An Overview of Fiduciary Duties

February 2016
Target Company Board Process – In General

February 2016
What does the board of directors do?

- Fundamental principle of corporate law:
  - “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors….” (DGCL §141(a))
- Directors serve as agents to the owners of the corporation (stockholders)
- Directors do not directly manage the business of the company, but they are ultimately responsible for the management of the corporation
- The Board discharges its duties by appointing and supervising officers who run the day-to-day operations
- Officers are subject to the same duties as directors
How do directors fulfill their role?

- The Board should be informed about the business, including results of operations, and should understand the company’s strategies and corporate plans.
- The Board should be involved in and approve major decisions for the corporations (such as entering into significant transactions).
What are the directors’ duties to the corporation and the stockholders?

Two Primary Fiduciary Duties

Duty of Care

Duty of Loyalty
Duty of Care

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Duty of Care

• The duty to make careful, informed decisions by assuming an active role throughout the entire decision-making process. In so doing, directors should:
  • Assure themselves that they have the information required to take action;
  • Devote sufficient time to reviewing such information; and
  • Obtain, if useful, the advice of experts
    • Directors may rely on information, opinions, reports or statements presented by any other person as to matters reasonably believed to be within such other person’s professional competence when that person has been selected with reasonable care by or on behalf of the corporation (DGCL §146)
Duty of Care (cont’d)

• Additional Considerations:
  • Non-Delegation: The duty of care cannot be delegated to other decision-makers
  • Recordkeeping: The board should establish an adequate record of the entire decision-making process
Duty of Care – what makes a good process?

Investigation

- Was the Board engaged in the process?
- Did directors attend meetings?
- Did directors question management and ask for more information?
- Did the Board consult with financial advisors? Legal experts?
- What materials did the Board review and consider?

Deliberation

- How often did the Board meet and how long was each meeting?
- Was there ample time for the Board to gather the requisite information and deliberate?
- Practical Note: Many clients are under significant time constraints and it is not uncommon for management to press to move forward with a “great deal” ASAP. However, ample time must be built in for the Board to adequately understand the transaction and deliberate.
Duty of Loyalty

- The duty to act in the best interest of the corporation and its stockholders by not putting any personal interest ahead of the interests of the corporation or its stockholders. This duty is implicated when:
  - Directors stand on both sides of a transaction or otherwise stand to receive a benefit not shared with the stockholders (an “interested” director); or
  - Directors are beholden to a party with an interest in the transaction (a “non-independent” director)
Directors can have interests that differ from the stockholders if they currently have or stand to receive:

- Rollover of equity or options;
- Compensation or benefits arrangements post-transaction;
- Parachutes or other change-in-control payouts; or
- Indemnification, advancement or insurance

To resolve such conflicts, utilize a combination of:

- Full disclosure of conflicts to board and stockholders;
- Procedural safeguards throughout the transaction process; and
- Special transaction committees
Judicial Review of Board Action

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Courts evaluate Board decisions using different standards of review:

- Business Judgment Rule
- Enhanced Scrutiny:
  - Revlon
  - Unocal
- Entire Fairness
Judicial Review of Board Action – Business Judgment Rule

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The presumption that, in making business decisions, 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 and its stockholders.

What this means:

- Directors’ actions will be upheld if it can be attributed to any rational business purpose.
- The presumption may be overcome only if a plaintiff pleads facts showing that a board has acted:
  - Disloyally,
  - In bad faith, or
  - With gross negligence.
Business Judgment Rule (cont’d)

- Policy Reasons for the Business Judgment Rule:
  - Courts are not well-positioned to make routine business decisions
  - Stockholders have selected the board to run the company
  - Encourages beneficial risk-taking
  - Attracts qualified individuals to serve as directors by minimizing their financial risk
What is the function of the Business Judgment Rule?

- The BJR is a judicial standard of review, not a duty
  - The lens through which a court may judge the propriety of board action
- If the BJR is satisfied, directors are not personally liable, and a corporate action will not be overturned
- These conditions are generally presumed, with the challenger bearing the burden of proving that one of the conditions was not satisfied
- “Substantive second-guessing of the merits of the business decision…is precisely the kind of inquiry that the business judgment rule prohibits.” In re the Dow Chemical Company Derivative Litigation (Del Ch. 2010)
- If one of the conditions of the BJR is not satisfied, the “entire fairness” standard applies
Judicial Review of Board Action – Enhanced Review under *Revlon*

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In the context of a change of control, the board must take efforts to achieve the highest value reasonably attainable for the stockholders.

Change of Control:
- What qualifies (in general):
  - A stock-for-stock merger when there would exist a post-merger controlling stockholder
  - The sale of a non-controlled company for consideration that is a blend of cash and stock, where the cash consideration makes up 50% of the sale price
- What does not qualify (in general):
  - A pure stock-for-stock merger between two non-controlled companies
  - The mere relegation of the target’s stockholders to a minority position in a post-merger combined company
Enhanced Review Under Revlon (cont’d)

- **Highest Value:**
  - Price is not the only relevant factor. Other factors include:
    - Proposed or actual financing;
    - Questions of illegality;
    - Risk of nonconsummation;
    - Bidder’s prior business experiences; and
    - Bidder’s business plans and their effect on the stockholders

- **Necessary Sale Process**
  - The decision as to which process will produce the best value for stockholders falls under the business judgment rule, provided the board exercises the duty of care and loyalty
Judicial Review of Board Action – Enhanced Review under *Unocal*

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Hostile takeovers usually lead to the replacement of management and the board of directors.

But in friendly transactions, the Board and management may remain with the corporation or get attractive severance packages.

Because there is an inherent conflict of interest when the Board seeks to fend off unwanted suitors, the Delaware courts will apply a heightened standard of review: the *Unocal / Unitrin* standard.
Enhanced Review Under *Unocal*

- Applies when directors unilaterally adopt defensive mechanisms in response to an alleged threat to corporate control or policy. Such defensive mechanisms must pass a test of reasonableness and proportionality
  - Reasonableness: The board must show that it had reasonable grounds to believe that a danger to corporate policy and effectiveness existed
  - Proportionality: The board must show that the defensive mechanism was reasonable in relation to the threat posed, meaning:
    - The action was not coercive or preclusive; and
    - Such action falls within a range of reasonableness
Enhanced Review Under *Unocal* (cont’d)

- Additional Considerations
  - Delaware courts will consider the preclusive nature of all deal protections included in a transaction—even those that take place outside the context of a hostile threat.
  - The idea of reasonableness overlaps with *Revlon*’s enhanced scrutiny standard – deal protection mechanisms cannot unreasonably interfere with the board’s obligation to obtain the highest value reasonably attainable.
Judicial Review of Board Action – Entire Fairness

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Entire Fairness

• Requires directors to demonstrate the inherent fairness of the questioned transaction or decision, and that they acted in good faith
  • How it works:
    • Step One: If a plaintiff rebuts the presumptive protections of the business judgment rule, entire fairness review is triggered
    • Step Two: The defendant will then have the burden of demonstrating that the transaction was “entirely fair,” meaning a showing of:
      • **Fair Price** – involves economic and financial considerations, including market value, earnings, future prospects, any other element that affects the value of the company’s stock
      • **Fair Dealing** – how the transaction was initiated, structured, negotiated, disclosed to the directors, and how approvals were obtained from the directors and stockholders
    • Step Three: HOWEVER, the defendant can shift the burden back to the plaintiff through the use of either:
      • A Special Committee; or
      • Approval of a majority of the minority stockholders
Judicial Review of Deal Protections

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Short Review of Deal Protections

- Buyers prefer to utilize deal protection mechanisms to ensure fulfillment of their fiduciary duties, while targets use deal protection mechanisms to limit the risk of third-party interference.
- Generally, there are few bright-line rules governing the use of deal protections; as such, deal protections must be analyzed as a whole and in light of the history of the transaction.
- For a more in-depth discussion of various deal protection mechanisms, refer to the slide presentation titled “Deal Protection Mechanisms.”
Challenges to the Public Company Deal

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Challenges to the Public Company Deal

• Four Basic Challenges:
  • Price
  • Process
  • Disclosure
  • Coercive/Preclusive Deal Protections

• Resolving Challenges to Public Company Deals
  • In resolving stockholder suits, courts may:
    • Require additional disclosures;
    • Require changes to the deal terms; or
    • Issue an injunction or settlement
Director Protection from Personal Liability

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Best Practice: Act with due care, in good faith and without conflict

Limited Liability: A director will not normally be liable for monetary damages to the company or the stockholders as a result of any breach of fiduciary duty except for:

- Any breach of the duty of loyalty;
- Any act or omission which involves intentional misconduct or a knowing violation of the law; or
- Unlawful dividends or stock repurchases
Director Protection from Personal Liability

• Indemnity
  • Most directors of public companies are entitled to indemnity for losses by reason of being a director as long as the director: (1) acted in good faith and in a manner reasonably believed to be in, or not opposed to, the best interests of the company; and (2) in the case of a criminal matter, had no reasonable cause to believe the conduct was unlawful

• Expense Advancement
  • Most public companies provide for director expense advancement in defending a claim, subject to the director undertaking to repay these advances if indemnification is later determined to not be available

• D&O Insurance