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Delaware Courts Give Guidance on M&A Transactions

Three recent opinions from the Delaware Court of Chancery offer important guidance to directors and management in effecting significant M&A transactions. Read together, these decisions emphasize the importance of disinterested decision-making, effectively managing actual and potential conflicts of interest, and employing a proper "process" to protect directors and officers.

Ryan v. Lyondell Chemical Company

The first decision is *Ryan v. Lyondell Chemical Company*. There, the Court of Chancery denied summary judgment based on allegations that the defendant-directors had intentionally abdicated their "*Revlon* duty" to obtain the best price reasonably available for stockholders in a sale of the company. The decision has received significant attention because 10 of the company's 11 directors were unquestionably independent, the board received a fairness opinion from an independent financial advisor, and the merger provided an all-cash offer at a 45 percent premium to the stock's preannouncement trading price.

Despite these indicia of fairness, the board came under scrutiny from the court, which had to draw all reasonable inferences in favor of the plaintiff, for absenting itself from the process and allowing the chief executive officer to negotiate the price and material terms of the agreement largely by himself. The court held that "a board contemplating a sale of control is duty bound to engage actively in the sale process" and that, for purposes of summary judgment, it could not exclude the inference that the directors consciously failed to take any steps to value or shop the company. The court focused on the fact that the board met only three times for "a total of no more than six or seven hours" during a seven-day period before approving the transaction. It also questioned the board's decision not to contact other potential buyers prior to signing the agreement, concluding that the board had "not satisfactorily demonstrated an assiduous balance of its 'single bidder strategy' with an effective and relatively unencumbered post-signing market check."

Directors and officers should not overreact to this decision, as it was driven largely by its procedural posture in litigation and is the subject of a pending appeal. In addition, the court's rejection as a matter of law that the directors were interested in the transaction due to the vesting of their stock options in the merger should comfort directors and officers. Nevertheless, *Lyondell* is significant because the plaintiff was permitted to proceed beyond the summary judgment stage with its attempt to hold the directors personally liable for their alleged bad faith breach of the duty of loyalty. The court's analysis almost exclusively focuses on the board's process leading to the signing of the agreement, including the limited number and length of the board's meetings, its minimal efforts to value the company, and the passive role of the company's outside advisors.

McPadden v. Sidhu

The second noteworthy decision is *McPadden v. Sidhu*, which involved the sale of a wholly-owned subsidiary to an officer of the parent company. The court found the directors were grossly negligent, in breach of their duty of care, when they instructed the officer to solicit third-party interest in the subsidiary when they knew he was interested in acquiring it. The court also found that the board violated its duty of care by relying on financial projections for the subsidiary prepared by or under the direction of that officer. While the board obtained a fairness opinion from an outside financial advisor, that outside financial advisor did not run the sale process and relied upon the same financial information prepared by the conflicted officer.

The *McPadden* court nevertheless dismissed the claims against the directors because the company's certificate of incorporation contained an exculpatory clause barring the plaintiff from recovering monetary damages for breaches of the duty of care. Notably, the court held that "reckless" conduct constitutes a breach of the duty of care, but not bad faith. With respect to the

officer, however, the court refused to dismiss the breach of fiduciary duty and unjust enrichment claims. The court reasoned that officers owe "to the corporation identical fiduciary duties of care and loyalty as owed by directors," but they are not protected by exculpatory clauses, which are limited to directors. Thus, while *McPadden* did not involve a change-of-control transaction, it involved a conflict of interest that predictably drew intense scrutiny from the court. It also raises the possibility of holding a fiduciary personally liable even though a transaction was approved by a majority of disinterested and independent directors.

Lear

The third decision is *In re Lear Corporation Shareholder Litigation,* where the court dismissed claims brought against directors who approved a "naked no-vote termination fee"—which is a fee payable to a buyer if the stockholders vote down the merger agreement even in the absence of a competing third-party proposal. Anticipating that the company's stockholders were unlikely to approve the proposed merger at the price initially offered by the prospective buyer, Lear Corporation's board of directors negotiated for an increase in the purchase price. The buyer, in exchange, negotiated for the naked no-vote termination fee equal to 0.9 percent of the transaction value. Despite the increased price, the stockholders still rejected the merger and the fee was paid to the would-be acquiror. The plaintiff alleged that the directors knew that the increased consideration would be insufficient to obtain the requisite stockholder approval of the merger and, therefore, breached their fiduciary duties and committed waste by agreeing to the termination fee.

The court dismissed the plaintiff's complaint: "Where, as here, the complaint itself indicates that an independent board majority used an adequate process, employed reputable financial, legal, and proxy solicitation experts, and had a substantial basis to conclude a merger was financially fair, the directors cannot be faulted for being disloyal simply because the stockholders ultimately did not agree with their recommendation." The court's holding reinforced the basic tenet that directors manage the business and affairs of the corporation and will not be held liable for pursuing what they believe in good faith to be in the best interests of its stockholders—even when large stockholders, commentators, or proxy advisory firms disagree with their decisions.

Lear is also significant because it seemingly tried to alleviate concerns about the court's decision in *Ryan v. Lyondell Chemical Company*. Specifically, the *Lear* court observed:

> Seizing specific opportunities is an important business skill, and that involves some measure of risk. Boards may have to choose between acting rapidly to seize a valuable opportunity without the luxury of months, or even weeks, of deliberation—such as a large premium offer—or losing it altogether. … Courts should therefore be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.

Companies should note, however, that the process employed in *Lear* involved a majority of independent and disinterested directors and an active go-shop process.

Conclusion

These recent Delaware decisions reflect several potential pitfalls in the M&A process. Although *Lyondell* raises the specter of director personal liability, it should not cause undue alarm—it does not create new law and it reiterates that a carefully managed process will protect directors. In particular, *Lyondell* should not be read as mandating an auction or questioning the viability of all post-signing market checks. But it does require the board to demonstrate that it engaged in an informed decision-making process, the earlier the better. In the absence of exigent circumstances, boards should take care to establish that process and not let management get too far ahead in the negotiations. Likewise, *McPadden* is an important reminder that process can matter outside the change-of-control context, particularly where a conflict of interest is present. In both *McPadden* and *Lyondell*, outside advisors were involved tangentially but were instructed not to solicit third-party interest on behalf of the corporation. These situations can be avoided through proper planning and by relying on cases like *Lear* that affirm the importance of core principles of M&A corporate governance.

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