

NAVIGATING FIDUCIARY DUTIES IN PRIVATE COMPANY MERGERS AND ACQUISITIONS

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NAVIGATING FIDUCIARY DUTIES IN PRIVATE COMPANY MERGERS AND ACQUISITIONS

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I. Introduction.

The conduct of corporate directors and officers is subject to particular scrutiny in the context of business combinations (whether friendly or hostile), executive compensation and other affiliated party transactions, allegations of illegal or improper corporate conduct, and corporate insolvency. The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners.

Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions (“*M&A*”) to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is insolvent, the constituencies claiming to be beneficiaries of those duties expand to include the entity’s creditors.

Similar fiduciary principles are applicable to governing persons of a general or limited partnership and a limited liability company (“*LLC*”). These entities are often referred to as “alternative entities” in recognition that the rights and duties of their owners and governing persons can be modified by contract to greater extent than is permitted in the case of corporations.

The focus of the Congress of the United States (“*U.S.*”) on how corporations should be governed following corporate debacles early in the last decade led to the Sarbanes-Oxley Act of

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2002 (“SOX”).¹ SOX was intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.²

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)³ into law. This sweeping legislation governs not only the financial services industry, but also public companies generally.

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the “JOBS Act”)⁴ into law. This legislation was enacted to bolster economic growth by providing certain private companies with greater access to early funding opportunities and exemptions from SOX.

While SOX, Dodd-Frank, the JOBS Act, and related changes to SEC rules and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law.⁵ Our focus will be in the context of companies organized under the applicable Delaware and Texas statutes.

Prior to January 1, 2006, Texas business corporations were organized under, and many are still governed by, the Texas Business Corporation Act, as amended (the “TBCA”),⁶ which was supplemented by the Texas Miscellaneous Corporation Laws Act (the “TMCLA”).⁷ However, corporations formed after January 1, 2006 are organized under and governed by the Texas Business Organization Code (“TBOC”),⁸ which was extensively amended in the 82nd Texas Legislature, 2011 Regular Session (the “2011 Texas Legislature Session”),⁹ and the 83rd

¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in several sections of 15 U.S.C.A.) (“SOX”); see *infra* **Appendix A**; Byron F. Egan, *Major Themes of the Sarbanes-Oxley Act*, 42 TEX. J. BUS. L. 339 (Winter 2008), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186>; and Byron F. Egan, *Perils of In-House Counsel* (July 22, 2010), <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1430>.

² SOX is generally applicable to all companies required to file reports, or that have a registration statement on file, with the Securities and Exchange Commission (“SEC”) regardless of size (“public companies”). Although SOX does have some specific provisions, and generally establishes some important public policy changes, it is implemented in large part through rules adopted by the SEC. See Summary of the Sarbanes-Oxley Act of 2002 attached as **Appendix A**. Among other things, SOX amends the Securities Exchange Act of 1934 (the “1934 Act”) and the Securities Act of 1933 (the “1933 Act”).

³ H.R. 4173, 111th Cong. (2nd Sess. 2010). See **Appendix B**. See also J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware’s Future Reviewing Company Defenses in the Era of Dodd-Frank* (2010), George Mason University Law and Economics Research Paper No. 10-37, available at http://ssrn.com/abstract_id=1655482.

⁴ H.R. 3606, 112th Cong. (2012). See **Appendix A**.

⁵ See William B. Chandler III & Leo E. Strine Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* (February 26, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367720; cf. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007); Leo E. Strine, Jr., *Toward A True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006).

⁶ TEX. BUS. CORP. ACT ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2007) [hereinafter “TBCA”].

⁷ TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2007).

⁸ The TEX. BUS. ORGS. CODE ANN. [hereinafter “TBOC”] provides that provisions applicable to corporations (TEX. BUS. ORGS. CODE ANN. Titles 1 and 2) may be officially and collectively known as “Texas Corporation Law” (TEX. BUS. ORGS. CODE ANN. § 1.008(b)). A detailed Table of Contents for the TBOC as of September 1, 2013 appears as **Appendix C**.

⁹ Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature* (July 13, 2011), <http://www.jw.com/publications/article/1629>.

Texas Legislature, 2013 Regular Session (the “*2013 Legislative Session*”).¹⁰ For entities formed before that date, only the ones voluntarily opting into the TBOC were governed by the TBOC until January 1, 2010, after which time all Texas corporations are governed by the TBOC. However, because until 2010 some Texas for-profit corporations were governed by the TBCA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “*Texas Corporate Statutes*” is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.¹¹

II. Corporate Fiduciary Duties Generally.

A. General Principles.

The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago. The current concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.¹²

Both the Texas Corporate Statutes and the Delaware General Corporation Law (as amended, the “*DGCL*”) provide that the business and affairs of a corporation are to be managed under the direction of its board of directors (“*Board*”).¹³ While the Texas Corporate Statutes and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the notice and voting procedures for meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director’s “fiduciary” duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions.¹⁴ In Texas, the fiduciary duty of a director

¹⁰ Byron F. Egan, *Legislative Update: Business Law* (July 2, 2013), <http://www.jw.com/publications/article/1871>.

¹¹ The term “*charter*” is used herein interchangeably with (i) “*certificate of incorporation*” for Delaware corporations, (ii) “*certificate of formation*” for corporations governed by the TBOC and (iii) “*certificate of incorporation*” for corporations organized under the TBCA, in each case as the document to be filed with the applicable Secretary of State to form a corporation. TBOC §§ 1.002(6) and 3.001-3.008; DGCL § 1.01. *See infra* notes 1101-1131 and related text.

¹² The “fiduciary duties of corporate officers and directors . . . are creatures of state common law[.]” *Gearhart Indus., Inc. v. Smith Int’l., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (citing *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949)); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005) (“Unlike ideals of corporate governance, a fiduciary’s duties do not change over time”), *aff’d*, 906 A.2d 27 (Del. 2006); *see also Burks v. Lasker*, 441 U.S. 471, 477 (1979). Federal courts generally apply applicable state common law in fiduciary duty cases. *See e.g. Floyd v. Hefner*, No. H-03-5693, 2006 WL 2844245 (S.D. Tex. 2006).

¹³ TBOC § 21.401; TBCA art. 2.31; and DEL. CODE ANN. tit. 8, § 141(a) (title 8 of the Delaware Code Annotated to be hereinafter referred to as the “*DGCL*”); *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (Board authority to manage the corporation under DGCL § 141(a) may not be infringed by a bylaw adopted by the stockholders under DGCL § 109 in a manner that restricts the power of directors to exercise their fiduciary duties); *see infra* notes 1136-1140 and related text.

¹⁴ Although the DGCL “does not prescribe in detail formal requirements for board meetings, the meetings do have to take place [and] the mere fact that directors are gathered together does not a meeting make”; where there is no formal call to the meeting and no vote taken, directors caucusing on their own and informally deciding among themselves how they would proceed is like simply polling board members and “does not constitute a valid meeting or effective corporate action.” *Fogel v. U.S. Energy Sys. Inc.*, No. 3271-CC, 2007 WL 4438978 at *2 (Del. Ch. 2007) (citations omitted).

The *Fogel* case arose in the context of a confrontation between three independent directors and the Board chairman they sought to terminate (there were no other directors). The opinion by Chancellor William B. Chandler III recounted that U.S. Energy “was in precarious financial condition” when Fogel was hired in 2005 to become both CEO and a

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