



Fiduciary Duties of a Board of Directors in the Context of a Significant Strategic Transaction

September 2007

This memorandum summarizes the fiduciary duties that the board of directors (the “Board”) of a publicly-held company (the “Company”) owes to its stockholders in considering and deciding upon a decision to pursue a significant strategic transaction, such as a merger or a sale of all or a substantial portion of the assets or voting control of the Company. This memorandum also provides practical guidelines through which the Board can fulfill these duties and reach a sound and well-supported decision.

1. General Standards for Director Conduct

The rules regarding a decision to enter into a significant transaction by the Company are grounded in the general standards of conduct for directors. Those standards are generally set forth in the Delaware General Corporation Law (“DGCL”) and the judicial decisions interpreting the DGCL. In discharging their responsibility to manage the affairs of a corporation, directors of Delaware corporations owe duties of care and loyalty to the corporation and to its stockholders. In addition, when seeking stockholder approval of a significant transaction, directors have a common law duty to disclose all material information related to the transaction. In general, if a director or board fails to comply with these duties, courts will review the board’s determination more critically and with less deference to the business judgment used by the board to make its determination. The following is a brief discussion of each of these duties.

1.1 Duty of Care

The duty of care requires that, in managing the corporation, directors use “that amount of

care which ordinarily careful and prudent men would use in similar circumstances.”¹ Stated another way, before making an important decision, directors have a duty to inform themselves of all material information reasonably available to them and, once so informed, to act with the requisite care in discharging their duties.² If the directors follow these steps, the business judgment rule (which is described in detail below) applies to their decisions.

Delaware law permits directors in exercising their duty of care to rely on certain materials and information:

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member’s duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.³

While Delaware law recognizes that directors may use outside experts to advise the board of directors on significant legal and financial matters affecting their analysis, that provision cannot be read to permit the board of directors to delegate its central responsibilities -- the

¹ *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125, 130 (Del. 1963).

² *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

³ DGCL § 141(e).

duties of loyalty and care -- to other decision-makers.

1.2 Duty of Loyalty

The duty of loyalty requires that directors act solely in the best interests of the corporation and its stockholders and avoid self-dealing, bad faith and fraud. Simply put, this duty requires that directors refrain from engaging in self-dealing transactions with the corporation or comply with relatively rigorous standards that ensure that the transaction is fair to the stockholders of the corporation. Like many states, Delaware has addressed this issue by creating a safe harbor statutory provision for transactions in which a director or directors have an independent interest. These transactions, and the statutory safe harbor, are discussed in Section 2.3 of this memorandum.

1.3 Duty to Disclose

If directors solicit stockholder approval with respect to a transaction, they have a duty to disclose all material information to each stockholder entitled to vote on the transaction. This disclosure must include all material facts within the directors' knowledge that would have a significant effect on the stockholder vote.⁴ Although directors do not have to disclose all available information, they must disclose all information that is material and necessary to be disclosed in order to avoid misleading the stockholders.⁵ Information is "material" if a stockholder or board member would consider it important in deciding how to vote.⁶

2. Fiduciary Duties and Judicial Standards of Review that Affect Whether a Board's Determination Will be Successfully Challenged in Court

If a board's determination with respect to a transaction is challenged in court, the standard that the judge will use to review the board's determination will be based on the significance of the transaction and whether the board met each of its duties and dealt properly with any conflicts of interest with respect to the transaction. Transactions resulting in a sale of

control of the company are considered to be some of the most significant transactions from a judicial perspective and, hence, are scrutinized more carefully. If the Board is faced with a decision to sell the Company or to sell voting control of the Company, or even to sell all or a substantial portion of the Company's assets, it is, therefore, imperative that the Board meet each of its duties and, if any conflicts of interest are present, comply with the available safe harbors.

2.1 Business Judgment Rule

The common law business judgment rule remains the basic standard of judicial inquiry with respect to directors' decisions. Under this rule, in the absence of any evidence that directors violated their fiduciary duties of loyalty or care, courts will presume that directors' decisions have been made on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company and its stockholders.⁷ Except where a board is evaluating a sale of the company, adopting defensive mechanisms to further the Board's control of the company, or entering into a transaction where members of the Board are interested in the transaction, a business decision by directors will not be disturbed if it can be attributed to any rational business purpose.⁸ The reasons for this deference by the courts include (1) the need to encourage directors to undertake the risks inherent in running an enterprise, (2) courts' general inability to conduct a meaningful review of ordinary business decisions and (3) the stockholders' grant of authority to directors to manage the everyday affairs of the corporation. Before the common law defense of the business judgment rule can be invoked, however, the directors' conduct must first meet the initial threshold duties of care and loyalty.

To demonstrate that the directors have not met their duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross negligence."⁹ Gross negligence has

⁴ Stroud v. Grace, 606 A.2d 75, 85 (Del. 1992).

⁵ Zirn v. VLI Corp., 681 A.2d 1050, 1056 (Del. 1996).

⁶ *Id.*

⁷ See, e.g., Aronson, *supra*, 473 A.2d at 812.

⁸ See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

⁹ See Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (in the context of a proposed merger, directors must inform themselves of all

been described as “reckless indifference to” or “deliberate disregard of” the interests of the stockholders. If directors fail to meet their duty of care, the court will, as described below, ignore the business judgment rule and place the burden on the board of directors to defend the challenged transaction by showing that it meets the requirements of intrinsic or “entire fairness” to the company and its stockholders.¹⁰

To show that the directors have not met their duty of loyalty, a plaintiff must prove that members of the board of directors engaged in “self-dealing” transactions. If directors appeared on both sides of, or derived an improper financial benefit from, a challenged transaction, the court will ignore the business judgment rule and place the burden on the board of directors to defend the challenged transaction by showing that it meets the requirements of entire fairness to the company and its stockholders.¹¹

2.2 Enhanced Scrutiny

In limited situations, a board’s action will be subjected to enhanced judicial scrutiny before the courts will grant the deferential protection afforded under the business judgment rule. These situations often include instances where a board acts in a way that raises a “specter that [they] may be acting primarily in [their] own interests, rather than those of the corporation and its shareholders,”¹² for example, by enacting defensive mechanisms that entrench existing management or ending an auction

prematurely resulting in an avoidance of the directors’ personal liability to creditors. As a general rule, enhanced business judgment is required in situations where a board (1) is adopting defensive mechanisms in response to alleged threats to corporate control or policy,¹³ (2) approves a transaction involving a sale of control or a break-up of the company,¹⁴ (3) initiates an auction process for the corporation, or (4) acts in a manner that makes a break-up of the corporate entity inevitable.¹⁵ The first of these examples triggers what is known as the *Unocal* analysis and the latter three trigger what is known as the *Revlon* analysis, in each case, by reference to the seminal Delaware cases addressing these situations. In reviewing a board’s determination under the “enhanced scrutiny” standard, a court will examine the adequacy of the decision making process employed by the board in addition to the reasonableness of the board’s action in light of the circumstances.¹⁶

2.2.1 Unocal Analysis – Management Entrenchment

Under the analysis set forth by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.* and subsequent cases,¹⁷ in addition to meeting the ordinary duties of the board and complying with the rational business purpose test, a board’s actions must be shown to be reasonable in relation to the perceived threat to the corporation in order to gain the court’s deference. In addition, the board also has the burden of proving that “they were adequately informed and acted reasonably”¹⁸ in these circumstances.

The analysis under the enhanced scrutiny standard is not meant to prevent boards from taking actions that are intended to protect stockholders from potentially harmful takeover bids either before or in response to an existing threat. For example, in the context of an

“information ... reasonably available to [them] and relevant to their decision” to recommend the merger); see also Aronson, 473 A.2d at 812 (“under the business judgment rule director liability is predicated upon concepts of gross negligence”).

¹⁰ See *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., Inc.*, 496 N.E.2d 959, 963 (1986) (“If the directors are not entitled to the protection of the [business judgment] rule, then the courts scrutinize the decision as to its intrinsic fairness to the corporation and the corporation’s minority shareholders.”)

¹¹ See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1993); see also *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (“where a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court’s satisfaction”); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (actions by board after a consent solicitation had begun, designed to thwart the dissident stockholder’s goal of obtaining majority representation on the board, violated the board’s fiduciary duty).

¹² See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

¹³ *Id.*

¹⁴ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); see also *Omnicare, Inc. v. NCS Healthcare, Inc. et al.*, 818 A.2d 914, 928 (Del. 2003).

¹⁵ See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 47 (Del. 1993); see *Revlon* at 182.

¹⁶ *Id.*

¹⁷ See *Paramount Communications Inc.*, 637 A.2d at 45 (Del. 1994); *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279 (Del. 1989).

¹⁸ *Paramount Communications Inc.*, 637 A.2d at 45.

unsolicited bid for control of a corporation, a board may conclude that the corporation should remain independent or be acquired only at a higher price. However, under this analysis, boards that adopt defensive measures in reaction to a perceived threat must prove that their process and conduct satisfy a two-pronged test. First, a board must show that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, which may be demonstrated by the directors' reasonable, good faith investigation. Second, a board must show that the defensive measure chosen was proportional in relation to the threat posed, which may be demonstrated by the objective reasonableness of the course chosen.¹⁹ If a board of directors satisfies both prongs of the *Unocal* test, its defensive actions will receive the presumptive protection of the business judgment rule.

In deciding whether to adopt a defensive mechanism, a board should consider the current takeover environment, existing takeover defenses available to the company under Delaware law and its charter documents, and the potential effects of the proposed defensive mechanism. If the defensive mechanism is adopted before a takeover threat materializes, it is more likely that the action (and the defensive mechanism itself) will be upheld under the *Unocal* standard.²⁰

Even though directors' actions with respect to a particular transaction may initially be subject to one standard of judicial scrutiny (e.g., business judgment rule), their subsequent actions relating to that same transaction may be subject to a different level of review (e.g., enhanced scrutiny – *Unocal* analysis). For example, in the case of *Paramount Communications, Inc. v. Time, Inc.*, the court held that although the original plan of merger that did not result in a change of control and was approved by the board of directors as part of a corporate strategy was subject to the business judgment rule, later board actions in response to a hostile tender offer were subject to the

enhanced *Unocal* standard.²¹ Rulings such as this indicate that a board of directors should continually assess the applicable judicial standard of review as it prepares for and responds to new developments such as unsolicited acquisition overtures.

2.2.2 Revlon Analysis – Selling the Company

Transactions involving a sale of control of the corporation will also be subject to enhanced scrutiny. The Delaware Supreme Court has defined the directors' duty in the sale of control context as achieving the highest value of the company reasonably available for stockholders.²² In *Revlon, Inc. v. McAndrews and Forbes Holdings, Inc.*,²³ the Delaware court found that, once the directors had decided to sell control of the company, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."²⁴ In this regard, courts require a reasonable decision on the part of the directors but not a perfect decision.²⁵

If a board of directors concludes that a change of control or sale of the company is in the best interest of its stockholders, then the actions it takes to further this position should conform to the *Revlon* standard. Under the *Revlon* standard, the duty of the board of directors is to maximize the company's value for the stockholders' benefit.²⁶ There is no single blueprint that directors must follow in selling the company.²⁷ Rather, a board of directors has reasonable latitude in determining the method of sale most likely to produce the highest value for the stockholders. Any method chosen that does not involve some form of realistic check of market value, however, may be difficult to justify.

Companies generally use one of two techniques for a public sale of a company. In a

¹⁹ *Unocal*, 493 A.2d at 955.

²⁰ *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (clarifying that *Unocal* mandates a more rigorous review of mechanisms enacted during an outstanding or pending threat).

²¹ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150-51 (Del. 1989).

²² *Revlon*, 506 A.2d at 182.

²³ *Id.* at 173.

²⁴ *Id.* at 182.

²⁵ *Paramount*, 637 A.2d at 45.

²⁶ See *Revlon*, 506 A.2d at 182.

²⁷ See *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989); *QVC*, 637 A.2d at 44.

“closed auction,” prospective acquirors are asked to make a confidential bid for the company by a fixed deadline. The company, usually with the assistance of an investment banker, may prepare a descriptive memorandum to be circulated to prospective bidders. Before the bidding, the company will often send interested bidders a draft agreement and related documentation and typically will allow the bidders to engage in limited due diligence. Interested parties submit their bids, together with any comments on the draft agreement if one has been provided. A significant advantage of a closed auction is that it can be effective even if there is only one bidder, because a bidder has no way of knowing whether there are other bidders and can therefore be expected to put forward its best bid. One disadvantage of the closed auction is that it may lead to suspicions among bidders that one bidder, such as a group affiliated with management, is favored over others, which may result in fewer bids or in later judicial actions scrutinizing the board of directors’ conduct in the auction.

A second technique for selling a public company is the “market check.” There are two general types of market checks. In the first form, the company attempts, before signing an agreement, to identify interested acquirors and the best price it is likely to receive without initiating a formal closed auction. In the second type of market check, a post-agreement market check, no detailed market investigation or auction of the company generally occurs before a merger agreement is signed. Instead, the parties agree to the terms of the transaction, subject to public announcement of the transaction and a fair opportunity for other bidders to make competing offers. One advantage of the post-agreement market check is that the target company can secure the offer put forth by the first bidder while remaining free to pursue higher offers. Bidders, of course, will typically seek to limit the market check and will negotiate for break-up fees payable by the target company in the event the initial transaction is not consummated due to the emergence of another bidder. For this type of market check to be effective, however, potential bidders must be aware of the opportunity to bid, have sufficient information and time to make a bid, and not be deterred by

breakup fees or lock-ups given to the first bidder.

2.3 Entire Fairness

When an actual conflict of interest exists between the personal or financial interests of directors and the interest of the company and its stockholders that affects a majority of the directors approving a transaction, Delaware courts apply the most exacting standard: “entire fairness” review, a judicial determination of whether the transaction is entirely fair to the stockholders.²⁸ Such conflicts of interest may arise in situations where the directors appear on both sides of a transaction, such as a management buyout, or derive a personal financial benefit that does not devolve generally upon the corporation and its stockholders.²⁹

When analyzing a transaction under the entire fairness standard, courts will consider both process (“fair dealing”) and price (“fair price”).³⁰ In assessing overall fairness, courts will therefore consider the process that the board of directors followed, the quality of the result it achieved, and the quality of the disclosures made to the stockholders.³¹ The notion of “fair price” does not mean the highest price financeable or the highest price that the buyer could afford to pay. Instead, at least in contexts other than self-dealing, it means a price that a reasonable seller, considering all the circumstances, would regard as being within a range of fair value: in other words, a price that a reasonable seller could reasonably accept.³²

In situations where a conflict of interest exists or may be perceived, many companies appoint a special committee of disinterested directors as a means of satisfying the “fair-dealing” aspect of the entire fairness standard. The special committee of disinterested directors must be genuinely independent and properly functional, however, in order to shift

²⁸ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

²⁹ See, e.g., *Ivanhoe Partners*, 535 A.2d at 1341.

³⁰ See, e.g., *Weinberger*, 457 A.2d at 711.

³¹ See, e.g., *Cede & Co. v. Technicolor, Inc.*, 663 A.2d 1134, 1140 (Del. Ch. 1994).

³² *Id.* at 1143.

the burden of proving unfairness to the plaintiffs in a suit challenging the transaction.³³ The appointment of such a committee in these circumstances, however, is not essential in order to meet the fair dealing requirements of the entire fairness review. Many companies have chosen in these circumstances to maintain review by the whole board rather than delegating to a smaller independent committee because it is often the interested individuals who have the most knowledge regarding the circumstances surrounding the transaction. It is imperative, however, that all material facts with respect to the conflict of interest are disclosed by the interested director to the remainder of the board in the case where the whole board rather than a committee is determining whether to enter into a transaction.

3. Board Procedures in the Context of a Significant Strategic Transaction

3.1 General Procedures

Decisions made by the board of directors in pursuing or rejecting significant strategic transactions, such as a sale of the company, a sale of voting control or a sale of all or a substantial portion of the assets, should be the result of careful consideration of the available information and alternatives relevant for deliberation by the board. The board may demonstrate the exercise of its duties of care and loyalty through careful attention to process and record keeping, necessary actions considering such a significant transaction. If any director has a material interest in the proposed transaction, or interests that differ significantly from other stockholders, the board of directors should consider appointing a committee of independent directors to actively oversee and conduct the sale process without the involvement of the interested director or directors. In situations in which there is an actual, or perceived, conflict of interest, an independent committee can help to ensure that the board of directors' decision will not be (and will not appear to be) tainted by self-interest or the appearance of improper motivation.

The procedural steps the board of directors should take to enable it to fulfill its fiduciary duties and to demonstrate the fulfillment of its duties, include:

- Holding frequent meetings or briefings to keep all directors apprised of current developments;
- Distributing to directors in advance of meetings copies of studies, agreements, reports and other key documents relating to a proposed transaction, in order to allow all directors sufficient opportunity to review the information before voting on any proposed transaction;
- Adjourning meetings and reconvening at a later time if the directors need more time to consider the issues presented or to review pertinent information;
- Encouraging directors to actively participate in meetings, ask questions and voice any concerns;
- Retaining appropriate advisors, including, for example, an investment bank to produce a fairness opinion or otherwise provide financial advice, if appropriate; and
- Keeping careful records of (1) the presence and participation of management and experts and (2) reports, studies and other documents used by the board of directors.

3.2 Procedures Relating to the Duty to Act as Auctioneer

If the board decides to pursue a sale of the company or of all or a substantial portion of its assets, the board does not have an absolute duty to “shop” the transaction to other potential acquirors before accepting a bid. The board has the freedom to simply say “no” to almost any acquisition bid. As discussed above, however, the board of directors must gather sufficient information through some form of market check in order to make an informed decision about what is the best available transaction for the stockholders, if any, in light of the risks and benefits involved.

Courts frequently cite several factors used as evidence that a board of directors fulfilled its

³³ Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997).

fiduciary duty to obtain the best possible transaction for the company's stockholders. These factors include:

- An attempt by the board of directors to “shop” the company;
- Provisions in the merger agreement that allow the board of directors or a special committee to actively solicit or receive proposals from third parties;
- The absence of “lock-up” provisions that effectively take the company off the market;
- A sufficient window between announcement of a merger or tender offer and its closing to allow other potential acquirors to approach the company; and
- The absence of a provision in the merger agreement requiring the company to submit the merger agreement to the stockholders regardless of whether the board of directors continued to recommend the merger.

In *Omnicare, Inc. v. NCS Healthcare, Inc. et al*,³⁴ a board of directors that was attempting to sell a company adopted a set of “safety devices” at the demand of an acquiror fearing that they would otherwise lose the acquiror’s offer. The devices included (i) a provision in the merger agreement requiring the board to submit the agreement to the stockholders for approval regardless of whether the board continued to recommend the merger, (ii) certain no-shop provisions and (iii) a break-up fee. In addition, the merger agreement did not maintain a “fiduciary-out” provision for the board. At the same time, the acquiror required the two holders with a majority of the company’s stock to provide irrevocable and specifically-enforceable voting agreements in favor of the merger agreement. Together, the merger agreement and the voting agreements irrevocably bound the company to be sold to the acquiror irrespective of any subsequent, more competitive offer that might be received from another bidder. The Delaware court analyzed these safety devices under the enhanced scrutiny standard and determined

³⁴ 818 A.2d 914 (Del. 2003).

that they were coercive and preclusive and not within the reasonable range of responses to the perceived threat of losing the offer.³⁵ As a result, the court held that the board’s actions and safety devices amounted to an unauthorized abdication of the board’s fiduciary duties, which remained in effect beyond the time the merger agreement was announced, and, therefore, concluded that these devices were invalid and unenforceable.³⁶

3.3 Factors to Be Considered in Assessing a Bid

Controlling and influential case law makes it clear that the primary duty of a board of directors in an extraordinary transaction is to obtain the best possible transaction for the stockholders. In practice, however, it is not always clear which of alternative bids offers the best value. Courts have stated that directors “should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the Board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives.”³⁷ While current market value provides the first and sometimes final step in any valuation, it is not always determinative. There are numerous factors that a board of directors should consider in evaluating a bid, including the following:

- the adequacy and terms of the offer;
- the offer’s fairness and feasibility;
- the proposed or actual financing for the offer and the consequences of that financing;
- the risk of nonconsummation;
- the stockholder interests at stake;
- the bidder’s business plans for the company and its effects on stockholder interests;
- the bidder’s identity, prior background and success in previous transactions and other business ventures;

³⁵ *Id.* at 63.

³⁶ *Id.* at 72.

³⁷ See *QVC*, 637 A.2d at 44.

- the bidder's ability to integrate operations, achieve cost savings and realize the potential synergies of the merged entity; and
- if stock is part of the consideration, the past performance of the security and its projected future performance, and the quality of the bidder's management and its likelihood of increasing the value of the merged entity.

In certain circumstances, it may also be appropriate to consider the effect that a particular offer will have on non-stockholder constituencies, such as the company's employees, its customers and the community in which it operates.

Conclusion

A proper understanding of the Board's obligations, and of the means by which it can satisfy those obligations, will assist directors in meeting the standards imposed by courts on directors considering an extraordinary strategic transaction. Through a careful and considered decision-making process, the Board can help to ensure that its ultimate business decision, rather than the decision of a court, determines the Company's fate and can reduce the likelihood and success of a stockholder derivative suit brought to challenge the Board's decision.