Fiduciary Duty Issues in Private Company M&A

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Byron F. Egan
Jackson Walker L.L.P.

Patricia O. Vella
Morris, Nichols, Arsht & Tunnell LLP

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Private Company Versus Public Company: Delaware

- In Delaware: "Fiduciary duties apply regardless of whether a corporation is registered and publicly traded, dark and delisted, or closely held."
  - *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 31 (Del. Ch. 2010) (internal quotation marks omitted)
  - Duties include the duty of care and the duty of loyalty.

Private Company Versus Public Company: Texas

- In Texas: No distinction between public or private corporations in measuring the duties of directors.
  - The Fifth Circuit stated in *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984), that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely, the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances. Good faith under *Gearhart* is an element of the duty of loyalty.
  - Texas has a strong business judgment rule which was explained in *Gearhart* as follows:
    - "The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act. If such a showing is not made, then the good or bad faith of the directors is irrelevant." *Id.* at 723 n.9.

Fiduciary Duties – *Revlon* Basics

- *Revlon:* The Basics
  - *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
  - Application of *Revlon* impacts both nature of directors' duties and standard of review.
    - *Nature of Duties*: Seek best short-term value reasonably available.
    - *Standard of Review*: Reasonableness. Intermediate standard, between business judgment rule and entire fairness.
- Does *Revlon* apply in Texas?
  - *Revlon* is a Delaware case and not binding in a Texas court. The *Revlon* duty is not among the Texas fiduciary duties enumerated in *Gearhart*.

Fiduciary Duties – *Revlon* In Private Company Setting

- It may not be practical to hire an investment banker to provide a fairness opinion or to run a full-blown auction process for a private company with limited resources.
- Nonetheless, *Revlon* duties apply in a small company setting.
  - "This raises a question as to when a small public company, like OPENLANE, would want to pay a financial advisor to undertake an extensive market check or provide a fairness opinion. The fact that a company is small, however, does not modify core fiduciary duties and would not seem to alter the analysis, unless its board, like OPENLANE's, was well-versed in the company's business. In other words, small companies do not get a pass just for being small. Where, however, a small company is managed by a board with an impeccable knowledge of the company's business, the Court may consider the size of the company in determining what is reasonable and appropriate." *In re OPENLANE, Inc. S'holders Litig.*, 2011 WL 4599662, at *7 (Del. Ch. Sept. 30, 2011) (Noble, V.C.).
- The board must act reasonably, but the court will take into account the context in which the decisions are made, including the resources available to the corporation.

Fiduciary Duties – *Revlon* In Private Company Setting

- *OPENLANE* – A Model "Not To Be Followed", But To Be Noted.
  - OPENLANE, a seller of "off-lease" vehicles, was sold to a strategic buyer for approximately $210 million.
  - At the time of sale, OPENLANE's directors beneficially owned approximately 60% of OPENLANE's capital stock (with management, this figure rises to nearly 70%).
  - Board launches strategic review process in May 2010 in anticipation of declining business, and engages banker to contact a limited number of strategic buyers. Prior to signing the merger agreement, the board reached out to 3 potential strategic buyers (including ultimate winning bidder), and no potential financial buyers.
  - The board did not obtain a fairness opinion. It did, however, review a board book provided by the banker.

Fiduciary Duties – *Revlon* In Private Company Setting

- *OPENLANE* – A Model "Not To Be Followed", But To Be Noted.
  - Holding:
    - Although the board did not effect a "traditional" market check, and its "decision-making process was not a model to be followed," the directors appeared to have "an impeccable knowledge of the company's business." The Court found, among other things:
      - 2 directors co-founded the company; remainder of board invested in OPENLANE or affiliated with an investor; directors have long tenure on board.
      - Board held nine meetings between 12/10 and 8/11, and adequately discussed reasons for not approaching financial buyers.
      - Directors held approximately 60% of OPENLANE stock.
  - Takeaway:
    - Although the Court found the OPENLANE process not to be "a model" of decision-making, the Court ultimately held that the directors were likely to have acted in accordance with their fiduciary duties.
    - This case reaffirms the "reasonableness" aspects of *Revlon*, which will take into account context, including the resources of the target company.

Fiduciary Duties – *Revlon* In Private Company Setting

- *In re Trados Inc. S'holder Litig.,* 2013 WL 4511262 (Del. Ch. Aug. 16, 2013) (Laster, V.C.).
  - Although in the context of entire fairness analysis, Court states the following:
    - "At trial, the defendants uniformly cited the cost of a fairness opinion, mentioning figures typical of bulge bracket institutions and their aspiring competitors. But no one appears to have explored the possibility contemporaneously, even after SDL's counsel expressed 'concerns over [the] common stockholders…not getting any consideration,' and questioned whether Trados needed a 'JMP fairness opinion.' One can remain appropriately skeptical of the value of fairness opinions while at the same time recognizing that an outside analysis of the alternatives available to Trados would have improved the record on fair dealing." *Id.* at *35.
  - The Court observed that "a duly empowered and properly advised committee" might not just have been probative of fairness, but "could well have resulted in business judgment deference." *Id.* at *35 n.39. The Court also recognized the reality, however, that a plaintiff "likely would have found reason to criticize" a one-person committee.

Fiduciary Duties When Common Stock Under Water: *Trados*

In re Trados, 2013 WL 4511262 (Del. Ch. Aug. 16, 2013).

- Lawsuit challenging Board approval of a merger of Trados into SDL. Of the $60 million merger consideration, approximately $52.2 million went to the preferred stockholders (who had a liquidation preference of $57.9 million) and approximately $7.8 million went to participants in a management incentive plan ("MIP"). No consideration was paid to the common stockholders.
- A seven person board – including two individuals who received a consideration under the MIP and three designees of VC firms that held preferred stock – approved the sale without forming a special committee and without obtaining a fairness opinion.
- At summary judgment stage, Court suggests "VC plus employment" gets plaintiff to trial. *Compare Orban v. Field*, 1997 WL 153831 (Del. Ch. Apr. 1, 1997).
- At trial, Court held (i) directors did not follow a fair process in approving the sale but (ii) because the common stock had no economic value before the merger, a transaction resulting in no consideration for the common stock was entirely fair.

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