("no comment") about merger negotiations, most often the triggering of the duty to disclose is the result of another disclosure duty such as the following:

3.3.1 Company's Repurchase of Stock. A company's repurchase of its own stock during merger discussions mandates the public disclosure of all undisclosed material facts including merger discussions. The defense of silence is not operative when a company is trading in its own securities.

3.3.2 Insider Trading. The limitation on insider trading in the company's securities during the time of merger negotiations is essentially the same as discussed in Section 3.3.1 above.

3.3.3 Selective Disclosure ("Leaks"). If a company believes that there is public trading in its securities on the basis of leaks about merger negotiations, the duty of disclosure can be triggered.

3.3.4 SEC Disclosure Forms. Certain line items of SEC forms specifically require disclosure of negotiations (e.g. Item 7 of Schedule 14 D-9). And, for instance, a Schedule 13-D filed by a controlling stockholder may have to be amended at the beginning of discussions with a target company about a going private transaction proposal.

3.3.5 Duty to Correct Prior Statement. A company has a duty to correct prior disclosures that were false or misleading when made. See *In re Healthcare Compare Corp.*, 75 F.2d 247 (7th Cir. 1996).

3.3.6 Duty to Update a Prior Statement. When a prior statement is continuing to be relied on by investors in the market place, the courts have imposed a duty on a company to update the statement when there is a material change. See *Ross v. A.H. Robins*, 465, F. Sup. 904 (S.D.N.Y. 1979).

3.4 Practical Guidelines in Managing the Disclosure of Merger Negotiations.

3.4.1 Legal Counsel Should Be Consulted Regarding Whether Current Discussions/Negotiations Trigger the Duty to Disclose.

3.4.2 Trading Activity in the Company's Securities Should Be Closely Monitored for Potential Trading on Leaks about the Negotiations.

3.4.3 Trading by Insiders Should Be Closely Monitored During Negotiations.

3.4.4 An Appropriate "No Comment" Policy about Mergers Should Be Adopted and One Person should be Designated Spokesperson to Handle Any Inquiries.

3.4.5 The Filing of Periodic Reports and Other Forms with the SEC Should Be Carefully Scrutinized When there are Current Merger Negotiations.

3.4.6 An Understanding as to Timely Disclosures Should Be Reached with the Other Party in the Negotiations.

4. OBLIGATIONS OF THE TARGET'S BOARD OF DIRECTORS IN CHOOSING AMONG/EVALUATING BIDS AND DEALING WITH A POST-AGREEMENT INTERLOPER. The board of directors of a public company, in pursuing a sale of the company, typically faces a number of issues regarding the discharge of its fiduciary duties.[1] In fact, in an substantial percentage of transactions involving the sale of a public company, there are shareholder suits asserting that the board of directors has breached it fiduciary duties in one or more respects. This portion of the outline summarizes the fiduciary duties of directors in connection with the sale of a company and addresses certain issues raised when choosing among competing bids and by the emergence of a third party bidder/interloper following the execution and delivery of an agreement providing for the sale of "control".

4.1 Fiduciary Duties of the Board of Directors.

4.1.1 General. As more fully described below, the board of directors of the target has certain fiduciary duties that it must fulfill in connection with a sale of the target, including, in the context of a sale of control of the target, a duty to maximize shareholder value. If the board of directors of the target does not fulfill its fiduciary duties in connection with the contemplated transaction, the individual directors may suffer financial liability and injury to their reputations. In addition, the transaction may be enjoined, denying the acquiring party the benefits of the transaction, and, potentially, leaving the acquiring party with no way to recover the expenses it

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1. In theory, the same duties apply to directors of private, as well as public, companies; however, existing case law usually, if not always, involves public companies. As a practical matter, the fiduciary duty concerns (including those regarding maximizing shareholder value) that arise with respect to public companies usually do not arise, or do not rise to the same level, in transactions involving private companies.

incurred in pursuing the transaction. Accordingly, it is in the best interest of the acquiring party, as well as the target, to ensure that the board's conduct fulfills its fiduciary duties.

4.1.2 Governing Law. Most of the cases dealing with the duty of directors in connection with mergers and acquisitions and acquiring party protections involve Delaware companies and, accordingly, have been decided by Delaware courts under Delaware law. This portion of the outline, therefore, focuses on Delaware cases and statutory law. In transactions involving the law of states other than Delaware, practitioners and courts frequently look to Delaware for guidance. *See, e.g., Priddy v. Edelman*, 883 F.2d 438, 443 n.* (6th Cir. 1989) (where the target was a Michigan corporation and Michigan law governed the plaintiff's common law claims: "[n]oting that the Michigan courts generally follow Delaware law in the absence of Michigan case law on particular corporate law issues, . . . the district court looked to Delaware law" (citation omitted)). Indeed, it is sometimes difficult to get practitioners to consider any law other than Delaware no matter how appropriate such consideration might be.

4.1.3 The Business Judgment Rule.

(A) The Traditional Business Judgment Rule. "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *see also* DEL. CODE ANN. tit. 8, § 141(a) (1998). The business judgment rule is an affirmation of the "managerial prerogatives of Delaware directors." *Aronson*, 473 A.2d at 812.

The rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* (citation omitted); *accord Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360-61 (Del. 1993) ("*Technicolor I*"). Stated differently, the business judgment rule is more than a defense; it is a presumption that the directors have acted appropriately. *See generally*, *Technicolor I*, 634 A.2d at 361; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). This presumption is valuable because "[a]bsent an abuse of discretion, [the directors'] judgment will be respected by the courts." *Aronson*, 473 A.2d at 812. In other words, "a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.'" *Unocal*, 493 A.2d at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (1971)). In fact, the burden of proof is on the party challenging the directors' decision to establish sufficient facts to rebut the presumption. *Aronson*, 473 A.2d at 812. The business judgment rule creates a similar presumption in most other states as well. *See* D. Block, S. Radin and N. Barton, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (Prentice Hall Law & Business, 4th Ed. 1993) (hereinafter "*Business Judgment Rule*").

It is important to note that while directors possess the power to manage the corporation, "[t]he existence and exercise of this power carries with it

certain fundamental fiduciary obligations to the corporation and its shareholders." *Aronson*, 473 A.2d at 811 (citation omitted). Specifically, in exercising their discretion, directors owe a duty of care and a duty of loyalty to the corporation's shareholders.

(B) Requirements for Application of the Business Judgment Rule. In order for a director to be entitled to the presumptions of the business judgment rule, at least three basic requirements must be met:

- A decision must be made which is later challenged as breaching the fiduciary duty of the director.
- In reaching the decision, each director must have fulfilled (or not breached) his or her duty of care.
- In reaching the decision, each director must have fulfilled (or not breached) his or her duty of loyalty to the corporation.

Failure to meet any of the foregoing requirements results in an opportunity for the plaintiff to rebut the rule's presumption that decisions were made on an informed basis, in good faith, and in the best interests of the corporation, and the burden of proof is shifted from the plaintiff to the defendant director.

(i) Decision. "[T]he business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act." *Aronson*, 473 A.2d at 813; *see also Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993) (citation omitted); *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 275 (2d Cir. 1986). Accordingly, the directors must make a decision or determination to act or refrain from acting. Ignoring a situation or failing to actually make a decision can result in loss of the protection of the rule for the directors involved. *See Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

(ii) Duty of Care. In order to invoke the rule's protection, "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties." *Aronson*, 473 A.2d at 812; *see also Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

The duty of care turns in large measure on the process utilized by the board in reaching its decision. Prior to making a decision, directors must consider all relevant information and engage in appropriate deliberations. The issue for counsel frequently is to determine when the directors are sufficiently informed and when their decision-making process has been appropriately deliberative. In short, when have the directors done enough to satisfy their duty of care? This determination can be very fact specific and subjective.

For an example of conduct of a board of directors in connection with a sale of control that failed to meet the duty of care, see *Van Gorkom*, 488 A.2d 858.

(iii) Duty of Loyalty. The business judgment rule assumes directors give their undivided loyalty to the corporation. When one or more directors have an interest in a decision made by them, the business judgment rule may not be available. In that circumstance, the burden of proof shifts to the board to show its decision was "entirely fair" to the corporation and its shareholders. In other words, the directors must prove that the transaction was the product of both fair dealing and fair price. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989). This standard is known as the "entire fairness test," and in the case of mergers and acquisitions, it means the court must review the entire transaction to determine whether or not it was fair to the corporation and its shareholders.

The more difficult issue is determining when the interest of a director in a transaction causes the entire board to lose the presumption of the business judgment rule. This issue was addressed in *Cinerama v. Technicolor Inc.*, 663 A.2d 1156 (Del. 1995) ("*Technicolor II*"), where the Delaware Supreme Court affirmed the Chancery Court's conclusion that the action of an entire board could be tainted and the business judgment rule not be available where:

(a) although less than a majority of directors had a material interest, those interested controlled or dominated the board; or

(b) the interested directors failed to disclose their interest and a reasonable board member would have believed the existence of the material interest significant in evaluating the proposed transaction. *Id.* at 1168.

The Delaware legislature has provided a safe harbor for contracts and transactions involving an interested director. Section 144(a) of the Delaware General Corporation Law provides that a contract or transaction in which a director has an interest is not void or voidable if:

— a director discloses any personal interest in a transaction to the board or committee and the board or committee authorizes the transaction by vote of a majority of the disinterested directors on the board or committee;

— a majority of the shareholders approve the transaction by good-faith vote and are also aware of the director's interest; or

— the transaction is fair to the corporation as of the time it was approved by the board or the shareholders.

DEL. CODE ANN. tit. 8, § 144(a) (1998).

However, Section 144(a) does not address the issue of director liability or the availability of the business judgment rule under the circumstances outlined.

4.1.4 Board Conduct and Corporate Control.

(A) Contests for Corporate Control; Enhanced Scrutiny. A number of the early cases regarding board conduct in connection with a sale of the company arose in the context of contests for corporate control. In a contest for control of the company, Delaware courts will not automatically apply the business judgment rule but will first review the board's action and process under a standard of "enhanced scrutiny." *See, e.g.*, *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994). The same standard is applied to adoption of defensive measures. *Unocal*, 493 A.2d at 954.

Unocal. *Unocal* is the landmark case involving "enhanced scrutiny" in the context of defensive measures or actions which might inhibit future takeover efforts. The board of directors of Unocal, in response to the commencement of a two-tier "front loaded" cash tender offer by Mesa, the owner of 13% of Unocal's stock, decided that it should institute a stock repurchase plan, excluding Mesa.

The *Unocal* court adopted a two-prong test for determining whether or not the business judgment rule applies to defensive measures adopted by a board. First, were there reasonable grounds for the board to conclude a danger to corporate policy existed? Second, was the defensive measure taken reasonable in relation to the threat posed? *Id*. at 955. This same test was discussed in *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995) ("before the board is accorded the protection of the business judgment rule, and that rule's concomitant placement of the burden to rebut its presumption on the plaintiff, the board must carry its own initial two-part burden") (citing *Unocal*). If the board carries its burden on each of these issues, then it is entitled to the benefits and protection of the business judgment rule. *Unocal*, 493 A.2d at 954-56.

The first prong of the test is satisfied "by showing good faith and reasonable investigation." *Unocal*, 493 A.2d at 955 (quoting *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964)). "Furthermore, such proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards." *Unocal*, 493 A.2d at 955. With respect to the second prong, "[a] corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available." *Id.* "[D]efensive measures which are either preclusive or coercive are included within the common law definition of draconian" and therefore exceed the proper proportionality. *Unitrin*, 651 A.2d at 1387-88.

(B) <u>Sale of Control; Stock for Stock/Strategic Mergers</u>. The responsibilities of a board of directors in the context of a sale of corporate control have been the subject of a significant amount of litigation. The duties of the board in this context can be generally illustrated by a review of *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990), and *QVC*.

(i) *Revlon*. The *Revlon* decision arose out of a battle for corporate control of Revlon, Inc. The court determined that once a sale or break-up of the company became inevitable, the board's duty was to maximize shareholder value. *Revlon*, 506 A.2d at 182.

> [w]hen Pantry Pride increased its offer to $50 per share, and then to $53 per share, it became apparent to all that a break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. ... The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

Id.

(ii) *Time*. Time had entered into a strategic stock merger agreement with Warner Communications, Inc. in which Warner shareholders would own approximately 62% of the common stock of the surviving entity. When Paramount subsequently made an unsolicited tender offer for 51% of Time's common stock at a significant premium to the market price and announced the tender offer would be followed by a back-end merger for cash and securities, Time restructured its merger with Warner for an immediate friendly tender offer for 54% of Warner, to be followed by a later purchase of the remainder of Warner. As restructured, the Warner transaction did not require approval of the Time shareholders.

The Delaware Supreme Court held there was no evidence that Time's board had triggered its *Revlon* duties because the break-up of Time had not been made inevitable as was the case in *Revlon*. *Time*, 571 A.2d 1140, 1150. The corporation neither initiated an active bidding process to sell itself nor abandoned its long-term strategy. In *Revlon*, the board responded to Pantry Pride's offer by contemplating a sale of assets. Thus, the court imposed upon the board a duty to maximize shareholder value. However, if "the board's reaction to a hostile tender offer is found to constitute only a defensive response and not an abandonment of the corporation's continued existence [as was the case in *Time*], Revlon duties are not triggered, though Unocal duties attach." *Id.* Furthermore, "[t]he adoption of structural safety devices alone does not trigger

Revlon. Rather . . . such devices are properly subject to a *Unocal* analysis." *Id.* at 1151.

(iii) *QVC*. *QVC* provided the Delaware Supreme Court with the opportunity to clarify both *Revlon* and the impact of *Time*, which permitted a corporation to rely on strategic objectives to avoid unwanted suitors, on *Revlon*. In so doing, the court provided an extended discussion of the importance of the sale of control and the standard of review that will apply to the conduct of a board of directors in the context of a sale of control.

Background. This case arose out of the contest between Viacom Inc. and QVC Network Inc. for Paramount Communications Inc. Paramount was a New York Stock Exchange listed company and a majority of its stock was "held by numerous unaffiliated investors". *QVC*, 637 A.2d at 37. Viacom was controlled by Sumner Redstone. *Id.* at 38. Paramount had a "goal of strategic expansion" that involved the consideration of acquisitions or mergers. *Id.*

Standard of Review. The court noted that "[u]nder normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled." *Id.* at 42 (citing *Aronson*, 473 A.2d at 812).

> Nevertheless, there are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable. The decisions of this Court have clearly established the circumstances where such enhanced scrutiny will be applied. ... The case at bar implicates two such circumstances: (1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to corporate control.

Id. (citations omitted).

In connection with a sale of control, directors

> have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.

Id. at 43.

As the court stated, quoting *Macmillan*,

> When *Revlon* duties devolve upon directors, this Court will continue to exact an enhanced judicial scrutiny at the threshold, as

> in *Unocal*, before the normal presumptions of the business judgment rule will apply.

Id. at 45 (footnotes and citations omitted).

Enhanced scrutiny will involve:

(a) a judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

Id.

However, under enhanced scrutiny, "courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness." *Id.* at 45. (citations omitted).

The Importance of Control; *Revlon* and *Time*. In its opinion, the *QVC* court devoted a significant amount of attention to the importance of control and, therefore, the reason for enhanced scrutiny. As a result of the Paramount-Viacom transaction, the Paramount stockholders would have a minority equity interest in Viacom and, accordingly, control of Paramount would pass from a "fluid aggregation of unaffiliated stockholders" to Redstone.[2] In effect, the sale of control overrides a corporation's strategic objectives: "Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision." *Id.* at 43. In addition, "the change in control would supplant the authority of the current Paramount Board to continue to hold and implement their strategic vision in any meaningful way. *Id.* at 50.

The defendants in QVC had argued that enhanced scrutiny was not appropriate "in the absence of a 'break-up' of the corporation." *Id.* at 46. Both *Revlon* and *Time* did use the term "break-up". However, the court found that the defendants had misinterpreted *Revlon* and *Time*. The court noted that a break-up is not necessary for *Revlon* duties to apply and cited several cases in which a change in corporate control gave rise to those duties. *Id.* With respect to *Time*, the court noted "that there was no change in control in the original stock-for-stock merger between Time and Warner

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2. *Id.* at 43.
The court noted that there will be a controlling stockholder who will have the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests.
Id.

because Time would be owned by a fluid aggregation of unaffiliated stockholders before and after the merger ... ." *Id.*

In effect, the court held that it was not setting a new standard in *QVC* or overruling anything in *Revlon* or *Time*, in spite of the significant discussion devoted to the importance of control; *QVC* was consistent with both of those cases. Accordingly, *QVC* reaffirms the holding in *Time*, that a stock for stock merger between two public companies will not necessarily constitute a change of control and thus will not necessarily trigger *Revlon* duties. *Id*. at 47. This is intuitive, for if the stock of both companies is widely dispersed, then control merely moves from one unaffiliated group of shareholders to another, notwithstanding that management of the surviving company may be quite different for some of the shareholders. But, at least where there will be a clear change of control, *Revlon* duties will apply and the requirement that the board maximize shareholder value cannot be avoided.

4.2 Choosing Among/Evaluating Bids for the Target.

4.2.1 The Target Board's Duties. As discussed above, if control is being sold, the board of directors the target has a duty to maximize shareholder value. As also discussed above, the target board has certain fiduciary duties that it must fulfill. Accordingly, in conducting a sale process and evaluating bids for the target, the target's board of directors must act in good faith, with due care, and in a disinterested fashion (the duty of loyalty). Obviously, then, plaintiffs challenging board action in this area claim that the board's conduct has failed in one or more of those aspects. The cases involving the board's actions with respect the conduct of a sale process and the evaluation of bids where control is being sold are quite fact intensive.

Once the sale process gets to the "final bid" stage and final bids are received, the board must then choose among the bids. Under *Revlon*, the board would be obligated to choose the bid with the highest nominal value, all other things being equal. However, it is doubtful that "all other things" will ever be "equal". Accordingly, the board of directors of the target must evaluate the competing bids to determine which one actually maximizes shareholder value. Even "the highest bid is not necessarily the best bid." *Caruana v. Saligman*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,889 at 99,380 (Del. Ch. Dec. 21, 1990) (citation omitted).

4.2.2 Proper Board Considerations. The court in *Revlon* acknowledged that a board may consider "various constituencies" outside of the context of a sale of control; however, non-stockholder interests are irrelevant where control is being sold.

> A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. *Unocal*, 493 A.2d at 955. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

506 A.2d at 182.

4.2.3 Alternate Constituency Statutes. A number of states, although not Delaware, have adopted statutes permitting (and in some cases, requiring) a board of directors to consider "alternate constituencies" in connection with a contest for corporate control. *See, generally, Business Judgment Rule* at 330-39. Under these statutes, the board of directors of the target may (and in some cases, is required to) "consider the interests of employees, suppliers, creditors, consumers, and, in some jurisdictions, the local and national economies and society as a whole." *Id.* at 333 (footnote omitted). Some statutes go even further, stating that the board of directors does not have to consider any particular interest as "dominant or controlling". *Id.* at 335.

4.2.4 Ability to Rely on Experts. The duty of care does not impose upon directors a requirement that they themselves be or become experts in the matters presented for their action. As a practical matter, directors often will have to rely on the advice and opinions of professionals and experts in coming to a decision. Indeed, Section 141(e) of the Delaware General Corporation Law provides that directors

> shall . . . be fully protected in relying in good faith upon . . . information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation. DEL. CODE ANN. tit. 8, § 141(e) (1998).

It is customary for boards and special committees to retain outside financial advisors in connection with a sale of control. Delaware courts have made it clear that not only must experts be selected with reasonable care, but the board or committee is also required to actively and directly oversee the experts in order to rely upon them. *Mills Acquisition*, 559 A.2d at 1281. And it is widely accepted that in order to meet this standard the advisor must be independent. Although past representation of the corporation will not give rise to disqualification *per se*, it is a circumstance which must be reviewed carefully. *See*, *In re Oracle Sec. Litig.*, 829 F.Supp. 1176, 1189-90 (N.D. Cal. 1993) (in-house attorney could not be relied upon in giving advice concerning settling litigation against officers of the corporation with whom he served); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978) (counsel to parent company could not give wholly independent advice because he was primarily interested in the parent company).

Similarly, investment bankers must be independent to be relied upon to give advice to a board of directors or a committee. *In re Tri-Star Pictures Litig.*, 634 A.2d 319, 323 (Del. 1993). Thus, the investment banker's compensation arrangement should be structured so as to avoid creating a question about independence.

Where non-cash consideration is involved, the "nominally highest" bid may not, in fact, be the highest bid. The non-cash consideration must be valued. Where that value may not be readily apparent to, or otherwise easily ascertainable by, the board of directors of the target, the board will likely rely on one or more investment bankers to value the non-cash consideration. *See, e.g., In re RJR Nabisco, Inc. Shareholders Litigation*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,712 (Del. Ch. Jan. 31, 1989), *appeal refused*, 556 A.2d 1070 (unpublished opinion, text available at 1989 Del. LEXIS 42 and 1989 WL 16907) (Del. Feb. 2, 1989). As was the case in *RJR Nabisco*, there may be a number of

reasons why the non-cash consideration is not worth the nominal amount claimed by the bidder.

4.2.5 Some Factors Applicable to the Determination of the "Best Bid". As indicated above, although the board of directors of the target has a duty to maximize shareholder value in connection with a sale of control, that does not mean that the board must simply select the highest bid. In choosing among bids, target board of directors may look to a number of other factors to determine which bid is in fact the "best bid". Courts have found a number of factors to be relevant in the evaluation of competing bids, including the following:

> The components of the various bids. *See, e.g., Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 63 (Del. 1990), (where the board chose an all cash offer over one of uncertain terms and valuation consisting of cash and securities); *RJR Nabisco* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,713 (where the chosen bid provided for a greater equity participation in the acquiring entity by the current target stockholders, although the cash component of the chosen bid was $3 less per share than in the other bid); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781 n.6 (Del. Ch. 1988); and *Cottle v. Storer Communications, Inc.*, 849 F.2d 570, 577 (11th Cir. 1988) (where the cash component of the chosen bid was $7.50 higher than that of the competing bid, although the chosen bid was $2 per share lower than the competing bid).

The risk associated with the financing for a transaction. In *Priddy v. Edelman*, 883 F.2d 438, 444 (6th Cir. 1989), the court found that the second step merger under one proposal was "particularly risky".

> The proposed $51 per share buyout in cash or nominally equivalent securities was contingent on corporate assets being sold quickly enough and at a high enough price to raise sufficient cash to make the payments. The Edelman group refused to commit itself to any definite timetable for completing the liquidations necessary to finance the second step of the takeover. ... [T]here was considerable doubt as to whether [the target's] remaining operations could produce enough revenue to service the debt that the company would have to take on to finance the $51 per share payout.

Id. (citation omitted).

See, also, Fairchild Camera, 569 A.2d at 66-67.

The antitrust implications of the various bids, which could result in a delay or prohibition against consummating a particular transaction. *See, e.g., J.P. Stevens*, 542 A.2d at 781 n.6, and *Fairchild Camera*, 569 A.2d at 63.

The tax consequences of the proposed transactions. *See, e.g., Cottle*, 849 F.2d at 577.

See, generally, Business Judgment Rule at 304-05.

4.2.6 *RJR Nabisco*. *RJR Nabisco* provides a good discussion of a number of the matters described above. In *RJR Nabisco*, the plaintiffs sought to enjoin the consummation of a tender offer for outstanding shares of RJR Nabisco. Among other things, the plaintiffs challenged the "good faith" of the special committee that oversaw the company's auction process and argued that the special committee breached its duty of care.

Background. This case arose out of the series of events that began when Mr. F. Ross Johnson, the president and chief executive officer of RJR Nabisco, informed the board of directors of the company on October 19, 1988 that his group was developing a proposal to take the company private through a leveraged buyout. Mr. Johnson's group included members of senior management, as well as Shearson Lehman Company and Salomon Brothers, Inc. (the "Management Group"). Mr. Johnson suggested a price of $75 per share. At the time, "RJR's common stock was trading on the New York Stock Exchange in the mid 50's." *RJR Nabisco* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,701.

The next day, the board issued a press release announcing the proposed transaction and the creation of a special committee of the board (the "Special Committee") to deal with the transaction. The Special Committee retained two financial advisors, Dillon, Read & Co. (the Company's regular investment banker) and Lazard Freres, Inc., and legal counsel.

On October 24, 1988, Kohlberg Kravis Roberts & Co. ("KKR") informed the Special Committee that it was planning to make an offer to acquire the company for $90 per share in cash and securities. Shortly thereafter, KKR commenced a tender offer for the company's stock.

On November 2, the Special Committee issued a press release announcing that it was interested in receiving proposals to acquire the Company. Shortly thereafter, the Special Committee established certain rules for the submission of proposals. The rules set 5:00 p.m. on November 11, 1988 as the deadline for the submission of bids. The rules specified that they were "intended to constitute a single round of bidding" and that any proposal "should reflect the potential purchaser's highest offer." *Id.* at 91,703. "The Special Committee also stated that it `encourage[d] proposals that provided to current RJR shareholders a prospect for a substantial common stock related interest in the purchasing entity.'" *Id.*

The Initial Bids. The Special Committee received three bids by the designated deadline.

Management Group Bid. The Management Group made a bid that it valued at $100 per share, "consisting of $90 in cash, $6 in preferred stock and an equity interest of $4." *Id.* at 91,704.

KKR Bid. KKR made a bid that it valued at $94 per share, consisting of "$75 in cash, $11 in preferred stock and $8 in convertible debentures (which would convert into 25% of the purchasing entity's equity)." *Id.*

First Boston Bid. First Boston Corporation made a bid, which was not "fully developed", which "contemplated an acquisition of the Company's tobacco business in 1989 for approximately $15.75 billion in cash and warrants, and an installment sale of the Company's food businesses immediately (by year end 1988), with the

proceeds of that sale to be held for the account of the [RJR] shareholders." *Id.* The estimated value of the proposal was "$98 to $110 per share in cash and cash equivalents, securities valued at $5 and warrants valued at $2-$3. The warrants would entitle RJR shareholders to acquire up to 20% of [RJR's] tobacco business." *Id.*

Extension of the Auction. The court noted that

> "[t]he First Boston approach was innovative, appealing and problematic. Its primary appeal lay in the fact that the installment sale mechanism would provide tax advantages estimated to be as high as $3 billion. There were two difficulties, however, with this proposal. First, its terms were not fully worked out. Second, impending changes in the tax code created time constraints which placed the realization of those tax benefits at risk."

Id.

Because the First Boston proposal "was at this point potentially the most attractive, that more time was necessary to develop it further," the bidding was extended to November 29. *Id.* The court noted that bids "were actively solicited by the Committee's investment bankers" during the extension. *Id.*

The second round of bids. Each of the bidders submitted a new bid by the new deadline. The Management Group valued its new bid at $101 per share, consisting of $88 cash, $9 preferred stock, and $4 convertible preferred stock. *Id.* KKR valued its bid at $106, consisting of $80 cash, $17 preferred stock and $8 automatically converting debentures. *Id.* The value of the First Boston's bid was in a range of $103 to $115. *Id.*

The Special Committee concluded that the First Boston bid "while attractive, was subject to too much uncertainty to be practicable." *Id.*

> Between the remaining bids, KKR's bid plainly appeared to be the higher if the securities included in the bids were worth what the bidders claimed. The Committee determined that before it would choose between these two bids it would seek to assure that KKR's higher bid was worth what it claimed. Accordingly, it directed its lawyers and investment bankers to negotiate the terms of the securities and the details of the merger agreement.

Id.

> Further Bidding. In response to a request from the Management Group, the Special Committee agreed to consider new bids, even though the November 29 deadline had passed. *Id.* at 91,705. Additional bidding in fact occurred.
>
> The Final Bids. The following final bids presented to the Special Committee:
>
>> Management Group Bid. The Management Group valued its final bid at $112 per share, which consisted of $84 in cash, $24 in pay-

> in-kind preferred stock and $4 in convertible preferred. *Id.* at 91,706.
>
> KKR Bid. KKR valued its bid at $109 per share, which consisted of "$81 in cash, $18 in pay-in-kind preferred stock and $10 in convertible debentures. *Id.* at 91,707.

Valuation. The Special Committee's financial advisors valued the Management Group's bid between $108.50 and $109 per share and the KKR bid between $108 and $108.50 per share. *Id.* at 91,708. The advisors discounted the value of the securities included in the Management Group's bid and the pay-in-kind preferred stock included in the KKR bid based on certain financial terms of the securities. *Id.*

> Based on these valuations, the unprecedented size of the debt offerings of high yield securities involved, and the inherent limitations of predicting future markets, the investment advisors concluded that the bids were substantially equivalent. Both investment bankers advised the Committee that, in their view, the Committee could exercise sound business judgment in recommending either offer, and that they were prepared to give fairness opinions on either transaction.

Id.

The minutes of the meeting of the Special Committee noted that, in choosing between the two bids, the committee considered several factors, including the risk that further negotiations could result in the withdrawal of a bidder, the higher equity interest offered in the KKR bid, the KKR proposal contemplated that a substantial part of the food business would remain in the company going forward and the fact that the amount of pay-in-kind securities involved in both bids was unprecedented and that the Management Group bid provided for $1.5 billion more of such securities. *Id.* Based on the cited considerations, "and without attempting to seek a higher bid from either party, the Committee elected to recommend the KKR bid ...". *Id.*

Good Faith. The plaintiffs argued that

> the Special Committee was not motivated in good faith to seek the best available transaction regardless of whose deal it was, but rather, was motivated to see that the Management Group did not succeed even if it would, marginally at least, pay more. This motivation is explained by a posited desire by the members of the Special Committee to disassociate themselves from public criticism directed against [Ross Johnson] and the avarice his initial proposal was said to represent. This inappropriate desire resulted, it is claimed, in (1) the premature termination of the auction, and (2) the choice of a demonstratively lower bid.

Id. at 91,711 (footnote omitted).

The defendants made two arguments in response: First, favoring one bidder over another for "private reasons" does not constitute bad faith under Delaware law; "only pursuit of financial interests opposed to those of the corporation and its shareholders counts in the evaluation of director good faith." *Id.* Second, the defendants argued that they had acted in good faith throughout. *Id.*

With respect to the defendants' first argument, the court stated that neither of the cases cited by the defendants "can be read to hold that the protections of the business judgment rule would be available to a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to the pursuit of the corporation's best interest." *Id.*

"Plaintiffs' argument with respect to motivation is built upon inferences from a series of acts or decisions that are claimed to be explicable only by a desire to favor KKR even if it meant not getting the best available transaction for the Company's shareholders." *Id.* The cited acts/decisions included the failure to break the "tie" in the auction and the choice of the KKR bid even though it provided $3 less in cash, which was really worth $3 less than the Management Group bid, and presented certain antitrust problems. *Id.*

> Consideration of this argument does not, however, require consideration of each of these elements. For present purposes, consideration of the critical elements would appear sufficient.

Id.

The court focused on what it considered the "critical elements" of the plaintiffs' arguments, which were the decision not to attempt to break the tie and the choice of the KKR bid over the Management Group bid.

In assessing the good faith of the Special Committee with respect to its decision to accept one of the two competing bids without attempting to break the tie, the court noted two "circumstances":

"First, the consideration offered in both proposals contained complex securities not susceptible to intuitive evaluation." *Id.* at 91,712. Accordingly, the Special Committee was entitled to rely on the advice of its experts as to value. "In this instance, the Committee did receive the advice of Lazard Freres and of Dillon Read that when the respective securities were appropriately valued, they regarded the bids as substantially equivalent." *Id.*

The court noted that the plaintiffs attempted to "show that the opinion was not only incorrect but was implausible. From this the plaintiffs would infer a motive to favor KKR (the unspoken link being the assumption that the bankers detected a preference by the Committee and fell in with it)." *Id.* The court could not conclude that the work of the bankers was flawed. The court found "quite sufficient bases to conclude that the opinions ... were competent and reached in good faith". *Id.*

Second, "the Committee had been placed under severe time constraints by KKR in submitting its final proposal -- the Committee was given thirty minutes to accept the bid on pain of its being withdrawn." *Id.* The court acknowledged that this may have been an "empty threat." *Id.* However, given that threat and the advice that they were at the upper end of the range of values for RJR Nabisco, "the decision not to break the tie and accept one of the bids and thus avoid the risk of loss of that bid ... can in no event be seen as justifying an inference that those who made such a choice must have had some motivation other than the honest pursuit of the corporation's welfare." *Id.* at 91,713 (citation omitted)

With respect to the fact that KKR's bid provided for $3 less per share in cash and was nominally less than that of the Management Group, the court found that choosing the KKR bid was not "so beyond the bounds of reasonable judgment as to raise an inference of bad faith". *Id.*

> The larger equity stub, the different future business plans of the two bidders, and the superior reset provision of KKR's proposed converting debentures, all provide a basis to support the notion that the choice was a rational one. That KKR as an acquiror presented antitrust questions or offered a somewhat lower proportion of cash simply presents an occasion for the exercise of judgment; the judgment reached does not, as indicated, appear so far afield as to raise a question of the motivation of the board.

Id.

Duty of Care. The plaintiffs claimed that the board breached its duty of care, arguing that "no person exercising even minimal care 'could have believed with any degree of certainty that at the time the auction was aborted either bidder's best, highest or final offer had been received." *Id.* at 91,702. The court noted that in order to succeed on this claim, the plaintiffs would have to prove that "in electing to sign the KKR proposed merger agreement, the directors were grossly negligent." *Id.* at 91,713.

The court stated that it could not find gross negligence in this case "under no responsible meaning of those words ... there appears to have been no neglect of duty of any sort in this instance." *Id.* "This would appear quite evident given the amount of attention the directors lavished upon this important transaction and the responsible steps they took to be completely advised concerning the alternatives open to them." *Id.*

Nevertheless, the court did address the issue of whether, in failing to continue the auction, the directors failed to fully inform themselves of all relevant information reasonably available, as required by the business judgment rule. "If the plaintiffs argument that the Special Committee was negligent is to be rejected ..., it is necessary to show that the Committee had `all material information reasonably available' at the time it decided to accept the KKR proposal without going back to invite a tie breaking round of bids." *Id.* at 91,713-14.

The court found a "compelling answer to this position." *Id.* at 91,714.

> It is premised upon the insight, upon the fact, that information has costs and it focuses verbally on the word "reasonably" in the *Aronson* formulation. It concludes that the amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make. ...
>
> Clearly, more information was available to the Committee on the cental question would either party pay more. Just ask and you may find out (if the answer is yes, time would of course be necessary to evaluate if another proposal *was* worth more). But in this setting, the act of asking another time for the highest and best bid *might* itself have costs. It is not inconceivable that KKR [protected by an expense reimbursement] could have walked away from the transaction. Thus, the risks (costs) associated with getting more information had to be weighed by the Committee against the likely benefits. The Rohatyn testimony (and it is not alone in this) tends to establish that the Committee addressed this question with due care. It concluded that in the circumstances (the stage of the auction, the level of the prices, the events of the day, etc.), the risks outweighed the potential rewards. ... [T]his important decision is itself entitled to the deference courts give to business decisions made by disinterested directors with care in the honest pursuit of the corporation's interest.

Id. (citation omitted)

The court concluded that

> the Committee had at the time it made its decision "all material information reasonably available" to it. Moreover, there is ... no sufficient evidence that it then failed "to act with requisite care" thereafter in reaching the particular decision to prefer the KKR proposal.

Id. (citation omitted)

4.3 Post-Agreement Interloper: Intervention of a Third Party Bidder in a Sale of Control. The reality is that the mere existence of an definitive agreement between a bidder and a target does NOT preclude a third party bidder from making an offer to acquire the target and, in fact, effecting such acquisition. Indeed, because shareholder approval is typically necessary, either through the tender of stock or a vote, it would be quite difficult to complete a transaction where an economically superior transaction has been publicly proposed. In addition, as a legal matter, in the absence of a full auction, an agreement that completely forecloses the possibility of a third party bid (either through restrictions on conduct of the target or the imposition of draconian economic consequences in the event the target were to accept a third party bid) would not be enforceable. So, the question is what happens if, after a bidder and a target have signed a definitive agreement, a third party bidder comes along. Assuming that there was no auction and that the definitive agreement is enforceable, the question then becomes what does the agreement provide on this issue? Typically, the agreement will contain a "no-shop" provision restricting the ability of the target to act with respect to a third party bidder. However, the typical agreement will also contain a post-agreement market check and a fiduciary out, which permit the target, under certain

circumstances, to respond to a third party bid, terminate the existing agreement and accept the third party bid.[3]

4.3.1 No-Shop Provisions; Auctions; Post-Agreement Market Checks; Fiduciary Outs.

(A) No-Shop Provisions. The bidder usually insists on a "no-shop" provision. These provisions typically prevent the target, its directors, officers, employees and representatives (*e.g.,* investment bankers) from soliciting other bids or providing information to, or entering into discussions or negotiations with, other potential bidders. As one would expect, these provisions are usually very broadly drafted, often providing that none of the enumerated persons may take any action to facilitate any other acquisition proposal or actions which may reasonably be expected to lead to an acquisition proposal. These provisions can have the effect of ending the bidding process or inhibiting other bidders and thus could be viewed as restricting the ability of the board to maximize shareholder value. Frequently, these clauses are subject to a “fiduciary out”, which is described below.

The merger agreement between American Bankers Insurance Group, Inc. and American International Group, Inc. contained a very restrictive no-shop provision that is probably more properly described as a "no-talk" provision. That provision prohibited the target from supplying confidential information to, or engaging in negotiations with, a third party bidder, unless 120 days had passed since the date of the agreement and the agreement had not been approved by the target's stockholders.

(B) No Auction Requirement. Although the *Revlon* court referred to directors as "auctioneers" who are charged with the duty of obtaining the best price for the stockholders at a sale of the company, subsequent cases have made it clear that directors are not required to perform a traditional auction in order to satisfy their *Revlon* duties. *Barkan v. Amsted Industries*, 567 A.2d 1279, 1286 (Del. 1989) ("*Revlon* does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest.") The procedures applied by the board must be sufficient to supply them with adequate information to make the best determination for shareholders, but "there is no single blueprint that a board must follow to fulfill its duties." *Id.* "A stereotypical approach to the sale and acquisition of corporate control is not to be expected . . . . Rather, a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith." *Id.*

3. It would appear that after a complete auction process where the highest bidder has been selected by virtue of having the highest bid and all other bidders have had an opportunity to match it, an absolute prohibition against providing information to, or entering into discussions with, a third party bidder may be acceptable. In that situation, there would be no opportunity for a post-agreement market check and there would be no fiduciary out.

(C) Market Checks and Fiduciary Outs. Few, if any, targets actually conduct a public auction. Instead, a target and its investment bankers may conduct a "controlled" or "private" auction. Short of a controlled auction, the target's investment bankers may "canvas the market" by contacting potential strategic and financial buyers to simply gauge their interest in pursuing a transaction. Sometimes, however, targets do not conduct any form of auction, and no canvas of the market is performed, prior to the execution of a definitive agreement providing for the sale of the target. If a bidder has not conducted a public auction, then, how does the board assure itself that it has met its duty of care and maximized shareholder value?

In several cases, the Delaware courts have considered whether a post-agreement "market check" was sufficient for the board of directors to fulfill its fiduciary duty. These provisions typically permit a target to entertain proposals from third party bidders. In effect, a post-agreement market check permits the market to confirm whether the board has maximized shareholder value and is a limitation on the scope of the no-shop provision. Should a superior proposal emerge, the "fiduciary out" provision of the existing agreement would permit the target to terminate that agreement and enter into an agreement with the third party bidder. As a practical matter, targets will always insist on a post-agreement market check and a fiduciary out, with the possible exception described in note 3 above.

In *In re Fort Howard Corp. Shareholders Litig.*, 14 Del. J. Corp. L. 699, 705 (Del.Ch. Aug. 8, 1988), the company did not conduct an auction. Rather, it "negotiate[d] provisions purportedly intended to permit an effective check of the market before the [transaction] could close." *Id.* The company had the right to and would entertain alterative proposals. That was made clear in a joint press release issued by the company and the acquiring party. The court concluded that this approach "was effective to give the board an informed, dependable basis for the view that the [proposed transaction] is the best available transaction from the point of view of the [company] shareholders." *Id.* The court found this approach "was reasonably calculated to (and did) effectively probe the market for alternative possible transactions." *Id.* at 720.

Similarly, in *Roberts v. General Instrument Corp.* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,465 (Del.Ch. Aug. 13, 1990), the target, General Instrument Corp., did not conduct an auction prior to entering into a definitive merger agreement. The merger agreement provided that the company would not solicit alternative buyers and that its directors and officers would not participate in discussions with or provide any information to alternative buyers "except to the extent required by the exercise of fiduciary duties." *Id.* at 97,403. In addition, the merger agreement permitted the company to terminate the agreement if the board determined that a third party offer was on terms more favorable to the company's stockholders than those reflected in the merger agreement. *Id.* Upon such termination, the company would be obligated to pay a fee of $33 million. In connection with the execution of the merger agreement, a press release was issued announcing the fact that the acquiring party would receive a $33 million fee if the board were to accept a higher unsolicited offer. The court noted that the board "would seem to have had adequate information to enter into" the merger agreement and found that

> the merger agreement contained a sufficient fiduciary out, a limited (2%) break-up fee and a sufficient extension of the closing date of the tender offer to permit the board to reasonably conclude that if this deal closed it would represent the best available transaction.

Id. at 97,405.

See also, *In re Formica Corp. Shareholders Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94362 at 92,393 (finding a 30 business day market test period to be an adequate procedure to effectively probe the market for possible alternative transactions).

In addition to containing the very restrictive "no-talk" provision referenced above, the merger agreement between American Bankers Insurance Group, Inc. and American International Group, Inc. contained a very restrictive fiduciary out termination provision. That provision prohibited the target from terminating the agreement to accept a third party offer until the 180th day following the date of the agreement.

4.3.2 The Typical No-Shop and Market Check Provisions. As noted above, the typical no-shop provision prohibits the target and its representatives from soliciting alternate proposals. However, the market check provision acknowledges the board's fiduciary duty and permits the board to take certain actions that are designed to ensure that the board has maximized shareholder value. Set forth below is a brief summary of the components of the typical no-shop and market check provisions:

Notification. The typical no-shop provision requires the target to notify the bidder of the third party inquiry and to identify the third party.

Target Evaluation of Third Party Bid and Legal Requirements. No-shop provisions typically prohibit the target from engaging in discussions with, or providing information to, the third party unless the board has determined, after consulting with its financial advisor, that the third party's proposal is, or discussions with the third party are likely to result in a proposal that is, more favorable to the target. Sometimes this provision is more broadly drafted, in that it requires that the board also make a determination, after consulting with its outside counsel, that its fiduciary duties require it to act in the manner otherwise prohibited.

Confidentiality Agreement. No-shop provisions typically prohibit the target from providing confidential or non-public information to any third party bidder unless that bidder has executed and delivered a confidentiality agreement with respect thereto. Often, the no-shop provision provides that the confidentiality agreement with the third party bidder may not be more favorable to the third party bidder than the confidentiality agreement executed and delivered by the bidder that is a party to the existing acquisition agreement.

Updating. No-shop provisions often require the target to update the bidder, on a prompt (or perhaps, immediate) basis, on the status and terms of any discussions or negotiations with any third party.

Pre-termination Notification. The fiduciary out provisions typically require the target to notify the bidder a specified time prior to endorsing or accepting a third party bid or terminating the agreement in order to accept a third party bid.

Payment of Deal-Bust Fee. Acquisition agreements typically require the target to promptly (or perhaps immediately) pay any deal-bust fee[4] upon the termination of the agreement pursuant to the fiduciary out provisions thereof.

Assuming the various no-shop and fiduciary out provisions have been properly drafted and are, therefore, enforceable as drafted, the process of dealing with a third party interloper under an existing acquisition agreement, insofar as assuring compliance with that agreement only, would appear to be largely mechanical: read the provisions and follow them to the letter. (Obviously, dealing with the third party bidder and the original bidder presents a number of strategic issues.) Nevertheless, targets have to be very careful to follow all of the applicable provisions, which often appear in several different sections of the agreement.

5. TERMINATION AS A RESULT OF A "MATERIAL ADVERSE CHANGE" IN THE TARGET. For obvious reasons, a bidder does not want to be obligated to consummate an acquisition of a target if there has been a "material adverse change" in the target. The bidder will often protect itself with respect to this risk by conditioning its obligation to close on the absence of such a change in the target. This is typically done in one of two ways: in a direct and express manner, by including an express condition to that effect in the closing conditions; or in a less direct manner, by including a representation as to the absence of a material adverse change and a closing condition that the representations must be true and correct.

Often the representation or condition is drafted to cover the occurrence of any event that has resulted in or would (or perhaps could) be reasonably expected to result in a material adverse change, usually in certain defined areas, which themselves would generally seem obvious.[5] Those areas would typically include the business, operations (or perhaps results of operations), assets,

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4. Note that some targets have begun asking for a "reverse deal-bust fee", which would be payable by the bidder if the bidder walks away from a transaction for a reason other than a material breach by the target of the acquisition agreement or because the target exercised its fiduciary out. Such a provision, in effect, recognizes the somewhat limited obligations of a bidder, or the highly conditional nature thereof, under the typical acquisition agreement (*i.e.,* the agreement may be more akin to an option) and that the target will be damaged if the bidder fails to effect the transaction. Like deal-bust fees, these fees are liquidated damages that are allocated to the other party to the acquisition agreement. As in the case of deal-bust fees, reverse deal-bust fees are not typically intended to exclude recovery under common law for a material breach of the acquisition agreement.

5. Often the representation or condition will refer to a "material adverse effect", rather than a "material adverse change. In that event, the provision would be drafted to cover the occurrence of any event that has had or would (or perhaps could) be reasonably expected to have a material adverse effect, again usually in certain defined areas.

financial condition, or, perhaps, prospects of the target and its subsidiaries, considered as a whole. By linking "material adverse change" to specified areas there is at least some limited guidance as to what the parties or a court should look at to determine whether the condition has been met; however, "business" and "operations" are quite broad terms. Even within this framework, however, one must still decide whether an adverse change is "material". Some agreements go so far as to specify the dollar or percentage change that would constitute a material adverse change. Many, perhaps most, do not. Therefore, bidders and targets are faced with a fact question that must be examined on a case by case basis. Note that materiality in this context is not necessarily the same a "materiality" in the context of disclosure obligations of an issuer under the federal securities laws. Specifically, although the occurrence of an event may be "material" for disclosure purposes under the federal securities laws (meaning a reasonable investor would consider it important in making an investment decision regarding the issuer's securities), it does not necessarily mean that the adverse effect triggered by the occurrence of the event will be material. Absent a clear provision to the contrary, it is likely that the threshold for materiality in the disclosure context is lower that the threshold for materiality for purposes of determining whether a material adverse change has occurred pursuant to a condition in an agreement between a sophisticated bidder and target.

As noted above, some definitions include events that "could" reasonably be expected to have a material adverse change or effect; some definitions use the word "would". Arguably, the former is a lower standard, as it could presume that there are some albeit remote or low probability circumstances under which a reasonable person could come to the specified conclusion; the latter standard would seem to be a higher standard requiring that a reasonable person would, in fact, come to the conclusion, presumably eliminating remote or low probability circumstances.

6. CONCLUSION.