Client Alert

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Fiduciary Duties of Buy-Side Directors: Recent Lessons Learned

Significant acquisitions always present risks to the acquiring entity and its stockholders. These risks may arise from, among other things, integration challenges or failing to identify operational problems or liabilities during due diligence that adversely affect the price paid to the sellers. Nevertheless, in the context of an acquisition—even a significant, "bet the company" transaction—the directors of the acquiring company are almost always protected by the business judgment rule. Two recent cases, however, show potential pitfalls when the buyer's board of directors may have conflicts of interest. When a majority of the directors is conflicted or there is a controlling stockholder on both sides of the transaction, courts will not apply the business judgment rule unless certain procedural safeguards are in place.

The General Rule: Acquisitions Are Usually Protected by the Business Judgment Rule

Whether to proceed with an acquisition is a quintessential business judgment made by a board of directors. Under the business judgment rule, a court will presume that a board's decision was made in good faith unless it can be rebutted by allegations that the directors breached their fiduciary duties or that a majority of the directors were not disinterested and independent. The general rule is reflected in the January 2010 decision in *In re The Dow Chemical Company Deriv. Litig.*

In *Dow Chemical*, the Delaware Court of Chancery dismissed breach of fiduciary duty claims brought against the directors of an acquiring company in connection with a completed merger. A stockholder of Dow Chemical Company ("Dow") had brought derivative claims challenging the Dow board's decision to acquire Rohm & Haas Company ("Rohm & Haas") in a $18.8 billion cash merger. Due to various difficulties, Dow initially refused to consummate the merger when the closing conditions were allegedly satisfied, forcing Rohm & Haas to sue for specific performance. Dow and Rohm & Haas eventually settled, however, and the merger was completed.

The Court of Chancery dismissed the derivative suit, finding that Dow stockholders had failed to allege that Dow's directors were incapable of considering a demand to initiate the litigation. The court further held that the plaintiffs failed to allege particular facts that could raise a doubt as to whether the merger was entitled to the protections of the deferential business judgment rule. The court's analysis made clear that substantive buy-side decisions, including the decision on whether to acquire another company, on how to structure the transaction, and on what terms to include in a definitive agreement, lie with the board of directors. Among other things, the court found that the complaint did not sufficiently allege that Dow's directors had "failed to put in the time and effort necessary to properly evaluate the risks and benefits of the transaction, or … that the board was unaware of any material terms of the transaction or failed to obtain the advice of experts before approving it." The court thus concluded that "substantive second-guessing of the merits of a business decision, like what plaintiffs ask the court to do here, is precisely the kind of inquiry that the business judgment rule prohibits."

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Exception to the Rule: The Business Judgment Rule May Not Apply Where There Are Conflicts of Interest

Two 2018 decisions of the Delaware Court of Chancery reflect the basic principle that the business judgment rule can be rebutted due to conflicts of interest—even in an acquisition. These decisions, which were decided based on the pleadings and without a factual record, are discussed below.

Oracle

On March 19, 2018, the court issued its holding in *In re Oracle Corporation*. The court held that a stockholder of Oracle Corporation ("Oracle") could bring suit against its directors in connection with Oracle's acquisition of NetSuite, Inc. ("NetSuite"), a company that prior to the transaction was owned in part by Oracle's chairman of the board and co-founder, Larry Ellison. The court found that, with respect to the acquisition, a majority of Oracle's board was not independent of Ellison, who was himself directly conflicted, and therefore demand could be excused.

Facts

In 1998, Ellison founded NetSuite. NetSuite provided cloud-based financial management and ERP software for medium-size businesses, filling a niche that was left open by software providers such as Oracle, SAP, and Microsoft who focused on servicing larger business clients. NetSuite's fortunes allegedly faded in the mid-2010s, however, as the company began facing direct competition from these larger players—and in particular Oracle. At the time, Ellison owned an approximately 45% stake in NetSuite and a 28% stake in Oracle. Therefore, according to the plaintiff, Ellison faced the possibility of watching as Oracle swallowed up NetSuite's market share, eroding the value that NetSuite had built up over more than a decade.

Plaintiff alleged that Ellison enlisted Oracle's management to carry out a plan that would have Oracle purchase NetSuite for an inflated price. During a strategy discussion at an Oracle board retreat in 2016, the board was presented with the idea of acquiring NetSuite and granted authorization to management to contact NetSuite. During the resulting discussions with NetSuite, Oracle's management allegedly discussed a price range of $100 to $125 per share with NetSuite's CEO despite specific instructions from the Oracle board to refrain from discussing price.

Upon hearing NetSuite was amenable to offers, the Oracle board formed a Special Committee of three outside directors to hold exclusive power regarding the acquisition. The Special Committee hired a financial advisor, retained legal counsel, and held 13 meetings over the course of months to discuss the potential transaction. Ellison did not attend any of the meetings of the Special Committee. The Special Committee ultimately determined that the acquisition of NetSuite was in Oracle's best interest and approved a purchase price of $109 per share. The plaintiff alleged, however, that the Special Committee was presented with an analysis showing that the proposed price greatly exceeded the median revenue multiples from precedent transactions.

Litigation

In July 2017, an Oracle stockholder brought a derivative suit in the Delaware Court of Chancery, alleging that Oracle's directors breached their fiduciary duties by agreeing to the NetSuite transaction in order to personally benefit Ellison at Oracle's expense. Plaintiff argued that demand was futile in this case because at least half of Oracle's 12 directors faced a substantial likelihood of liability, but the court rejected that argument. Plaintiff also argued that demand was futile because a majority of Oracle's board lacked independence from Ellison, who was interested in the NetSuite transaction. The court deemed this claim a "closer question" than the plaintiff's first claim and excused demand.

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The court concluded that (i) Ellison was conflicted because of his material ownership stake in NetSuite, (ii) three board members lacked independence because they were also senior Oracle officers and thus subject to Ellison's "firm grip on Oracle's daily operations," and (iii) there was at least reasonable doubt as to the independence of three other board members from Ellison due to an entanglement of various business and personal relationships with Ellison. Therefore, a majority of the board lacked independence, pre-suit demand was excused as futile, and the stockholder had standing to pursue a derivative action on behalf of Oracle against these directors.

Tesla

A mere nine days following its holding in *Oracle*, the Court of Chancery issued a decision in another case involving a similarly strong executive personality who allegedly dominated a board of directors' decision making. This time, the personality was Elon Musk, and the company was Tesla Motors, Inc. ("Tesla"). In *In re Tesla Motors, Inc.*, the court found that Tesla's stockholders adequately pled that Tesla's directors had breached their fiduciary duties in connection with their approval of Tesla's acquisition of SolarCity Corporation ("SolarCity"), which was co-founded by Musk. At the time, Musk was Tesla's chairman and CEO as well as its largest stockholder, owning approximately 22% of Tesla's common stock. He also owned 21.9% of SolarCity.

Facts

SolarCity was co-founded in 2006 by Musk as a solar energy system installer. SolarCity's primary business involved leasing solar panel equipment. As SolarCity grew, it took on debt to cover the upfront costs of purchasing and installing solar panels. SolarCity allegedly faced a liquidity crisis in the years preceding its acquisition by Tesla as its debt grew to over $3.5 billion. In addition, SolarCity was sued for alleged misappropriation of intellectual property and trade secrets.

It was against this backdrop that Musk allegedly began advocating for Tesla to acquire SolarCity. Musk proposed the transaction at three successive board meetings, and at the fourth meeting the board authorized its advisors to make an offer. According to the plaintiff, the board did not consider acquisitions of any alternative targets. Musk and another Tesla director who also served on SolarCity's board recused themselves from the vote, but "both remained for the entirety of the meeting while the potential acquisition … was discussed, and Musk led most of those discussions."

Tesla's offer to acquire SolarCity valued the company at $2.6 to $2.8 billion, reflecting a 21% to 30% premium. Allegedly, Musk actively promoted the offer within Tesla and used his public statements to establish an expectation of deal certainty that, accordingly to the plaintiff, boxed in Tesla's board so that "they had no choice but to follow through with the Acquisition." Plaintiff also focused on the fact that Tesla's due diligence of SolarCity revealed liquidity issues as well as the fact that one of SolarCity's new manufacturing facilities was behind schedule, risking tax incentives from the State of New York.

Litigation

A month following the announcement of the execution of the merger agreement, certain Tesla stockholders filed suit challenging the acquisition. The plaintiffs alleged that the transaction was an effort led by Musk to rescue a company in which he owned a substantial stake, all at the expense of Tesla's stockholders. They brought a number of derivative and direct claims.

The defendants sought dismissal of the claims under *Corwin*, which holds that a transaction approved by an informed majority of disinterested stockholders is protected by the business judgment rule. The court rejected this argument, reasoning that the plaintiffs adequately pled that Musk was a conflicted controlling stockholder. This is significant because *Corwin* does not protect transactions between a controlling stockholder and the controlled corporation. Rather, those transactions must include additional procedural

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safeguards under *Kahn v. M&F Worldwide Corp.*, including approval by a special committee and a majority of the outstanding minority shares, to be protected by the business judgment rule.

To be a controlling stockholder, a stockholder must own a majority of the voting stock or be found to dominate and control the company. Here, Musk only held a minority voting stake, but the plaintiffs asserted numerous allegations asserting that Musk effectively exercised control over Tesla. The court found that Musk's domination over Tesla's decision-making process, his influence on and relationship with the individual directors, various directors' alleged conflicts of interest, and the board's seeming failure to implement measures to insulate the decision from Musk, all combined to support a reasonable inference that Musk exercised his influence as a controlling stockholder with respect to the SolarCity transaction. Therefore, the court allowed plaintiffs to proceed with discovery to prove their claims for breach of fiduciary duty.

Take-Aways and Conclusion

A decision to acquire another business is a quintessential exercise of business judgment that directors must make in executing a company's long-term strategy. By their nature, these transactions involve risk and reward; some acquisitions are extremely successful while others are not. For this reason, such decisions, when made by a majority of disinterested and independent directors, should not be second-guessed by courts. Such is the basis of the business judgment rule.

Stockholders of acquiring companies are rarely successful in challenging acquisitions for at least two reasons. First, these claims are derivative in nature and, consequently, require that a stockholder either demand that the board initiate the litigation or overcome the stringent test of demonstrating why demand is futile. Second, these claims are usually brought as breaches of the duty of care or oversight or as corporate waste claims, all of which are difficult to prove in light of the business judgment rule. In the 2000 decision of *Ash v. McCall*, for example, the Court of Chancery dismissed the plaintiff's allegations that the board had breached its duties and committed waste by failing to detect accounting irregularities at the target company during its due diligence investigation. Among other things, the *Ash* court explained that the acquiring company's board of directors was entitled to rely in good faith on the company's management and outside advisors.

Another potential source of liability comes from disclosure violations under state and federal law relating to the acquiror's public statements about the transaction. Such challenges are most likely to occur where the acquiror needs stockholder approval because, for example, it plans to issue more than 20% of its outstanding shares in the transaction, in which case stockholder approval might be required under applicable stock exchange rules. Stockholder approval would also be necessary under state law if the acquiror needed to amend its charter in connection with the acquisition. In *Vento v. Curry*, C.A. No. 2017-0157-AGB (Del. Ch. Mar. 22, 2017), the Court of Chancery enjoined a buyer's stockholder meeting to approve a stock-for-stock merger because it found that the buyer failed to disclose all material information relating to its financial advisor's compensation and interest in the transaction.

In most cases, like *Dow Chemical*, the acquiror's board of directors will be protected by the business judgment rule, which is a presumption that the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. *Dow Chemical* also makes clear that the business judgment rule should protect "buy-side" decisions regardless of whether they relate to a relatively small acquisition or a " 'bet the company' transformational transaction"— "Delaware law simply does not support [a] distinction" based on the size of an acquisition.

In contrast, *Oracle* and *Tesla* reveal vulnerabilities in the business judgment rule armor. In particular, where a court finds that the board lacks sufficient independence from a conflict of interest, demand may be excused. This is especially true where a dominant executive personality exercises control over the board's decision-making process, and that process leads the company to engage in a transaction that directly benefits that dominant personality. Delaware courts have also increased their scrutiny in recent

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years of overlapping business relationships in the technology industry and in venture capital circles (*see, e.g., Sandys v. Pincus*).

Practical suggestions for directors of acquiring companies in fulfilling their fiduciary duties, which will vary depending on the size and complexity of a transaction, include:

- understanding the extent of the due diligence conducted on the target;
- examining the strategic rationale and pros and cons of the transaction;
- informing themselves with respect to the target's valuation and, when stock is being used as currency, the acquiror's valuation;
- understanding the alternatives to the transaction that might be available to the acquiror;
- inquiring into the risks involved to the acquiror if the transaction is consummated;
- understanding the acquiror's contractual obligations to close the acquisition and the other material terms in the definitive agreement;
- identifying and addressing conflicts of interest, including any relationships between the acquiror's directors and executive officers and the target;
- relying on the advice of outside financial and legal advisors; and
- generally establishing a process in which the board receives all material information reasonably available and has the opportunity to deliberate and meet with management and the company's outside advisors to discuss the transaction.

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