FIDUCIARY DUTIES
OF DIRECTORS CONSIDERING A PROPOSAL FOR AN
ACQUISITION OF A PRIVATELY HELD COMPANY

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This article outlines the fiduciary duties of directors of Delaware and California corporations considering a proposal for an acquisition of a privately held company and legal counsel’s role in assisting directors to meet these duties. It is important to note at the outset that the board of directors of a privately held company owes these duties to its stockholders to the same extent as does a director of a public company. See Cirrus Holdings Co. Ltd. v. Cirrus Industries Inc., 794 A.2d 1191 (Del. Ch. Jul. 19, 2001).

Of course, some private company boards are not particularly susceptible to a claim of breach of fiduciary duty, either because there are few minority holders without board representation, or such holders are either passive, not informed or indifferent about the corporation’s affairs, unsophisticated, and/or widely dispersed and not in contact with one another. There are many other settings where a claim by minority or substantial stockholders is a very real possibility however. These include situations where there were several rounds of prior financing, and possibly a “down round” or “cram-down” financing which created a disgruntled stockholder base, corporations where reductions in force or other employment actions have created a class of former employee stockholders who may lack goodwill toward the company and its board, and corporations where a significant institutional or otherwise sophisticated stockholder (a founder, a former strategic partner, etc.) for one reason or another lacks board representation or is hostile to the current board. In these cases, there is a risk of lawsuit challenging directorial conduct, particularly where the value of the corporation warrants such litigation.

It is important for directors to comply with their fiduciary duties and equally important to establish a record to give such directors the protection of the business judgment rule.

The Business Judgment Rule.

The common law “business judgment rule” reflects the recognition by the courts that business men and women, not judges or stockholders, run corporations. The rule provides an important defense to sustain well reasoned, informed and good faith business decisions by the board. The Delaware Supreme Court has summarized the rule as follows:

“The business judgment rule `is a presumption 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.’ . . . A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be `attributed to any rational business purpose.’” Unocal Corp. v. Mesa Petroleum Co. ("Unocal"), 493 A.2d 946, 954 (Del. 1985).
Under California law, the business judgment rule similarly shields each director from second-guessing by the courts with regard to any exercise of business judgment made “in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 710, 208 Cal. App. 3rd. 1250, 1264 (Cal. App. Dist. 1989).

Directors are ordinarily entitled to the presumption of the business judgment rule where they establish that they have met their duties of care and loyalty, and have acted in good faith.

_Duty of Care_. Directors have the duty to make decisions with reasonable care. In Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court explained this duty in the context of mergers as the duty “to act in _an informed and deliberate manner_ in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.” _Id._ at 873 (emphasis added). In determining whether a board has met its duty of care, the legal test is whether the board availed itself of all reasonably available material information about the subject of the decision. _Id._ at 872.

Practical guidelines on how a board may satisfy the duty of care can be distilled from Delaware and California court decisions:

1. The board should avoid not only haste, but the appearance of haste, in making decisions. Major decisions should be made only after directors have had a full opportunity to digest all available material information, which may require more than one meeting.

2. Directors should review and consider carefully all available material information. Pertinent information should be distributed to the board as far in advance of the meeting as reasonably possible. The board should carefully review all relevant documents prior to authorizing their execution.

3. The board may consider the advice of advisors or experts, including outside counsel and/or the corporation’s investment banker. (The use of investment bankers is not required to show that the directors exercised due care, but such advice can provide a record that the board considered the merger environment and other alternatives. It is within the directors’ business judgment to decide whether to retain investment bankers to assist in a merger.)

4. The board may consider the advice of Company officers and employees who would be expected to have relevant information on the subject and should seek out such officers in the event the board believes they may have pertinent information.

5. The board should consider whether persons providing information regarding a merger are potentially biased due to fee arrangements or otherwise. Directors should also reasonably believe that the advisors to the board are competent, were chosen with reasonable care and are providing sound advice.
6. Directors should ask questions and actively probe and test all information presented to them, judging its reliability and accuracy and understanding it fully, and review all issues important to the directors’ conclusion.

7. The record of the board’s deliberations should be documented carefully and completely.

Neither the presence nor absence of any one of these factors is likely to be dispositive; instead courts will consider whether directors have given thoughtful consideration to what methods of inquiry and sources of information are available and appropriate for consideration. It is important to note, however, that courts have been more likely to find that directors have failed to meet their duty of care when they have acted hastily or as passive participants without carefully and critically scrutinizing information provided by management and investment bankers.

Accordingly, the board of a privately held company considering such an acquisition transaction should have meetings as necessary and appropriate to review the terms of the proposed transaction, and consider all reasonable available alternatives, including other possible transactions and continuation as a stand-alone entity. The board should consider background information regarding the proposed buyer pertinent to risk of non-consummation, the availability and likelihood of financing where relevant, and in a stock-for-stock merger, the possible risks and benefits of such a business combination. The board should review and as necessary, provide input on, the status of negotiations, and in cases where a conflict of interest may exist for management, the board should participate in the negotiations. The board should receive and review the terms of draft agreements and have the benefit of presentations by management, as well as the Company’s investment banker (if one has been engaged) and outside legal counsel as appropriate to assure that the key terms of the agreements are understood. In a private company merger agreement, often the most complex terms relate to indemnification, and the board should assure itself that it understands these terms fully.

There is often pressure in a private company acquisition to ignore the formalities of a meeting and to forego the discussions which create a record of due care. Counsel should keep in mind that often this is the first experience for many of the company’s directors in selling a company. The directors need to be informed of the need for a thorough review of the transaction and alternatives; after all, it is quite possibly the single most important event in the company’s history. The length and formality of the discussion is less important legally than its quality in light of all relevant considerations. Process, not the “right” decision, is the key to directors being able to avail themselves of the business judgment rule. If the board has carefully reviewed the material terms of the deal, the quality and quantity of the proposed consideration, the risk of non-consummation, availability of financing and other risks relating to the transaction, alternatives to the transaction (including continuing as an independent company) and other relevant information about the buyer, as well as the target’s prospects, the board will generally have established a record of due care.

_Duty of Loyalty._ In addition to the duty of care discussed above, directors owe a duty of loyalty to the corporation and its stockholders. The duty of loyalty requires that a director make decisions based on the best interests of the corporation, and not any personal interest. The duty of loyalty is said to prohibit “self-dealing” by directors. Directors are required to have an
absence of personal financial interest in the matters before them. The fact that a director may be
retained as a director of the combined entity is not of itself generally viewed as tainting his
independence. Further, the fact that a director owns shares of the target corporation has not been
deemed a financial interest inconsistent with the exercise of his fiduciary duties on behalf of the
target corporation and his fellow stockholders. Unocal, 493 A.2d at 957-58. Further, a mere
allegation of a motive to retain corporate control is not sufficient to state a cognizable claim that

In contrast, a director who also serves as an officer or employee of the corporation, or
who is a member of a firm receiving substantial revenue from the corporation, may be viewed as
having a self-interest not shared equally by all stockholders. Gantler v. Stephens, 965 A.2d 695
(Del. 2009). In the case of management or employees, the transaction may result in loss of
employment or at least a change in job responsibilities on the one hand, and benefits related to
the change in control such as vesting or severance, on the other. A director who works for a
supplier or customer of the target company may have the interests of his or her employer to
consider. If a stockholder has special interests in the proposed transaction or will receive a
benefit not shared by other stockholders (such as special tax or accounting benefits), such special
interests would raise duty of loyalty issues for any director employed by such stockholder. A
director employed by a parent stockholder who is a proponent of the transaction will be viewed
as interested due to the controlling influence of the majority stockholder. See e.g., McMullin v.
Beran, 765 A.2d 910 (Del. 2000); In re Digex, Inc. Shareholders Litigation (“Digex”), 789 A.2d

Note also that a director must exercise independent judgment for the overall benefit of the
corporation and all of its shareholders, even if elected at the request of a controlling shareholder,
a union, a creditor, or an institutional shareholder or pursuant to contractual rights. All possible
transactions or relationships that might influence a director’s decisions concerning a particular
transaction, including relationships with other prospective parties, should be fully disclosed to
the board as a whole. See In re Oracle Corporation Derivative Litigation, 824 A. 2d 917 (Del.
Ch. 2003). Courts have found that a board has met the requirement of independence where a
majority of the board consists of independent outside directors. It is sometimes advisable in
these situations to allow the independent directors to deliberate separately concerning the
transaction, particularly during the discussion of the issues giving rise to a conflict of interest for
one or more and more director (e.g., an employment arrangement).

These issues become particularly sensitive when a director is on the board of each of the
buyer and seller. Here the director owes conflicting duties and should be advised as to his or her
particular situation. The director owes a duty to disclose information to the respective boards
and also a duty to keep confidential information in trust, two duties which put the director in a
difficult situation unless one directorship is relinquished or the director is absent from all
discussions during the period relating to the transaction. A director in this circumstance must
recuse himself from any discussion about a potential transaction for the company, and cannot
serve as an agent in the transaction without potentially breaching his duty to one or the other
corporation.

One situation involving a merger in which private company directors may confront an
issue regarding duty of loyalty is a transaction in which the preferred stockholders are receiving
merger consideration, but the common stockholders are not, because of the liquidation
preferences applicable in that merger. In the case In re Trados Incorporated Shareholder Litigation, 2009 WL 2225958 (Del.Ch. 2009), the Delaware Chancery Court denied the defendants’ motion to dismiss breach of fiduciary duty claims arising out of the approval by Trados’s board of directors of a sale of the company for $60 million. Of the $60 million sale price, Trados’s preferred stockholders received approximately $52 million. The remaining $8 million was distributed to Trados’s management under a management incentive plan. Trados’s common stockholders received nothing for their common shares. The court found that the former Trados common stockholder acting as plaintiff made a plausible argument that the directors breached their fiduciary duties in approving the sale transaction because at least a majority of the directors, most of whom were designated by preferred stockholders, were incapable of exercising independent and disinterested business judgment and favored the interests of the preferred stockholders at the expense of the common stockholders. The Delaware Chancery Court denied the defendants’ motion to dismiss, finding that the plaintiff alleged sufficient facts to demonstrate that at least a majority of the members of the Trados board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger at a price that yielded no return to the common stockholders.

The Delaware Chancery Court noted that at this stage of the proceeding, it was reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred. In circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, the court concluded, it is generally the duty of the board to prefer the interests of common stock to the interests of preferred stock. The court emphasized the importance of individual facts and circumstances of this case and underscored that it would not necessarily be a breach of fiduciary duty for a board to approve a transaction that, as a result of liquidation preferences, does not provide any consideration to the common stockholders. However, the court concluded that it is possible that a director could breach her fiduciary duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders in approving a transaction that triggered a liquidation preference of the preferred and resulted in no consideration for the common stockholders. In light of this decision, directors of companies with preferred stock outstanding should consider carefully whether the directors have interests which diverge with the common stockholders. This decision clarifies that one such situation is a merger in which the common get no consideration, but where the company could continue as an ongoing entity. In such a case, the directors should consider implementing some process to address the interests of the common stockholders. See Equity Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997)(no breach of duty where board continued corporate enterprise where liquidation would have made preferred holders whole, but common stockholders would have received nothing). Alternatively, preferred holders might negotiate contractual rights, such as drag along rights, that would force the stockholders to go along with a transaction approved by the preferred; in this case, the board would still be required to negotiate the best possible transaction.

A few other recent Delaware cases have clarified the fiduciary duties owed to preferred stockholders or other contract holders. For example, in LC Capital Master Fund, Ltd. v. James, 990 A. 2d 435(Del. 2010), the Delaware Supreme Court rejected the claims of a preferred stockholder that the board failed to make a “fair allocation” of the merger consideration between the common and the preferred stock in allocating the stock on an “as-converted” basis as
required by the certificate. The court noted that once the board complies with the contractual rights of preferred it is entitled to then favor the common. In Nemec v. Shrader, 2009 WL 1204346 (Del. Ch. 2009) the Chancery Court held that the exercise of an express contractual right to call stock at book value prior to a merger where the stock would have received a higher consideration did not constitute a breach of the directors’ duty of loyalty or a breach of the implied covenant of good faith and fair dealing. The Chancery Court held that the directors did “not owe separate and distinct fiduciary duties to plaintiffs.”

Where a board does not have a majority of disinterested directors, courts have consistently held that a committee consisting solely of independent directors may be used to obtain the same result. Legal counsel should determine early on if a special committee will be necessary or advisable to resolve a duty of loyalty issue. The formation of a special committee creates another layer of decision making, typically necessitates additional meetings and additional time in the negotiation process and may require retention of independent advisors. Independent advisors are viewed as one key indicia of a committee’s independence. It is important to plan for these procedural matters early on. The independence of a special committee is subject to judicial scrutiny; care must be taken to ensure that committee members and their advisors have no relationships which might taint their independence. Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110 (Del. 1994); Kahn v. Tremont Corporation, 694 A.2d 422 (Del. 1997); In re Oracle Corporation Derivative Litigation, 824 A. 2d 917 (Del. Ch. 2003).

Process becomes increasingly important when a special committee is employed. In order for the use of an independent special committee to establish that the board has satisfied the duty of loyalty, the committee also must have the power to act independently. It is key to establishing the independence of the special committee that the Committee engages in arm’s-length bargaining. The Delaware courts focus on the committee’s role. “[T]here is a strong role under Delaware law for meaningful independent director committees.” Digex, 2000 WL 1847679, at *26. The board in establishing such a committee should take care to empower the committee appropriately so that it has a meaningful role in negotiating terms of the transaction or indeed in determining whether a transaction is advisable at all and is truly an independent decision maker.

It is important to give the special committee full decision-making authority regarding the transaction early in the process, so that decisions regarding process are subject to the committee’s business judgment review. It is not generally sufficient to provide the benefit of a special committee, simply to have a fully negotiated transaction ratified by the special committee, because in this case the committee has not exercised arms’ length bargaining in the negotiation of the transaction, acting on behalf of stockholders. Typically, counsel for the special committee should draft the committee’s charter or authorizing resolutions to assure proper authority and resources for the committee. Further, depending on the prior relationship between the current outside counsel to the company and current management or directors, and the potential for conflicts of interest, the special committee may require separate independent legal counsel and sometimes an independent financial advisor. If the formalities cannot be observed, the committee might not provide significant benefits as far as demonstrating a fair process.

Another common instance in a privately held company where duty of loyalty issues arise is where the company is majority-owned by one stockholder, the parent corporation. Often the
minority stockholders are employees, former employees and participants in financings who expected the subsidiary to be spun off or sold. Three recent Delaware cases outline the spectrum of duties of the board of the majority-owned subsidiary.

In McMullin v. Beran, 765 A.2d 910 (Del. 2000), Atlantic Richfield owned 80% of ARCO Chemical. The parent wanted to sell the subsidiary, and could have vetoed any transaction it had not approved. The court affirmed the right of the majority of stockholder to sell or vote its shares without regard for the minority. Nonetheless the court held that subsidiary’s directors owed a duty of loyalty to all of its stockholders. The directors were obligated “to make an informed and deliberate judgment, in good faith, about whether the sale proposed by the majority shareholder will result in maximization of value for the minority shareholders.” McMullin, 765 A.2d at 919. The board could not abdicate its duty by simply deferring to the judgment of the controlling stockholder. Id. at 920. The court held that the board, itself comprised primarily of employees of the parent, was required to use a special committee to make an independent judgment as to whether the transaction maximized value for all shareholders. The board failed to empower the special committee to participate actively in the sale of the Company.

In sharp contrast to McMullin, the court in Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) held that in a short form merger (where the parent owned at least 90% of the voting stock), the parent corporation can use the abbreviated process of the short form merger. Directors need not consider or approve the merger and stockholders need not vote on the merger. The exclusive remedy for a minority stockholder in this case is right to receive the fair value of the holders’ shares through the appraisal. Neither the board nor the majority shareholder need to establish entire fairness. However, since the only choice for a minority stockholder is to accept the merger consideration or pursue appraisal, the stockholder must receive all information material to that decision. Note that this court’s rationale does not seem to apply in California where the statute requires board approval of the short form merger. Although there is no case law on the duties of a board in considering a short form merger in California, the teaching of McMullin v. Beran may be relevant in advising the Board of a California corporation considering a short form merger.
In another recent case, the parent corporation sought a waiver from the board of the subsidiary under the Delaware antitakeover statute, Section 203. Digex, 2000 WL 1847679. The court stated that the defendants had the burden of establishing entire fairness, as all four votes to waive the protection of Section 203 were cast by interested directors who not only sat on the boards of both parent and subsidiary, but who also had substantial direct, personal financial interests in the proposed transaction. Id. at *24. The court found that the special committee formed to consider the requested Section 203 waivers was comprised of both interested and independent directors, and had not been permitted to act in keeping with the role of “meaningful independent director committees.” Id. The independent directors were not empowered to negotiate nor to delay the subsidiary board’s decision to grant the waiver. The court found that the special committee had not established fair dealing. Id.

In summary, the duty of loyalty is often an issue in a private company setting. It is important to determine if conflicts exist, evaluate whether process can be used to cure the conflict and implement such process early in the board’s consideration of the transaction. In the event that plaintiffs allege facts which are sufficient to establish a breach of the duty of loyalty, that will rebut the business judgment presumption and the claim will be judged under the entire fairness standard. Gantler v. Stephens, 965 A.2d 695 (Del. 2009). If directors are held to have violated the duty of loyalty, they would not be exculpated from damages and would not be able to seek indemnification.

Good Faith. The duty of good faith is the duty to act in a reasonable and deliberate manner and in the best interest of the corporation. The Delaware Supreme Court has stated that, “[t]he good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, … but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.” In re Walt Disney Co. Derivative Litigation, 906 A. 2d 27, 67 (Del. 2006)(“Disney”).

The Delaware Supreme Court explained in Disney that: “[a] failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. If the directors are held to have violated the duty of good faith, they would not in such case be exculpated or able to seek indemnification.”

Duties of Directors in Considering a Proposal for a Business Combination.

Decisions with respect to a proposal for a business combination are squarely within the province of the board, which must only approve a transaction if the board, in the exercise of its fiduciary duty, concludes that the proposal is in the best interest of the stockholders. The Van Gorkom decision makes clear that a Delaware corporation’s board of directors is not obligated to approve a merger proposal simply because the proposed share price represents a premium to the current market price. Van Gorkom, 488 A.2d 858, 875 (Del. 1985); see Cede & Co. v. Technicolor, 634 A.2d 345 (Del. 1993). Indeed, courts have made clear that directors of Delaware and California corporations may not simply delegate the decision on a merger to the stockholders. See Van Gorkom, 488 A.2d at 873; Jewel Cos. v. Pay Less Drug Stores
Northwest, Inc., 741 F.2d. 1555, 1560-1561 (9th Cir. 1984) (applying California law); McMullin v. Beran, 765 A.2d at 924.

Of course, a board may determine not to approve a merger transaction. In a recent case the Delaware Supreme Court stated that “[a] board’s decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework.” Gantler v. Stephens, 965 A.2d 695 (Del. 2009), citing TW Servs., Inc. v. SWT Acquisition Corp., 1989 WL 20290 (Del. Ch. 1989). The statutory authority to propose a merger is also the power to decline. The Supreme Court explained in Gantler that in analyzing a board’s decision not to pursue a merger, a Delaware court must first consider whether the board reached its decision “in the good faith pursuit of a legitimate corporate interest. Second, did the board do so advisedly?” Id.

As described above, the directors always have the duty to exercise their fully-informed business judgment to determine if a proposal for a business combination is in the best interest of the Company’s stockholders. Directors must be diligent and vigilant in examining critically the proposal and any alternatives, must act in good faith, must act with due care in considering all material information reasonably available, including information necessary to compare an offer to alternative courses of action, and, in certain contexts, negotiate actively to obtain the best available transaction for the stockholders.

“Higher Stakes” Transactions: The Sale of Control and Impediments to Competing Transactions

Summary.

There are two types of transactions where the Delaware courts have recognized that shareholders may lose flexibility and directors’ actions may be particularly important to the shareholders’ fate, because the directors’ decision either forecloses a competing bid or the shareholders will lose the opportunity to obtain a control premium in a later transaction. Thus, the board of directors has heightened duties under Delaware law in two circumstances: (1) where the transaction will result in a sale of control, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (“Revlon”) 506 A.2d 173, 182 (Del. 1986), and (2) where impediments to another transaction are included in the merger agreement being considered. Paramount Communications, Inc. v. Time, Inc. (“Paramount”), 571 A.2d 1140, 1152 (Del. 1989) citing Unocal, 493 A.2d 946. These heightened duties are discussed below.

To date, California courts have not expressly differentiated the duties of directors of California corporations in a “sale of control” compared to another business combination. Further, the only reported case interpreting California law regarding impediments to a competing bid holds that directors have the right to enter into exclusive merger agreements requiring directors to forbear from negotiating or accepting competing offers until the shareholders have the opportunity to accept or reject the first offer. Jewel Cos. 741 F.2d at 1564. However, in both the Jewel Cos. and Gaillard cases the court emphasized the directors’ duties to scrutinize transactions carefully and weigh alternatives in reaching a decision. Further, no California court has addressed the duties of directors in a business combination since the development of extensive Delaware case law in this area. Accordingly, directors of California corporations would be well advised to take note of the factors considered by the Delaware courts, which
provide guidance on the directors’ duties in these types of transactions with the most at stake for shareholders.

Sale of Control.

Where the proposed transaction will result in a sale of control or an inevitable break up of a company, Delaware directors are subject to the heightened duty to obtain the best available value for the stockholders. Revlon, 506 A.2d at 182. A merger or other business combination in which stockholders are cashed out, or in which a stockholder or affiliated group of stockholders of the corporation control the continuing entity, is generally viewed as a “sale of control,” because the transaction at hand represents the only opportunity to receive a control premium.

Of course, the clearest method to assure that the directors have obtained the “best” available price is to conduct a public auction of the company. Nevertheless, the courts have recognized that such an auction damages the company, perhaps irretrievably, in the event a deal cannot be made with potential buyers (and adversely affects the company’s ongoing operations, and relationships with employees, customers and suppliers) during the auction process. Perhaps as importantly, most bidders are unwilling to expend the time and effort on a possible acquisition merely to serve as a “stalking horse” for another bidder. Accordingly, Delaware courts do not require an auction. The courts have accepted as reasonable directors’ reliance on a “market check” in which private inquiries to the most likely bidders have been made, or where the transaction has been publicly announced far enough in advance so that competing bidders may have a reasonable opportunity to express interest.

Moreover, Delaware courts have held that in determining the adequacy of the offer in a sale of control, directors may approve a transaction without employing an auction or a market check, so long as they are able to demonstrate that they possessed a “body of reliable evidence” on which to base their decision. QVC Network v. Paramount Communications, 635 A.2d 1245, 1267-1268 (Del. Ch. 1993) (citing Barkan v. Amsted Industries, 567 A.2d 1279, 1287 (Del. 1989), affirmed 637 A.2d 34 (Del. 1993)). In Barkan, the Delaware court noted that there is “no single blue print” for obtaining the necessary evidence to satisfy Revlon duties. However, Delaware law is still developing as to what constitutes sufficient “reliable evidence” on comparative value.

In Cirrus Holding Co. Ltd., 794 A.2d 1191, Vice Chancellor Lamb considered an agreement under which the issuance of shares would constitute a change of control of a privately held company. He commented in dicta that Revlon duties did apply in this context. Thus, Vice Chancellor Lamb believes that directors of a privately held Delaware company owe Revlon duties. In another Delaware case, Vice Chancellor Strine confirmed that an auction was unnecessary to establish that the directors had satisfied their Revlon duties. In re Pennaco, Inc. Shareholders Litigation, 787 A.2d 691 (Del. Ch. Feb. 5, 2001). Vice Chancellor Strine explained in Pennaco that although the target “negotiated with a single bidder, it bargained hard and made sure the transaction was subject to a post–agreement market check unobstructed by onerous deal protection measures that would impede a topping bid.” Id.

Note, however, that a post-signing market check is generally not a very effective means of providing reliable evidence that a particular deal constitutes the best available terms in the acquisition of a privately held company. Although the transaction may be announced, the
competing bidder does not have access to the deal documents, there is no trading market for the target stock and no possibility of an unsolicited tender offer. Moreover, in order for a post-signing market check to be effective, the target must have the right to consider competing bids, which is not typically the case in a private acquisition for cash. Often, in a cash transaction, a buyer will seek to have the shareholders of a private company approve the transaction at the time of the signing of the agreement, and there will be no “fiduciary out” after the date of the agreement permitting the board to consider other offers. Accordingly, a private company board in such a transaction will generally have to base its decision on data gleaned from inquiries, contacts and discussions with likely interested acquirors prior to the execution of a definitive acquisition agreement with the buyer.

In a recent case, the Delaware Chancery Court held that “[a]lthough the directors have a choice of means they do not comply with their Revlon duties unless they undertake reasonable steps to get the best deal.” In re Netsmart Technologies, Inc. Shareholders Litigation, 924 A.2d 171 (Del. Ch. 2007). In the Netsmart case, the Chancery Court noted the obligation of the board or committee to control every aspect of the process, including the diligence process, to maximize value, and also criticized the special committee in that case for failing to consider seriously possible strategic buyers. The target company board there developed a process with their banker seeking only private equity buyers, and relying on a post-signing market check as the means to determine if other interest, including interest from strategic buyers, existed. The Netsmart case signals the Delaware courts’ view that if a board decides to pursue a cash sale of the company, the directors are obligated to take “reasonable efforts to maximize the return to … investors.” This recent case confirms earlier cases permitting the board to use a “market check” of likely buyers rather than a full-blown auction, but requires the board to use its business judgment to develop a process that will enable a market check for logical buyers, and notes that reliance on a post-signing market check is not per se reasonable.

In the Netsmart case, the Chancery Court noted the “potential utility of a sophisticated and targeted sales effort,” tailored to “a few logical buyers” and the use of a banker with industry connections to market the company. The Chancery Court in this case noted that a board can legitimately consider the risks to the company from going to a broad group of potential buyers, but that the risk must be real and weighed against the board’s duty to obtain the best available price and terms. The board must make a “genuine and reasonably-informed evaluation of whether a targeted search might bear fruit.” In a private company acquisition context, the case demonstrates the need for the target board to consider reasonable means to inform itself of the reasonable alternatives available to the target prior to locking up a deal with one buyer.

Delaware courts have held that a sale of control is not generally implicated in a “stock for stock” merger, where a majority of the shares in the continuing entity will continue to be held after the merger by a “fluid aggregation of unaffiliated shareholders representing a voting majority,” since the target stockholders continue to have the opportunity to receive a control premium, even if the target stockholders will represent only a minority of the ongoing entity. Paramount, 571 A.2d at 1150; Arnold v. Society for Savings Bancorp, 650 A.2d 1270 (Del. 1994). Delaware courts have not yet considered whether a stock-for-stock merger in which the combined entity is not a publicly held corporation is a sale of control.

In a business combination not involving in “sale of control,” the board of directors does not have the heightened duty to demonstrate by an auction or another form of market check that
the price obtained is the “best” available. Nevertheless, the directors of both Delaware and California corporations have the duty of care generally to evaluate all information concerning the value of the transaction and any alternatives reasonably known to the board in determining whether to approve and recommend the transaction in question to the stockholders. A board considering a business combination involving an exchange of stock will therefore generally be well advised to evaluate carefully whether the proposed combination provides substantial synergies in which the Company’s stockholders will be able to participate in the long-term and which the board believes will offer more value to stockholders in the long-term than other available alternatives, including staying independent. Further, a board that is considering a possible cash offer in comparison to a stock-for-stock transaction will be required to comply with Revlon duties in the event that the cash transaction is approved, and therefore it is advisable that the board engage in the process of reviewing alternatives and considering the best available terms in making its determination regarding the various possible transactions.

The Delaware Supreme Court recently considered the duties of the board to take actions to seek the best possible transaction for stockholders in Lyondell Chemical Co. v. Ryan, 970 A. 2d 235 (Del. March 25, 2009). The Delaware Supreme Court confirmed that Revlon duties do not apply until the board decides to sell the company or the sale is inevitable. The court explained that the Revlon doctrine does not expand the fiduciary duties of directors beyond the duty of care and the duty of loyalty, but under the doctrine the board must “perform its duties in the service of a specific objective: maximizing the sale price of the enterprise.” The court held that the Revlon duty is to get the best price on the sale of the company, and that “[n]o court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control.” Id. The Delaware Supreme Court reversed the Chancery Court, finding that the record established that the directors did not breach their duty of loyalty. Rather, the court explained, if they failed to do all they should have in the sales process, they breached their duty of care. “Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.” Id. The Delaware Supreme Court explained that an arguably imperfect attempt to carry out Revlon duties will not be equated with a knowing disregard of duties. Further, the court held that “there are no legally prescribed steps that directors must follow to satisfy their Revlon duties. Thus, the directors’ failure to take any specific steps during the sales process could not have demonstrated a conscious disregard of their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.” Id.

The Delaware Supreme Court considered whether the actions by the directors amounted to a failure to act in good faith. The court assumed for purposes of this decision that the directors did nothing to prepare for the offer and that they did not consider conducting a market check before agreeing to the merger. The court held that where the directors met several times to consider a premium offer, were generally aware of the value of their company, knew the market for the industry generally, solicited and followed advice of their bankers and counsel, and attempted to negotiate a higher price even though the price was a “blowout” price, the directors
cannot be held to have breached their duty of loyalty by failing to act in good faith in approving the merger as proposed.  

Lessons Learned.  The various recent cases discussing the Revlon duty, such as Netsmart and Lyondell, provide guidance to a board in determining what its duties are in considering a possible sale of control.  It is important to note that the courts have recognized that Revlon does not demand a perfect process.  Lyondell Chemical Co. v. Ryan, 970 A. 2d 235 (Del. March 25, 2009).  Nonetheless, some best practices emerge from the various decisions, which can be considered in considering a possible acquisition proposal:

First, the board should be informed about the value of the company, if not before the offer, then after it is made.

Second, the board should be actively involved in the process, not necessarily negotiating the deal, but certainly reviewing and guiding overall strategy.

Third, the board should consider all alternatives available to the company, including independence and other possible bidders.

1 In the Chancery Court decision for Lyondell, the court concluded that the board did not demonstrate that it had a sufficient body of evidence about the value of the target to satisfy its Revlon duties for a single bidder deal.  Although this decision was reversed, it is worth noting the facts in Lyondell which gave rise to judicial scrutiny.  The Chancery Court explained that the deal had materialized very quickly, and was negotiated and finally agreed to in less than seven days.  This caused the court to consider how hard the Board really thought about the particular transaction and the available market evidence, although the court acknowledged that a week is not an impossibly short time to strategize on price and negotiate a deal..  More important to the court was how the directors spent the week.  The court noted that the board only spent a total of seven hours on the transaction during the week, and half of that was spent on the day it reviewed the final terms of the transaction, thus suggesting the board did not carefully consider all alternatives available to the target.  The board hired Deutsche Bank as a financial advisor, and the bank put together a fairness opinion and compiled a list of potential strategic partners who might be interested in the company, but under instructions from the client did not attempt to solicit any competing offers.  The bank’s analysis showed 20 other companies who might have an interest and provided reasons why none had made an offer and none was likely to top the $48 bid.  The Chancery Court dismissed the bankers’ “idle speculation” that it was unlikely another bidder would top the offer.

Thus, from the Chancery Court’s perspective, it would have been helpful to a determination that the directors met their Revlon duties to see more time by the board deliberating on the transaction and, in particular, more effort reviewing alternatives, and some record of an attempt to conduct a pre-signing market check, or specific evidence of knowledge of the company’s value or buyers’ interest in a possible transaction.  Although the Chancery Court decision was ultimately reversed, and the Supreme Court noted that it would have been inclined on the record to conclude that here the board had met its duty of care, given the issues raised by the Chancery Court as to the process undertaken by the Board to support its Revlon duties, a board would be wise to develop a record of its deliberations regarding alternatives and evidence of value to satisfy judicial scrutiny on the question of whether the target board had met its duty of care.
Fourth, if the board does not have a “body of reliable evidence” about the company’s value, the board must consider what it reasonably believes is the appropriate process to obtain that information, which may be through a pre-signing market check, or in some cases a post-signing market check or the go shop process, or some other reasonable process, and pursue that process as appropriate in the exercise of its business judgment.

**Exclusivity Agreement.** A prospective buyer will sometimes propose an exclusivity agreement to a target, arguing that the buyer does not want to be a stalking horse and is unwilling to undertake significant expense in diligence efforts and negotiation of an acquisition agreement without such an exclusivity agreement. These types of arrangements are subject to significant scrutiny by the courts, particularly in a cash transaction, given the board’s duty to maximize stockholder value, and should be evaluated with caution. These arrangements should not be entered into without board approval and only after considering all the factors relevant to the arrangement, including the likelihood of other bidders, the duration and extent of any market check undertaken, the amount of time requested for exclusivity, the status of negotiations relating to price and terms and the relative attractiveness of the offer compared to other alternatives reasonably available to the company, the risk of losing the transaction at hand in the event exclusivity is not granted and any other relevant factors.

In a private transaction these exclusivity agreements are more common, but also more problematic since as noted above there is little or no opportunity for a post-signing “market check.” Boards of private companies would be advised to consider the “body of reliable evidence” regarding the transaction at hand compared to other alternatives prior to entering into an exclusivity agreement.

**No Shop Clauses, Break Up Fees and Voting Agreements.**

In recent years it has become common to include in merger agreements provisions which may impede competing offers or provide compensation to one party in the transaction if the transaction is aborted by the other. The most common of these arrangements in an acquisition of a privately held company are (1) a clause prohibiting the Company from soliciting other bids or negotiating with another interested bidder (a “no-shop clause”); (2) a substantial fee, payable in cash if the transaction is aborted due to a competing bid or major share accumulation (a “break up fee”); and (3) voting agreements from one or more stockholders, representing a sizable percentage of the corporation’s outstanding common stock.

**Delaware.**

Impediments such as a “no shop” clause, “break up” fee or voting agreements are designed in part to deter a competing bid. Because these provisions may deter or preclude alternative bids which may offer a better immediate price to the stockholders, a Delaware board has a duty to analyze these provisions carefully. The board should consider whether these provisions are so broadly drawn that they would preclude competing bids offering substantially greater value to the stockholders. A Delaware board may reasonably conclude that the enhanced value offered by the combined entity due to synergies arising from the business combination offer greater value to the stockholders than any likely alternative transaction, and conclude that the measures implemented are reasonably tailored to protect the favorable transaction at hand, but may not legally preclude deals of significantly higher value. A Delaware board should
inquire of the company’s management and investment banker to determine facts sufficient to form a judgment regarding likely competing transactions and relative value and the impact of the measures on a competing bidder’s ability to make a higher bid. Further, if “sale of control” is involved, such provisions will generally be upheld only if they are reasonably necessary to induce an offer the board reasonably believes is the best available bid. Paramount Communications v. QVC Network (“QVC”), 637 A.2d 34 (Del. 1994). Such provisions are often judged under the Unocal review standard, and must be reasonably tailored and not preclusive. McMillan v. Intercargo Corp., 768 A.2d 492 n. 62 (Del. Ch. 2000)

“No Shop” Clauses. A “no shop” clause, for example, has been found to be enforceable if the board concludes that it was reasonably necessary to induce or protect an attractive transaction, and if the consequence of a breach of the “no shop” clause would be payment of an objectively reasonable fee. However, in Phelps Dodge Corporation v. Cyprus Amex Minerals Co., No. Civ. A. 17398, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999) Chancellor Chandler held that a straight “no talk” provision, with no fiduciary out, preventing the target from considering information about alternative deals, was likely unenforceable even in a setting not involving a change of control. Chancellor Chandler held “the decision not to negotiate…must be an informed one,” and that an agreement foreclosing all opportunity to discuss alternatives is “the legal equivalent of willful blindness.” See also Ace Limited v. Capital Re Corporation, 747 A.2d 95, 109 (Del. Oct 28, 1999) (“No talk provisions…are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party.”) These cases involved stock for stock mergers, making clear that the duty exists regardless of whether Revlon duties are triggered.

Vice Chancellor Lamb analyzed a no shop provision in Cirrus Holdings Co. Ltd., 794 A.2d 1191, in a transaction involving a privately held target company. As noted earlier, in dicta, Vice Chancellor Lamb noted that Revlon auction duties were implicated for the board to secure the best available value for the stockholders. He stated, “As part of this duty, directors cannot be precluded by the terms of an overly restrictive “no shop” provision from all consideration of possible better transactions. Similarly, directors cannot willfully blind themselves to opportunities that are presented to them, thus limiting the reach of ‘no talk’ provisions.” Id. at *13. “No talk” provisions have become extremely common in private company acquisitions, but the recent Phelps Dodge, Ace and Cirrus decisions make clear that Delaware courts are unlikely to uphold such “no talk” provisions absent a strong showing of an auction or other evidence that there was no need for a right to consider other possible bids.

The duty to consider other bids is, however, generally thought to extend only through stockholder approval of the transaction. See In re Mobile Communications, 1991 WL 1392 (Del. Ch. 1991). In a private company setting it may be possible to structure the agreement to provide a limited window shop only through stockholder approval, or to obtain such approval essentially simultaneously with the signing of the agreement. In the latter case, the fact that there is no subsequent no shop is not a problem. This is because the target board no longer has the duty to consider a third party proposal once stockholder approval is obtained. In cases where stockholder approval cannot be obtained simultaneously with the signing of the agreement, however, such as in a transaction involving the issuance of stock as consideration, the board is well-advised to negotiate for a so-called “fiduciary out” to the no shop provision, allowing the board to consider and negotiate a possible competing transaction in certain cases where the target
board determines in good faith that failure to do so would be a violation of or inconsistent with the board’s fiduciary duties. The right to consider a bid from a third party is typically conditioned on the offer being “superior” to the deal at hand, or at least “reasonably likely to lead” to a superior proposal. Note also that the target board would retain its duty of candor to advise stockholders of any third party proposal received prior to stockholder approval of the transaction, and so should retain the right to provide information to stockholders.

**Right to Change Board Recommendation.** In addition to the target board’s desire to have some latitude to consider superior proposals without violating the no shop covenant, the target board typically also negotiates for the right to withdraw its recommendation of the deal at hand if a superior offer is received before stockholders approve the deal. This right to change the board’s recommendation might be stated in the agreement, by way of example, as follows: “The board will submit, and subject to its fiduciary duties, recommend the deal to target stockholders.” An acquiror often seeks to limit the right of the board to withdraw its recommendation to situations in which the board is considering a “superior proposal.” However, although no case has yet decided the issue, it is likely that Delaware courts would not enforce such a limitation on the right of a board to exercise its fiduciary duty.

The right of the target board to change a recommendation generally has less relevance in a private company acquisition for cash. As noted above, acquirors of a privately held company in a cash transaction often require stockholders with a controlling block of shares to deliver sufficient written consents upon execution of the agreement to approve the transaction, or have a meeting of stockholders to approve the transaction prior to or simultaneous with the signing of the agreement. Accordingly, the time in which an interim bid might be received is often limited or nonexistent. In addition, the transaction is often not announced until stockholder approval is received. In this case, the chances that a competing bid will be received prior to stockholder approval are quite limited. Until stockholder approval is obtained, however, the private company target board should retain its right to change its recommendation. See the discussion below under “Delay in Obtaining Stockholder Approval After Signing; Securities Law Considerations.” The buyer would typically also have a right to a break up fee in the event of a change of recommendation.

**Breakup Fees.** An unreasonably large “break up” fee could deter or preclude bids which would offer substantially more value to stockholders than the deal in hand. A Delaware board must therefore consider whether the size of any proposed “break up” fee would deter other bids of substantially greater value than the deal being considered or would adversely impact the company. The board should consider all fee and expense provisions as a whole in making this determination. Chancellor Chandler noted in dicta in Phelps Dodge that a fee of 6.3% “seems to stretch the definition of range of reasonableness…. probably beyond its breaking point.” 1999 WL 1054255, at *2. Recent Delaware cases have considered fees of less than 4% as being reasonable assuming there was negotiation and the fee is not deemed preclusive; fees in excess of 4% are subject to significant judicial scrutiny and the Delaware courts will review the negotiation record for any “break up” fee, even one that is less than 4%, to determine reasonableness.

The board should also give attention to the timing of when such fees become payable. Thus, if a fee is due upon the Company’s provision of information to another prospective bidder,
the risk of losing the current deal would preclude a board from making such a decision. In a recent Delaware Chancery Court case, Vice Chancellor Strine approved of a termination fee payable only if the stockholders received a better deal. In re Pennaco Shareholders Litigation, 787 A.2d 691.

In a private company acquisition for cash, the board is typically precluded from shopping once the acquisition agreement is executed, as discussed above, because stockholder approval is required at the time of signing. Thus, there would be no termination right and no issue raised regarding break up fees. If there is a gap between the signing of the definitive agreement and stockholder approval, however, the target board should have a right (a “fiduciary out”) under the no shop covenant to consider a better, unsolicited bid, and should also have a right to change its recommendation. The target may also negotiate for the right to terminate the first agreement in favor of the competing bid if it is superior. In the event the target board can change its recommendation, or terminate the transaction for a superior proposal, the buyer may seek a breakup fee due upon any change in recommendation or termination. The target board would in that case seek to limit the fee, and as noted above, the size of the fee should not be “preclusive” of another transaction. The buyer may also seek a fee or reimbursement of expenses upon any “no” vote by stockholders; the target board will need to consider whether any such provision would be deemed “coercive” of the stockholder vote.

Voting Agreement and Alternatives. Acquirors try to “lockup” their deal by obtaining a commitment by target stockholders with significant holdings to vote for the deal at hand and against any proposal adverse to the acquisition (like a proposal for another deal, or to change the board’s composition). Often as part of the voting agreement a buyer will also insist on an irrevocable proxy. If a voting agreement is signed, the shareholder would be committed to vote for the deal at hand despite a competing bid. Transfer of shares is typically restricted; however, it is often reasonable to request exceptions for de minimis or estate planning transfers. Termination of the voting agreement is typically tied to the termination of the merger agreement.

Several Delaware cases have addressed the impact of voting agreements on the total deal lockups and the target board’s compliance with its fiduciary duties. See Ace Limited RE Corporation, 747 A.2d 95 (Del. Ch. 1999) (preclusive terms of a merger and stockholder agreement which locks up necessary votes may be unenforceable under Unocal test even in a stock for stock transaction); see fn. 55 (“the result of the vote is foreordained because [the buyer] will no doubt prevail absent an out for the 33.5% holders . . .”); compare In re IXC Communications, Inc. Shareholders Litigation, CA No. 17334, 1999 Del. Ch. Lexis 210 (Oct. 27, 1999) (“Almost locked up [40%] does not mean “locked up.”) These decisions made clear that a buyer could not legally lock up a preclusive vote, but the issue is still open as to what constitutes a preclusive voting block, and this issue will be governed by the facts and circumstances of the particular case.

Shareholders are, of course, free to enter into such agreements without board approval. Delaware General Corporation Law Section 203 does not apply to private companies unless the company “opts in,” and therefore the buyer will typically not require board approval. The size of the voting lockup, if known to the Board at the time of the definitive agreement, should impact the target board’s consideration of other deal terms, since a large voting lockup could render any “fiduciary out” (or right to consider a competing higher bid) illusory.
In 2003, the Delaware Supreme Court reversed the Chancery Court’s approval of a voting agreement in conjunction with a merger agreement requiring a shareholder vote. Omnicare Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) and 2002 WL 31767892 (Del., Dec. 10, 2002) reversing In Re NCS Healthcare, Inc. Shareholder Litigation, Civ. A. No. 19786, 2002 WL 31720732 (Del. Ch., Nov. 25, 2002). There was a requirement in the merger agreement that the merger be submitted to a shareholder vote even if the Board changed its recommendation (a so called “force the vote” provision). By itself this provision is lawful. However, a majority of shares outstanding, held by two large shareholders, one of whom had Board representation, committed to vote in favor of that transaction under voting agreements approved by the target board under Delaware General Corporation Law Section 203. The Delaware Supreme Court held that these voting agreements effectively precluded a competing bid in light of the “force the vote” provision. Therefore the Court concluded that the target board breached its fiduciary duties by not negotiating a fiduciary termination right. Under Omnicare, if the board agrees to a “force the vote” provision, either the target board must have a “fiduciary termination right” or voting agreements representing a preclusive number of voting shares are prohibited. The percentage of voting shares deemed to be “preclusive” is still to be determined.

The impact of this decision on private company acquisitions is unclear, particularly if holders representing a majority of the outstanding shares of a private company insist on the deal at hand. Note that private companies are generally not subject to Section 203. Accordingly, the target board of a privately held Delaware corporation may not be asked to review and approve voting agreements negotiated between the target shareholders and the buyer. If the target board does not review and approve the voting agreements, and have not otherwise exercised their judgment with respect to these agreements, it remains to be seen whether the target board would be held to have breached its duty simply because such agreements exist between target shareholders and buyer. An open issue is when the target board should be charged with knowledge of those agreements. In most cases, however, the board will be aware of these agreements while considering the other deal terms as the major stockholders will typically be represented on the board.

In many private company transactions the buyer avoids this issue entirely by avoiding the use of voting agreements, and instead requiring stockholder approval immediately after board approval. The vote (via consent or otherwise) would end any obligation on the part of the target board to keep a right to a fiduciary termination right or otherwise to exercise its duties regarding the deal. See In re Mobile Communications, 1991 WL 1392 (Del. Ch. 1991). Note that under Delaware law one may not solicit stockholder approval before Board approval. In some cases it will be possible to deliver sufficient signed written consents for the requested vote immediately upon signing, or within 24 hours after signing. This assumes that the persons giving approval have all material information needed to make a decision on the transaction. A typical agreement would provide for a right of the buyer to terminate if stockholder approval is not obtained within a short time after the signing. See Optima International of Miami, Inc. v. WCI Steel (Del. Ch. July 14, 2008).

In Optima, the Delaware Chancery Court approved the use of a written consent executed by the holders of a majority of the target’s voting power pursuant to Section 228 of the Delaware General Corporation to obtain stockholder adoption of a merger agreement. In this case, in lieu of holding a special meeting of stockholders to approve the merger, the merger agreement
required the target’s board to seek a written consent from the holders of a majority of the target’s outstanding voting stock promptly after the board’s approval or face termination of the agreement. The court distinguished this written consent requirement from the lockups at issue in the Omnicare case (which the court noted “is of questionable continued vitality”) and held that “nothing in the DGCL requires any particular period of time between a board’s authorization of a merger agreement and the necessary stockholder vote.” This recent decision confirmed that targets, in business combinations had an approved technique in appropriate situations for avoiding Omnicare limitations on lockups.

Note however, that this technique of using written consents to approve an acquisition transaction, cutting off the target board’s duty to consider alternative bids, is most effective in the case of a cash acquisition. In the case where buyer is using stock or other securities as part of the consideration for the transaction, there will need to be some interim period between signing and stockholder approval, and during that interim period, the target board will need to retain its duties to consider third party proposals. See the discussion below under “Delay in Obtaining Stockholder Approval After Signing; Securities Law Considerations” for further information regarding transactions where the securities laws mandate some period between signing and stockholder approval, with fiduciary duties of the target board remaining in place during this interim period.

Some bidders may insist that, in lieu of or in addition to a voting agreement, shareholders grant the buyer an option to buy his or her shares in the face of a competing bid. Note, however, that if this option creates a preclusive lockup, the legality of the option agreement is uncertain. Accordingly, the target board of a private company may want to consider negotiating a fiduciary out in this case.

Delay in Obtaining Stockholder Approval After Signing; Securities Law Considerations. It is possible that the target will not be in position to deliver consents or have a stockholder meeting immediately after signing a definitive agreement. For example, the parties will need to comply with state corporate laws in obtaining votes or consents, including a required notice for a stockholder meeting, if that method is employed, and the solicitation statement or other disclosure documents may not be ready at the time of signing. In any interim period between signing and stockholder approval, the target board must retain a “fiduciary out” to consider third party proposals which are superior to the transaction under agreement, and possibly those “reasonably likely” to lead to such a superior proposal. In the event that target stockholders representing a controlling percentage of the voting stock have delivered voting agreements in favor of the transaction under agreement, thus assuring approval, the target board would, under the Omnicare decision, also be required to retain a fiduciary termination right. During the period prior to stockholder approval, the target board must retain its right to change its recommendation and to satisfy its duty of candor by informing stockholders of any competing bid that is received.

If the buyer is issuing stock in the transaction, the buyer will want to be sure that the parties comply with the requirements of federal and state securities laws in obtaining the target company shareholders’ vote, as the vote is an investment decision.

Section 3(a)(10). The buyer may rely on Section 3(a)(10) of the Securities Act of 1933 and seek a fairness hearing under the California securities laws [or other state laws as applicable]. In that event, no consents can be obtained until after the order is issued following
such a hearing. The process to obtain a fairness hearing requires an application to be filed, a
notice of hearing and, following a hearing, the mailing of solicitation materials to stockholders.
The entire process from application to voting under California securities law procedures could
take 30-60 days. Note that in this case, the target board should have a right to terminate in favor
of a superior bid in this interim period between signing and closing, whether or not the buyer has
voting agreements in place, or at a minimum should have a “fiduciary out” to the no shop
covenant, to provide information to and to negotiate with a third party bidder whose proposal is
superior to [or possibly “reasonably likely to lead to a superior proposal to] the current
transaction, and must satisfy its duty of candor to stockholders in the event any such proposal is
received. Note also that the transaction will be disclosed to stockholders, increasing the potential
for a competing bid in this scenario.

**Registration.** The SEC has recently issued an interpretation that indicates that
registration on Form S-4 is not permitted for securities issued in a transaction if a majority of the
shareholders have previously approved the transaction by written consent before the filing of the
registration statement. SEC C&DI 239.13 (published November 26, 2008). This C&DI initially
restates the SEC’s guidance with respect to former proposed Rule 159, confirming that, due to
the legitimate business reasons for seeking lockup agreements, the SEC staff has not objected to
the registration of offers and sales where lockup agreements have been signed in circumstances
that satisfy three requirements. Under proposed Rule 159, the parties to a proposed business
combination transaction could lock up prospective target stockholders before a registration
statement was filed, if:

- the lockup agreements involved only executive officers, directors, affiliates, founders and
  their family members, and holders of 5 percent or more of the equity securities of the target
  company;

- the persons signing lockup agreements owned less than 100 percent of the voting equity
  securities of the target company; and

- votes were solicited from shareholders of the target company who had not signed lockup
  agreements and who would otherwise be ineligible to purchase securities under Section
  4(2) or 4(6) of the Securities Act or Rule 506 of Regulation D.

The SEC goes on to state, however, that “[w]here, however, the persons entering into the
lock-up agreements also deliver written consents approving the business combination
transaction, the staff has objected to the subsequent registration of the exchange on Form S-4 for
any of the shareholders because offers and sales have already been made and completed
privately, and once begun privately, the transaction must end privately.” (emphasis added).

Unlike a situation where stockholders have delivered voting agreements, and there are
still target stockholders left to solicit regarding the business combination transaction, a
transaction approved by a pre-filing written consent involves a completed investment decision.
Any subsequent filing of a Form S-4 would result in a general solicitation that would cause the
private placement exemption to fail. A registration statement on Form S-3 covering the resale of
the new shares issued in the business combination transaction would, however, be permitted.
The impact of this C&DI is that if the acquisition transaction does not qualify for an exemption from registration under Regulation D, because of the number or sophistication of the security holders of target, and a registration statement on Form S-4 must be filed, the parties cannot use a written consent to approve the transaction prior to the filing of the Form S-4. Note that in such a case, where a registration statement is required, there will obviously be a lengthy period between signing and closing to accommodate preparation and filing of the registration statement, and respond to any SEC comments, as well as preparation and mailing of the notice for a stockholders meeting, if one is called. Of course, the target could solicit written consents of stockholders through a solicitation statement, which would possibly shorten the period between effectiveness and the approval of stockholders, because there would not be a notice requirement under state law for a stockholder meeting. In any case, the target board would require a “fiduciary out” to any “no shop” covenant during this interim period between signing and stockholder approval to consider and respond to unsolicited transactions which are superior to the current transaction, or possibly those which are “reasonably likely to lead” to a superior transaction. Further, during the interim period, the target board would need to have the right to change its recommendation and to inform stockholders of any competing bid. Finally, note that the target board would need to retain the right to terminate the transaction for a superior proposal until stockholder approval is obtained if voting agreements covering a controlling percentage of stock, assuring approval of the transaction, have been delivered by target stockholders.

Regulation D. The SEC staff also has clarified its views regarding acquisition transactions relying on the exemption from registration under Regulation D. The SEC staff has advised publicly several times during 2009 that in the event an issuer relies on Regulation D for an acquisition transaction where stockholder approval is delivered via written consent, the investment decision is being made at the time of the delivery of written consents sufficient to approve the transaction. Accordingly, the SEC staff has indicated that the information requirements of Regulation D must be satisfied prior to the delivery of written consents approving the transaction, and the information must be placed in the hands of all stockholders, not just those delivering written consents. Thus, in order to satisfy Regulation D requirements, a target company must provide the information required under Regulation D to all stockholders prior to the time that written consents sufficient to approve the transaction are delivered. This is because the investment decision is completed at the time of the delivery of the written consents. Even if a stockholder doesn’t deliver a written consent, because the stockholder will be bound by the written consents delivered by other stockholders, all stockholders must be informed of the transaction and receive the other information mandated for the transaction under Regulation D.

The practical impact of this interpretation is that in a transaction for the acquisition of a privately held company where stock is being used as consideration, all stockholders will receive notice of the transaction and all information required by Regulation D prior to approval of the transaction. Realistically, the preparation of such information will take some time, and may not be completed at the time of the signing of the agreement. The target board must have a “fiduciary out” to the no shop covenant to respond to any third party proposals received in the period between the signing of the agreement and the approval of stockholders, if any such proposal is superior to the current transaction, and possibly if it is reasonably likely to lead to such a superior proposal. As noted above, a target board might also negotiate a fiduciary termination right for this interim period, and will need to have this right to terminate if voting agreements are delivered by controlling stockholders assuring approval of the current
transaction. The dissemination of the Regulation D information can be done via a solicitation statement, seeking written consent of stockholders, rather than by calling a meeting of stockholders, to keep the period between signing and approval to a minimum. Targets will need to provide some period of time between dissemination of the solicitation materials and stockholder approval to permit stockholders to review the information. Buyers can provide for a termination fee in the event of a termination of a transaction for a superior proposal, or a change in the target board recommendation, or possibly for a no vote by target stockholders, subject to the fiduciary issues discussed above.

California.

In Jewel Cos., the Ninth Circuit considered the directors’ authority to enter into an exclusive merger agreement. The court held that “under California law, a corporate board of directors may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal.” 741 F.2d at 1564. The court expressly refrained from deciding whether the board must recommend the approval of the initial merger proposal of the board receives an unsolicited but more favorable offer after signing a merger agreement.

The Jewel Cos. court considered the board’s authority in negotiating a merger agreement and concluded that “the Corporate Code of California does not adopt the auction model in regulating negotiated acquisitions. To the contrary, California’s regulatory scheme for negotiated merger transactions is predicated on the idea that the board of directors of each merging entity will deliberate upon a decision and then negotiate and execute a merger agreement of the type that it, in its business judgment, deems best for the shareholders.” Id. at 1562. The Jewel Cos. court explained that to enter into an agreement under which the corporation must refrain from entering into competing contracts until the shareholders consider the proposal does not conflict with the board’s fiduciary duty. The court explained that an exclusive agreement may well benefit shareholders because a merger partner will be reluctant to agree to a merger unless it is confident its offer will not trigger an auction. Id. at 1563.

The Ninth Circuit recognized, however, that the board may not lawfully divest itself of its fiduciary obligations in a contract. Id. Moreover, the court noted that the board may not, consistent with its fiduciary obligations to shareholders, withhold information regarding a potentially more attractive competing offer. The board may bind the corporation only temporarily and in limited areas pending shareholder approval. Shareholders remain free to accept or reject the merger proposal in light of another offer. Id. at 1564.

A careful reading of Jewel Cos. thus suggests that California law will not impose on directors the obligation to obtain the “best” price, and the requirement of an auction which might be triggered on a sale of control under Delaware law. See discussion above. However, even this conclusion is uncertain, since many of the cases in which Delaware courts have articulated the requirement for evidence in a sale of control that the transaction affords the “best” available price were decided after Jewel Cos. and California courts may be persuaded that a higher standard is required where shareholders are being cashed out.

Most importantly, Jewel Cos. does not stand for the proposition that directors of a California corporation can agree to any lockup under a merger agreement without breaching
fiduciary duties. For example, Jewel Cos. does not support the right of a board to agree to a “no shop” clause which prevents the company from providing information to a competing bidder sufficient to permit the bidder to evaluate and formulate a competing bid, or to negotiate with a bidder offering a superior proposal. Further, the discussion in Jewel Cos. suggests that directors might be held to violate their fiduciary duties if they agreed to a merger agreement with break up fees which are triggered either on discussions with another party or a shareholder vote against the merger agreement. See 741 F.2d at 1563-1564. Further, it is clear that under California law the target board must retain its right to keep its shareholders fully informed of any competing bids. Id. Accordingly, the Delaware courts’ discussion of director duties in considering provisions which may impede competing bids may be helpful in guiding the directors’ decisions on these provisions. The Jewel Cos. court focused on the need to induce a favorable bid and holds that the board can only bind the corporation “temporarily, and in limited areas, pending shareholder approval.” Id. at 1564.

Finally, it is important to note that the Jewel Cos. court reserved the question of the board’s recommendation of a competing bid, and it is not clear that directors would be able to contract away the right to recommend a competing transaction without breaching their fiduciary duty. It might, for example, be lawful to limit the directors’ right to recommend another business combination by requiring the payment of a fee, so long as such fee would not be so large that it would unreasonably deter a competing bidder. The law in California in this area is sparse and directors would be well advised to act cautiously in limiting their ability to respond to a more favorable offer.

A buyer of a private company might require shareholder approval immediately after the execution of the definitive acquisition agreement in the case of a California target to avoid any argument that a fiduciary “out” to a no shop covenant was otherwise required. The discussion above under the heading “Delays In Obtaining Stockholder Approval After Signing; Securities Law Considerations” will provide guidance with regard to transactions where stockholder approval is delayed, whether due to securities law requirements or otherwise. Note that California corporate law permits shareholder approval to be obtained either before or after board approval, making it easier in some cases to seek shareholder approval for a transaction prior to the buyer committing to the transaction. Note also that under Section 603 of the California General Corporation Law, if less than 100% of the shareholders are solicited for approval, reorganization transactions cannot close until other shareholders have received 10 days’ notice of the transaction; this delays closing but does not prevent the vote from being obtained immediately after signing of the definitive agreement if that is otherwise legal.

Conclusion

Arrangements such as “no shop” clauses, “break up” fees and voting agreements may have some relevance in the private company acquisition context. In these cases the target board should consider whether the defensive provision is necessary to obtain a favorable merger proposal and that the benefits of such proposal, when weighed against the alternatives, justify the cost to the corporation and its stockholders. These types of “lockup” provisions are not to be entered into without board scrutiny and a determination that the provisions are not designed to foreclose or preclude all competing deals prior to obtaining shareholder approval.