SHEPPARD, MULLIN, RICHTER & HAMPTON LLP
Since 1927

Structuring Mergers, Acquisitions, and Going Private Transactions to Reduce Litigation Risks

I. Types of Transactions

A. **The Classic "Squeeze-Out."** Existing majority shareholder of the target seeks to acquire the balance of the stock from the target's minority shareholders, or merge the target into another controlled company, thus eliminating the minority position. *See, e.g.*, *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110 (Del. 1994); *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 710 (Del. 1983); *Orman v. Cullman*, 794 A. 2d 5, 23, n. 40 (Del Ch. 2002); *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, *13 (Del. Ch. 1996).

1. Majority shareholder, on "both sides" of the transaction, owes fiduciary duties to the minority shareholders of the target company.

2. Majority shareholder probably has directors on the board of the target who owe fiduciary duties to minority shareholders.

B. **Management Buy-Out**. Existing minority shareholder or management seeks to acquire a controlling position in the company and/or take it private.

1. Does minority shareholder "control" the target or the board of the target. If so, the shareholder owes fiduciary duties to the minority shareholders.

2. Likelihood of conflicted directors on the board of the target who owe fiduciary duties to the target and its minority shareholders.

C. **Arm's Length Transactions**. Transactions in which an unrelated third-party seeks to acquire a controlling position in the target company and/or take it private.

1. No existing relationship between the acquirer and the target.

2. Conflicts are less likely, but risks still exist.

D. **If You're a Plaintiff, Everything's a "Squeeze Out."**

II. Structuring the Transactions

A. Negotiated Long Form Mergers under Del. Gen. Corp. Law § 251

1. Acquiror creates an acquisition vehicle to merge with the target.

2. Required a merger agreement, satisfaction of all conditions in § 251, each board must approve the merger and recommend it to its shareholders, and a majority of shareholders of each company must approve.

3. Minority shareholders of target are usually eliminated (converted to cash and/or securities of acquiror).

4. Insiders of target may convert their interests into equity of the acquisition vehicle.

5. A controlling or dominating shareholder on both sides of a merger has the burden of proving its "entire fairness."

6. Appraisal rights under DGCL § 262.

7. *See* Cal. Corp. Code §§ 1100, *et seq*.

B. Tender Offers and Exchange Offers - not addressed in the Delaware Statutes

1. Public offers to purchase a stated minimum number of shares directly from the shareholders of the target company, usually at a premium over the prevailing market price, and usually in an effort to gain control of the target company. *Wellman v. Dickinson*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd*, 682 F. 2d 355 (2d. Cir. 1982).

2. Can avoid "entire fairness" review.

C. Short Form Mergers under Del. Gen. Corp. Law § 253

1. Parent must hold 90% or more of each class of its subsidiary's stock that would otherwise be entitled to vote on a merger. Parent board need only adopt a resolution and file a certificate of ownership with Delaware's Secretary of State in order to complete the merger.

2. Short form mergers under § 253 were designed by the Delaware General Assembly to be an efficient way to eliminate minority shareholders in a streamlined fashion. The purpose of Section 253 is to provide a parent corporation a means to eliminate unilaterally the

minority stockholders' interest in the enterprise. 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations & Business Organizations* § 9.17, at 9-30 (3d ed. 1998 & Supp. 2002).

3. "Entire fairness" review, discussed below, is inapplicable to short-form mergers. *See Glassman v. Unocal Exploration Corp.*, 777 A. 2d 242, 247-48 (Del. 2001).

4. Appraisal rights under DGCL § 262.

5. *See* Cal. Corp. Code § 1110.

III. Fiduciary Duties in Merger Transactions

A. **Duties of Care, Loyalty, Good Faith, and Candor/Disclosure**. Directors have broad decision-making control over the corporate enterprise. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a); Cal. Corp. Code § 300. As a quid pro quo, they owe fiduciary obligations to the corporation's shareholders. In general, directors owe fiduciary duties of care, loyalty, good faith and candor to the corporation and its shareholders. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A. 2d 1261, 1280 (Del. 1989).

1. **Duty of Care**. Directors have a duty "to act in an informed and deliberate manner in determining whether to approve [a transaction] before submitting [it] to the stockholders." *Smith v. Van Gorkom,* 488 A.2d 858, 873 (Del. 1985).

2. **Duty of Loyalty**. Directors have a duty to make decisions based on the best interests of the corporation and its shareholders. The duty of loyalty is satisfied when the director is in a "position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences." *Kaplan v. Wyatt*, 499 A. 2d 1184, 1189 (Del. 1985).

3. **Duty of Good Faith**. Whether an "independent" duty or a "fundamental component of the duty of loyalty," directors have a duty to act in good faith. *Emerald Partners v. Berlin*, C.A. No. 9700, slip op. at 101, n. 133 (Del Ch. April 28, 2003). *But see Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345 , 361 (Del. 1993), *modified*, 636 A. 2d 956 (Del. 1994) ("[t]o rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any of the triads of their fiduciary duty – good faith, loyalty or due care."); *In re The Walt Disney Co. Derivative Litig.*, 825 A. 2d 275, 278-290 (Del. Ch. 2003).

4. **Duty of Disclosure**. When soliciting shareholder approval or advising shareholders of material information regarding a merger, acquisition, or going private transaction, directors have a duty to disclose all material information in their control that would have a significant effect upon the shareholder's decision to approve or reject the transaction. *Arnold v. Society for Savings Bancorp Inc.*, 650 A. 2d 1270, 1276-77 (Del. 1994); *Stroud v. Grace*, 606 A. 2d 75, 85 (Del. 1992).

B. ***Revlon* Duties**. In a sale of control transaction, the directors are obligated to maximize the value of the company to its shareholders. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173, 182 (Del. 1986); *In re Digex, Inc. S'holders Litig*., 789 A. 2d 1176, 1195 (Del. Ch. 2000). The directors "have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders." *Paramount Communications, Inc. v. QVC Network, Inc*., 637 A. 2d 34, 43 (Del. 1993).

1. This is the sole opportunity to obtain the control premium.

2. "'*Revlon* duties' refer only to a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise." *In re Lukens Inc. S'holders Litig.*, 757 A. 2d 720, 731 (Del. Ch. 1999). "Plaintiffs [still must] plead sufficient facts to support the underlying claims for a breach of fiduciary duties in conducting the sale." *Malpiede v. Townson*. 780 A. 2d 1075, 1083-84 (Del. 2001).

3. "A corporate board's failure to obtain the best value for its stockholders may be the result of illicit motivation (bad faith), personal interest divergent from shareholder (disloyalty) or a lack of due care." *In re Lukens Inc. S'holders Litig.*, 757 A. 2d 720, 731-32 (Del. Ch. 1999).

4. There are unsettled issues about what control is, what a change of control is, and when a target is in "*Revlon*-land." *See, e.g., Paramount Communications, Inc. v. Time, Inc*., 571 A. 2d 1140, 1151 (Del. 1989). "Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. *See, e.g., Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. Supr. 1988). However, *Revlon* duties may also be triggered where, in response to a bidder's

offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company. Thus, in *Revlon*, when the board responded to Pantry Pride's offer by contemplating a 'bust-up' sale of assets in a leveraged acquisition, we imposed upon the board a duty to maximize immediate shareholder value and an obligation to auction the company fairly. If, however, 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, *Revlon* duties are not triggered, though Unocal duties attach. *See, e.g., Ivanhoe Partners v. Newmont Mining Corp.*, 525 A.2d 1334, 1345 (Del. Supr. 1987)." *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. Supr. 1989).

5. In litigation, the directors may have to demonstrate that they adequately canvassed the market and shopped the corporation to determine whether a higher price could have been obtained, or that they had a boy of reliable evidence upon which to judge the adequacy of the price offered. *Barkan v. Amsted Indus., Inc.*, 567 A. 2d 1279, 1286-87 (Del. 1989).

6. An exculpatory provision can immunize the directors from a *Revlon* claim based solely on a lack of due care. *In re Frederick's of Hollywood, Inc.*, No. Civ.A. 15944, 2000 WL 130630, *5 (Del. Ch. 2000) *aff'd sub nom. Malpiede v. Townson,* 780 A. 2d 1075 (Del. 2001) (discussed below). "The fact that a corporate board has decided to engage in a change of control transaction invoking the so-called *Revlon* duties does not change the showing of culpability a plaintiff must make in order to hold the directors liable for monetary damages. For example, if a board unintentionally fails, as a result of gross negligence and not of bad faith or self-interest, to follow up on a materially higher bid and an exculpatory charter provision is in place, then the plaintiff will be barred from recovery, regardless of whether the board was in *Revlon*-land." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 502 (Del. Ch. 2000). *See also In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 733-34 (Del. Ch. 1999).

7. In *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *4-8 (Del. Ch. Feb. 18, 2004), the Chancery Court found that the MONY board had not breached its *Revlon* duties in connection with the merger of MONY into AXA. After protracted negotiations and substantive concessions by both MONY and AXA, the companies signed a definitive merger agreement which contained a non-solicitation provision and a termination fee, but also contained a broad fiduciary out. While MONY did not conduct an auction, it

had used the merger agreement to establish a "floor" for the transaction, and then conducted a post-agreement market check for 5 months, during which time no third party made a competing bid. The MONY board had rejected the idea of conducting an auction, for fear that dissemination of information about the company would reveal the company's weaknesses and provide competitors with an advantage. The Court found that this concern was reasonable. The Court also found that MONY's CEO, who negotiated the transaction, had acted diligently, had secured concessions from AXA, and had been adequately supervised and controlled by the MONY's independent board of directors, which had made the initial decision to explore strategic alternatives.

C. ***Unocal* Duties**. Target directors owe their shareholders a fiduciary duty to protect them from threats, and a board that believes a tender offer is harmful to the company or its shareholders can adopt defensive measures proportionate to the perceived threat. *Unocal Corp. v. Mesa Petroleum Co*., 493 A. 2d 946, 954-55 (Del. 1985). A poison pill or other defensive measures can be employed to deflect a coercive tender offer, such as a front-end loaded offer promising junk bonds at the back end. *Id.* at 956.

1. Where impediments to a competing transaction are included in a business combination proposal, the board may have additional duties to determine whether these terms are reasonably necessary to protect legitimate corporate interests of the acquirer and are reasonably tailored to achieve those corporate interests. *Id*. at 955. A board can determine that enhanced value offered by the business combination due to synergies (long term participation in a continuing equity interest) offers greater value than an alternative transaction (like a cash tender).

2. Before the business judgment rule is applied to a board's adoption of defensive measures, the burden is on the board to prove (a) reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and (b) that the defensive measures adopted were reasonable in retaliation to the threat posed. *Unocal*, 493 A.2d at 954-55. Directors can satisfy the first part of the test by showing good faith and reasonable investigation. When evaluating a threat posed by a takeover bid, the directors may consider the "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders…the risk of nonconsummation, and the quality of securities being offered in exchange. 493 A. 2d at 955. The second prong "requires an evaluation of the importance of the corporate objective; impacts of the 'defensive' action, and other relevant

factors." *Paramount v. Time*, 571 A. 2d at 1154. When both parts of the *Unocal* inquiry are satisfied, the business judgment rule will attach to the defensive actions.

D. **Fiduciary Duties of Target Directors in Long Form Mergers – *The Springboard for the Use of Investment Advisors.*** In determining whether board members exercised due care in approving a merger transaction, courts will analyze whether the board members "(i) informed themselves of available critical information before approving the transaction; (ii) considered expert opinion; (iii) provided all Board members with adequate and timely notice of the [transaction] before the full Board meeting and of its purpose; or (iv) inquired adequately into the reasons for or terms of [the transaction]." *Ash v. McCall*, No. Civ.A. 17132, 2000 Del. Ch. LEXIS 144, at *34 (Del. Ch. Sept. 15, 2000). *See Smith v. Van Gorkom,* 488 A. 2d 858, 872-3, 891, 893 (Del. 1985); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A. 2d 34, 44 (Del. 1993); *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345, 367-68 (Del. 1993) (in a merger, directors have a duty to be reasonably informed).

1. "Directors of Delaware Corporations have a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1056 (Del. 1996). "A combination of the fiduciary duties of care and loyalty gives rise to the requirement that 'a director disclose to shareholders all material facts bearing upon a merger vote....'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1163 (Del. 1995) *reh'g denied* (Aug. 16, 1995) *quoting Zirn v. VLI Corp.*, 621 A. 2d 773, 778 (Del. 1993). In the context of a merger, "the directors of a constituent corporation whose stockholders are to vote on a proposed merger have a fiduciary duty to disclose to the stockholders the available material facts that would enable them to make an informed decision, pre-merger, whether to accept the merger consideration or demand appraisal." *Turner v. Bernstein*, 1999 Del. Ch. LEXIS 18, at *19-*20 (Del. Ch. Feb. 9, 1999).

E. **Fiduciary Duties of Target Directors Facing Tender Offers**. Under Delaware law, target directors are not necessarily required to recommend the merits or lack thereof of a tender offer and can take a neutral position. *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *37, *56-*57 (Del. Ch. June 19, 2001). *See also In re Pure Resources, Inc., S'holders Litig.,* 808 A. 2d 421, 437 (Del Ch. 2002) ("neither the tender offer nor the short-form merger requires any action by the subsidiary's board of directors.") When they do communicate, however, they are under a strict duty to communicate truthfully with their shareholders. *Malone v. Brincat*, 722 A. 2d 5, 11 (Del. 1998).

1. Rule 14d-9 of the '34 Act requires the target board to (1) recommend acceptance or rejection of a tender offer, or (2) express no opinion and remain neutral toward a tender offer, or (3) state its inability to take a position with reference to a tender offer, and (4) give the reasons for the position taken. See also Rule 14e-2.

F. **Fiduciary Duties of Target Fiduciaries Who Make Tender Offers**. Target fiduciaries who make tender offers are subject to an "exacting" duty of disclosure and must honestly communicate all material information about the offer. *Eisenberg v. Chi. Milwaukee Corp.*, 537 A. 2d 1051, 1057 (Del. Ch. 1987); *Malone v. Brincat*, 722 A. 2d 5, 10 (Del. 1998); *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1056 (Del. 1996); *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *36 (Del. Ch. June 19, 2001). **This duty should not, however, require the fiduciary acquirer to make disclosures regarding the fairness of its offer or whether tendering would be in the minority's best interests.** *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *22-*23 (Del. Ch. June 19, 2001).

1. So long as the tender offer is voluntary, *i.e.*, there is no coercion or disclosure violations, **target fiduciaries making a tender offer are not required to offer a fair price**. *Solomon v. Pathe Communications Corp.*, 672 A. 2d 35, 39-40 (Del. 1996); *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *22-23 (Del. Ch. June 19, 2001). "Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders." *In re Aquila, Inc. S'holders Litig.*, 805 A. 2d 184, 190 (Del. Ch. 2002) ("unless coercion or disclosure violations can be shown, no defendant has the duty to demonstrate the entire fairness of this proposed tender transaction."). *In re Ocean Drilling & Exploration Co. S'holders Litig.*, No. Civ.A. 11898, 1991 Del. Ch. LEXIS 82, at *9-*10 (Del. Ch. Apr. 30, 1991).

2. Actionable or wrongful coercion exists "where the board or some other party takes actions which have the effect of causing the stockholders to vote in favor of the proposed transaction [or tender their stock] for some reason other than the merits of that transaction." *Williams v. Geiger*, 671 A. 2d 1368, 1382-83 (Del. 1996); *Ivanhoe Partners v. Newmont Mining Corp.*, 553 A. 2d 585, 605 (Del. Ch. 1987) *aff'd* 535 A. 2d 1334 (Del. 1987); *Weiss v. Samsonite Corp.*, 741 A. 2d 2366, 372 (Del. Ch. 1999).

3. Coercion in a tender offer is a "wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even

worse fate later on...." *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 438 (Del Ch. 2002), citing *In re Marriott Hotel Props. II Ltd. Partnership*, 2000 WL 128875, at *18 (Del. Ch. Jan. 24, 2000).

G. **Fiduciary Duties of Controlling Shareholders**. "Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." *Ivanhoe Partners v. Newmont Mining Corp*., 535 A. 2d 1334, 1344 (Del. Ch. 1987) (citations omitted). *Kahn v. Lynch Communication Systems, Inc*., 638 A. 2d 1110, 1113 (Del. 1994).

1. "'[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status.' For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct." *Citron v. Fairchild Camera & Instrument Corp*., 569 A. 2d 53, 70 (Del. 1989)(citations omitted); *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1114 (Del. 1994) (quoting *id*.) Control can be shown by actions and behavior, threats, etc., demonstrating de facto control by the minority shareholder. *See, e.g., Kahn v. Lynch,* 638 A. 2d at 1114-15.

2. The determination of control will "take into account whether the stockholder, as a practical matter, combines voting power and managerial authority enabling it to control the company…." *In re Cysive, Inc. Shareholders Litigation* (Consolidated Civil Action No. 20341, August 15, 2003) (40% shareholder found to be controlling). Compare *In re Western National Corp. Shareholders Litigation*, 2000 WL 710192 (Del. Chan. May 22, 2000) (46% shareholder found not controlling).

   (a) *See* California Corporations Code § 160(a) for a definition of "control." 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) (citing Del. Gen. Corp. Law § 141(a)). At least for purposes of appraisal as an exclusive remedy under California Corporations Code § 1312, control is "factual control." 2 Marsh, <u>California Corp. Law</u> (4th ed. 2003) § 19.9[B]. *See also* Del. Gen. Corp. Law § 203(c)(4) and California Corp. Code § 309.

IV. <u>The Business Judgment Rule</u>

A. **The Delaware Rule**. The business judgment rule is a counterbalance to the enormous responsibilities required of directors who comply with their fiduciary duties. "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 interest of the company…. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984).

1. In Delaware, the "hallmark" of the business judgment rule and presumption is that the court will not substitute its judgment for that of an independent board so long as the board's decision "can be 'attributed to any rational business purpose.'" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946, 954 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984)(citations omitted). Decisions made by an independent board of directors are protected by the business judgment rule and will not give rise to liability or equitable remedies if made in good faith and with due care. *In re J.P. Stevens & Co., Inc. Stockholders Litig.*, 542 A. 2d 770, 780 (Del. Ch. 1988) *appeal refused, mem.* 540 A. 2d 1088 (Del. 1988).

2. "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 at 811 (citing Del. Code. Ann. tit. 8, § 141(a)).

3. Under the rule, for example, a director has satisfied the duty of care if he acts without self-interest, in an informed manner, and with a rational belief that the decision is in the best interests of the corporation. In *Smith v. Van Gorkom*, 488 A. 2d 858, 874-878 (Del. 1985), the Delaware Supreme Court specified new standards for determining whether a decision making process was properly informed. Among other things, the Court indicated that the procurement of an independent fairness opinion would have insulated the directors from liability. *Id*. at 876-78.

B. **An Evidentiary Presumption and a Substantive Rule of Law**. The business judgment rule "operates as both a procedural guide for litigants and a substantive rule of law." As a procedural rule, the business judgment presumption is a rule of evidence that places the initial burden of pleading and proof on the dissenting shareholder. The rule "creates a 'presumption that in making a business decision, the directors of a corporation acted on an informed basis [*i.e.*, with due care], in good faith, and in the honest belief that the action was taken in the best interests of the company.'" *Citron v. Fairchild Camera & Instrument Corp.*, 569 A. 2d 53, 64 (Del. 1989) (quoting *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984)). The presumption protects a director approved transaction absent evidence of "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment." *Grobow v. Perot*, 539 A. 2d 180, 187 (Del. 1988). To rebut the presumption, a plaintiff must introduce evidence of either director self interest, or that the directors lacked good faith or failed to exercise due care. *Smith v. Van Gorkom*, 488 A. 2d 858, 872 (Del. 1985) (citing *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984)). If the rule is rebutted, the burden shifts to the defendant directors to prove the entire fairness of the transaction. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1162 (Del. 1995) *reh'g denied* (Aug. 16, 1995).

1. Courts are reluctant to assess the merits of business decisions unless there is illicit manipulation by self-interested corporate fiduciaries. *Bomarko, Inc. v. Int'l Telecharge, Inc.*, 794 A. 2d 1161, 1178 (Del. 1999) (citing *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A. 2d 1261, 1279 (Del. 1989). The rule shields directors from liability for making good faith decisions, even if they later turn out wrong. *Strassburger v. Early*, 752 A. 2d 557, 581-82 (Del. Ch. 2000).

C. **The California Rule**. California Corp. Code § 309 requires a director to perform "the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in like position would use under similar circumstances."

1. The business judgment rule is premised on the "presumption that directors' decisions are based on sound business judgment," which judgment may only be attacked by a factual showing of fraud, bad faith, or gross overreaching. *Eldridge v. Tymeshare, Inc.*, 186 Cal. App. 3d 767, 776 (1986). *See Beehan v. Lido Isle Community Assoc.*, 70 Cal. App. 3d 858, 865 (1977); *Lee v. Interinsurance Exchange*, 50 Cal. App. 4th 694, 711 (1996); *F.D.I.C. v. Castetter*, 184 F. 3d 1040 (9th Cir. 1999) .

2. "[M]anagement of the corporation is best left to those to whom it has been entrusted, not the courts." *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 1263 (1989). "The rule requires judicial deference to the business judgment of corporate directors so long as there is no fraud or breach of trust, and no conflict of interest exists."

Desaigoudar v. Meyercord, 108 Cal. App. 4th 173, 183 (2003) *reh'g denied* 108 Cal. App. 4th 173 (2003). *See Natomas*, 208 Cal. App. 3d at 1263; 1 Marsh, Cal. Corporation Law (4th ed. 2003) § 11.03.

V. Delaware's Entire Fairness Doctrine

A. **The Entire Fairness Test**. The entire fairness test applies when proof of "'breach of either the duty of loyalty or the duty of care rebuts the presumption that the directors have acted in the best interests of the stockholders, and requires the directors to prove that the transaction was entirely fair.'" *In re Tri-Star Pictures, Inc.*, 643 A. 2d 319, 333 (Del. 1988) quoting *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345, 371 (Del. 1993), *Smith v. Van Gorkom*, 488 A. 2d 858, 893 (Del. 1985), and *Shamrock Holdings, Inc. v. Polaroid*, 559 A. 2d 257, 271 (Del. 1989). "Such a demonstration of breach of any of the duty of loyalty, care or good faith shifts to the directors, in the event of a challenge of their decision, the burden to establish that the challenged transaction was entirely fair." *Emerald Partners v. Berlin*, 726 A. 2d 1215, 1221-22 (1999).

B. **Much More Exacting**. The entire fairness test is the most exacting standard of review used by the Delaware courts. *Nixon v. Blackwell*, 626 A. 2d 1366, 1376 (Del. 1993); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A. 2d 1261, 1279 (Del. 1988).

C. **Entire Fairness Review and Interested Party Transactions**. "A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness." *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1115 (Del. 1994) citing *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 710 (Del. 1983) and *Rosenblatt v. Getty Oil Co.*, 493 A. 2d 929, 937 (Del. 1985). When a majority shareholder stands on both sides of a transaction, the court will review the terms of that transaction under the entire fairness test. *Id*.

1. "[If] actual self-interest is present and affects a majority of directors approving the transaction, the entire fairness standard applies." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1168 (Del 1995) *reh'g denied* (Aug. 16, 1995). An interested transaction with a controlling shareholder is reviewed under the entire fairness doctrine as opposed to the business judgment rule. *Ryan v. Tad's Enterprises, Inc.*, 709 A. 2d 682, 689, (Del. Ch. 1996) *aff'd* 693 A. 2d 1082 (Del. 1997).

D. **The Burden of Pleading or Proving Entire Fairness**. The burden of proving entire fairness is normally on the conflicted majority shareholder.

See, e.g., *Weinberger v. UOP, Inc*., 457 A. 2d 701 (Del. 1983). The minority shareholders' interests are not being adequately protected because the fiduciaries responsible for protecting the minority are conflicted. Therefore, they have the burden of demonstrating "their utmost good faith and the most scrupulous inherent fairness of the bargain." *Pinson v. Campbell-Taggert, Inc.*, No. Civ.A. 7499, 1989 Del. Ch. LEXIS 50, at *16 (Del. Ch. Nov. 8, 1989).

1. *But Using an Independent Committee can Shift the Burden Back to the Challenging Shareholder*. "[A]n approval of the transaction by an independent committee of the directors or an informed majority of minority shareholders shifts the burden of proof on the issue of entire fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff." *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d at 1117. "The result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal…at arm's length." Weinberger v. UOP, 457 A.2d at 709, n.7.

E. **Two Elements of Entire Fairness Review: Fair Dealing and Fair Price**. The board of directors must establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1162-3 (Del. 1995) *reh'g denied* (Aug. 16, 1995). *See also Weinberger v. UOP, Inc*., 457 A. 2d 701, 711 (Del. 1983); *Ryan v. Tad's Enters., Inc*., 709 A. 2d 682, 690 (Del. Ch. 1996) *aff'd* 693 A. 2d 1082 (Del. 1997). The test is not bifurcated. "'All aspects of the issue must be examined as a whole.'" *Cede & Co. v. Technicolor, Inc*., 542 A. 2d 1182, 1187 (Del. 1988) quoting *Rabkin v. Philip A. Hunt Chem. Corp*., 498 A. 2d 1099, 1106 (Del. 1985); *Sterling v. Mayflower*, 93 A. 2d 107, 115 (Del. 1952).

1. **Fair Price -** economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that impact the intrinsic or inherent value of a company's stock. *Weinberger v. UOP, Inc*., 457 A. 2d 701, 711 (Del. 1983). *See also Boyer v. Wilmington Materials, Inc*., 754 A. 2d 881, 898-99 (Del. Ch. 1999); *Cinerama, Inc. v. Technicolor, Inc*., 663 A. 2d 1134, 1143 (Del. Ch. 1994), *aff'd*, 663 A. 2d 1156 (Del. 1995), *reh'g denied* (Aug. 16, 1995).

   (a) "In this case, because the contested action is the sale of a company, the 'fair price' aspect of entire fairness analysis requires the board of directors to demonstrate 'that the price offered was the highest value reasonably available under the circumstances.'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1163 (Del. 1995) *reh'g denied* (Aug. 16, 1995) quoting *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345, 361 (Del. 1993).

(b) Use statistical information regarding premiums over trading prices to show fair price. *See, e.g.*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1177 (Del. 1995) *reh'g denied* (Aug. 16, 1995).

2. **Fair Dealing -** "Fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained." *Boyer v. Wilmington Materials, Inc.*, 754 A. 2d 881, 898-99. *Accord Weinberger v. UOP, Inc*., 457 A. 2d 701, 711 (Del. 1983). *See, e.g., Rosenblatt v. Getty Oil Co*., 493 A. 2d 929, 937 (Del. 1985); *Summa Corp. v. Trans World Airlines, Inc.*, 540 A. 2d 403, 407 (Del. 1988), *cert. denied*, 488 U.S. 853 (1988); *Van de Walle v. Unimation, Inc.*, C.A. No. 7046, slip op. at 24-28 (Del. Ch. Mar. 7, 1991).

(a) "Another well-recognized aspect of fair dealing is the board of directors' duty of disclosure to the shareholders." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1176 (Del. 1995) *reh'g denied* (Aug. 16, 1995) citing *Weinberger v. UOP*.

(b) "Arms length negotiation between independent bargaining parties is a well recognized touchstone of fair dealing." *Kahn v. Dairy Mart Convenience Stores, Inc*., 1996 Del. Ch. LEXIS 38, at *25 (Del. Ch. 1996).

F. **Entire Fairness and Long Form Mergers**: Delaware courts apply the entire fairness standard of review to long form mergers involving controlling shareholders. *See Weinberger v. UOP, Inc*., 457 A. 2d 701, 710-11 (Del. 1983); *Kahn v. Lynch Communication Systems, Inc*., 638 A. 2d 1110, 1117 (Del. 1994); *In re Siliconix Inc. S'holders Litig*., No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *25-*27 (Del. Ch. June 19, 2001).

1. **Burden Shifting**. Approval of the transaction by a properly functioning and independent special committee or by a minority of the disinterested shareholders can shift the burden of proving lack of entire fairness to the dissenting shareholder.

2. **Beware the "800-Pound Gorilla," Coercion, and an Ineffective Special Committee**. *Kahn v. Lynch Communication Systems, Inc.*,

638 A. 2d 1110 (Del. 1994). A long form merger by a controlling shareholder pursuant to a merger agreement was reviewed under the entire fairness standard, even when the merger was approved by an independent board majority, negotiated and recommended by a special committee with the power to veto the merger, and subject to approval by a majority of the minority disinterested shareholders. Alcatel was found to be a controlling shareholder of Lynch, as a result of its 43.3% ownership position in Lynch, its right to designate 5 of 11 Lynch directors, 2 of 3 executive committee members, and 2 of 4 compensation committee members, Lynch's requirement that 80% affirmative vote was needed to approve any business combination, and certain threatening and dominating conduct of Alcatel. *Id*. at 1112. Lynch sought to acquire Telco, but Alcatel opposed and suggested Lynch combine with Celwave, an indirect subsidiary of Alcatel's parent CGE. The Alcatel directors on the Lynch board made it clear a Telco deal would not be considered before Celwave. Lynch created a special committee and Alcatel's investment bankers made a presentation in support of a Celwave deal at an exchange ratio of .95 Celwave share per Lynch share. The special committee's bankers determined Alcatel's bankers had overvalued Celwave, and the special committee voiced unanimous opposition to the Celwave deal. Alcatel responded by withdrawing the Celwave deal and offering to buy the remaining 57% of Lynch shares not already owned by Alcatel at $14 per share. The special committee negotiated for a higher price, resulting in Alcatel's final offer of $15.50 per share and threat to proceed with an unfriendly tender at a lower price if $15.50 was not recommended by the special committee and approved by the Lynch board. *Id*. at 1119. After determining that alternatives were not available (white night, repurchase of Alcatel's shares, poison pill), the special committee voted to recommend $15.50 and the Lynch board approved.

3. **Was the Special Committee Truly Independent**? Kahn sued for injunctive relief, then amended to seek damages after the injunction was denied and the merger closed. The Delaware Supreme Court reversed the Chancery Court's ruling that the burden of proving lack of entire fairness shifted to Kahn. The Court spent the next five pages explaining all the reasons why the evidence did not support the trial court's finding that the Lynch special committee was sufficiently independent of Alcatel to shift the burden of proving lack of entire fairness to Kahn. "A condition precedent to finding that the burden of proving entire fairness has shifted in an interested merger transaction is a careful judicial analysis of the factual circumstances of each case. Particular consideration must be given to evidence of whether the special committee was truly independent,

fully informed, and had the freedom to negotiate at arm's length." *Id.* at 1120-21 citing *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 709-10, n.7 (Del. 1987). The court reversed the trial court and remanded for further proceedings, "including a redetermination of the entire fairness of the cash-out merger to Kahn and the other Lynch minority shareholders with the burden of proof remaining on Alcatel, the dominant and interested shareholder." *Id.* at 1121-22.

(a) The *Lynch* court recognized the inherent coercion present when a controlling shareholder, the "800-pound gorilla," desires to buy the minority's shares. There is fear of retribution if the shareholder does not get its way, even if none is threatened. *Id.* at 1116. *See In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 436 (Del Ch. 2002) (discussing *Lynch*); *see also In re Cysive, Inc. S'holders Litig.*, 836 A. 2d 531, 553 (Del. Ch. 2003) (In the context of a management buy-out proposal, the court found that the CEO was a controlling shareholder because he possessed a combination of stock voting power and managerial authority that enabled him to control the corporation if he so chose and he would be "perceived as having such capability by rational and independent directors, public stockholders, and other market participants". The court therefore applied the entire fairness standard but found that it was satisfied because the decision to accept the management's proposal was preceded by an active and aggressive search for a third-party buyer, there was an independent special committee who took its responsibilities seriously and was not subjected to pressure and strong-arming by the controlling shareholder, there was an independent board majority, and the process leading to the signing of the merger agreement allowed for a post-signing market check).

4. **Duty of Full Disclosure of All Material Information**. The directors' duty "to ensure that the terms in [an interested long-form] merger are entirely fair to the minority shareholders . . . includes a duty of full discourse which requires directors to disclose 'all information which a reasonable stockholder would consider important in decided on the transaction.'" Accordingly, the court found that the directors breached their duty of disclosure when they failed to disclose to the minority information regarding how the directors arrived at the merger price. *Wacht v. Continental Hosts, Ltd.*, No. Civ.A. 7954, 1994 Del. Ch. LEXIS 171, at *9-*10 (Del. Ch. Sept. 16, 1994).

G. **Entire Fairness and Tender Offers or Exchange Offers**: Delaware courts do not apply the entire fairness standard of review to tender offers made by controlling shareholders to acquire shares directly from minority shareholders, so long as the offer is voluntary (not coercive) and full disclosure is made, because the target board in these transactions remains uninvolved. *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *25-26 (Del. Ch. June 19, 2001); *In re Aquila, Inc. S'holders Litig.*, 805 A. 2d 184, 190 (Del. Ch. 2002); *Solomon v. Pathe Communications Corp.*, 672 A. 2d 35, 39 (Del. 1996). The majority shareholder is not on both sides of a tender offer, so *Kahn v. Lynch* and *Kahn v. Tremont Corp*. are inapplicable (Del. 1997). *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *28, n.26 (Del. Ch. June 19, 2001).

H. **Entire Fairness and Short Form Mergers**: Absent fraud or illegality, short form mergers are not subject to entire fairness review and appraisal is the exclusive remedy for dissenting shareholders. *Glassman v. Unocal Exploration Corp.*, 777 A. 2d 242, 247-48 (Del. 2001) ("[Entire fairness review] plainly conflicts with the [short-form merger] statute. If a corporate fiduciary follows the truncated process authorized by § 253, it will not be able to establish the fair dealing prong of entire fairness. If, instead, the corporate fiduciary sets up negotiating committees, hires independent financial and legal experts, etc., then it will have lost the very benefit provided by the statute - a simple, fast and inexpensive process for accomplishing a merger. We resolve this conflict by giving effect to the intent of the General Assembly. In order to serve its purpose, § 253 must be construed to obviate the requirement to establish entire fairness."); *Stauffer v. Standard Brands, Inc.*, 187 A. 2d 78, 80 (Del. 1962).

VI. A Two-Step Merger Reduces Litigation Risk

A. **A Tender Offer Followed by a Short Form Merger Can Preserve Business Judgment Review and Avoid Entire Fairness Review**. By first tendering for ninety percent of the target's stock, a majority shareholder can cash out minority shareholders via a second step § 253 short form merger theoretically without either step being subject to entire fairness review. The burden of rebutting the business judgment rule should remain with the dissenting shareholder. T**his is now "settled law" in Delaware, but the transaction must have certain key provisions in order to qualify, discussed below.** *Next Level Communications, Inc. v. Motorola, Inc.*, No. Civ.A. 20144, tr. at 3-4 (Del. Ch. Feb. 27, 2003) (oral ruling by trial judge denying Next Level's application for interlocutory appeal to the Delaware Supreme Court); *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421 (Del. Ch. 2002).

1. **First Step - Tender Offer.** A majority shareholder tendering for the minority's interest does not owe a duty to offer a fair price and is not subject to entire fairness review if the tender offer is voluntary (not coercive), full disclosure is made, and majority of minority shareholder approval and a prompt second step short form merger at same price are part of the deal. *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421 (Del Ch. 2002); *Next Level Communications, Inc. v. Motorola, Inc.*, No. Civ.A. 20144, 2003 Del. Ch. LEXIS 13 (Del. Ch. Feb. 25, 2003); *In re Ocean Drilling & Exploration Co. Shareholders Litig.*, No. Civ.A. 11898, 1991 Del. Ch. LEXIS 82, at *9-*10 (Del. Ch. Apr. 30, 1991); *In re Aquila, Inc. S'holders Litig.*, 805 A. 2d 184 (Del. Ch. 2002); *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *23 (Del. Ch. June 19, 2001); *Solomon v. Pathe Communications Corp.*, 672 A. 2d 35, 39 (Del. 1996).

2. **Second Step - Short Form Merger.** Entire fairness is inapplicable to short-form mergers, and appraisal is the dissenting shareholder's sole remedy. *Glassman v. Unocal Exploration Corp.*, 777 A. 2d 242, 247-48 (Del. 2001).

B. **Avoiding Entire Fairness Review in a Two Step Merger Under *Pure Resources*.** *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421 (Del. Ch. 2002). Even though the court applied the *Solomon/Siliconix* standards, rather than entire fairness, to Unocal's exchange offer, it did apply some entire fairness standards within the *Solomon/Siliconix* form of review to ensure that the tender offer was free of distorting effects on free stockholder choice. The court also required a candid and unfettered recommendation from the special committee of the target. **The court specifically held that, in order to find a tender offer non-coercive, it must be subject to a non-waivable majority of the minority tender condition, the controlling shareholder must promise to promptly consummate a § 253 merger at the same price as the tender offer if it receives 90% of the shares, and the controlling shareholder must not make any retaliatory threats. *Id.* at 445. In addition, the majority owes the target a duty to permit the independent directors on the target board "both free reign and adequate time to react to the tender offer . . . ."** *Id.* "When a tender offer is non-coercive in the sense I have identified and the independent directors of the target are permitted to make an informed recommendation and provide fair disclosure, the law should be chary about superimposing the full fiduciary requirement of entire fairness upon the statutory tender offer process." *Id.* at 445-446.

1. The court granted the injunction because it found the offer coercive ("minority" was improperly defined to include stockholders

affiliated with Unocal), and because information material to the Pure stockholders' decision was not disclosed. *Id*. at 424, 449-50. Specifically, the court found that the 14d-9 should have contained a fair summary of the work performed by the investment bankers upon whose advice the Special Committee relied in recommending the transaction. The court also found that the 14d-9 contained an inaccurate and materially misleading statement regarding the Special Committee's request for full authority, and the denial of that request after interested directors objected. Also, Unocal's S-4 omitted material information regarding the "Key Factors" motivating Unocal's decision. *Id*. at 451-452. Two Key Factors, eliminating potential liability exposure to two Unocal directors on Pure's board resulting from Unocal competing with Pure, and Unocal's dislike of Pure's plan to raise capital through a Royalty Trust arrangement, were not disclosed by Unocal in its S-4. *Id*. at 452.

2. Notes the considerable tension between *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110 (Del. 1994) (entire fairness review applied to long form going private transaction by merger agreement implemented by controlling shareholder) and *Solomon v. Pathe Communications Corp*., 672 A. 2d 35, 39 (Del. 1996) ("Delaware law does not impose a duty of entire fairness on controlling shareholders making a noncoercive tender or exchange offer to acquire shares directly from the minority holders.") *In re Pure Resources*, 808 A. 2d at 435-39.

   (a) In a negotiated merger, the controlling shareholder is on both sides of the transaction, but in a tender offer, he is not because the offer is made directly to the shareholders of the target. In *Pure Resources*, Vice Chancellor Strine spends a great deal of time discussing the issue of whether tender offers by majority shareholders made directly to the minority are any less coercive than a negotiated merger. The majority shareholder has access to the subsidiary's confidential information in both contexts. The same potential for retributive action by the controlling shareholder exists, should the merger be rejected by the minority. The *Lynch* court's distrust of the majority of the minority provision was based on this fear of retribution if the minority shareholder votes no. The same fear among the minority shareholders is present in the tender offer context. In fact, there may be more coercion present in tender offers because, in mergers, the dissenting shareholder can receive the same consideration if he votes no (assuming a majority votes yes), but in a tender, a refusal to tender will result in an even smaller minority position followed by a squeeze out at the end, at a lesser price (given the time value of money), or an appraisal proceeding. Also, tender offers can be made in surprise and force a rapid response, while mergers are not necessarily subject to any time constraints. *In re Pure Resources,* 808 A. 2d at 441-443.

3. The controlling shareholder's reserve price need not be disclosed. *In re Pure Resources*, 808 A. 2d at 451 (even though the disclosure stating that Unocal's board authorized the tender offer at the specific exchange ratio ultimately used in the offer was literally false, since Unocal had a reserve price, it was not material since it does not state that Unocal cannot or will not offer a higher price.)

C. **Avoiding Entire Fairness Review in a Two Step Merger under *Next Level.*** *Next Level Communications, Inc. v. Motorola, Inc.*, No. Civ.A. 20144 (Del. Ch. Feb. 25, 2003). Motorola's tender offer was found noncoercive because it contained a non-waivable majority of the minority provision and a promise to promptly complete a short form merger at the tender price if Motorola received 90% or more in the tender offer. Next Level's Special Committee recommended against the Motorola tender, and initiated litigation and a request for a preliminary injunction, which was denied. Using the *Siliconix* framework, the court rejected Next Level's arguments that Motorola's tender was coercive because it was timed to take advantage of Next Level's weakening financial condition, a threat of de-listing by NASDAQ, a "going concern" threat from its auditors, and because Motorola had threatened retribution by refusing to provide future financing to Next Level and refusing to clearly state that it would support Next Level's efforts to secure much needed third-party financing. The Court of Chancery found Motorola's statements "obvious truths" that are "neutrally stated." *Next Level*, slip op. at 50. Motorola's failure to fund Next Level was not a breach of duty or in bad faith. The Court was skeptical about Next Level's "substantive coercion" timing argument, the "soft" (supposedly confidential) information about Next Level's future prospects known to Motorola, and the widely different projections presented by Next Level and Motorola. (Next Level's information regarding future plans had been disclosed in an analyst call, so the Court felt that Next Level's stock price reflected that information.) The court found Motorola's tender offer was not substantively coercive because Next Level's shareholders had sufficient information to evaluate Next Level's prospects and value.

1. *Siliconix, Unocal Exploration,* and *Next Level* encourage the majority shareholder to avoid negotiations with the target subsidiary and to avoid entire fairness review by first making a tender offer and then following that tender offer with a § 253 short form merger.

VII. <u>Using Special Committees to Avoid Entire Fairness Review</u>

A. **Special Committees and the Burden of Proof**. One of the goals of the transactional lawyers should be to shield the transaction within the business judgment rule so that entire fairness review is not applied by a court. The use of a properly functioning independent special committee can "cleanse" the transaction by eliminating the conflicts of interest in interested-party transactions, thus preserving business judgment rule review. In the case of a negotiated merger (rather than tender offer) between a corporation and its controlling shareholder, the use of a special committee can shift the burden of pleading and proving lack of entire fairness to the dissenting shareholder.

B. **Delaware Courts Have Encouraged the Use of Special Committees of Independent Directors to Avoid the Abuses Inherent in Interested Party Transactions**. *See Weinberger v. UOP, Inc.*, 457 A. 2d 701, 709, n. 7 (Del. 1983) ("the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal...at arm's length.").

1. "[F]airness in this context can be equated to conduct by a theoretical, wholly independent, board of directors." "[A] showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness." *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 709, n. 7 (Del. 1983).

2. The existence of a well functioning, independent special committee brings the special committee's recommendations within the purview of the business judgment rule**.** *In re Western Nat'l Corp. S'holders Litig.*, No. Civ.A. 15927, 2000 WL 710192, at *20 (Del. Ch. May 22, 2000).

3. "To be sure, our case law recognizes that establishing an independent negotiating committee, and obtaining an investment banker fairness opinion (or asset appraisal), are indicia of 'fair dealing' in a merger." *Seagraves v. Urstadt Property Co., Inc.*, 1989 WL 137918 at *4 (Del Ch. Dec. 4, 1989). *See also Harbor Finance Partners v. Huizenga*, 751 A. 2d 879, 891 (Del. Ch. 1999).

4. *Chaffin v. GNI Group, Inc.*, No. Civ.A. 16211-NC, 1999 WL 721569, at *5 (Del. Ch. Sep. 3, 1999) ("the plaintiffs must show that the board's decision was not approved by a majority of independent or disinterested directors.")

C. **California Law is Limited on the Use of Special Committees**.

1. *See Lewis v. Anderson*, 615 F. 2d 778, 783 (9th Cir. 1979), *Gaines v. Houghton*, 645 F. 2d 761 (9th Cir. 1981), *and Desaigoudar v. Meyercord*, 108 Cal. App. 4th 173, 185 (2003), *reh'g denied*, 108 Cal. App. 4th 173 (2003).

VIII. Delaware's Exculpatory Provision

A. **Delaware Gen. Corp. Law § 102(b)(7)**. "In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following: ...A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit."

B. **Can Protect Directors Against Duty of Care and Disclosure Claims**. Section 102(b)(7) permits a corporation to "protect" its directors from monetary liability for duty of care violations. *In re Lukens Inc. S'holder Litig.*, 757 A. 2d 720, 732-33 (Del. Ch. 1999); *Rothenberg v. Santa Fe Pacific Corp.*, No. Civ.A. 11749, 1992 WL 111206, at *4 (Del. Ch. May 18, 1992). An exculpatory provision bars damage claims based on non-disclosures unless the plaintiff alleges specific facts of bad faith motivating the non-disclosures. *Arnold v. Society for Saving Bancorp., Inc.*, 650 A. 2d 1270, 1286-87 (Del. 1994).

C. **Burden of Proof Issues**. "Defendants seeking exculpation under such a provision will normally bear the burden of establishing each of its elements." "[T]he burden of demonstrating good faith, however slight it might be in given circumstances, is upon the party seeking the protection of the statute. Nonetheless, where the factual basis for a claim *solely* implicates a violation of the duty of care, this Court has indicated that the protections of such a charter provision may properly be invoked and applied." *Emerald Partners v. Berlin*, 726 A. 2d 1215, 1223-24, 1999 Del. LEXIS 97 (Del. 1999) citing *Arnold v. Society for Saving Bancorp., Inc.*, 650 A. 2d 1270 (Del. 1994) and *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1061 (Del. 1996).

1. "The presence of the section 102(b)(7) provision in the Lukens charter thus causes me to inquire, at the threshold, into the nature of

the breaches of fiduciary duty alleged in the Complaint. Any claim that adequately alleges solely a violation of the duty of care and does not also allege the existence of circumstances constituting one of the exceptions to that exculpatory provision [bad faith, disloyalty, intentional misconduct, knowing violation of law, or improper personal benefit] must be dismissed." *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 728 (Del. Ch. 1999).

D. **What is Bad Faith?** *In re J.P. Stevens & Co., Inc. Stockholders Litig.*, 542 A. 2d 770, 780 (Del. Ch. 1988), *appeal refused, mem.*, 540 A. 2d 1088 (Del. 1988) (bad faith exists only if "the decision is so beyond the bounds of reasonable judgment that it seems essentially inexplicable on any [other] ground"); *In re Rexene Corp. S'holders Litig.*, 1991 Del. Ch. LEXIS 81, at *12-13 (Del. Ch. 1991) (courts should not infer bad faith when the board's decision is "readily explainable" or when the wisdom of a decision is "open to debate"); *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1061-62 (Del. 1996) (bad faith does not exist where directors lack "any pecuniary motive to mislead" the company's shareholders and "where no plausible motive for deceiving the stockholders [had] been advanced"); *In re Dataproducts Corp. S'holders Litig.*, 1991 Del. Ch. LEXIS 149, at *17 (Del. Ch. 1991) (an exculpatory provision will therefore protect directors if a complaint's allegations are "equally consistent with director gross negligence as with conduct that was intentional or in bad faith"); *Grace Bros., Ltd. v. Uniholding Corp.*, 2000 Del. Ch. LEXIS 101 (Del. Ch. 2000) (allegations of bad faith sufficient); *O'Reilly v. Transworld Healthcare, Inc.*, 745 A. 2d 902, 914-15 (Del. Ch. 1999) (same).

E. **California's Exculpatory Provision is Limited to Derivative Actions.** *Compare* California's Exculpatory Provision - Cal. Corp. Code §§ 204(10), 204.5.

1. The statute expressly states that provisions eliminating or limiting the liability of a director for monetary damages only apply "in an action brought by or in the right of the corporation for breach of a director's duties...." "No insulation from direct shareholder actions: Directors may only be relieved of liability to the corporation - i.e., from direct suits against them by the corporation or derivative suits brought by shareholders on the corporation's behalf. Directors remain personally liable in connection with direct shareholder suits, whether brought individually or as a class action. C. Hugh Friedman, CAL. PRAC. GUIDE: CORPORATIONS (The Rutter Group 2003) § 4:88.4.

IX. The Business Judgment Rule, Entire Fairness, Exculpatory Provisions, and the Burden of Pleading and Proof

A. **Years of Litigation Might Have Been Avoided Through the Use of an Independent Committee.** *Emerald Partners v. Berlin*, 726 A. 2d 1215 (Del. 1999) (summary judgment in favor of the defendants reversed on appeal). This litigation arose out of the long form merger of May Petroleum into companies owned and controlled by Craig Hall, who was a majority shareholder of May. An injunction granted by the trial court was reversed on appeal, and the merger closed in August of 1988. The ensuing 11 years of damages litigation saw no less than 8 reported decisions in the Court of Chancery. Ultimately, the lower court granted summary judgment for the defendants on the basis of the exculpatory provision, refusing to apply entire fairness review to the merger (there was a procedural issue as to whether plaintiffs had timely raise entire fairness review in the litigation). Defendants argued on appeal that entire fairness was not timely raised by the plaintiffs, causing them prejudice, but even if it was, it was inapplicable because they were not on both sides of the transaction.

1. The Supreme Court reviewed *de novo* the issue of whether entire fairness was subsumed within the complaint sufficient to give "fair notice" to the defendants, applying liberal pleading standards. *Id.* at 1220. The court found that it was, referring to prior orders in the case which discussed entire fairness. The court also found that entire fairness was implicated because Hall "clearly stood on both sides of the transaction." *Id.* at 1221. Accordingly, defendants had "the burden to establish that the challenged transaction was entirely fair." *Id.* at 1222. "[T]he shield from liability provided by a certificate of incorporation provision adopted pursuant to [§ 102(b)(7)] is in the nature of an affirmative defense." *Id.* at 1223. "[W]here the factual basis for a claim *solely* implicates a violation of the duty of care, this court has indicated that the protections of such a charter provision may properly be invoked and applied." *Id.* at 1224, citing *Arnold v. Society for Savings Bancorp.*, 650 A. 2d 1270, 1288 (Del. 1994) and *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1061 (Del. 1996). The court also found that plaintiffs' disclosure allegations and entire fairness review are intertwined and should not have been considered separately. Standing alone, defendants were shielded from liability for the alleged false disclosures because of May's exculpatory provision. But entire fairness review required defendants to demonstrate fair price and fair dealing. The court did acknowledge that the burden of showing a lack of entire fairness can be shifted to the plaintiff in two scenarios: (1) approval of the transaction by an independent Special Committee with "real bargaining power that can be exerted in dealings with a majority

shareholder who does not dictate the terms of the merger..." (citing *Kahn v. Lynch*); and (2) "the approval of the transaction by a fully informed vote of a majority of the minority shareholders (citing *Rosenblatt v. Getty Oil*). 726 A. 2d at 1222-1223. Here, the trial court did not determine whether the burden should be shifted to the plaintiffs because of sufficient independent director approval or fully informed shareholder approval.

B. **If the Complaint Only Alleges A Breach of the Duty of Care, the Exculpatory Provision Can Protect the Defendants at the Pleading Stage.** *In re Frederick's of Hollywood, Inc.*, No. Civ.A. 15944, 26 Del. J. Corp. L. 351, 2000 WL 130630 (Del. Ch. 2000) (motion to dismiss granted) *aff'd sub nom. Malpiede v. Townson*, 780 A. 2d 1075 (Del. 2001). Knightsbridge ("K") acquired Fredericks ("F") by cash merger on September 29, 1997. Plaintiffs, dissenting F shareholders, sued for an injunction, which was denied, then amended to seek damages claiming the Fs' board failed to obtain the highest available price and misstated and omitted material information from its disclosures. F started a auction process in June of 1996. After conferring with over 100 prospective purchasers, K offered between $6.00 and $6.25 per share in a two step tender offer - merger deal, conditioned on an exclusive due diligence period. In June 1997, they signed a merger agreement at $6.14 per share. F could not solicit alternative deals, but the F board could pursue alternative transactions "if their fiduciary obligations [so] required." 780 A. 2d at 1080. If they approved a different deal, they could terminate the K merger agreement and pay a $1.8 million breakup fee. Fs' CEO, Townson, was to receive a $750,000 termination fee, consulting (and non-competition) payments of $250,000 plus 16 $100,000 quarterly payments, plus $.05 for his "underwater" options having a strike price over $6.14. In addition, Barrett, a board member of F, was also affiliated with JMS, and JMS would receive a $2 million fee if the merger closed. Before the board voted, two F directors resigned. The board approved the K merger agreement at $6.14, and F sent a Consent Solicitation Statement to its shareholders. Then, F received a fully financed offer at $7.00 per share from Milton. K countered by entering into a Stock Purchase Agreement giving it the right to buy F stock from certain Fredericks family trusts, which owned 43% of F, terminable if the merger agreement was terminated by its terms. Another third party offer came in from Veritas ("V") at $7.75, but was not binding, and the closing with K was postponed. F and V negotiated and exchanged draft merger agreements, V delivered a $2.5 million escrow deposit, and then K obtained an amendment to the Stock Purchase Agreement amending, among other things, the termination right, exercised its rights, and purchased 43% of F from the family trusts. K then made it clear it would not approve the Veritas or Milton deals, upped its offer to $7.75, but with four new conditions, a "no-talk" provision prohibiting negotiations with any other bidder, a $4.5 million break up fee, a K "observer" present at all F board meetings, and a matching option provision. The F board accepted the K revised offer on September 8, 1997. K purchased 195,000 shares of F on the open market the next day, but could not vote them in favor of the merger because it was after the record date. V responded with an unsolicited non-binding offer at $9.00 per share. The F board did not respond because of the "no-talk" provision (*i.e.*, no fiduciary out), K's position as a majority shareholder as of that date, and F's concern over the legality of the dilutive option requested by V.

1. Plaintiffs claimed that the F directors breached their duties of care and loyalty by failing to obtain the highest value as required by *Revlon* and failing to enact adequate defensive measures to prevent K from gaining control of F. They also alleged breach of loyalty by Townson and Barrett who would receive benefits not shared by others. Lastly, they claimed that F made certain misrepresentations and omissions, *e.g.*, the Consent Solicitation falsely stated that the board orally informed V of a September 4, 1997 deadline for its final offer, and it failed to disclose the reasons for the resignations of the two directors. Defendants moved to dismiss arguing that the exculpatory provision barred plaintiffs' claims for damages, that the complaint did not allege any breach of loyalty, and that the alleged misstatements and omissions were not material as a matter of law.

2. The Chancery Court dismissed the *Revlon* claim that the board was grossly negligent in failing to negotiate a higher price. Dismissal was proper because plaintiffs alleged, at best, a breach of the duty of care, "a claim that is not cognizable because of the exculpatory clause in Frederick's charter." 2000 WL 130630 at *5. The facts alleged did not support a finding of bad faith or breach of loyalty. Plaintiffs argued that under *Emerald Partners*, the exculpatory provision is "in the nature of an affirmative defense," and defendants "bear the burden of establishing each of its elements."

> "The plaintiffs misread *Emerald Partners*. This Court has interpreted the above-quoted language as not precluding a Rule 12(b)(6) dismissal of claims that the directors breached their fiduciary duty of care on the basis of an exculpatory provision, so long as a dismissal on that ground does not prevent a plaintiff from pursuing well-pleaded claims that the directors breached their fiduciary duty of loyalty. *Id.* at *6 (citing *In re General Motors Class H S'holders Litig.*, 734 A. 2d 611, 619 n. 7 (Del. Ch. 1999) and *In re Lukens Inc. S'holder Litig.*, 757 A. 2d 720, 733, n. 33 (Del. Ch. 1999)). **Under this reading of *Emerald Partners*, where a**

complaint alleges actionable disloyalty the burden will shift to the defendants to show the immunizing effect of the charter provision, but where the complaint only alleges a breach of the duty of care, that claim may be dismissed at the pleading stage." 2000 WL 130630 at *6. See also In re Lukens Inc. S'holders Litig., 757 A.2d 720, 734 (Del. Ch. 1999) ("Here the complaint alleges, if anything, only a breach of the duty of care. The function of the § 102(b)(7) provision is to render duty of care claims not cognizable and to preclude plaintiffs from pressing claims for breach of fiduciary duty, absent the most basic factual showing (or reasonable basis to infer) that the directors' conduct was the product of bad faith, disloyalty or one of the other exceptions listed in the statute. Dismissal is proper where no exception is alleged. Further, Emerald Partners supports the conclusion that the Director Defendants are entitled to this dismissal at this stage of the process, without having to engage in discovery or shoulder the burden of proving that they acted loyally and in good faith.")

3. Drawing all inferences in favor of the plaintiffs as must be done on motions to dismiss, the court assumed that plaintiffs had alleged gross negligence by the F board. However, the § 102(b)(7) exculpatory provision was properly before the trial court. **The court specifically held that a § 102(b)(7) provision can be raised in a motion to dismiss, converting it to a summary judgment motion if the provision is outside the scope of the complaint**. 780 A. 2d at 1091-92. *Accord McMichael v. United States Filter Corp.*, 1001 U.S. Dist. LEXIS 3918, at *27 (C.D. Cal. 2001). *But see McMillan v. Intercargo Corp.*, 768 A. 2d 492, 501, n. 40 (Del. Ch. 2000), and *In re Wheelabrator Technologies, Inc. S'holders Litig.,* No. Civ.A. 11495, 1992 Del. Ch. LEXIS 196, at *38 (Del. Ch. Sept. 1, 1992) (a court may take judicial notice of an exculpatory provision in a motion addressed to the pleadings). **Further, the court held that "if a complaint unambiguously and solely asserted only a due care claim, the complaint is dismissible once the corporation's Section 102(b)(7) provision is invoked."** 780 A. 2d at 1093. Because the complaint did not properly allege any breach of loyalty or "other claims that are not barred by the charter provision," dismissal was appropriate. Id

4. The Chancery Court dismissed the allegations that the directors breached their duty of loyalty because two of them were conflicted, that the merger was not approved by a majority of disinterested directors, and that the defendants had the burden of showing entire

fairness. The court agreed that based on the facts alleged Townson was conflicted because of the payments for his worthless options and under two lucrative contracts. But on the facts alleged, Barrett was not conflicted because the JMS fee was payable regardless of who the buyer was, and the fee increased as the merger price increased. Barretts' interests were aligned with the interests of the F shareholders in getting the highest possible price. Since a majority of disinterested directors approved the K transaction, the breach of loyalty claim failed as a matter of law.

5. Before the Supreme Court, plaintiffs also argued that the directors breached their duty of loyalty because they supported the K transaction out of fear they would be subject to personal litigation filed by K if they did not. "Except in egregious cases, the threat of personal liability for approving a merger transaction does not in itself provide a sufficient basis to question the disinterestedness of directors because the risk of litigation is present whenever a board decides to sell the company." 780 A. 2d at 1085 (citing *Aronson v. Lewis*, 473 A. 2d 805, 815 (Del. 1984)).

6. Finally, the Chancery Court dismissed the disclosure allegations, finding that the alleged misstatements and omissions were not material as a matter of law. "The test of materiality is whether 'there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . [there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" 2000 WL 130630 at *8 (quoting *Rosenblatt v. Getty Oil Co.*, 493 A. 2d 929, 944 (Del. 1985)).

7. In affirming, the Supreme Court observed that "[a]lthough materiality determinations under this standard are necessarily fact-intensive and do not generally lend themselves to dismissal on the pleadings, some statements or omissions may be immaterial as a matter of law." 780 A. 2d at 1086 (citations omitted). "To survive a motion to dismiss, the plaintiffs 'must provide some basis for a court to infer that the alleged violations were material. For example, a pleader must allege that facts are missing from the statement, identify those facts, state why they meet the materiality standard and how the omission caused injury.'" 780 A. 2d at 1086-87, quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A. 2d 135, 142 (Del. 1997). No facts were alleged showing that the board knew why the two directors had resigned, and the resignations took place before the board approved the June 1997 merger agreement, and more than

3 months before the stockholders were asked to approve the September 1997 merger agreement.

8. The Supreme Court distinguished between the defendants' burden of proving good faith under the exculpatory provision at trial, discussed in *Emerald Partners*, and a plaintiff's pleading burden. "A plaintiff must allege well-pleaded facts stating a claim on which relief may be granted. Had plaintiff alleged such well-pleaded facts supporting a breach of loyalty or bad faith claim, the Section 102(b)(7) charter provision would have been unavailing as to such claims, and this case would have gone forward." 780 A. 2d at 1094. To survive a motion to dismiss, the "plaintiffs must plead facts supporting a claim that is not barred by the exculpatory charter provision — for example, a claim for breach of the board's duty of good faith or loyalty." 780 A. 2d at 1094, n. 64. This is consistent with Delaware's public policy and the purpose of § 102(b)(7), which "was to permit stockholders to adopt a provision in the certificate of incorporation to free directors of personal liability in damages for due care violations, but not duty of loyalty violations, bad faith claims and certain other conduct." *Id.* at 1095.

9. Lastly, the Supreme Court affirmed the dismissal of the claim that K tortiously interfered with the F shareholders' prospective opportunity to obtain a higher price. The court applied the pleading elements of tortious interference "'in light of a defendant's privilege to compete or protect his business interests in a fair and lawful manner.'" 780 A. 2d at 1099 (quoting *De Bonaventura v. Nationwide Mut. Ins. Co.*, 428 A. 2d 1151, 1153 (Del. 1981)). It held that "the plaintiffs' tortious interference claim fails as a matter of law because the allegations in the amended complaint do not support an inference that [K's earlier] misrepresentation [which was effectively remedied when K ultimately did acquire more than 40% of F's stock two days before the board accepted the merger agreement] proximately caused the board to accept the [K] offer and to reject the higher [V] offer." *Id.* at 1100.

C. **To Satisfy the Pleading Burden in the Face of an Exculpatory Provision, the Plaintiff must Plead a Breach of Loyalty.** *McMillan v. Intercargo Corp.*, 768 A. 2d 492 (Del. Ch. 2000) (motion for judgment on the pleadings granted). In the presence of a § 102(b)(7) provision, a plaintiff can survive a motion to dismiss "only if the complaint contains well-pleaded allegations that the defendant directors breached their duty of loyalty by engaging in intentional, bad faith, or self interested conduct that is not immunized by the exculpatory charter provision." *Id.* at 495. *See also In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 734 (Del. Ch. 1999).

1. "As applied to this case, this means that the defendant directors are entitled to dismissal unless the plaintiffs have pled facts that, if true, support the conclusion that the defendant directors failed to secure the highest attainable value as a result of their own bad faith or otherwise disloyal conduct. Absent well-pled facts supporting an inference of such disloyalty, the defendant directors are entitled to dismissal." *Id.* at 502-3.

2. "The plaintiffs concede that a majority of Intercargo's board was disinterested and independent, and the plaintiffs have failed to allege facts that, if true, support a reasonable inference that the loyalties of two of the other three directors were conflicted. And even if one or more of those three directors were interested in the merger, the plaintiffs have failed to allege that those directors dominated or controlled, other otherwise influenced in any improper way, the concededly disinterested board majority." "Finally, the complaint itself paints a picture that is incongruent with a loyalty breach." *Id.* at 495. "In sum, the complaint alleges no facts from which a reasonable inference can be drawn that any conflicting self-interest or bad faith motive caused the defendant directors to fail to meet their obligations to seek the highest attainable value or to provide Intercargo stockholders with all material information." *Id.* at 496.

3. "In analyzing a motion to dismiss, the court may consider, for carefully limited purposes, documents integral to or incorporated into the complaint by reference." "In this case, therefore, I may consider the proxy statement in determining whether the non-disclosures alleged by the plaintiffs were material in light of what was in fact disclosed by the proxy. But as a general matter, I cannot consider the proxy statement in determining whether the plaintiffs' Revlon claim is viable." *Id.* at 500 (citing *In re Santa Fe Pacific Corp. S'holders Litig.*, 669 A. 2d 59, 69-70 (Del. 1995)). The exculpatory charter provision may also be considered. 768 A. 2d at 501, n. 40.

4. The court properly noticed that "[m]ost of the statute's exceptions simply iterate particular examples of breaches of the duty of loyalty. For example, the statute provides exceptions for conduct not in good faith, intentional misconduct, and knowing violations of the law - quintessential examples of disloyal, i.e., faithless conduct." 768 A. 2d at 501, n. 41 (citations omitted).

5. "By showing that the certificate of incorporation bars duty of care claims *and* by further demonstrating that the well-pled allegations of the complaint fail to support a claim that the defendant directors

engaged in non-immunized conduct, the defendant directors meet their affirmative duty to justify dismissal of the entire complaint under *Emerald Partners*...." 768 A. 2d at 501, n. 43.

6. "In a case involving a merger with a genuine third-party acquiror: the plaintiff must show that [the] materially self-interested members [of the board] either: (a) constituted a majority of the board; (b) controlled and dominated the board as a whole; or (c) (i) failed to disclose their interests in the transaction to the board; and (ii) a reasonable board member would have regarded the existence of their material interests as a significant fact in the evaluation of the proposed transaction. Absent such a showing, the mere presence of a conflicted director or of disloyalty by a director, does not deprive the board of the business judgment rule's presumption of loyalty." 768 A. 2d at 504, n. 54 quoting *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345, 363 (Del. 1993); *Goodwin v. Live Entertainment*, mem. op. at 51, 1999 De. Ch. LEXIS 5, at *77 (Jan. 22, 1999).

X. <u>The Role of Investment Banks in Change of Control Transactions</u>

A. **Capital Raising and Acquisition Financing**.

1. Designing, underwriting, marketing, and brokering securities.

B. **Conducting an Auction Process to Maximize Shareholder Value**.

C. **Providing a Fairness Opinion**.

1. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. Supr. 1985), discussed below, and Del. Code Ann. tit. 8, § 141(e) ("[d]irectors…shall be fully protected in relying in good faith upon…information, opinions, reports or statements presented…by any…person as to matters the [director] 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.")

2. Though not required, the failure to obtain a fairness opinion in a change-of-control transaction would be exceptional.

3. What is fair?

(a) Different valuation methodologies

(b) Long term or short term value? Continued independent operation? Value derived in a competitive auction or an arm's length negotiated transaction? Synergies? Costs savings? economies of scale?

D. **Strategic Advisor.**

XI. <u>Key Deal Terms in Change of Control Transactions</u>

A. **Majority of Minority**

1. In finding the tender offer in *Siliconix* to be voluntary and not coercive, and thus not requiring entire fairness review, the court emphasized the significance of the fact that the majority shareholder's tender offer was conditioned on obtaining the approval of a majority of the target company's minority shareholders. *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *15 (Del. Ch. June 19, 2001) (the tender offer "contained a non-waivable 'majority of the minority' provision providing that Vishay would not proceed with its tender offer unless a majority of those shareholders not affiliated with [it] tendered their shares."); *In re Aquila, Inc. S'holder Litig.*, 805 A. 2d 184, 190 (Del. Ch. 2002); *In re Ocean Drilling & Exploration Co. S'holders Litig.*, No. Civ.A. 11898, 1991 Del. Ch. LEXIS 82, at *22-*23 (Del. Ch. Apr. 30, 1991); *Next Level Communications, Inc. v. Motorola, Inc.*, No. Civ.A. 20144 (Del. Ch. Feb. 25, 2003).

2. In addition to approval of the transaction by an independent Special Committee with real bargaining power, "the approval of the transaction by a *fully informed* vote of a majority of the minority shareholders will shift the burden" of proving lack of entire fairness to the plaintiff. *Emerald Partners v. Berlin,* 726 A. 2d 1215, 1223 (Del. 1999) (citing *Rosenblatt v. Getty Oil Co.*, 493 A. 2d 929, 937 (Del. 1985) and Del. Gen. Corporation Law § 144(a)(2)).

3. Must condition the offer on approval of a majority of the target's unaffiliated stockholders. If the definition of minority stockholder includes target stockholder affiliated with the majority, then the tender offer is coercive because the majority of the minority condition includes conflicted majority affiliated shareholders. *In re Pure Resources, Inc., Shareholders Litig.*, 808 A. 2d 421, 446 (Del Ch. 2002).

4. At a settlement hearing in *Hartley v. Peapod, Inc.*, No. Civ.A. 19025, tr. at 7 (Del. Ch. Feb. 27, 2002), the court found the transaction was not voluntary because the short form merger would take place regardless of whether any shareholders tendered in the first step. Accordingly, the court found that entire fairness would be

applied. A majority of the minority provision in this transaction apparently would have rendered the offer voluntary and non-coercive.

5. "Generally, 'where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail.'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1176 (Del. 1995) *reh'g denied* (Aug. 16, 1995) *quoting Smith v. Van Gorkom*, 488 A. 2d 858, 890 (Del. 1985). "[A] fully informed vote of stockholders approving a merger will extinguish a claim for breach of fiduciary duty stemming from a board of directors' failure to reach an informed business judgment authorizing that transaction." *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 737 (Del. Ch. 1999).

B. Prompt Second Step on the Same Terms

1. In *In re Aquila, Inc. S'holder Litig.*, 805 A. 2d 184, 188 (Del. Ch. 2002), the bidder guaranteed that the second step of the merger, a short-form merger, would be effected on the identical terms as the original tender offer. Similarly, in *Next Level Communications, Inc. v. Motorola, Inc.*, No. Civ.A. 20144 (Del. Ch. Feb. 25, 2003), Motorola stated that if it obtained 90% of Next Level through the tender offer, it would pursue a second step short form merger at the tender offer price. In *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 429, 433 (Del Ch. 2002), Unocal made it clear that upon receipt of 90% of the shares in the exchange offer, it would promptly effect a short form merger with Pure at the same exchange rate offered in the exchange offer.

    (a) In these cases, this was an important factor supporting the court's finding that the offer was voluntary and not coercive, and therefore, entire fairness review would not be applied.

C. The Fiduciary Out

1. The target board should negotiate for the right to withdraw its recommendation of the deal if a better offer is received. The board of the target agrees to submit the deal to its shareholders, and, subject to its fiduciary duties, recommend the deal. Fiduciary out typically terminates upon shareholder vote in favor of the deal.

2. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 a. 2D 914 (Del. 2003). While in bankruptcy, NCS received competing acquisition proposals from Genesis and Omnicare. In its negotiations, Genesis insisted that NCS submit the merger agreement to NCS's shareholders for

approval, even if the NCS board did not recommend the transaction; the merger agreement not contain a fiduciary out clause that would allow NCS to terminate the agreement upon receipt of a better offer; and that two NCS shareholders with over 65% of the voting power in NCS enter into voting agreements locking up their votes. The NCS board, on the recommendation of an independent Special Committee, approved the transaction. Omnicare had expressed an interest in acquiring the assets of the company, but its proposal was considered too conditional and provided no recovery for NCS shareholders. After NCS entered into the merger and voting agreements with Genesis, Omnicare made an economically superior offer. The NCS board withdrew its recommendation, but the agreements assured consummation. Omnicare and the minority shareholders sought an injunction, which the trial court denied under the business judgment rule and *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946, 954-55 (Del. 1985), finding that the "deal protection devices" employed by NCS were reasonable defensive measures in relation to the threat posed, *i.e.*, the loss of the Genesis deal, the possibility that there would be no deal at all, and some recovery for NCS shareholders. The Supreme Court reversed and enjoined the transaction, finding that the absence of a "fiduciary out" clause rendered the deal protection devices "preclusive" and "coercive," and that NCS had not met its burden of showing that the defense response was reasonable in relation to the threat posed. The agreements entered into by NCS "completely prevented the board from discharging its [continuing] fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction." 818 A. 2d at 936. Thus, the court appears to have established a per se rule requiring the present of a "fiduciary out" in all transactions.

(a) Two justices dissented arguing that the court should not replace its judgment after the fact for the decisions of the NCS board at the time of the negotiations. The majority's opinion means NCS would never have had the Genesis deal, which was the only "value enhancing transaction" available at the time. The deal protection devices were not adopted by the NCS board as part of an entrenchment strategy, in self interest, or to fend off a hostile takeover, but rather were adopted at the insistence of Genesis in arm's length negotiations.

XII. <u>Special Committees</u>

A. Duties of the Special Committee

1. The duties of the special committee are to hire "their own advisors, [provide] the minority with a recommendation as to the advisability of the offer, and [disclose] adequate information for the minority to make an informed judgment." They must "undertake these tasks in good faith and diligently, and . . . pursue the best interests of the minority." *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 445 (Del Ch. 2002).

2. As discussed above, in determining whether board members exercised due care in approving a merger transaction, courts will analyze whether the board members "(i) informed themselves of available critical information before approving the transaction; (ii) considered expert opinion; (iii) provided all Board members with adequate and timely notice of the [transaction] before the full Board meeting and of its purpose; or (iv) inquired adequately into the reasons for or terms of [the transaction]." *Ash v. McCall*, No. Civ.A. 17132, 2000 Del. Ch. LEXIS 144, at *34 (Del. Ch. Sept. 15, 2000). *See Smith v. Van Gorkom,* 488 A. 2d 858, 872-3, 891, 893 (Del. 1985); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A. 2d 34, 44 (Del. 1993); *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345, 367-68 (Del. 1993) (in a merger, directors have a duty to be reasonably informed).

3. "Directors of Delaware Corporations have a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." *Zirn v. VLI Corp.*, 681 A. 2d 1050, 1056 (Del. 1996). "A combination of the fiduciary duties of care and loyalty gives rise to the requirement that 'a director disclose to shareholders all material facts bearing upon a merger vote....'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1163 (Del. 1995) *reh'g denied* (Aug. 16, 1995) *quoting Zirn v. VLI Corp.*, 621 A. 2d 773, 778 (Del. 1993). In the context of a merger, "the directors of a constituent corporation whose stockholders are to vote on a proposed merger have a fiduciary duty to disclose to the stockholders the available material facts that would enable them to make an informed decision, pre-merger, whether to accept the merger consideration or demand appraisal." *Turner v. Bernstein*, 1999 Del. Ch. LEXIS 18, at *19-*20 (Del. Ch. Feb. 9, 1999).

B. **Independence of the Special Committee**

1. There is a two part test used to determine whether "burden shifting is appropriate in an interested merger transaction." *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1117 (Del. 1994) (citations omitted). "The mere existence of an independent special committee . . . does not itself shift the burden. At least two factors are required. First, the majority shareholder must not dictate the terms of the merger. *Rosenblatt v. Getty Oil Co.,* 493 A. 2d 929, 937 (Del. Ch. 1985). "Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis." *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1117 (Del. 1994) quoting *Rabkin v. Olin Corp*., No. Civ.A. 7547, 1990 Del. Ch. LEXIS 50, at *18-*19 (Del. Ch. Apr. 17, 1990) *aff'd* 586 A. 2d 1202 (Del. 1990).

2. To shift the burden of proving entire fairness to the challenging shareholder, "the controlling shareholder must do more than establish a perfunctory special committee of outside directors. Rather, the committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power "'at an arm's length.'" *Kahn v. Tremont Corp*., 694 A. 2d 422, 429 (Del. 1997) quoting *Rosenblatt v. Getty Oil Co.*, 493 A. 2d 929, 937 (Del. 19085).

3. To shift the burden, "[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length." A special committee thus must have the power to veto a transaction that is not in the best interests of the minority. *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1119, 1120-21 (Del. 1994). The special committee must in fact operate "'as though each of the contending parties had in fact exerted its bargaining power at arm's length.'" *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1121 (Del. 1994) quoting *Weinberg v. UOP, Inc*., 457 A. 2d 701, 709-10, n.7 (Del. 1983).

4. Was each member of the special committee "'in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences.'" *Katz v. Chevron,* 22 Cal. App. 4th 1352, 1367 (1994) (quoting *Kaplan v. Wyatt*, 499 A. 2d 1184, 1189 (Del. 1985)).

5. "It is the care, 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); *Kahn v. Tremont Corp.*, 694 A. 2d 422, 430 (Del. 1997); *Emerald Partners v. Berlin*, 726 A. 2d 1215 (Del. 1999).

6. "The presence of an unconflicted board majority undercuts any inference that the decisions of the Intercargo board can be attributed to disloyalty." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 503 (Del. Ch. 2000).

C. **The Authority Given the Special Committee**

1. "A showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness." *Kahn v. Lynch Communication Systems, Inc.*, 638 A. 2d 1110, 1115 (Del. 1994).

2. "This court has held that arm's-length negotiation provides 'strong evidence that the transaction meets the test of fairness.'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1167, 1172 (Del. 1995) *reh'g denied* (Aug. 16, 1995) *quoting Weinberger v. UOP* and *Rosenblatt v. Getty Oil*.

3. Even though Unocal had made a tender offer in *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421 (Del Ch. 2002), Pure's board created a Special Committee, but the Special Committee's authority, per Unocal's suggestion, was limited to the power to retain independent advisors, to make a recommendation regarding the tender offer's advisability on behalf of Pure, and to negotiate a higher exchange rate with Unocal. When the Special Committee requested full authority to respond to the offer, interested Unocal directors on the board of Pure raised concerns, and the authority of the committee was not enlarged. *Id.* at 430-431.

D. **The Special Committee Must Be Fully Informed and Must Maintain Proper Records**

1. To establish that the Committee has done its work carefully, so as to shift the burden of proof to the plaintiff, it is important to make a record of the meetings of the Committee, including telephonic meetings, with appropriate minutes reflecting the members' knowledge of the company's business and their careful consideration of the issues. *See, e.g., Kahn v. Tremont Corp.*, 694 A. 2d 422 429-30 (Del. 1997) (Delaware Supreme Court noted lack of attendance

and diligence by some committee members as part of the basis for its conclusion that the defendants retained the burden of showing the entire fairness of the transaction, despite the use of a special committee).

2. In finding that the target board had satisfied its *Revlon* duties, the Chancery Court considered the fact that the board was comprised of financially sophisticated members who were fully informed about the negotiations. *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *4-5 (Del. Ch. Feb. 18, 2004).

E. **Shopping the Deal - Market Checks - Negotiating a Higher Price**

1. Evidence that the target, through its special committee and advisors, shopped the company, contacted potential buyers, sought a topping bid, and/or tried to negotiate for a higher price with the acquirer, is all valuable and will show independence and arm's length dealings.

2. **The Special Committee Negotiated a Higher Price**. *In Re Grace Energy Corp. S'holder's Litig.*, 1992 Del. Ch. LEXIS 134, *11 (Del. Ch. 1992) (in the context of a motion for a preliminary injunction to enjoin a merger, the court found that the plaintiffs failed to meet their burden of showing reasonable probability that the special committee breached its duty of loyalty where, *inter alia*, the special committee undertook steps to negotiate merger price from $16.50 to $19.00 per share).

3. **The Special Committee Did Not Try to Negotiate a Higher Price**. *See, e.g., Kahn v. Lynch*, 638 A. 2d 1110, 1117-1121 (Del. 1994) (Supreme Court held that the trail court erred in shifting the burden of proof with regard to entire fairness to the plaintiff because the record did not support the trial court's conclusion that the special committee had negotiated at arms-length); *Freedman v. Restaurant Assoc. Indus., Inc.*, 1990 Del. Ch. LEXIS 142, *22-*23 (Del. Ch. 1990) ("In this instance, facts are alleged that would establish that this special committee was not given the opportunity to select from among the range of alternatives that an independent, disinterested board would have had available to it; it was, in effect, "hemmed in" by the management group's actions. Under these circumstances, where, according to the allegations contained in the amended complaint, the management group could (and did) veto any action of the special committee that was not agreeable to the conflicted interests of the management directors it would be formalistically perverse to afford the special committee's action the effect of burden shifting of which that device is capable. Thus, I conclude that the

complaint alleges in effect, a self-interested transaction that will require the interested directors to prove the entire fairness of that transaction to the minority shareholders.")

4. In finding that the target board had satisfied its *Revlon* duties, the Chancery Court considered the fact that the board tested the definitive merger agreement for 5 months through a post-agreement market check, and no competing bids were received. The court determined that 5 months allowed sufficient time for due diligence. *In re MONY Group Inc. S'holders Litig*., 2004 WL 303894, at *7 (Del. Ch. Feb. 18, 2004).

5. Despite the fact that the defendant directors carried their burden of proving the entire fairness of the transaction, the Supreme Court noted that '[t]he Court of Chancery properly considered that the Technicolor board's now undisputed lack of care in making a market check [none was made] was a flaw in its approval process." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1175 (Del. 1995) *reh'g denied* (Aug. 16, 1995).

6. In determining the adequacy of an offer in a sale of control, directors may approve a transaction without an auction or market check so long as they based their decision on a "body of reliable evidence." *QVC Network, Inc. v. Paramount Communications, Inc.*, 635 A. 2d 1245, 1268 (Del. Ch. 1993) *citing Barkan v. Armsted Industries*, 567 A. 2d 1279. 1287 (Del. 1989).

7. The Special Committee tried unsuccessfully to negotiate a higher price in *Pure Resources*, 808 A. 2d at 432 (Del Ch. 2002).

XIII. <u>Lock-Ups, No-Shops, and No-Talks</u>

A. Voting Agreements and Irrevocable Proxies

1. In *In re IXC Communications, Inc. S'holders Litig*., No. Civ.A. 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999), the court denied plaintiffs' motion for a preliminary injunction and upheld a voting agreement because plaintiff failed to show that it defrauded or disenfranchised other shareholders. "Absent these deleterious purposes, a shareholder may commit his vote as he pleases." Id. at *22-*23. The court rejected the plaintiffs' argument that the vote buying agreement disenfranchised other shareholders by making it seem to them that their vote was meaningless, because the voting agreement did not lock up an "absolute majority" and therefore did not "make the outcome of the vote a foregone conclusion." Id. at *23-*24.

2. *See Ace Ltd. v. Capital Re Corp.*, 747 A. 2d 95 (Del. Ch. 1999), discussed below.

3. Where a majority of shareholders insist on the deal, there may be less risk to the target board when a voting agreement is approved, even though the voting lock up will trump the fiduciary out.

4. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914, 936 (Del. 2003). Deal protection devices that make it "mathematically impossible" to accept a subsequent, better proposal, including voting agreements that irrevocably and absolutely lock-up a transaction without a "fiduciary out," are probably coercive under Delaware law.

B. **No Shop and No Talk Provisions**

1. "Likewise, the fact that the merger agreement contained a rather standard no-shop provision does little to bolster the plaintiffs' claim. The no-shop permitted the Intercargo board to consider an unsolicited proposal that the board determined was likely to be consummated and more favorable to Intercargo's stockholders than the XL merger. The presence of this type of provision in a merger agreement is hardly indicative of a *Revlon* (or *Unocal*) breach." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 506 (Del. Ch. 2000) (footnotes and citations omitted).

2. A Delaware board can contract away its ability to consider other deals in some circumstances. *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985).

   (a) Was provision bargained for? Did target negotiate? Does protected deal offer enhanced value? Is there a fiduciary out (discussed below)? The better the deal, the more justified the no shop.

3. *Matador Capital Mgmt. Corp. v. BRC Holdings, Inc.*, 729 A. 2d 280, 291 (Del. Ch. 1998) ("[c]ontrary to plaintiffs' suggestion, these measures [in particular, a no-shop provision] do not foreclose other offers, but operate merely to afford some protection to prevent disruption of the Agreement by proposals from third parties that are neither bona fide nor likely to result in a higher transaction.")

4. "Although it is true that Technicolor could not 'shop' for competing bids, it successfully preserved its right to provide information to, and engage in discussions with, competing bidders. The Court of Chancery concluded on remand that the MAF transaction was not 'locked up' by any device except its very high price." *Cinerama*,

Inc. v. Technicolor, Inc., 663 A. 2d 1156, 1173 (Del. 1995) *reh'g denied* (Aug. 16, 1995).

5. *Phelps Dodge Corp. v. Cyprus Amex Minerals Co.*, No. Civ.A. 17398, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999) (no talk provision preventing board from considering information with no fiduciary out likely unenforceable).

6. In *Ace Ltd. v. Capital Re Corp.*, 747 A. 2d 95 (Del. Ch. 1999), the plaintiff brought a motion for a TRO to enjoin the defendant from terminating the parties' merger agreement. The court denied the motion. The merger agreement contained a "no talk" provision restraining Capital Re from considering a third party proposal unless the target board made certain determinations in good faith, including the determination that the competing proposal was reasonably likely to result in a superior offer. The provision stated that the board would not engage in discussions unless it received written legal advice from outside counsel that the board's fiduciary duties mandated such discussions. Ace, the acquirer, already owned 12.3% of the target and obtained voting agreements for another 33.5%. The voting agreements required 33.5% support of the merger unless the board of the target terminated the merger per its terms, which included a fiduciary out. The day before the shareholder vote, XL made a superior offer and Capital Re's board terminated the merger agreement after receiving various opinions and reports from counsel and financial advisors. Ace made a counteroffer, XL raised its offer, and then Ace filed suit. The court was unwilling to enforce Ace's interpretation that the fiduciary out required Capital Re's board to obtain a written opinion of counsel that its fiduciary duties required it to consider the competing offer. The court viewed this as an impermissible abdication of the board's duties.

7. Typically, auctions required under Rules 14d-9 and 14e-2 are exempted from the no-shop, no talk provisions.

8. In California, a board may bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had a chance to consider the proposal. *Jewel Cos. v. Payless Drug Stores Northwest, Inc.*, 741 F. 2d 1555, 1564 (9th Cir. 1984).

    (a) See William T. Allen, Understanding Fiduciary Outs: The What And The Why of an Anomalous Concept, 55 Bus. Law. 653 (Feb. 2000).

C. **Breakup Fees, Termination Fees, Liquidated Damages Provisions, and Chilling**

1. Typically paid by the target if the target terminates the transaction pursuant to a termination right in the merger agreement. An right or event of termination can include a fiduciary out, a withdrawal of the target board's recommendation, the announcement of a competing bid, a no-vote of shareholders in the face of a competing bid, the target board entering into discussions with a third party pursuant to the fiduciary out, or the target board's failure to reject another bid.

    (a) Conditions in the merger agreement that would chill the target's willingness to enter into negotiations or discussions that could lead to a superior offer may be coercive. Try to condition fee on consummation of alternative transaction, or alternative agreement and recommendation, so not viewed as preclusive.

2. "Commentators have expressed the view that liquidated damages provisions in the one-to-five percent range of the proposed acquisition price are within a reasonable range...." *Kysor Indus. Corp. v. Margaux, Inc.*, 674 A. 2d 889, 897 (Del. Supr. 1996).

3. *Brazen v. Bell Atlantic Corp.*, 695 A. 2d 43 (Del. 1997) (no facts alleged showing fee was coercive; termed and treated as liquidated damages fee and found that damages were uncertain and fee was a reasonable forecast of damages and not a penalty, proper to consider lost opportunity costs, expenses incurred, likelihood of a competing bid, and range of typical breakup fees); *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173, 182 (Del. 1985) (affirming trial court's order enjoining payment of $25 million termination fee because the fee was part of the board's overall plan, including the use of a "poison pill" and "no shop" and "lock up" provisions to thwart the efforts of another bidder to acquire the target company and prevent an active auction); *In re J.P. Stevens & Co. S'holders Litig.*, 542 A. 2d 770, 783 (Del. Ch. 1988) (upholding a $17 million termination fee because there was no evidence that it prevented the board from seeking the "best available deal for the shareholders.")

4. *Malpiede v. Townson*, 780 A. 2d 1075, 1081, n.10 (Del. 2001) (termination fee was 7% and complaint was dismissed). But after *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A. 2d 34 (Del. 1993), no fee is per se reasonable in Delaware in a sale of control context, and a fee of 6.3% "stretched the definition of range of reasonableness . . . probably beyond the breaking point." *Phelps*

Dodge Corp. v. Cyprus Amex Minerals Co., No. Civ.A. 17398, 1999 Del. Ch. LEXIS 202 (Del. Ch. Sept. 27, 1999).

5. "Although in purely percentage terms, the termination fee was at the high end of what our courts have approved, it was still within the range that is generally considered reasonable. As important, the termination fee was structured so as to be payable only in the event that the Intercargo stockholders rejected the XL merger and were benefited by a more favorable strategic transaction within ninety days or another acquisition proposal within the ensuing year. This structure ensured that the Intercargo stockholders would not cast their vote in fear that a 'no' vote alone would trigger the fee; the fee would be payable only if the stockholders were to get a better deal. From the preclusion perspective, it is difficult to see how a 3.5% fee would have deterred a rival bidder who wished to pay materially more for Intercargo. No doubt the presence of the fee would rebuff a bidder who wished to top XL's bid by a relatively insignificant amount that would not have been substantially more beneficial to Intercargo's stockholders, but to call such an insubstantial obstacle 'draconian' is inconsistent with the very definition of the term." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 505-506 (Del. Ch. 2000) (footnotes and citations omitted).

6. A termination fee of 3.3% of the target's total equity value, and 2.4$ of the total transaction value was found reasonable. *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *8 (Del. Ch. Feb. 18, 2004).

XIV. <u>Coercion, Timing, Misrepresentations and Omissions</u>

A. **Timing Issues**

1. The court applied entire fairness because the timing of the offer supported the minority shareholder's theory that the § 251 merger was inequitably timed in order to deprive the minority of a higher price. The timing allegations constituted part of the procedural inquiry of entire fairness. *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A. 2d 1099, 1100 (Del. 1985). *See also Eisenberg v. Chicago Milwaukee Corp.*, 537 A. 2d 1051 (Del. Ch. 1987).

2. Coercion exists when a board of directors "believes that the company's present strategic plan will deliver more value than the premium offer, the stock market has not yet bought that rationale, the board may be correct, and therefore there is a risk that 'stockholders might tender . . . in ignorance or based upon a

mistaken belief.'" *Chesapeake Corp. v. Shore*, 771 A. 2d 293, 324 (Del. Ch. 2000) (citations omitted).

3. Directors should be able to demonstrate that they spent an appreciable or even substantial amount of time making a particular decision, in order to demonstrate that it was "informed" and in compliance with the duty of care. *Smith v. Van Gorkom*, 488 A. 2d 858, 874 (Del. 1985).

4. The timing factor does not entitle a minority to entire fairness in a § 253 short form merger, and timing can be considered in the appraisal action. *Glassman v. Unocal Exploration Corp.*, 777 A. 2d 242, 248 (Del. 2001).

B. **Disclosures, Omissions, and Misrepresentations**

1. "In circumstances such as these, the Pure stockholders are entitled to disclosure of all material facts pertinent to the decisions they are being asked to make." [T]he S-4 and the 14D-9 must contain the information that "'a reasonable investor would consider important in tendering his stock.'" *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 447-448 (Del Ch. 2002) quoting *Zirn v. VLI Corp.*, 621 A. 2d 773, 779 (Del. 1993). The S-4 and the 14D-9 are required "'to provide a balanced, truthful account of all matters' they disclose." *In re Pure Resources*, 808 A. 2d at 448 quoting *Malone v. Brincat*, 722 A. 2d 5, 12 (Del. 1998). *Accord Emerald Partners v. Berlin*, 726 A. 2d 1215, 1223 (Del. 1999).

2. In granting the motion to enjoin the merger, the Chancery Court found a breach of the duty of disclosure. The target board had temporarily suspended merger negotiations while it reduced the amount of money that would be owed under change in control agreements with senior management. By industry standards, the amounts that would be owed were still high. The target's disclosures discussed the steps taken to reduce the change in control payments, but did not provide industry comparisons, which would have shown the lower amounts were still relatively high. The court found this information material, and required under a partial disclosure theory. *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *9-10, 14 (Del. Ch. Feb. 18, 2004).

3. Must the Special Committee or the target disclose the substantive portions of the work performed by the investment advisors, as opposed to just their opinions? **"In my view, . . . stockholders are entitled to a fair summary of the substantive work performed by**

the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." "The disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability." *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 449 (Del Ch. 2002).

4. *Malpiede v. Townson*, 780 A. 2d 1075, 1086-87 (Del. 2001) ("a pleader must allege that facts are missing from the statement, identify those facts, state why they meet the materiality standard and how the omission caused the injury") (quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A. 2d 135, 142 (Del. 1997)).

5. In *Eisenberg v. Chicago Milwaukee Corp.*, 537 A. 2d 1051 (Del. Ch. 1987), the court found the bidder's disclosures misleading and inaccurate. The bidder claimed that its offer represented a 33% premium over the company's trading price, but did not disclose that the company's shares had been trading at historic lows, and that the offer only constituted a 5% premium over the average trading price of the stock. The court also found that the "only apparent purpose" of the bidder's statement that it intended to de-list the company's stock after the tender was to induce the shareholders to tender. *Id.* at 1062. The court also found the timing of the offer suspect. Accordingly, the court found the offer inequitably coercive under the entire fairness test. *Id.*

6. In *Cottle v. Standard Brands Paint Co.*, 1990 Del. Ch. LEXIS 40 (Del. Ch. Mar. 22, 1990), the court found that the disclosures by the tenderer, especially the disclosures regarding the potential adverse effects on non-tendered shares of paying the premium offered by the tenderer, rendered the disclosures truthful and therefore non-coercive. So long as shareholders are provided with all material information regarding a tender offer, including potentially adverse effects that the offer may present, the offer will be considered voluntary and not coercive. *In re Siliconix Inc. S'holders Litig.*, No. Civ.A. 18700, 2001 Del. Ch. LEXIS 83, at *60 (Del. Ch. June 19, 2001).

7. Non-disclosed information must be material, in order to find a breach of duty of disclosure. "What the standard…contemplates is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. Supr. 1985) quoting *TSC Industries*,

Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). The test of materiality can be determined at the pleading stage by a court on a motion to dismiss. *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 736 (Del. Ch. 1999).

XV. Conflicts of Interest

A. Fees for Services Rendered by Special Committee Members

1. A fee payment to a director "related to his work and tied to overall enhancement in the value of the merger transaction" was "simply not enough to mandate strict scrutiny of the [company's] actions." *State of Wisconsin Inv. Bd. v. Bartlett*, No. Civ.A. 17727, 2000 WL 238026, at *4 (Del. Ch. 2000).

2. Payments to directors for services rendered in connection with a merger alone do not amount to a material interest sufficient to constitute a breach of the duty of loyalty. *Grobow v. Perot,* 539. A. 2d 180, 188 (Del. 1998); *In re E. F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986); *Moran v. Household Int'l, Inc.*, 490 A. 2d 1059, 1074-75 (Del. Ch. 1985), *aff'd*, 500 A. 2d 1346 (Del. 1985).

3. Target director's interest as a managing director of investment banking company hired to prepare fairness opinion was not sufficiently material as a matter of law to implicate his duty of loyalty to the target's shareholders. *Crescent/Mach1 Partners, L.P. v. Turner*, 2000 WL 1481002, at *11 (Del. Ch. 2000).

B. Interested Directors Communicating With the Special Committee

1. The key is to avoid improper influence, the appearance of improper influence, and evidence for the plaintiffs supporting an inference of improper influence. *Kahn v. Tremont Corp.*, 694 A. 2d 422, 426 (Del. 1997) (in concluding that defendants would still bear the burden of proving entire fairness despite the use of a special committee, the court noted that the committee member with the closest ties to the controlling shareholder chose the financial advisors, and the company's general counsel, who was also general counsel for the affiliated company/target, suggested the company's law firm); *Kahn v. Dairy Mart Convenience Stores, Inc.*, 1996 Del. Ch. LEXIS 38, at *22, n. 6 (Del. Ch. 1996) (not helpful that the committee's investment banker was recommended by the controlling stockholder's counsel).

C. **Domination and Control over Special Committee Members**

1. In connection with their showing of entire fairness, the defendant directors proved at trial that the board acted in good faith, and was not "dominated or manipulated by a person with a material conflicting interest or otherwise lacked independence." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1156, 1176-7 (Del. 1995), *reh'g denied* (Aug. 16, 1995).

2. Plaintiff must plead facts to demonstrate that the directors are "beholden to the [controlling person] or so under their influence that their discretion would be sterilized." *Rales v. Blasband*, 634 A. 2d 927, 936 (Del. 1993).

3. A long standing relationship between the CEO/Chairman and a director does not demonstrate control. *Crescent/Mach 1 Partners v. Turner*, 2000 WL 1481002, at *30 (Del. Ch. Sept. 29, 2000); *California Pub. Employees' Retirement Sys. v. Coulter*, 2002 Del. Ch. LEXIS 144, at *29 (Del. Ch. Dec. 18, 2002) (relationships and approval of transaction are insufficient to show domination and control).

4. *In re Grace Energy Corp. S'holders Litig.*, No. Civ.A. 12464, 1992 WL 145001, *4 (Del. Ch. Jun. 26, 1992) ("conclusory allegations of such personal affinity alone are not sufficient to establish director interest. Actual financial interest must be shown.")

XVI. Independent Counsel and Financial Advisors

A. **Independent Legal and Financial Advice has been Recognized as Central to a Special Committee's Independence**. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact Or Fancy?*, 45 Bus. Law 2055, 2061-62 (1990). *Polk v. Good*, 507 A. 2d 531, 537 (Del. 1986) (by relying on an investment banker, the directors fulfilled their duty of good faith and reasonable investigation); *Citron v. E.I. duPont de Nemours & Co.*, 584 A. 2d 490, 512 (Del. Ch. 1990) (same).

B. **All Advisors Should Know This Case – *Van Gorkom*.** The ruling in *Smith v. Van Gorkom*, 488 A. 2d 858, 876-78 (Del. 1875) made it clear that, as a general proposition, the retention of an independent third-party advisor would help the directors satisfy the "informed" requirement of the duty of care. Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1453 (19185) (**the "outside consultants are the biggest winners after [*Van Gorkom*]. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost."**)

C. **Reliance on Independent Advisors Can Preserve Business Judgment Rule Review**.

1. "The board's reliance upon an investment banker (whose independence and qualifications are not challenged in the complaint) is another factor weighing against the plaintiffs' ability to state an actionable claim that the defendant directors breached their fiduciary duties by failing to secure the highest value reasonably attainable." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 505, n. 55 (Del. Ch. 2000) (citations omitted).

2. The directors "also relied upon reports by Goldman Sachs and by Debevoise & Plimpton. Indeed, as set forth below in my opinion they relied upon the advice of their special counsel and that reliance is itself a relevant factor in assessing overall fairness." "[T]he Technicolor board's reliance upon experienced counsel evidenced good faith and the overall fairness of the process." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1134, 1141-42 (Del. 1994) *aff'd* 663 A. 2d 1156 (Del. 1995) *reh'g denied* (Aug. 16, 1995).

3. In finding that the target board had satisfied its *Revlon* duties, the Chancery Court considered the fact that the board (no special committee was created because the transaction was an arm's length transaction and none of the board members of the target were conflicted) had engaged CSFB for advice designed to maximize shareholder value, including the exploration of alternative transactions. *In re MONY Group Inc. Shareholders Litig.*, 2004 WL 303894, at *6 (Del. Ch. Feb. 18, 2004).

4. Directors are "fully protected in relying in good faith upon . . . [any person] as to matters the [director] 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. Gen. Corp. L. § 141(e).

5. *F.D.I.C. v. Castetter*, 184 F. 3d 1040, 1046 (9th Cir. 1999) (California's business judgment rule cannot be rebutted when directors reasonably relied upon information obtained from outside advisors).

D. **Director Duties When Relying on Independent Experts**

1. "When directors rely on fairness opinions, they should have the following duties: (1) to select the investment banker with care; (2) to disclose accurate information to the investment banker; (3) to determine whether the investment banker followed accepted valuation procedures; and (4) to examine the investment banker's conclusions." Robert J. Giuffra, Jr., 96 Yale L. J. 119, 132 (1986).

2. **Director Decisions Still Must be Informed, and Directors Must Consider all Relevant Information, Ask Questions, and be Proactive**. "In fact, the because the procurement of a fairness opinion helps to preclude liability, board passivity may even be encouraged in the management-captured entity. If there is no punishment for passivity, those structural factors promoting board passivity will continue to dominate the directors' decision making process." Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. Cin. L. Rev. 649, 685.

E. **Fairness Opinions**

1. "Fairness opinions have become so much a part of the routine of public company acquisitions that today the absence of such an opinion . . . would probably raise eyebrows . . . . An investment banker's opinion on financial fairness may be influential with a court which reviews the fairness of the acquisition [and] . . . a fairness opinion may protect the acquired company's directors against a lawsuit charging that they failed to exercise reasonable business judgment when they approved the acquisition." Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 Ohio St. L. J. 951, 957, n. 11 (1992) (quoting Leonard Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 Bus. Law. 1439, 1442 (1981)).

2. In finding that the target board had satisfied its *Revlon* duties, the Chancery Court considered the fact that the board had engaged CSFB and had obtained a fairness opinion from CSFB. *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *6 (Del. Ch. Feb. 18, 2004).

F. **Disclosure Issues**

1. "In my view, . . . stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." "The disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability." *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 449 (Del Ch. 2002). This is especially true where the Special Committee of the target recommended against the tender, but did nothing else to stop it. *Id.* at 450.

2. "Hiding behind" the attorney-client privilege when the Special Committee members are sued. *In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 431, n.8 (Del. Ch. 2002) ("in general it seems unwise for a special committee to hide behind the privilege, except when the disclosure of attorney-client discussions would reveal litigation-specific advice or compromise the special committee's bargaining power.")

3. Under Delaware law, disclosure of the underlying analysis supporting a fairness opinion "[is] not ordinarily required." *Matador Capital Management Corp.* 729 A. 2d 280 (Del. Ch. 1988). *But see In re Pure Resources, Inc., S'holders Litig.*, 808 A. 2d 421, 449 (Del Ch. 2002) ("In my view, . . . stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." "The disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability.**")**

4. In *In Re JCC Holding Co., Inc. S'holders Litig.*, Consol C.A. No. 19796, Strine V.C. (Del. Ch. Sept. 25, 2003), the Court found that the allegations in the complaint failed to state a disclosure claim under Delaware law. Specifically, the plaintiffs alleged that the JCC board of directors failed to make adequate disclosures in the proxy statement disseminated in connection with the merger because: (1) the JCC board did not require its financial advisor, Houlihan Lokey Howard & Zukin ("Houlihan"), or JCC's management to perform certain valuation analyses and disclose the results of those analyses; and (2) the JCC board disclosed certain valuation analyses

that the plaintiffs alleged were incorrectly performed by Houlihan. The Court rejected plaintiffs' claims arising from the alleged wrong of failing to requisition and disclose the valuation analyses at issue. Specifically, the Court noted that the proxy statement disclosed that the analyses were not performed because JCC did not have reliable information from which Houlihan could perform them. Accordingly, the Court held that under well-established precedent, the Court would not compel pure speculation nor would it require a board of directors to disclose information that simply does not exist. The Court similarly rejected the plaintiffs' disclosure claims based on the alleged wrong of disclosing valuation analyses that allegedly were incorrectly performed. Specifically, the Court found that, even if the plaintiffs were correct that Houlihan failed to perform certain valuation analyses correctly, Houlihan's error in subjective judgment on how to perform the analyses failed to state a disclosure claim under Delaware law since the proxy statement disclosed why Houlihan chose the methodology it used.

5. **SEC Disclosure Requirements**. The Securities and Exchange Commission requires companies to disclose relatively detailed information relating to fairness opinions or valuation analyses they receive in connection with certain transactions for which shareholder approval is required, including mergers, consolidations and "going private" transactions. *See e.g.* Schedule 14A, Item 14; Schedule 13e-3, Item 9.

6. **Avoid Partial or Misleading Disclosures**. "[D]irectors must . . . avoid misleading partial disclosures. Once directors undertake a partial disclosure they assume an 'obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events.' . . . This partial disclosure rule 'is implicated only where the omission of a related fact renders the partially disclosed information materially misleading." *Goodwin v. Live Entertainment*, 1999 Del. Ch. LEXIS 5 (Del. Ch. 1999) at (ruling that failure to disclose certain facts, valuations and methods of valuation in proxy statement was not materially misleading and within board's reasonable judgment, and that in fact, inclusion of certain information may have confusing or misleading.)

7. **Update Disclosures, if necessary**. In *In re: Trump Hotels S'holder Derivative Litig.*, 2000 U.S. Dist. Lexis 13550 (S.D.N.Y. 2000), the Court ruled that plaintiffs stated a valid claim because the board of directors disclosed a fairness opinion for a transaction in a proxy statement, when the analysis for this opinion relied upon the

completion of certain events that board of directors knew or should have known would not take place at the time of disclosure.

8. In *Emerald Partners v. Berlin, et. al.*, 2003 Del. Ch. LEXIS 42, at *65 (Del Ch. 2003), the court held that, "[r]egardless of whether or not the decision [not to update the fairness opinion] turned out to be correct or wise, the court is satisfied, both from the documentary evidence and from the demeanor of the defendant directors during their trial testimony, that the board's decision was made on a rational basis, was the result of a rational process, and was made in good faith and independently of [the conflicted director]."

9. In granting the motion to enjoin the merger, the Chancery Court found a breach of the duty of disclosure. The target board had temporarily suspended merger negotiations while it reduced the amount of money that would be owed under change in control agreements with senior management. By industry standards, the amounts that would be owed were still high. The target's disclosures discussed the steps taken to reduce the change in control payments, but did not provide industry comparisons, which would have shown the lower amounts were still relatively high. The court found this information material, and required under a partial disclosure theory. *In re MONY Group Inc. S'holders Litig.*, 2004 WL 303894, at *9-10, 14 (Del. Ch. Feb. 18, 2004).

G. **Independence of the Investment Advisor**

1. "Broadly speaking, judicial inquiry has focused on whether the investment bank was sufficiently independent or was dominated by management or a controlling shareholder; whether the investment bank's methodology was objectively unreasonable; and whether adequate disclosure of the investment bank's analysis and conclusion was made either to the directors or shareholders." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions,* New York Law Journal, June 16, 1994, pg. 5.

2. "[C]ourts have discounted the reliability of a valuation analysis or fairness opinion rendered by an investment bank where management of a controlling shareholder is interested in the outcome of the transaction, such as a management buy-out or parent-subsidiary merger, and where the interested party is shown to dominate and unduly influence the investment bank." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions*, New York Law Journal, June 16, 1994, pg. 5.

3. In *In re Tri-Star Pictures Inc., Litig.*, 634 A. 2d 319 (De. 1993), the Delaware Supreme Court held that the minority shareholders stated a valid claim against a significant shareholder, and could prevail if they could prove that this significant shareholder had so dominated and controlled the transaction as to become a fiduciary. **This finding was based, in part, on the Court's finding that "inextricable ties" existed between the significant shareholder and the investment bank which rendered a fairness opinion to the minority shareholders**. In this transaction, the investment bank (i) provided extensive investment banking services to the significant shareholder, (ii) the bank's CEO was a member of the board of directors of the significant shareholder, and (iii) the bank's CEO was scheduled to sit on the board of directors of the corporation resulting from the transaction.

4. "The directors' decision-making process may become tainted if something about the advisor's past relationship with the corporation gives rise to a disabling conflict that prevents him from representing the directors. A director's independence typically will not be tainted, however, merely because the corporation has a past relationship with the advisor. Dennis J. Block and Jonathan M. Hoff, *Outside Advisors, Director Disinterestedness*, New York Law Journal, October 19, 1995, pg. 5.

5. In *Mills Acquisition Co. v. MacMillan*, 559 A. 2d 1261 (De. 1988), the Delaware Supreme Court questioned the fairness analysis of an investment bank in a proposed management buy-out where the bank had worked with management for over 500 hours on the transaction before it was appointed as financial advisor to the special committee of the board of directors; was selected as the financial advisor to the special committee by interested members of management; and acceded to the primacy of management's financial advisor in conducting a subsequent auction of the company.

6. "Boards relying on an investment bank's analysis are well advised to make every effort to ensure the independence of their financial advisors, particularly where management is interested in the outcome of the transaction." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions*, New York Law Journal, June 16, 1994, pg. 5.

7. "If . . . a bank writing a fairness opinion is not involved with other aspects of the transaction, such a bank will not be influenced by the possibility that a particular fairness opinion might create more work. Furthermore, hiring an 'outside' bank will reduce the psychological

and social factors that tend to create pro-management fairness opinions. A second investment bank will be at a distance from the transaction and thus more likely to write a more neutral opinion." Lucian Arye Bebchuk and Marcle Kahan, *Fairness Opinions: How Fair Are They And What Can Be Done About It?*, 1989 Duke L. J. 27 at 50.

H. **The Investment Advisor's Methods and Processes of Valuation**.

1. "[C]ourts have not permitted directors to claim reliance on a fairness opinion to obtain the protection of the business judgment rule . . . where a court finds an investment bank's valuation analysis or fairness opinion to have been unreliable." Dennis J. Block and Jonathan M. Hoff, Reliance on Fairness Opinions, New York Law Journal, June 16, 1994 pg. 5.

2. "[Because] of the varying methods of valuation considered acceptable by the financial community, an evaluator of valuation is given a wide range of latitude in establishing the value of a particular enterprise. Given this fact . . . the 'partisan' pressures placed on a bank asked to evaluate the 'fairness' of a transaction are such that truly objective and independent valuation advice is, as a practical matter, difficult to achieve. Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 Ohio St. L. J. 951, 970 (1992).

3. **Ensure sufficient time to prepare a thorough analysis**: "[S]everal courts have indicated that a board cannot reasonably rely on a hastily prepared or incomplete fairness analysis." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions*, New York Law Journal, June 16, 1994 at 5, *citing Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F. 2d 264, 271 (2nd Cir. 1976); *Weinberger v. UOP Inc.*, 475 A. 2d 701 (De. 1983); *Joseph v. Shell Oil Co.*, 482 A. 2d 335 (De. Ch. 1984).

4. **Competing Bids**. "[W]here the investment bank is advising a board as to the relative merits of competing proposals, its advice may be questioned if it fails to present the competing alternatives to the board in an objective manner." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions*, New York Law Journal, June 16, 1994, pg. 5. "It is easy to give fairness opinions when an auction has been conducted, and every potential bidder has had the opportunity to inspect the selling corporation before deciding whether to bid. In a fairness opinion delivered under circumstances in which no auction has been held, as in a take-out merger, the

investment banker is asked to render an opinion about the probable behavior of many participants in the market without observing them." William J. Carney, *Fairness Opinions: How Fair Are They And Why We Should Do Nothing About It*, 70 Wash U. L. Q. 523, 533.

5. **Avoid Any Appearance that the Investment Advisor was "Offered" a Conclusion**. "Considering the vast numbers of combinations possible and the fact that each approach may yield 'different ranges of values' a bank is confronted with the prospect of opining to the fairness of any number of values based on its valuation process. This fact suggests that a bank has the ability to be 'offered' a conclusion as to value by a board seeking a finding of being properly informed, and, by using the right combination of valuation methods, may create a process to justify the preferred conclusion. A number of commentators have criticized this ability, suggesting that is creates a 'fairness for hire.'" Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 Ohio St. L. J. 951, 964-65 (1992).

6. **Analysis should reflect a thorough review of supporting data**. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F. 2d 264 (2d Cir. 1986), the Second Circuit held that the directors breached their duty of care, in part, because the decision to grant a lock-up option was made hastily, and based on the investment banker's conclusory opinion that the option was within a range of fair value, without reviewing supporting data or a written opinion from the bankers. Had the directors inquired, they would have learned that the bankers did not investigate a range of fair value.

7. **Analysis should present information accurately**. In *QVC Network, Inc. v. Paramount Communications Inc.*, 635 A. 2d 1245 (Del. Ch. 1993), *aff'd*, 537 A. 2d 34 (De. 1994), the Delaware Chancery Court criticized the investment bank's fairness opinion on several grounds, including the apparent manipulation of the information the investment bank presented to the board by presenting competing offers differently. In this case, the merger was preliminarily enjoined, because the board has not satisfied its duty of care in approving the transaction based on informed business judgment, in part because of this information provided by the investment bank.

I. The Investment Advisor's Access to Information.

1. **The Investment Bank should have Full Access to all Relevant Information**. In *Joseph v. Shell Oil Co.,* 482 A. 2d 335 (De. Ch. 1984), the Delaware Chancery Court enjoined a tender offer for all of the outstanding minority shares of Shell Oil by Shell Oil's majority shareholder, based in part on deficiencies in a fairness opinion prepared by Morgan Stanley which was included in the tender offer materials. The Court concluded that the majority shareholder "withheld from Morgan Stanley essential facts necessary for Morgan Stanley to arrive at a fair and accurate opinion as to the value", and "[failed] to make available to the appraiser hired by the offeror the essential information needed by the appraiser if his appraisal was to have any meaning." The court concluded that such conduct was a breach of the majority shareholder's fiduciary duty to the minority shareholders.

2. The court in *QVC* also considered the fact that Paramount management placed various limitations on the fairness diligence reviewed by the investment bankers in granting the preliminary injunction.

3. "[D]irectors should carefully consider whether the restrictions they impose on the investment banker's conduct of the fairness evaluation (such as no market check) will result in an opinion that does not adequately support the board's analysis . . . or that raises inferences of bias or conflict." Theodore N. Mirvis, *Takeover Law and Practice 2002*, ALI-ABA Course of Study Materials, Ninth Annual Corporate Governance Institute, V. II.

J. Consideration of the Fairness Opinion

1. **Plaintiffs will scrutinize the Board's consideration of the fairness opinion**. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F. 2d 264 (2d Cir. 1986), the Second Circuit held that the directors breached their duty of care, in part, because the decision to grant a lock-up option was made hastily, and based on the investment banker's conclusory opinion that this option was within a range of fair value, without reviewing supporting data or a written opinion from the bankers. Had the directors inquired, they would have learned that the bankers did not investigate a range of fair value.

2. "The issue of whether a fairness opinion should be 'brought down' from the time of signing a merger agreement to the time of mailing the related proxy statement is a point to be considered by each

party's board." Theodore N. Mirvis, *Takeover Law and Practice 2002*, ALI-ABA Course of Study Materials, Ninth Annual Corporate Governance Institute, V. II.

3. In *Emerald Partners v. Berlin, et. al.*, 2003 Del. Ch. LEXIS 42, at *65 (Del Ch. 2003), the court held that, "[r]egardless of whether or not the decision [not to update the fairness opinion] turned out to be correct or wise, the court is satisfied, both from the documentary evidence and from the demeanor of the defendant directors during their trial testimony, that the board's decision was made on a rational basis, was the result of a rational process, and was made in good faith and independently of [the conflicted director]."

K. **Investment Advisor Fees, Flat Fee and Contingent Fee Arrangements**

1. Beware of conflicts of interest between the shareholders (the purported beneficiaries of the fairness opinion) and the investment advisors. A contingent fee arrangement could support an inference that the advisor had a strong incentive to find that the transaction was fair.

2. "[C]ourts have questioned the reliability of an investment bank's analysis where part of the bank's compensation was linked to a particular result that did not necessarily obtain an increased value for the shareholders." Dennis J. Block and Jonathan M. Hoff, *Reliance on Fairness Opinions*, New York Law Journal, June 16, 1994 at 5, *citing Dynamics corp. of Am. v. CTS Corp.*, 794 F. 2d 250, 257 (7th Cir. 1986).

3. In *City Capital Assoc. v. Interco Inc.*, 551 A. 2d 787, 793 (De. Ch. 1988), the Court stated that the investment advisor contingency fee for completion of a management restructuring alternative created a conflict of interest when the same advisor opined to the fairness of a cash tender offer.

4. Fee arrangements should be reasonable, and should not be, or appear to be, detrimental to the minority shareholders' interests. The advisors' interests should be aligned with the special's committees' and the minority shareholders' so that they obtain the highest value for the shares. *Golaine v. Edwards*, 1999 Del. Ch. LEXIS 237, at *30-*31 (Del. Ch. 1999) ($20 million fee to investment bankers in $8 billion merger was not excessive, even though two of KKR's principals were on board of Duracell and negotiated the merger between Duracell and Gillette, and KKR owned 34% of Duracell's stock - complaint lacked allegations that fees tainted the merger's

final terms in a way that injured Duracell's shareholders); *Smith and Gosselin v. Pritzker*, 1982 Del. Ch. LEXIS 552, at *11 (Del. Ch. 1982) (fee contingent on Solomon negotiating higher price upheld).

(a) In finding that the target board had satisfied its *Revlon* duties and acted reasonably, the Chancery Court found that the investment advisor's fees were reasonable and incentivized the advisor to obtain the vest available price, because the fee was set at one percent of the transaction value. *In re MONY Group Inc. S'holders Litig*., 2004 WL 303894, at *6 (Del. Ch. Feb. 18, 2004).

XVII. <u>Theories of Investment Advisor Liability</u>

A. **Intentional or Negligent Misrepresentation**. *Dowling v. Narragansett Capital Corp*., 735 F. Supp. 1105 (D.R.I. 1990) (recognizing shareholders' cause of action against investment bank for negligently issued fairness opinion). To be successful, this claim will require a finding of contractual privity between the bank and the shareholders.

B. **Violation of Federal Securities Laws**. *Herskowitz v. Nutri/Sys., Inc.*, 857 F. 2d 179 (3d. Cir. 1998).

C. **Aiding and Abetting Directors in their Breach of Fiduciary Duties**. *Anderson v. Boothe*, 103 F.R.D. 430 (D. Minn. 1984).

1. To plead a cause of action for aiding and abetting a breach of duty, the plaintiff must allege facts showing: "(1) the existence of a fiduciary duty; (2) a breach of the fiduciary duty; (3) knowing participation by the non-fiduciary in that breach; and (4) resulting damages." *HMG/Courtland Props., Inc. v. Gray*, 749 A. 2d 94, 120 (Del. Ch. 1999). *Accord Malpiede v. Townson*, 780 A. 2d 1075, 1096 (Del. 2001); *McGowan v. Ferro,* No. Civ.A. 18672-NC, 2002 WL 77712, *2 (Del. Ch. Jan. 11, 2002); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A. 2d 377, 391-92 (Del. Ch. 1999); *Gilbert v. El Paso Co*., 490 A.2d 1050, 1057 (Del. Ch. 1984), aff'd, 575 A.2d 1131 (Del. Supr. 1990).

2. Knowing participation must be reasonably inferred from the facts alleged. *In re Lukens Inc. S'holders Litig*., 757 A.2d 720, 734-35 (Del. Ch. 1999). "Knowing participation in a board's fiduciary breach requires that the third party act with the knowledge that the conduct advocated or assisted constitutes such a breach. Under this standard, a bidder's attempts to reduce the sale price through arm's-length negotiations cannot give rise to liability for aiding and abetting, whereas a bidder may be liable to the target's stockholders

if the bidder attempts to create or exploit conflicts of interest in the board. Similarly, a bidder may be liable to a target's stockholders for aiding and abetting a fiduciary breach by the target's board where the bidder and the board conspire in or agree to the fiduciary breach." *Malpiede v. Townson*, 780 A. 2d 1075, 1097-98 (Del. 2001) (footnotes and citations omitted) (dismissal affirmed on appeal).

3. Do not revise fairness opinions so that the bid will fall within the range of fairness. *Kahn v. Dairy Mart Convenience Stores, Inc.*, No. 12489, 1996 WL 159628, at *9 (Del. Ch. Mar. 29, 1996). Beware the "quick and cursory" fairness opinion. *Joseph v. Shell Oil Co*., 482 A.2d 35, 344 (Del. Ch. 1984).

D. **Agency Theories**. *Schneider v. Lazard Freres & Co.*, 552 N.Y.S. 2d 571 (App. Div. 1990) (investment advisors were treated as agents of the special committee, which in turn was an agent of the shareholders, charged with obtaining the highest price for the shareholders. The court rejected the banker's argument that because the fairness opinion was addressed to the special committee, the bank did not owe any duties to the shareholders.)

1. Structure the engagement as an independent contractor.

E. **Professional Negligence and Breach of Fiduciary Relationship**.

1. In Delaware, the courts have declined to find that bankers owe fiduciary duties to minority shareholders. *Weinberger v. UOP, Inc.*, 426 A.2d 1333 (Del. Ch. 1981), aff'd, No. 58-1981 (Del. Supr. Feb. 9, 1982), withdrawn, 457 A.2d 701 (Del. Supr. 1983) (en banc); *Lewis v. Leaseway Transportation Corp.*, No. 8720, 1990 Del. Ch. LEXIS 69 (Del. Ch. May 16, 1990); *In re Shoe-Town, Inc.*, No. 9483, 1990 Del. Ch. LEXIS 14 (Del. Ch. Feb. 12, 1990); Anderson v. Boothe, 103 F.R.D. 430, 441 (D. Minn. 1984) (applying Delaware law); *Rubin v. Posner*, 701 F.Supp. 1041, 1053 (D. Del. 1988).

2. *In re Daisy Sys. Corp.*, 97 F.3d 1171 (9th Cir. 1996) (summary judgment in favor of advisor, and denial of leave to amend to plead breach of fiduciary duty, reversed); *In re County of Orange*, 245 B.R. 138, 148-50 (C.D. Cal. 1997). *See* M. Breen Haire, *The Fiduciary Responsibilities of Investment Bankers in Change-of-Control Transactions: In re Daisy Systems Corp.*, 74 N.Y.U. L. Rev. 277 (1999).

(a) **Professional Negligence**. In a series of engagement letters signed by Bear Stearns and the company (which had been forced into bankruptcy after a proposed merger failed), Bear Stearns had agreed to act as the company's "exclusive financial advisor" in connection with the acquisition. The court did not agree that the engagement letters had limited to scope of Bear Stearns' duties. The court found that Bear Stearns' advice to adopt a hostile takeover strategy, and the company's reliance on that advice, raised a triable issue of fact as to whether the Bear Stearns' advice "put the company in a position in which it was dependent upon financing that was either impossible to obtain or available only on exorbitant terms," which eventually became a "substantial factor" in the company's bankruptcy. 97 F. 3d at 1177.

(b) **Breach of Fiduciary Duty**. The essence of a fiduciary relationship is that "the parties do not deal on equal terms, because the person in whom trust and confidence is reposed and who accepts that trust and confidence is in a superior position to exert unique influence over the dependent party." *Id*. While the trial court found that both parties were sophisticated business entities, the appellate court found that issues of fact existed as to whether Bear Stearns had superior knowledge "in the niceties of public acquisitions," an area in which Daisy had no experience. The court also rejected Bear Stearns argument that no fiduciary relationship existed as a matter of law, finding that the existence of a fiduciary relationship is normally a question of fact based on the particular facts and circumstances of each case. Whether a fiduciary relationship existed in this case will depend "on whether Daisy reposed confidences in Bear Stearns" an on whether an agency relationship existed (an agent is presumed to have a fiduciary relationship with its principal). Bear Stearns argued that it fulfilled any duties it had because its recommendation to pursue a hostile takeover strategy caused the target to negotiate a friendly merger. In response, the court found that Bear Stearns misunderstood the duty owed, which is "to provide Daisy with reliable information based upon diligent and thorough analysis." *Id*. at 1180. Bears Stearns' alleged breach "resulted in Daisy making stock purchases with the intention of pursuing a transaction which Daisy contends the market would under no circumstances support." *Id*.

(c) **Negligent Misrepresentation**. The court dismissed this theory, which was based on Bear Stearns' "ill-founded representations to Daisy – via the 'highly confident' letters - that the market would support the Daisy/Cadnetix transaction." The letters were only expressions of confidence that financing could be obtained upon satisfaction of certain express conditions. The court found that any reliance on the letters was unreasonable as a matter of law. The court also found that any reliance on any oral promise to loan money was also unreasonable and unjustified, since Daisy knew that any loan had to be approved by the Bear Stearns Commitment Committee.

(d) *Daisy* forces bankers to demand increased risk premiums in their engagements.

XVIII. <u>Cashing out Stock/Options and Accelerated Vesting</u>

A. No Conflicts or Bad Faith if Directors Receive the Same Price for their Stock or Options.

1. Directors who cash out options at the same cash-out price as all other stock and options have interests that are aligned with the minority and do not breach their duty of loyalty. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A. 2d 1134, 1151 (Del. Ch. 1994) *aff'd* 663 A. 2d 1156, 1177 (Del. 1995) *reh'g denied* (Aug. 16, 1995); *In re Western Nat'l Corp. S'holders Litig.*, No. Civ.A. 15927, 2000 WL 710192, at *12 (Del. Ch. May 22, 2000) (the accelerated vesting of a director's stock options "cannot possibly indicate (i.e., under any interpretation) that [the directors'] personal economic and professional incentives were other than aligned with the public shareholders of [the company].")

2. No bad faith because the "defendant directors received the same cash dividend in the same amount per share as all other Rexene stockholders." *In re Rexene Corp. S'holders Litig.*, 1991 Del. Ch. LEXIS 81, *12 (Del. Ch. 1991).

3. *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 504 (Del. Ch. 2000) (complaint dismissed because the "normal presumption is that the owner of a substantial block who decides to sell is interested in obtaining the highest price"); *Parnes v. Bally Entertainment Corp.*, No. Civ.A. 15192, 2001 WL 224774, at *11-*12 (Del. Ch. Feb. 23, 2001).

4. Director who was to receive a special price for his worthless options was conflicted and interested. *In re Fredericks of Hollywood, Inc.*, No. Civ.A. 15944, 2000 WL 130630 (Del. Ch. 2000) (motion to dismiss granted) *aff'd sub nom. Malpiede v. Townson*, 780 A. 2d 1075 (Del. 2001).

XIX. Employment Contracts and Severance Payments

A. No Personal Benefit at the Expense of the Shareholders.

1. Employment benefits negotiated in connection with a merger generally do not implicate the duty of loyalty or bad faith because they usually do not result in a personal benefit at the expense of the shareholders. *In re Western Nat'l Corp. S'holders Litig.*, No. Civ.A. 15927, 2000 WL 710192, at *12 (Del. Ch. May 22, 2000) ("[h]istorically, Delaware courts have been quite reluctant to second-guess compensation decisions made by boards, even though those decisions always can be seen as clubby, or even as blatantly self-interested."); *In re Lukens Inc. S'holders Litig.*, 757 A. 2d 720, 730 (Del. Ch. 1999); *In re Pennaco Energy, Inc.*, 787 A. 2d 691, 708 (Del. Ch. 2001).

2. Employment benefits conferred upon executives in connection with a merger are subject to challenge only where "the merger itself was unfair." *Akins v. Cobb*, No. Civ.A. 18266, 2001 WL 1360038, at *6 (Del. Ch. Nov. 1, 2001).

3. In order to plead self-dealing or lack of independence on the part of a director based on an employment contract, a plaintiff must allege facts showing that the director "expects to receive additional financial benefits . . . for acceding to [the dominating director's] wishes in connection to the Employment Agreement." *In re Walt Disney Co. Derivative Litig.*, 731 A. 2d 342, 358, 360 (Del. Ch. 1998) *rev'd in part on other grounds sub nom. Brehm v. Eisner*, 746 A. 2d 244 (Del. 2000) ("Plaintiffs have not alleged any particularized facts that raise a reasonable doubt that Mitchell voted in favor of the Employment Agreement in order to obtain a specific financial benefit. Without such allegations, Plaintiffs' conclusory assertion that Mitchell was under Eisner's influence or otherwise interested in any aspect of the Employment Agreement is insufficient as a matter of law to raise a reasonable doubt as to Mitchell's independence.")

4. Where there is admissible evidence that two directors were bargaining with the acquirer for employment on enhanced terms after the merger, the court held that there was a triable issue whether their "expectations constituted a material interest in the merger not shared by the stockholders." *Goodwin v. Live Entertainment, Inc.*, No. Civ.A. 15765, 1999 Del. Ch. LEXIS 5, *79-*80 (Del. Ch. Jan. 22, 1999) *aff'd* 741 A. 2d 16 (Del. 1999).

B. **Offers of Future Positions.**

1. Self interest does not exist where directors are offered future positions with the surviving entity. *See Citron v. Fairchild Camera & Instrument Corp.*, 569 A. 2d 53, 65 (Del. 1989); *In re Western Nat'l Corp. S'holders Litig.*, No. Civ.A. 15927, 2000 WL 710192, at *15 (Del. Ch. May 22, 2000).

2. A director who was a partner of a law firm that represented the target was not conflicted. If, as plaintiffs allege, the target had a long term business plan that would make the target more valuable, why would the lawyer support the change of control transaction at a less than optimum price? "Would not this tend to be self-destructive in that it would subject Rudnick & Wolfe to the substantial risk of losing a client? Frankly, I don't get it, especially because the plaintiffs do not allege that Rudnick & Wolfe was promised a continued role as counsel for XL...." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 503 (Del. Ch. 2000).

3. "[Plaintiffs] ask me to infer that Galanski [a target director promised future employment with XL after the merger] was motivated not by a desire to get the highest value but to secure a buyer who would keep him on board.... If Galanski was motivated by entrenchment purposes, why did he apparently support Intercargo's voluntary, uncoerced search for a buyer?... In this case, plaintiffs attack the motivation of a CEO who worked with his board to retain an investment bank to look for buyers. The stole basis for this attack is that the CEO was asked by the ultimate buyer to stay on. The plaintiffs do not even allege that the CEO was hired by XL on terms materially more favorable than his (apparently non-threatened) employment with Intercargo." *McMillan v. Intercargo Corp.*, 768 A. 2d 492, 503 (Del. Ch. 2000).

C. **Golden Parachutes.**

1. Where CEO was to receive a $20 million golden parachute as a result of a sales transaction, but there was no allegation that he dominated or controlled the board, there was "no basis to say that the board as a whole lacked independence." Accordingly, the payment of the golden parachute did not implicate any director's duty of loyalty or good faith (exceptions to the exculpatory provision). *In re Lukens Inc. S'holders Litig.*, 757 A. 2d 720, 730 (Del. Ch. 1999).

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