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Why Putting Shareholder Interests First Is A Good Idea

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Law360, New York (April 07, 2014, 2:35 PM ET) -- In recent weeks, Delaware courts have issued two decisions that are reminders to board members and their advisers about the importance of placing shareholder interests first in the merger and acquisition process by conducting unconflicted strategic merger processes that the board (or a special committee) actively oversees and that are structured to incentivize the board and its advisers for obtaining the best result for shareholders.

In Kahn v. M&F Worldwide Corp., No. 334, 2013, -- A.3d --, (Del. Mar. 14, 2014), the Delaware Supreme Court held that a controlling stockholder merger is subject to business judgment review if the board follows certain minority shareholder protections, thus according more deference to both the process and the board's decisions. In In re Rural Metro Corp. Stockholders Litigation, No. 6350-VCL, (Del. Ch. Mar. 7, 2014) (unpublished), Vice Chancellor J. Travis Laster held an investment bank liable for monetary damages for aiding and abetting breaches of fiduciary duties by members of the target corporation's board.

The M&F Worldwide and Rural Metro decisions demonstrate that where directors and advisers do their best to do the right thing for shareholders in the M&A process, the courts will stand behind them, but where directors and/or advisers can be viewed as acting first in their own interest, then Delaware courts will not be accommodating.

Moreover, if a given M&A process presents circumstances that create a perception that shareholder interests were not primary, the decisions starkly demonstrate that under Delaware law, investment advisers (and potentially other advisers) have a greater risk of monetary liability than directors of Delaware corporations.

Directors have statutory and charter protections against personal liability under Section 102(b)(7) of the Delaware General Corporation Law, and are further protected in their reliance on advisers. These advisers, however, do not share the same protections. Indeed, Laster's characterization of financial advisers in Rural Metro as "highly compensated" "gatekeepers" in the merger process may encourage plaintiffs to more regularly add investment bankers as defendants in the near-inevitable lawsuits that follow announced change-of-control transactions.

Plaintiffs may also be tempted to test the limits of aiding and abetting liability by pursing actions against other deal advisers, such as lawyers, accountants and restructuring advisers. Although it is unclear whether the "gatekeeper" concept as articulated by Laster is intended to impose a new standard of conduct on investment bankers and other advisers, the disparity in risk between directors and advisers should incent M&A advisers to be scrupulous in their actions to ensure shareholders' interests come first in the M&A process.

Kahn v. M&F Worldwide Corp.

M&F Worldwide concerned a going-private transaction involving a majority shareholder. The issue before the Delaware Supreme Court was what standard of review applied to the board's decision to recommend the transaction. The court, affirming then-Chancellor Leo Strine's decision and adopting his framework, held that a going-private merger with a controlling stockholder is subject to the business judgment standard of review, rather than the more rigorous entire fairness review, if the transaction process from its inception and before any negotiation commences follows a “dual procedural protection merger structure.”

This dual protection structure involves: (1) approval of the transaction by an independent special committee of directors fully empowered to hire advisers and reject the offer, and (2) an uncoerced and informed vote of a majority-of-the minority shareholders (i.e., a majority of the shares held by persons unaffiliated with the controlling stockholder) to which the majority shareholder will be bound.

Under the business judgment standard, directors are presumed to have complied with their fiduciary duties and acted in the best interests of the corporation. Director decisions reviewed under the business judgment standard receive deference and generally are upheld if there is an articulable rational basis for the decision.

Under the entire fairness standard, however, director decisions are viewed with greater skepticism and directors have the burden to demonstrate a fair process and price. Before M&F Worldwide, the Delaware Supreme Court had applied the entire fairness standard of review to mergers where controlling stockholders were part of the acquiring group, although the burden of persuasion would shift in cases where there was a special committee or shareholder ratification by a majority-of-the-minority shareholders.

After M&F Worldwide, a controlling shareholder merger that does not follow the dual protection structure remains subject to the entire fairness standard of review, but the case affirms a blueprint for obtaining review of a transaction under the more deferential — and thus less risky to directors — business judgment standard.

The Delaware Supreme Court articulated four rationales for applying business judgment review to controller transactions with a dual procedural protection structure:

(1) the dual procedural protection structure is a practical analogue to third-party, arm’s length mergers that are reviewed under the business judgment standard;

(2) the dual procedural protections provide optimal protections for minority stockholders in controlling shareholder buyouts;

(3) the dual procedural protections provide an independent negotiating agent for minority shareholders; and

(4) business judgment review confirms the reasonableness of the price by assessing whether the special committee acted independently with due care and determining whether the price was ratified by the minority shareholders.

Taken together, the court’s decision can be understood as a recognition that business judgment review is appropriate because the dual procedural protection structure creates unconflicted incentives to obtain maximal shareholder results, as opposed to value for some other constituency, such as majority shareholders or directors, through the independent special committee and majority-of-the-minority vote.

The court emphasized that to be eligible for application of the business judgment rule, a controlling shareholder buyout must satisfy each of the following prerequisites:

- The transaction process must be structured from the beginning to require the approval of both a special committee and a majority-of-the-minority stockholders;
- The special committee must be independent;
- The special committee must be empowered to select its own advisers;
- The special committee must be empowered to reject definitively the controlling shareholder offer;
- The special committee must meet its duty of care in negotiating a fair price; and
- The vote of the minority shareholders must be fully informed and not coerced in any respect.

Applying each of these factors to the pretrial record in M&F Worldwide, the court determined that the special committee members were independent and appropriately empowered. It also concluded that the members had exercised due care by meeting eight times during the process, exploring alternative strategic options, actively requesting information from and directing the activities of the financial adviser, and aggressively negotiating the share price with the controlling shareholder.

The court further determined that minority shareholders were adequately informed in the proxy of how the price was negotiated, what valuation ranges were considered, and what analysis supported the financial adviser’s fairness opinion. Having determined that each of the dual procedural protection prerequisites were established, the court held that the board’s decision to move forward with the merger was rational and thus protected by the business judgment rule.

The M&F Worldwide decision had been prefigured in a series of decisions in the Chancery Court recognizing the availability of business judgment review in controlling shareholder mergers that use the dual procedural protection structure. Then-Vice Chancellor Strine had posited in dicta that business judgment review presumptively applies if a freeze-out merger is structured with dual procedural protections to mirror an arms-length merger. See In re Cox Communications Inc. Shareholders Litigation, 879 A.2d 604 (Del. Ch. 2005). Laster later endorsed that approach. See In re CNX Gas Corp. Shareholders Litigation, 4 A.3d 397 (Del. Ch. 2010).

The business judgment standard of review of controlling shareholder transactions affirmed in M&F Worldwide, however, is not a panacea. The court’s decision was based on a record developed through pretrial discovery, and the court was clear that a plaintiff challenging a controlling shareholder merger involving dual procedural protections is entitled to discovery if it can plead a “reasonably conceivable” set of facts showing that a transaction fails to meet any of the prerequisites to business judgment review.

Moreover, failing to adhere strictly to the procedural prerequisites results in application of entire fairness review. Laster demonstrated this risk by applying entire fairness review in In re Orchard Enterprises Inc. Stockholder Litigation, No. 7840-VCL, (Del. Ch. Feb. 28, 2014), a case that predated M&F Worldwide yet applied the dual protection standard articulated in Strine’s decision that was appealed and affirmed in M&F Worldwide.

In Orchard Enterprises, Laster rejected application of business judgment review to a controlling stockholder transaction ostensibly structured with dual procedural protections because the controlling shareholder had not agreed to the dual protections before starting to negotiate the potential transaction.

In re Rural Metro Corp. Stockholders Litigation

In Rural Metro, Laster held that RBC Capital Markets LLC was liable for aiding and abetting breaches of fiduciary duty by members of the board of Rural/Metro Corp. related to conflicts of interest in connection with Rural Metro's merger with an affiliate of Warburg Pincus.

Rural Metro is the most recent of two prominent decisions by Laster addressing conflicts of interest of investment banks in change-of-control transactions, the other decision being In re Del Monte Foods Co. Shareholders Litigation, 25 A.3d 813 (Del. Ch. 2011).

In each case, the investment bank served as both the target company's financial adviser ("sell-side") and also participated or sought to participate in the buyer's transaction financing ("buy-side"), thus raising judicial concerns that something other than shareholder interests were foremost.

Although the cases do not announce a prohibition on sell-side advisers providing buy-side financing, Rural Metro is the most recent reminder of the substantial risks to investment banks that participate on both the sell-side and buy-side of the same transaction.

Where M&F Worldwide demonstrates the deference that Delaware courts are willing to provide an M&A process structured in a way to put the interests of shareholders first, Rural Metro highlights (again) the problems with an M&A process that does not.

The decision highlights that investor advisers do not share the same exculpatory protections and favorable standards of review as do directors of Delaware corporations. Even though Rural Metro and Del Monte found that the directors had breached their duties, the decisions recognized the implausibility that directors will be subject to monetary liability due to statutory protections and exculpatory clauses.

In Del Monte, Laster reviewed the circumstances of Del Monte's acquisition by a consortium led by Kohlberg Kravis Roberts & Co. As described in Laster's opinion, granting a preliminary injunction against the shareholder vote on the proposed merger, Del Monte's financial adviser, Barclays Capital, "manipulated the sale process" to result in a transaction that would permit Barclays to obtain buy-side financing fees from the KKR consortium in addition to transaction success fees from Del Monte.

Specifically, Laster found that at the same time Barclays was assisting Del Monte to explore strategic alternatives and negotiate a merger price, it also was working to team potential bidders in breach of existing standstill agreements and negotiating with the bidders to provide financing for the deal.

Barclays did not disclose its buy-side financing negotiations with the Del Monte board until after reaching an agreement on providing the financing. Laster found that Barclays had improperly withheld information about its buy-side intentions, its involvement with KKR, and its pairing of bidders. He concluded that Barclays had "deceived" the board, yet nonetheless found that the board had breached its fiduciary duties in its decision process by relying on conflicted advisers.

In Del Monte there was no shareholder claim directly against the financial adviser under consideration, but Laster held that the buyer had aided and abetted the directors' breach of fiduciary duty by knowingly participating in Barclays' self-interested, conflicted activities.

Rural Metro presented similar factual circumstances, except in that case, the only consideration before Laster was a direct claim against the financial adviser, RBC. Rural Metro's directors, as well as Moelis & Co. LLC, which had served as financial adviser in a secondary role, settled before trial.

Laster found RBC liable for aiding and abetting a breach of fiduciary duty by Rural Metro board members because RBC had multiple conflicts of interest that ran counter to maximizing shareholder value and resulted in the shareholders receiving less than fair value for their shares. According to the decision, as with the financial adviser in Del Monte, RBC was conflicted by its motivation for multiple potential fees — its sell-side contingent advisory fee and its buy-side financing work for Rural Metro that would result in fees in excess of the sell-side advisory fees.

Laster found that members of the special committee had personal incentives to favor a merger over other possible strategic alternatives — one member ran a hedge fund that was looking to sell its stake in Rural Metro, and another risked losing the value of equity absent a change of control transaction.

On top of these director incentives to favor a merger transaction, RBC as adviser structured a sale process that would maximize its opportunities to secure multiple fees related to the transaction but effectively excluded many likely bidders. Moreover, according to the decision, RBC withheld from the board and special committee its concerted attempts to obtain buy-side financing work, failed to present timely interim valuation materials to Rural Metro's board or special committee, and prepared valuation materials for Rural Metro's board that made Warburg's offer appear unduly favorable.

Under these circumstances, Laster found that the board and special committee formed to consider strategic alternatives had breached their duties in several respects, most notably that:

(1) the special committee exceeded its delegated power (the committee had been empowered only to identify strategic alternatives and make a recommendation, not to pursue a sale process);

(2) the special committee met only twice and did not actively oversee the financial advisers; and

(3) the board failed to receive or review valuation materials until only hours before the vote to approve the proposed transaction, resulting in a failure to consider the value of the merger transaction as compared to other options, including the value of not pursuing a transaction.

Although RBC had indicated at the outset that it would seek to provide financing to potential buyers, and ultimately did not provide financing to Warburg, Laster criticized Rural Metro's special committee for failing to discharge its duty to provide "guidance about when staple financing discussions should start or cease," failing to make "inquiries on that subject," and failing to impose a "practical check on [the investment bank's] interest in maximizing its fees."

For example, the board acquiesced to RBC participating in the buy-side financing even though that meant paying $3 million for a second fairness opinion, and the board did not seek any concessions from RBC to offset this increased cost. The court found that RBC knowingly participated in the board's breaches by establishing an "unreasonable process" driven by its own conflicted incentives and also by creating "informational gaps" that induced the breach.

Laster rejected the investment bank's argument that the exculpatory provision in Rural Metro's certificate of incorporation should apply to a party charged with aiding and abetting a director's breach of fiduciary duty. He reasoned that the "literal language of Section 102(b)(7)," which grants corporations the ability to exculpate directors against personal liability, "only covers directors; it does not extend to aiders and abettors."

Moreover, Laster noted that the Delaware courts previously have allowed cases to proceed against aiders and abettors even if the directors were exculpated. He determined that there was a rational legislative basis for the resulting disparity in risk between directors of Delaware corporations and the "highly compensated advisers" upon which they rely, because exculpation prevents directors from becoming overly risk averse from fear of personal liability.

Moreover, notwithstanding that "director primacy remains the centerpiece of Delaware law," In re CNX Gas Corp. Shareholders Litigation, at *15, the Rural Metro decision characterizes investment banks in the strategic sale process as "gatekeepers" for which the risk of aiding and abetting liability "creates a powerful financial reason" to act appropriately.

Investment advisers are, of course, not the only advisers that directors rely upon in a strategic process. It remains to be seen whether Laster's invocation of the "gatekeeper" concept will result in plaintiffs more regularly adding investment bankers as defendants in shareholder suits challenging mergers, and whether it will tempt plaintiffs to test the limits of aiding and abetting liability with claims against other deal advisers such as lawyers, accountants or restructuring advisers.

Laster's decisions in Rural Metro and Del Monte sandwich Chief Justice (then-Chancellor) Strine's decision in In re El Paso Shareholder Litigation, 41 A.3d 432 (2012), which raised significant concerns over Goldman Sachs & Co.'s conflict in serving as financial adviser to El Paso regarding consideration of its purchase by Kinder Morgan, an entity in which Goldman held a substantial ownership position.

In El Paso, the board retained another financial adviser, Morgan Stanley & Co. LLC, to provide advice in connection with Kinder Morgan's proposal. Nevertheless, Strine found that the El Paso board continued to receive advice from the Goldman investment banking team concerning a potential alternative transaction, and also structured fee incentives to Morgan Stanley that counseled in favor of a merger with Kinder Morgan.

He was additionally concerned that the lead Goldman banker working for El Paso personally owned a large amount of Kinder Morgan stock and failed to share this information with the board. In light of these factors, Strine found it more likely than not that the plaintiffs would succeed on their claims against the board for putting "incomplete and inadequate" protections in place to address Goldman's conflicts.

He noted, however, that (unlike the case in Del Monte and Rural Metro) Goldman's largest conflict was surfaced and thus success on an aiding and abetting claim against Goldman was "doubtful." Ultimately, however, Goldman Sachs agreed to forgo its $20 million fee in the acquisition as part of the case settlement.

The M&F Worldwide and Rural Metro cases are timely reminders that directors and advisers must put shareholder interests first in the M&A context, that directors should inquire into and have the right to expect their advisers to disclose significant conflicts of interest, and also that investment bankers may have to pay damages if they withhold from the board what could be deemed conflicting interests in a deal.

Additionally, the cases highlight the structural disparity in the liability risks to directors and financial advisers for process failures with respect to change-of-control transactions.

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