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Court Upholds Challenges to Failed Management Buyout

The Delaware Court of Chancery recently issued its decision in *Louisiana Mun. Police Employees' Ret. Sys. v. Fertitta*, 2009 WL 2263406 (Del. Ch. July 28, 2009), in which it denied a motion to dismiss a stockholder's complaint that alleged the company's directors and chief executive officer had breached their fiduciary duty of loyalty in connection with a failed management buyout. Specifically, the court upheld challenges to a special committee's decision to terminate a merger agreement and not block an insider's open-market purchases to acquire control of the company. Unlike third-party transactions, this case illustrates the problems and potential personal liability facing a special committee of disinterested and independent directors when charged with negotiating a transaction led by another insider of the company.

Background

Fertitta arose from Landry's Restaurants' ("Landry's") failed go-private transaction led by its chief executive officer, who owned 39 percent of the company prior to signing the merger agreement. After the merger was announced, some of the company's Texas locations were damaged by a hurricane. The CEO promptly claimed that his lenders would withdraw from their financing commitments by declaring the occurrence of a material adverse effect unless the transaction was renegotiated. The company's special committee, which had negotiated and approved the merger agreement, agreed with the CEO and reduced both the merger consideration and the reverse termination fee. In exchange, the CEO negotiated with his lenders and obtained their commitment to refinance the company's existing debt if the merger was not consummated.

After the renegotiation, two key events took place. First, the CEO made open-market purchases of the company's stock, increasing his stake from 39 percent to 56.7 percent. Second, the Securities and Exchange Commission requested additional disclosures in the company's proxy statement with respect to the acquisition financing. The lenders refused to consent to the disclosures, so the company terminated the merger agreement rather than sue the CEO for breach of contract. The special committee claimed that by terminating the merger agreement, it preserved the lenders' obligation to refinance $400 million of the company's existing debt — though it also relieved the CEO from paying a $15 million reverse termination fee to the company under the merger agreement.

The Opinion

A common stockholder brought suit alleging that the CEO, special committee and remaining directors breached their fiduciary duty of loyalty. In particular, the plaintiff challenged the CEO's role in negotiating the refinancing terms and the special committee's inaction in face of the CEO's open-market purchases to acquire control. The plaintiff also alleged that the special committee committed waste by terminating the merger agreement and forgoing the reverse termination fee otherwise payable by the CEO.

The Court of Chancery upheld the claims against the CEO and directors, basing its decision on the following three factors:

- the CEO's "negotiation (and the board's acquiescence to his taking that role) of the refinancing commitment on behalf of the company as part of the amended debt commitment letter";
- the board's "apparent and inexplicable impotence in the face of [the CEO's] obvious intention to engage in a creeping takeover"; and
- the board's "agreement to terminate the merger agreement, thus allowing [the CEO] to avoid paying the $15 million reverse-termination fee."

The court stated that while any one of those factors "might raise the eyebrows of the court to varying degrees," collectively they made it impossible to dismiss the complaint.

Under well-established Delaware law, the decision could rest almost exclusively on the CEO's status as controlling stockholder. Because of the potential for undue influence, most transactions with controlling stockholders are subject to a *per se* rule of heightened scrutiny under the "entire fairness" standard, which requires a showing of "fair price" and "fair dealing." For purposes of the motion to dismiss, the court viewed the CEO's management position plus 39 percent stock ownership as sufficient to demonstrate actual control over the corporation and the board. The CEO then obtained true majority control through his stock accumulation by the time Landry's terminated the merger agreement. In light of these allegations, the CEO's argument that he was acting solely in his capacity as a stockholder was unavailing, particularly with respect to his lead role in negotiating the refinancing.

The court also upheld the breach of loyalty claims against the independent and disinterested directors in connection with the CEO's open-market purchases of company stock — which the court characterized as a "creeping takeover." Although there is no *per se* rule that directors adopt a particular defensive measure in response to an accumulation of shares, the court found that, under the circumstances, "the board's failure to employ a poison pill to prevent [the CEO] from obtaining control without paying a control premium" was sufficient "to infer fiduciary misconduct more serious than a breach of the duty of care." Importantly, the stockholders' lost ability to obtain a control premium in the future may be a significant issue at trial with respect to damages and remedies. For example, last year, in *In re Loral Space & Communications Inc. Consol. Litig.*, the court converted voting preferred shares into nonvoting shares because they were issued in breach of the board's fiduciary duties.

The court then upheld the waste claim challenging the special committee's decision to forgo the reverse termination fee. Waste claims usually are unsuccessful because the test is fairly stringent, requiring that a transaction must have been so one-sided that no businessperson of ordinary, sound judgment could conclude that the corporation received adequate consideration. Based on Delaware's traditional reluctance to second-guess board decisions, one might have expected the court to dismiss the claim based on the directors' business judgment to secure a $400 million refinancing by forgoing a $15 million reverse termination fee.

The court was also critical generally of the special committee's decision to terminate the merger agreement, and the opinion highlights ongoing disclosure issues relating to buyer-financing. The court was skeptical that the banks had the right, under the commitment letters to finance the transaction, to withhold consent to the additional disclosures required by the SEC. The court noted that "such commitment letters generally contain an exception to any confidentiality clause to the extent disclosure is required by applicable law." Because this may be an increasing area of SEC review, commitment letters and other material agreements should be structured with clear "outs" to disclose otherwise confidential information.

Conclusion

Fertitta shows how even a process involving an independent and disinterested special committee can go wrong. Earlier this year, in *Ryan v. Lyondell Chemical Co.*, the Delaware Supreme Court set a high standard for director liability in change of control transactions. The court held that, in order to hold directors personally liable for a breach of the duty of loyalty based on allegations that they knowingly disregarded their so-called *Revlon* duty to maximize stockholder value, a plaintiff must show that those directors "utterly failed to attempt to obtain the best sale price." That standard largely insulates disinterested and independent directors from personal liability in third-party transactions. As we noted at the time, however, *Lyondell* should not be understood as lowering the level of judicial review in conflict of interest transactions.

In *Fertitta*, the court was presented with direct allegations of disloyal conduct in which "the board knowingly preferred the interests of the majority stockholder to those of the corporation or the minority." The special committee members were disinterested and independent, and a decision to terminate a merger agreement is usually an exercise of business judgment. However, the court refused to dismiss the claims, due to the CEO's alleged domination and control of the process. That a board would also permit an insider to obtain majority control without paying a control premium was particularly troubling to the court. *Fertitta* thus serves as a reminder that transactions involving conflicts of interest between the corporation and its directors or officers must be approached with special planning and vigilance.

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