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# Delaware Chancery Court Finds Reasonable Likelihood That Sales Process Undertaken by an Unconflicted Board Nevertheless Was Not Designed to Produce the Best Price for Stockholders, But Declines to Enjoin Transaction

In *Koehler v. Netspend Holdings Inc.*, CA No. 8373-VCG (Del. Ch. May 21, 2013), Vice Chancellor Glasscock reviewed the sales process for an acquisition of Netspend by Total System Services, Inc., a strategic buyer, scheduled to close May 31, 2013. An eight-person board, with each member an independent director other than the CEO, approved the merger transaction; four of the directors were affiliated with Netspend's two largest stockholders. The record shows that the board was actively involved in the negotiation and strategy relating to the merger transaction, as well as earlier expressions of interest by potential buyers. The board had recent active interest from two private equity firms offering to purchase substantial blocks of stock from the two largest stockholders at a price significantly below the merger price. Those two private equity firms signed "don't ask, don't waive" standstills of one- and two-year durations in connection with their diligence relating to their potential investment, although the shareholders did not sell their stock to these firms in light of the merger discussions with Total Systems that commenced at about the same time as the private equity firms' indication of interest at the lower price. Earlier in 2012, the board had declined to pursue a merger of equals with another strategic buyer due to the board's view that Netspend's stock was undervalued and the strategic buyer's stock was overvalued, as well as a variety of other business risks. Thus, the board was aware of current market interest relating to the company and sophisticated in developing a strategy to maximize value.

In October 2012, Netspend was contacted by Total Systems about a possible change-of-control transaction. The board determined to pursue the opportunity while maintaining that the company was not for sale. The board contacted one strategic buyer who had a contractual right to notice, and who the board thought could be a credible buyer due to its size, financial capacity and strategic interest. That strategic buyer did not indicate any interest in a possible transaction with Netspend, and the board took that buyer's lack of interest as indicative of the marketplace's general lack of interest in Netspend. The board declined to grant exclusivity to Total Systems, but did not contact any other potential acquirors because of the risk of leaks and rumors regarding a potential sale of the company. The board tried for a go-shop provision in the draft merger agreement it prepared for Total Systems, but eventually gave this up in return for a significant increase in purchase price and a reduction in the termination fee. One condition of the transaction was the extension of an important commercial contract with a subsidiary controlled by one of the two large stockholders.

The board properly considered that special interest of that shareholder in approving the transaction. The board also reviewed the deal protection provisions, including a 3.9 percent termination fee, matching rights, a no-shop provision with a fiduciary out for a superior proposal, and voting agreements by the two major holders covering 40 percent of the voting stock, with such agreements permitted to be terminated if the board terminated the merger agreement to accept a superior proposal. The merger agreement included a covenant not to waive existing standstill agreements. The board's negotiations had increased the purchase price from $14.50 per share to $16 per share, a 45 percent premium to the stock price one week before the announcement.

Vice Chancellor Glasscock initially reviewed the *Revlon* standard applicable to this transaction, noting that directors "need not follow a particular path to maximize stockholder value, but the directors' path must be a reasonable exercise toward accomplishing that end." He explained that enhanced scrutiny under *Revlon* is a test of reasonableness, "which requires that the board be informed and that it construct a sales process to maximize value in light of that information." He noted that the directors have the burden of proving they were fully informed and acted reasonably. The Vice Chancellor observed that under *Revlon,* the court is also required "to scrutinize the board's true intentions to determine if the board is acting with the best interests of the stockholders in mind."

> *Enhanced scrutiny under Revlon is a test of reasonableness, "which requires that the board be informed and that it construct a sales process to maximize value in light of that information."*

The Vice Chancellor noted that the stock ownership attributed to four of the directors was not a conflict in this case, but rather an indication that those directors were aligned with the interests of stockholders generally. This is an interesting perspective in light of a few recent cases in which directors representing large stockholders were viewed with suspicion. See e.g. *In re Answers Corp. S'holder Litig.*, C.A. No. 6170-VCN (Del. Ch. Apr. 11, 2012). The Vice Chancellor noted that the facts in this case demonstrated that one of the major stockholders had abandoned the sale of its stock to the private equity buyers in favor of a higher price in the merger, despite the fact that the merger transaction would be at a higher tax rate, and the other stockholder had engaged in a distribution of stock to its investors, and therefore he found that neither director had conflicts due to the stockholders' ownership or interests. Similarly, the Vice Chancellor found that the CEO's interests were aligned in achieving the highest price for stockholders, and that even if he were conflicted, the majority of directors were motivated by achieving the highest price reasonably available.

The Vice Chancellor nevertheless expressed significant criticism over a few aspects of the board's process, derived from the fact that this transaction was a "single bidder" transaction without a pre-signing market check of other likely bidders. He found that "in forgoing a pre-Agreement market check, and relying on an ambiguous fairness opinion, the Board had to be particularly scrupulous in ensuring a process to adequately inform itself that it had achieved the best price." He initially expressed concern over the lack of a go-shop clause, although he eventually found that the board had acted reasonably in giving up the go-shop provision in exchange for more value. He also criticized a weak banker opinion and the "don't ask, don't waive" provisions in the standstill and merger agreement. The "don't ask don't waive" provisions seemed particularly troublesome to the Vice Chancellor, as he observed that the private equity firms had just completed diligence and had expressed an interest in buying substantial blocks at $12 per share. The board never unilaterally waived these provisions and did not inquire as to the private equity firms' potential interest in an acquisition of the entire company despite their recently expressed interest. The Vice Chancellor concluded in light of these two process defects, the weak fairness opinion and these "don't ask, don't waive" provisions, that he could not find that the board was sufficiently informed to create a process to ensure the best price.

The Vice Chancellor carefully reviewed the case law regarding single-bidder situations in assessing the process here, and relied on distinctions between the information available to the boards in the prior cases versus the situation faced by the Netspend board. He noted that reliance on investment bankers has been deemed a "pale substitute" for a market check. The question was "whether the board had sufficient knowledge of the relevant markets and a body of reliable evidence to agree to the transaction without any market check." He noted that other cases involving single-bidder situations had reasonably long post-signing periods, and relatively mild deal protection. The Vice Chancellor found favorable facts here regarding the process, noting that the directors were "sophisticated professionals with extensive business and financial expertise," and "well informed about the process of selling the company and had engaged in prolonged negotiations" with other merger partners. He outlined the board's strategy to tell "would be acquirors that it was not for sale while intimating that it could be for sale for a high enough offer," and called it "a deliberate strategy to maximize value." The Vice Chancellor found this strategy to be within the range of actions a reasonable board could undertake to maximize shareholder value. He concluded that the initial decision to engage in a single-bidder process was reasonable.

Vice Chancellor Glasscock then explained that this conclusion that the decision to enter into the single-bidder process was reasonable did not end his analysis and that the board must produce a process reasonably designed to maximize price. He then reviewed the banker's fairness opinion, and criticized the "weak" opinion in several important respects – first, although two of the five valuations were based on the price of Netspend's stock, the board had acknowledged that the stock price was not a good indicator of its value, as the board believed the stock to be undervalued. Second, the comparable companies used in the analysis were dissimilar to Netspend and the comparable transactions were quite old, so therefore neither the comparable companies analysis nor the comparable transactions were strong indications of Netspend's value. Thus he found four of the five valuation analyses flawed or unreliable, and the final valuation metric, the discounted cash flow valuation (DCF) analysis showed the Total Systems offer to be inadequate. The board argued that this analysis was based on five-year projections, and was therefore outside the range of management's customary three-year projections, making the analysis unreliable. The banker opinion was therefore not a strong substitute for valuation compared to the preferable market check, which the board had decided to forgo. Vice Chancellor Glasscock held that the directors' reliance on the fairness opinion was not a breach of their fiduciary duty, noting that directors relying on experts in good faith are fully protected. However, he observed that the board's reliance on a weak fairness opinion provided context for their other process decisions, and he noted that the fact that the fairness opinion was a poor substitute for a market check for value was available to the board when it approved the merger. He seemed to be suggesting that the board, faced with a weak fairness opinion, should have realized that it needed more current information about value in assessing whether the deal at hand was the best available price and terms.

The Vice Chancellor also reviewed the deal protection devices. The plaintiff conceded that the package of devices was "relatively mild and could be considered reasonable under different circumstances." Importantly, Vice Chancellor Glasscock concluded that the voting agreements, which were 40 percent of the outstanding stock, but which were terminable on a termination for a superior offer, posed no credible barrier to the emergence of a superior offer. He further held that the 3.9 percent termination fee ($53 million on a $1.4 billion deal) was within the range of termination fees held to be reasonable in the past and would not deter a serious bidder.

The Vice Chancellor discussed the board's decision to forgo the go-shop and to agree to the no-shop after extracting further consideration from the buyer in an increased purchase price and lower termination fee. He noted that this decision was not unreasonable. However, he also pointed out that the board expected a short period before the deal's consummation and therefore was not counting on a leisurely post-signing market check, so important in earlier single-bidder deals. The Vice Chancellor also noted that the "don't ask, don't waive" provisions prevented the private equity buyers from bidding. It is particularly noteworthy that the Vice Chancellor was troubled by the fact that the record does not show that the board even considered whether the standstills should remain in place once it started negotiating with Total Systems, which he observed "would have been the ideal time to waive" those clauses. Whether or not the proper time to waive these standstills was during the ongoing negotiation with Total Systems, or rather only after an agreement had been signed, the ultimate and defining issue in this case is that the board never considered the matter as part of its value-maximizing strategy. The Vice Chancellor observed: "[t]he record suggests that the Board did not consider, or did not understand, the import of the ["don't ask, don't waive"] clauses..." As one would expect, Netspend argued that it did not believe that either private equity firm was interested in bidding for Netspend, but the Vice Chancellor rejected this argument completely, stating that "Netspend cannot have known with certainty that those entities are uninterested in Netspend." Interestingly, the Vice Chancellor enjoined those clauses for each of the private equity firms at oral argument, and neither private equity firm expressed any indication of interest through the date of his opinion.

In summary, Vice Chancellor Glasscock concluded that it was reasonably likely that the Netspend board would fail to meet their burden at trial in proving that they acted reasonably to maximize share price in light of the following:

- the lack of a market check
- the board's reliance on a weak fairness opinion
- the "don't ask, don't waive" provisions, and the remainder of the deal lockup provisions
- the lack of an anticipated leisurely post-agreement process giving other suitors the opportunity to appear

As noted above, and instructively for boards engaged in processes in the future, the Vice Chancellor focused particularly on the failure to waive the "don't ask, don't waive" provisions and the board's seeming lack of understanding as to the effect these provisions would have on those potential bidders' ability to make any expression of interest post-signing. He concluded that the board simply did not satisfy its burden of showing that it acted reasonably in developing a process in this single-bidder setting to show that it was maximizing value.

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Although the Vice Chancellor also concluded that the plaintiff faced irreparable harm in the absence of an injunction, he nevertheless declined to enjoin the transaction. He explained that the plaintiff "bears the burden of showing that the magnitude of the harm absent an injunction exceeds the potential harm of an injunction" and noted that the court is generally reluctant to enjoin a transaction that affords stockholders a premium in the absence of a competing offer. He observed that the merger parties had also postponed the deal twice, making a further delay less of an apparent burden, and thus weighed the marginal benefit of an injunction against the marginal harm caused by an injunction (given the parties' seeming lack of urgency to close). Ultimately, he properly noted the deal risk from a delay in the form of a possible material change that could result in a failure of condition. He also noted that the "glaring flaw in the Board's process, the thoughtless incorporation of the ["don't ask, don't waive"] provisions in the Merger Agreement" posed little risk of irreparable harm because the affected entities showed no interest in acquiring Netspend once the offending provisions were withdrawn. Thus the transaction is set to close later on May 31, 2013.

## Lessons Learned

This decision is somewhat surprising, given the unconflicted board's careful and thoughtful process, ably described by the Vice Chancellor, showing every intention to maximize value. Single-bidder cases are always fraught with potential missteps, given the lack of a market check to provide information to the board about the company's value. Clearly one takeaway here is that single-bidder transactions will continue to be subjected to significant scrutiny under *Revlon*. From our vantage point, one could question the board's decision to forgo a soft market check, but we must keep in mind that we do not know the competitive dynamics in this industry and the risk to business from leaks, or the potential disruption in the company management or workforce from a leak, and the board must weigh these matters against the benefits of a market check. It may be that the board weighed these matters carefully and came to a reasonable conclusion given their existing knowledge of the market, and one practice pointer is to reflect such discussions in the minutes.

Further, while one can understand the board's desire to avoid leaks, it is worth noting that the court here wasn't expecting a full auction, and that a limited and soft market check could have gone a long way in satisfying the court that the board was well-informed. The key lesson here is that in a single bidder situation the board must keep top of mind the information it has available to assess the single bidder's terms, and to take steps to obtain all reasonably available information.

The key process flaws identified by the court were the fairness opinion and the "don't ask, don't waive" provision. As to the fairness opinion, we do not know the thought process behind the choices for the comparable transactions and companies analyses, but this case demonstrates the importance of vetting those metrics carefully with the board. Moreover, the bankers should discuss early on the length of the period for projections and the pros and cons of three-year versus five-year projections early in the process, and should also consider the significance of stock-based valuations in light of the board's view of the stock valuation. The board may conclude that a fairness opinion is not reliable, and this will suggest that further information may be helpful to the board's decision as to whether the deal at hand offers the best value for stockholders.

As to the "don't ask, don't waive" provisions, recent case law makes clear that these provisions will be part of every *Revlon* analysis going forward. The board should be briefed on the standstill provisions and the reasons for them, and should be consulted regarding a possible waiver in light of "don't ask, don't waive" provisions in the merger agreement. The board should understand the impact of these provisions on the bidding process both before and after the merger agreement is signed. In a single-bidder situation, any other limitations on the information about alternative bidders should be removed to the extent possible.

*As to the 'don't ask, don't tell' provisions, recent case law makes clear that these provisions will be part of every Revlon analysis going forward. The board should be briefed on the standstill provisions and the reasons for them, and should be consulted regarding a possible waiver in light of "don't ask, don't waive" provisions in the merger agreement.*

The bottom line is that the board's role is to maximize value. Here the board took those responsibilities very seriously and nonetheless is criticized for the banker's opinion and the standstill provisions. This case points out the importance of experienced and thoughtful advisors who can advise the board about the impact of various decisions on the process.

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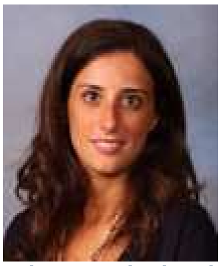

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# Lessons in Attorney-Client Privilege From a Recent Delaware Decision

In *Kalisman v. Friedman*, the court examined the extent to which privileged corporate materials may be withheld from a current corporate director and ordered the production of certain privileged materials, including internal law firm discussions. This case indicates the Delaware Chancery Court's willingness to carefully consider claims of privilege and delve into the facts and circumstances of the documents' creation, statements made within documents, and the parties against whom the privilege is asserted. Companies should be careful not to assume the privilege of documents simply because they were created by a lawyer and should be prepared to defend their privilege designations.

## *Kalisman v. Friedman*

In *Kalisman*, a director of Morgans Hotel Group Co. brought an action against the remaining directors of the company, seeking to enjoin the implementation of a recapitalization plan. Plaintiff was originally a member of the special committee formed by the board to evaluate potential strategic alternatives for the company. However, after a shareholder controlled by plaintiff announced that it intended to nominate candidates for election and make certain business proposals at the company's annual meeting, the remaining members of the special committee began to explore new possibilities. Acting in secret without the knowledge of plaintiff, the special committee decided to propose a recapitalization plan. Plaintiff only learned of the recapitalization plan when company counsel notified him that a special meeting of the board would take place the following day to consider and approve the plan.

Plaintiff filed suit immediately after the recapitalization plan was approved by the board and served document requests on the defendants and subpoenaed the law firms representing the company, as well as the law firm representing the special committee. Defendants asserted privilege over these documents and plaintiff moved to compel.

Vice Chancellor Laster granted plaintiff's motion to compel. The court held that a director's right to information in a company is "essentially unfettered in nature" and extends to privileged materials. In light of this right, the company could not assert privilege against the plaintiff while waiving privilege as to the remaining directors, reasoning that he has an equal right of access given his capacity as a director and in light of his status as a joint-client of the subpoenaed law firms.

The court also held that such access is not absolute and that two exceptions to a director's ability to access privileged materials applied. First, the court noted that a special committee can retain their own legal counsel, which may allow the committee to protect its information from other directors or the board. The court found that since plaintiff was a member of the special committee, he was entitled to access to its materials. However, to the extent a subcommittee was openly formed, privilege could be asserted with respect to advice given to that subcommittee.

*The court held that a director's right to information in a company is "essentially unfettered in nature" and extends to privileged materials.*

Second, the court held that a board or committee can withhold privileged information once sufficient adversity exists between the director and corporation such that the director could no longer have a reasonable expectation that he was a client of the board's counsel. The court found that once plaintiff learned that the special committee was meeting in secret and its plan was revealed, he could no longer have a reasonable expectation that he was a client of the board's counsel. The court emphasized the fact that the defendants acted in secret and even attempted to mislead plaintiff, and therefore it would be inequitable to give them the benefit of an earlier date for purposes of limiting plaintiff's access.

## Conclusion: Asserting and Protecting Privilege

*Kalisman* contains an important lesson regarding the assertion of privilege over attorney materials. *Kalisman* demonstrates that if a board wishes to assert privilege against certain directors, the board must take care to either openly create a separate committee represented by its own counsel, or make clear that such adversity exists between the director and the corporation so that the director could not reasonably expect to be a client of the board's counsel. In either instance, such actions should be taken openly. As demonstrated by *Kalisman*, courts will likely view attempts to do so in secret unfavorably and may order the production of materials which could otherwise be protected.

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# Delaware Chancery Court Explains That Resignation May Not Immunize Directors From Liability in Every Case, and Declines to Dismiss *Caremark* Claims Where Directors Allegedly Abdicated Their Duties as Directors

Two recent Delaware Chancery Court cases have provided guidance to directors who are confronting difficult and challenging operational problems in a company and who are considering whether to resign from the board to avoid further liability. *Rich v. Chong (Fuqi)*, CA No. 7616-VCG (Del. Ch. April 25, 2013) and *In re Puda Coal, Inc. Stockholder Litigation* Consolidated CA No. 6476-CS (Del. Ch. February 6, 2013) (transcript ruling) demonstrate that resignation is not always the safest or most advisable course of action, particularly if directors are faced with so-called *Caremark*[1] claims. These two recent cases address board liability in the face of egregious actions of management of Chinese-based companies who had gone public in the United States after incorporation in the state of Delaware. These decisions also offer lessons for directors facing less sensational, but difficult management or operational situations here in the US.

*These [two] decisions ... offer lessons for directors facing ... difficult management or operational situations here in the US.*

## The *Fuqi* Decision

In *Fuqi*, a Delaware entity by that name whose sole asset was stock of a Chinese jewelry company, completed a public offering in the US in 2009, but in March 2010 announced a need to restate its 2009 financial statements. Fuqi later disclosed the transfer of $120 million of cash from the company to third parties in China authorized by the chairman of the board pursuant to an oral agreement with Fuqi's bank. Fuqi was unable to confirm the accuracy of the business addresses or the extent or nature of the business operations of the entities receiving the transfers. It later reported that the company had been repaid in full with no loss resulting from the transfers, but at the time of the decision by Vice Chancellor Glasscock, the company had not been able to produce audited financial statements confirming the amounts were repaid. The audit committee commenced an investigation, but before that investigation was completed, management failed to pay the fees of the audit committee's outside legal counsel, forensic specialists and auditor. These professionals withdrew from the engagement or suspended their services to the audit committee.

Two independent directors then resigned in protest of the defunding. Fuqi disclosed to stockholders that the cash-transfer transactions were the result of material weaknesses in Fuqi's internal controls, acknowledging that the company's treasury controls did not require that internal fund transfer applications identify any specific business purpose or be accompanied by supporting documentation, such as a copy of a relevant invoice, purchase order or pre-

[1] See *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959 (Del. Ch. 1996).

payment statement. From June 2010 until March 2012, Fuqi's board and executive team experienced mass defections, including the resignations of four directors (two of whom expressly resigned, as noted above, due to management's failure to pay the professional service providers engaged by the audit committee, as well as a protest to management assuming authority for engaging an accounting firm without the approval of the audit committee).

Plaintiffs made a demand on Fuqi, but two years later the board had not acted in response to the demand. Fuqi had set up a special committee to consider the demand, but it held no meetings, released no progress reports, and all members resigned shortly after formation with essentially no activity. More than two years had passed since the demand letter was sent to Fuqi, and plaintiffs submitted that Fuqi's board had sufficient time to investigate.

Vice Chancellor Glasscock considered the board's "abandonment of the investigation as an abdication of its duty to investigate the demand," noting that the protections of the business judgment rule do not apply...where directors have either abdicated their functions or absent a conscious decision, failed to act." The investigation "has been left in limbo, with no progress, for several months," and therefore the Vice Chancellor concluded that Fuqi management was not entitled to the business judgment rule. The Vice Chancellor then observed that "[t]o make matters worse, the independent directors, who could have conducted a meaningful investigation on behalf of the company, have resigned from their posts." The Vice Chancellor concluded that the plaintiff "pled with particularity facts that create a reasonable doubt that the Fuqi board [has] acted in good faith in investigating" the facts underlying the demand.

The Vice Chancellor then considered whether to grant a motion to dismiss the complaint for failure to plead facts that show that the directors "consciously and in bad faith failed to implement any reporting or accounting system or controls." The Vice Chancellor declined to consider claims against the defendants individually. He noted that some of the former independent directors who had been on the audit committee and had resigned in protest, as noted above, might have attempted to fulfill their duties in good faith. He observed, however, that Chancellor Strine had recently commented in *In re Puda* that "it is troubling that independent directors would abandon a troubled company to the sole control of those who had harmed the company." Vice Chancellor Glasscock then explained directors would not be "automatically exonerated because of their resignations."

> *...directors would not be "automatically exonerated because of their resignations."*

The Vice Chancellor refused to dismiss the *Caremark* claims, holding that Fuqi's public disclosures led him to believe that Fuqi "had no *meaningful* controls in place," and that even if Fuqi had some system of internal controls in place, he could infer that "the board's failure to monitor that system was a breach of fiduciary duty." He also concluded that the board was aware of "red flags" as to the deficiencies in Fuqi's internal controls, and that it was reasonable to infer from the facts pled "that the directors knew that the internal controls were inadequate and failed to act in the face of a known duty." He noted that the fact that the CEO "was able to transfer $130 million out of the company's coffers, without the directors knowing about it for over a year, strains credulity... If the directors had even the barest framework of appropriate controls in place, they would have prevented the cash transfers."

The Vice Chancellor explained that "when faced with knowledge that the company controls are inadequate," the directors "must *act*, i.e., they must prevent further wrongdoing from occurring." He concluded that the directors were either complicit in the money transfers, or were "aware of the pervasive, fundamental weaknesses in Fuqi's controls and knowingly failed to stop further problems from occurring." Thus he held that the complaint stated a claim for breach of the duty of good faith under *Caremark*. He also noted that failing to "utilize an existing audit committee [is] an example of directors' disabling themselves from being informed."

## The *In re Puda Coal* Ruling

In *In re Puda Coal*, Chancellor Leo Strine issued a transcript ruling concerning three independent directors who had resigned from the board of directors of Puda Coal after a lawsuit against them was filed in Delaware. An audit committee comprised of those three directors had reported publicly that the CEO and Chairman, Messrs. Zhu and Zhao, had sold the company's assets to an affiliate without compensation to the company, or essentially the assets had been "stolen out from under them." [See the Form 8-K filed by Puda Coal, Inc., on September 1, 2011]. The three directors did not cause the company to sue to recover the assets, although they controlled the board, but instead resigned. Mr. Zhu had already resigned, and thus the three directors' resignation left one of the thieves, Mr. Zhao, as the sole remaining director.

Chancellor Strine noted that the purported effect of the resignations by the three directors was to immunize each of the three from suit "while simultaneously making it impossible for the company itself to sue to recover the assets." The Chancellor therefore excused demand because the controlling independent directors had quit rather than commencing a lawsuit against the perpetrators. Chancellor Strine noted that the directors "were faced with...the most extreme sort of fiduciary violation you could imagine." He noted that those same directors attempted to use the procedural demand futility standard to "disable the derivative plaintiffs from even going after the bad guys." Later he noted that "knowing that they could actually cause the company to join the lawsuit and pursue things, these directors quit" and thereby "leave the company under the sole dominion of a person they believe has pervasively breached his fiduciary duty." He declined to premise a dismissal of the lawsuit on demand excusal grounds for this reason, terming such a dismissal as "Kafkaesque" and noting it would subject the Delaware courts to ridicule.

In explaining the *Caremark* claim, Chancellor Strine noted in his transcript ruling that "if you are going to have a company domiciled for purposes of its relationships with its investors in Delaware and the assets and operations of that company are situated in China, that in order for you to meet your obligations of good faith, you'd better have your physical body in China an awful lot." He observes:

- "You better have in place a system of controls to make sure that you know that you actually own the assets."
- "You better have the language skills to navigate the environment in which the company is operating."
- "You better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company."

These are sound, common sense prescriptions for directors acting in companies with their primary operations and assets overseas, to be able to exercise required oversight and control. Chancellor Strine found that the allegations here, including the magnitude of wrongdoing and the length of time it went undiscovered, to give rise to a *Caremark* claim.

In reviewing this case, Chancellor Strine supports the business judgment rule. He explains that Delaware law permits "dummy directors," but "you have to be an active dummy director." The Chancellor observes that a director "can be trying and misses stuff and...you get credit for that." He notes that "what you can't be is a dummy director in the sense of an actual dummy. Like...a mannequin, somebody who allows themselves to be appointed to something without any serious effort to fulfill the duties." He then explains: "Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors." He continues: "if the assets are in Russia, if they are in Nigeria, if they are in the Middle East, if they are in China, then you are not going to be able to sit in your home in the US and do a conference call four times a year and discharge your duty of loyalty." In evaluating the *Caremark* claims, the Chancellor notes that one picks independent directors "not for their industry expertise, but because of their independence and their ability to monitor the people who are managing the company." In that regard, he observes that "if I don't understand how the company makes money, that's a danger...if all the flow of information is in a language I don't understand in a culture where there's frankly not legal structures or...ethical mores...where I am comfortable...it would be very difficult..."

> *Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors.*

Beyond the failure to provide oversight, Chancellor Strine finds that the resignations themselves here state a claim for breach of fiduciary duty, explaining that "[th]ere are some circumstances where running away does not immunize you." He advised that if at the time these directors quit, "they believed that the chief executive officer of the company had stolen the assets out from under the company, and they did not cause the company to sue or do anything but simply quit," that decision may be a breach of fiduciary duty. Accordingly, Chancellor Strine denied the motion to dismiss the lawsuit.

## Lessons from *Fuqi* and *In Re Puda* Coal

Obviously, the facts faced by the independent directors in *Fuqi* and *In re Puda Coal* were egregious and unusual. Nevertheless, one can draw some important "rules of the road" for independent directors generally. Here are some take-aways:

- Directors cannot ignore or abdicate their duties without a risk of personal liability. Directors do not have the protection of the business judgment rule if they fail to act, or in Chancellor Strine's words, if they act like "mannequins."

- A key criteria for selection of independent directors is their ability to monitor the people who are managing the company. Independent directors should keep this key oversight responsibility top of mind in performing their duties as directors, and in deciding whether to take on a new director role.

- Directors need to pay attention to red flags and monitor internal controls.

- Directors serving in companies with significant assets in a foreign country should have a clear understanding of the internal controls over the company's assets and operations in that foreign country, and language skills to permit understanding of the activities in the foreign country. They should make sure that the company has professional advisors who can monitor and advise the board with respect to appropriate internal controls. Directors in such companies should plan to spend sufficient time in the company's foreign operations to make sure the director has a good understanding of the foreign business, assets and internal controls, and should assess the culture of compliance.

- If directors see red flags, they need to act to prevent further harm to the company and further wrongdoing.

- Resignations will not necessarily immunize or exonerate a director if he should have taken action to prevent wrongdoing.

- A resignation that leaves the company in the control of a looter is a potential breach of the resigning director's duty if the director fails to act to seek redress and his resignation leaves the company unable to take such action.

*Resignations will not necessarily immunize or exonerate a director if he should have taken action to prevent wrongdoing.*

In summary, a director considering a resignation must carefully consider the impact of that resignation on the company. If the resignation will leave the company worse off, unable to pursue a remedy against a wrongdoer or to pursue the board's fiduciary duties, due to the composition of the remaining board or otherwise, the director should consider the risks of potential liability not just for the period prior to the resignation, but for consequences of the resignation. A director may have liability stemming from facts arising before the resignation, and should keep in mind that once the director has resigned, that director cannot take any further steps to correct the deficiencies or problems. Directors of troubled companies do not have an easy road whichever path they take, particularly where management is unresponsive or suspected of malfeasance, but must consider the best interests of stockholders as well as their personal interests.

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# Common Stockholders Successfully Challenge Delaware Board Actions Favoring Preferred Stockholders in Dilutive Financings

The Delaware Court of Chancery issued a recent opinion that affords common stockholders an avenue for challenging decisions by boards of directors resulting in preferential payments to preferred over common stockholders in a company sale. In *Carsanaro v. Bloodhound Technologies, Inc.*, 2013 WL 1091048 (Del. Ch. March 15, 2013), the company at issue was sold pursuant to a transaction in which the lion's share of the proceeds was paid to preferred stockholders in liquidation preferences and to then-current management in the form of transaction bonuses. Practically no consideration was paid to the common stockholders, including the company's founder. In this regard, the *Carsanaro* decision is reminiscent of *In re Trados Inc.*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

## *Trados*: Light Shed on Fiduciary Duties to Common Stockholders

In *Trados*, a common stockholder alleged that the interests of the preferred stockholders and common stockholders diverged because the merger triggered a multimillion-dollar liquidation preference for the preferred stockholders, while leaving the common stockholders with nothing. The Delaware Court of Chancery refused to dismiss claims against the company's directors for breach of fiduciary duties to common stockholders, finding that it was reasonable to infer that the board designees of the preferred stockholders, who made up a majority of the board, were conflicted and had differing interests in the transaction from the common stockholders, given the preferred stock liquidation preferences, and may have breached their duty of loyalty. The plaintiff argued that the company's prospects were improving, and although the sale paid off the preferred stockholders' liquidation preference, the holders of common stock were deprived of the opportunity to defer the sale to a later point in time, when the company could be worth more. Thus, a key issue in *Trados* was whether the board could properly make the decision to sell the company at a point in time and at a price that provided no consideration to the common stockholders, given the differing interests of the preferred and common stockholders, and the alleged conflicts of interest of board members who were designees of the preferred or members of current management who received sale bonuses.

## *Carsanaro*: Dilutive Financings Under Scrutiny

In *Carsanaro*, however, the key issue was not whether the company should have been sold at that particular time and at that particular price. Rather, the case focused on whether liquidation preferences paid to preferred stockholders should be set aside because much of the preferred stock was issued pursuant to earlier financing transactions that were wrongfully dilutive to the common stockholders.

In *Carsanaro*, Bloodhound Technologies, the company at issue, developed web-based software applications to monitor fraudulent healthcare claims. The plaintiffs were five software developers, including the company's founder, who held common stock and claimed that their years of hard work laid the foundation for the company's success. They claimed that after Bloodhound raised its initial rounds of venture capital funding, the venture capitalists took control of the board, forced founding members to resign from the board and management, and from that point on, financed the company through self-interested and highly dilutive stock issuances. According to the complaint, the plaintiffs were not aware of these stock issuances or their effects until the company was sold for $82.5 million, at which point the plaintiffs were collectively left with less than $36,000 of the proceeds based on their diluted one percent equity ownership.

The plaintiffs challenged previous dilutive stock issuances, the allocation of $15 million of merger proceeds to management pursuant to a management incentive plan, and the fairness of the merger. The plaintiffs sued the members of the board who approved the transactions and their affiliated venture capital funds, and the defendants moved to dismiss. With limited exceptions, the motions to dismiss were denied.

In contrast with earlier rounds of preferred stock financing when then-CEO and founder Carsanaro led wide-ranging efforts to raise funds through arm's length negotiations with prospective investors, after the venture capitalist takeover, the defendants' control of the board allowed them to provide additional financing themselves (and from other like-minded venture capitalists) on terms they set unilaterally.[1] According to plaintiffs, some of the later financings were done on the basis of lower company valuations and thus higher dilution to the holders of common stock.[2] Despite the upward trajectory of the company, the complaint alleged that the board continued to approve additional preferred stock issuances by way of inside rounds at low company valuations. In addition to approving these financings, in connection with a later round of preferred stock financing, the company engaged in a 10-for-1 reverse split of its common stock without adjusting the conversion price of certain series of preferred stock. The effect of this reverse split and other offsetting and questionable transactions approved by the board was that the preferred stock became ten times more valuable, and the interests of common stockholders were diluted even further.

*The plaintiffs challenged previous dilutive stock issuances, the allocation of $15 million of merger proceeds to management pursuant to a management incentive plan, and the fairness of the merger.*

The Chancery Court found that the facts set forth in the verified complaint laid out a prior history of financing and related transactions evidencing a level of self-dealing by the board, rebutting the presumption of the business judgment rule[3] and shifting the burden of proving entire fairness of the transactions to the defendants. Under Delaware law, if the various transactions were not approved in each case by a board majority consisting of disinterested directors, the business judgment rule does not apply and the defendants have the burden of proving that each transaction is entirely fair.

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[1] Before founder Carsanaro was asked to resign as CEO and director, the company had worked out terms with a new investor who would purchase Series C Preferred Stock at a pre-money valuation of $20-25 million. Following Carsanaro's resignation, the board approved a Series C financing on different terms. The new terms implied a pre-money valuation of $10 million. Under the previously negotiated terms, only the new investor would participate in the Series C financing, but under the new terms, the lead venture capital investors from the previous rounds also participated to avoid dilution of their own holdings.

[2] To the extent that existing venture capital investors participated in later rounds, including "down rounds," they were able to avoid such dilution. The board also issued additional shares of common stock to the new management to offset the dilutive effects on their interests. Thus, the dilutive impact fell primarily on the founders.

[3] The business judgment rule presumes that in making a business decision, 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 interests of the company.

## Lessons From the *Carsanaro* Decision

Of course, the *Carsanaro* decision sets forth allegations of facts that show egregious and secretive self-dealing in various financings that well-counseled boards will avoid. Typical "down round" financings are carried out with various protections for the minority, such as rights offerings and notice, which are completely absent on the facts alleged in *Carsanaro*. Moreover, boards will typically employ established processes to assure independent decision-making and to provide directors and investors protection for decisions made in interested transactions, such as the use of special committees of independent directors or obtaining the vote of a majority of unaffiliated stockholders.

In any case, as *Carsanaro* demonstrates, the board's decision to sell the company, and at what price and on which terms, are not the only decisions open to challenge in a company sale in which one or more groups of stockholders receive significantly less or no proceeds. Earlier decisions of the board regarding dilutive financing or other transactions preferential to one group of stockholders may also be challenged, particularly if the result of the earlier transactions is to reduce the proceeds allocable to the common stockholders from a company sale. *Carsanaro* provides a good reminder that all board decisions that favor one group of stockholders over another are potentially subject to judicial scrutiny. Whenever possible, the board should provide independent approval of such transactions either by a special committee of independent directors or by conditioning the deal on the approval of a majority of the unaffiliated stockholders, or should be advised to provide other indicia of fairness such as a rights offering, a fairness opinion taking into account the different classes of stock, or some other evidence that the interests of all stockholders were appropriately considered.

*As Carsanaro demonstrates, the board's decision to sell the company, and at what price and on which terms, are not the only decisions open to challenge in a company sale in which one or more groups of stockholders receive significantly less or no proceeds.*

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# The Significance of Comprehensive Non-Reliance and Integration Clauses in Light of a Broad Full-Disclosure Representation

A recent decision from the US District Court for the Western District of Virginia reinforces the significance of a comprehensive integration and non-reliance clause in a contract for the sale of a business. In *Pyott-Boone Electronics, Inc., Etc. v. IRR Trusts for Donald L. Fetterolf Dated December 9, 1997, et al.*, 2013 U.S. Dist. LEXIS 6112 (W.D. Va. Jan. 15, 2013), the court, applying Delaware law, dismissed a claim brought by a buyer of a business against the sellers thereof, based on an alleged breach of a full-disclosure representation in the stock purchase agreement (SPA) pursuant to which the business was sold. The court held that an alleged material misrepresentation in certain sales projections provided during the preliminary investigation and negotiations phase of merger discussions did not constitute a breach of the full-disclosure representation, in large part because the non-reliance and integration provisions of the SPA limited the scope of such representation.

Pyott-Boone, the plaintiffs in the suit, alleged that IRR, the defendants, had breached the full-disclosure representation in the SPA[1] by virtue of having provided, through investment bankers engaged to solicit interest in a possible acquisition of the sellers' business, a document detailing anticipated future sales opportunities for several major distributors of a key business line. Subsequently, Pyott-Boone, IRR and certain others entered into the SPA, which, as the court points out, included "twenty-four pages of express representations and warranties...[and] more than seventy pages of schedules and exhibits, representing the information upon which the parties were to have relied in concluding their agreement."[2] The court further notes that despite the comprehensive representations and warranties in the SPA and robust attachments and schedules, neither the distributor analysis nor the information in the analysis were referenced in or attached to the SPA.[3]

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[1] The SPA contained the following representation: "No representation or warranty by the Company or Stockholders contained in this Agreement, the Schedules attached hereto or in any statement or certification furnished or to be furnished to Buyer pursuant hereto or in connection with the transactions contemplated hereby, contains or will contain any untrue statement of a material fact or omits or will omit to state a material fact necessary to make the statements contained herein or therein not misleading." *Pyott-Boone Electronics, Inc., Etc. v. IRR Trusts for Donald L. Fetterolf Dated December 9, 1997, et al.*, 2013 U.S. Dist. LEXIS 6112, *8 (W.D. Va. Jan. 15, 2013).

[2] *Pyott-Boone v. IRR*, p. 8. This representation was broadly drafted to cover statements beyond the representations in the SPA, and would fairly be viewed as buyer favorable.

[3] Of course, it is not typical to include a representation concerning future projections or market analysis in a definitive acquisition agreement, nor would well-advised sellers readily permit this.

Later, after the acquisition closed (and presumably the business proved to be less successful than anticipated), Pyott-Boone claimed the distributor analysis contained knowing and negligent misrepresentations, and that Pyott-Boone, in justifiably and foreseeably relying on the representations in the distributor analysis, had suffered damages as a result of these misrepresentations. Pyott-Boone contented that the distributor analysis constituted a "statement... furnished...to Buyer pursuant [to the SPA] or in connection with the transactions contemplated [by the SPA]," which either contained an untrue statement of a material fact or a material omission, and thus was within the scope and constituted a breach of the full-disclosure representation.

*The court seems to be of the view that even broadly written full-disclosure representations have limitations, and cannot be used to bring in materials and topics not addressed by express representations in an acquisition agreement.*

In rejecting this claim, the court identified two other provisions in the SPA that worked together to foreclose this attempted avenue of recovery. The first was the integration clause in the SPA[4], which the court held to plainly state that IRR was making no representations beyond those specifically included in the SPA, and the second was the non-reliance clause[5], which the court held to specifically disclaim reliance by Pyott-Boone on information provided pursuant to fulfillment of due diligence requests or in preparation for the acquisition. Working together, these two clauses were held to exclude from the scope of the full-disclosure representation "statement[s] provided to a prospective buyer over four months before a deal is ultimately struck." Accordingly, the court concluded that such statements "cannot truly be understood as 'pursuant to' or in connection with some future hypothetical agreement."

In coming to these conclusions, the court highlighted the fact the SPA was a negotiated agreement between represented and sophisticated parties, and had the parties intended for the distributor analysis to be included in the scope of the SPA, the parties would have done so. Notwithstanding the foregoing admonition, negotiated acquisition agreements do not typically include detailed representations on sales projections, and do not normally attach or incorporate materials such as the distributor analysis, but these materials seem to fall naturally within the types of statements a buyer would intend to be addressed by a full-disclosure representation. In essence, the court seems to be of the view that even broadly written full-disclosure representations have limitations, and cannot be used to bring in materials and topics not addressed by express representations in an acquisition agreement.

[4] The SPA provided that "[t]his Agreement, including the Schedules and Exhibits hereto, together with the Confidentiality Agreement constitutes the entire agreement of the parties hereto respecting its subject matter and supersedes all negotiations, preliminary agreements and prior or contemporaneous discussions and understandings of the parties hereto in connection with the subject matter hereof. There are no restrictions, promises, representations, warranties, agreements or undertakings of any party hereto with respect to the transactions contemplated by this Agreement, the Confidentiality Agreement, or the Transaction Documents, other than those set forth herein or therein or in any other document required to be executed and delivered hereunder or thereunder." *Id.*, p. 11.

[5] The SPA further provided that "Buyer...has not relied upon and shall have no claim or right to indemnification...and none of the Stockholders shall have or be subject to any liability to Buyer or any other Person with respect to any information, documents or materials furnished by the Stockholders, [the Company] or any of their respective officers, directors, employees, agents or advisors to Buyer...relating to [the Company] and any information, documents or material made available to Buyer in fulfillment of due diligence requests, the management presentations or in any other form in expectation of the transactions contemplated hereby, provided, however, that the foregoing shall not apply to any such information included or referenced in [the Representations and Warranties sections of the SPA]." *Id.*, p. 12.

*This case serves as a reminder to buyers that even a negotiated full-disclosure representation may not provide a meaningful remedy beyond the representations in the agreement.*

In coming to its decision, the court also pointed to the fact that the statements at issue were provided in the early stages of the negotiations, through an investment banker whose job was to sell the transaction. As a result, it is not entirely clear the same decision would have been reached had the alleged misrepresentations been included in materials provided in response to specific diligence requests during the later stages of the deal negotiations, even if these materials were not explicitly referenced in the SPA.

From the perspective of a seller, this case highlights the benefits and protections of well-drafted non-reliance and integration clauses, particularly if a buyer is insisting on a broad full-disclosure representation. From a buyer's perspective, this case reinforces the need to exercise caution in relying on a full-disclosure representation. The full-disclosure representation in the Pyott-Boone SPA was buyer-favorable, but in harmonizing this provision with the non-reliance and integration clauses, the court seems to give limited meaning to the language that included within the representation's scope "statements pursuant [to the SPA]." This case serves as a reminder to buyers that even a negotiated full-disclosure representation may not provide a meaningful remedy beyond the representations in the agreement.

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