Sale of a Company: Director Duties and Personal Protection

By Priya Cherian Huskins

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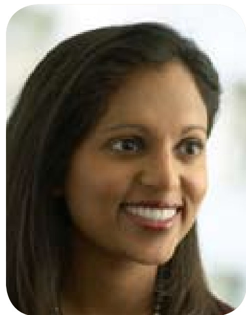
Priya Cherian Huskins

Consider this scenario: a company's CEO tells his board that he has received a compelling offer for the sale of the company. Upon reviewing the offer, the directors agree that the offer is attractive, and think that the shareholders would be well-served to accept the offer. However, as experienced board members, they know that the potential sale of a company is an inflection point for litigation. After all, 24% of securities class action law suits include merger-and-acquisition-related allegations[1], and shareholders often bring breach-of-fiduciary duty suits in connection with M&A activities.

The board's next steps are critical, both to maximize shareholder value and to avoid litigation that may result from failing to do so. This article outlines the fundamental duties of a board considering the sale of a company. The article also details what a board can do—beyond diligently fulfilling its duties—to protect itself from liability and thereby focus entirely on promoting the interest of shareholders.

Directors' duties under the law

When it comes to directors' duties, it is always useful to think in terms of the golden triad of the duties (1) care, (2) loyalty, and (3) appropriate disclosure. As is the case in other situations that call for director action, this triad provides a useful framework for thinking about the sale of a company.

1. Duty of Care. The duty of care requires that directors diligently pursue the interests of the shareholders who elected them. Consistent with this duty, and articulated in the well-known *Revlon*[2] case and its progeny, once a company is up for sale directors of the company must "undertake reasonable efforts to secure the highest price realistically achievable given the market for the company."[3]

If the board's efforts are subsequently challenged, the court will review the process set up by the directors for reasonableness. This is a tougher standard of review than the usual "bare rationality" standard that courts apply to other board decisions, referred to commonly as the business judgment rule. As one Delaware Chancery Court opinion described it, "this reasonableness review is more searching than [the business judgment rule's] rationality review, and *there is less tolerance for slack by the directors* [emphasis added]."[4]

Recognizing that one size will not fit all, Delaware courts have declined to provide boards with the comfort of a "judicially prescribed checklist of sales activities."[5] Instead, directors must use sound business judgment to construct a deliberate, systematic sale process reasonably designed to maximize shareholder value.

One sales process that most would agree is designed to maximize shareholder value is to conduct an auction of a company. There is, however, no requirement to conduct an auction of the company. In the June 2007 Delaware Chancery Court decision concerning the sale of the baseball card maker Topps Company, Inc., the Court noted that in light of a failed auction attempt two years earlier there was no need for the company to conduct an auction when it decided to sell itself. The Court ruled this way in part because Topps did not have a poison pill in place that would otherwise discourage other buyers from approaching the company.[6]

Nevertheless, companies should be on guard against prematurely cutting off alternative buyers. Consider, for example, the proposed sale of Netsmart Technologies, Inc. In its March 2007 decision concerning that company's sales process, the Delaware Chancery Court was unimpressed by the board's consideration of only private equity buyers. The Chancery Court took special note of the board's failure to consider strategic buyers when it decided to sell the company. In the words of the Chancery Court "it was incumbent upon the board to make a reasonable effort to maximize the return to Netsmart's investors. On the existing record [which supports no serious consideration of strategic buyers], I cannot conclude that

1 *Woodruff-Sawyer & Co. Proprietary Securities Class Action Litigation Database.*

2 *Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).*

3 *In re Netsmart Technologies, Inc. Shareholder Litigation, 2007 WL 1576151 (Del. Ch.).*

4 *Netsmart at *15.*

5 *Ibid.*

6 *In re The Topps Company Shareholder Litigation, 2007 WL 1732586 (Del. Ch.) at 50.*

their approach to this issue is indicative of such an effort."[7]

Part of a board's ability to put together a reasonable sales process will depend on the board's familiarity with a variety of sophisticated deal-protection devices such as no-shop provisions, break-up or termination fees, matching or topping rights, and the like. In addition to understanding the mechanics of these types of provisions, a board must also understand the impact these types of provisions will have on the board's ability to maximize value for its shareholders.

This is an area where the board is well-served by seeking advice from independent litigation counsel and having its discussions with counsel protected by the attorney-client privilege. Consistent with the public policy that supports attorney-client privilege, a board will want an opportunity to freely ask questions about the proposed transaction and to debate the merits of the deal. The possibility of future litigation can chill this kind of back and forth. Directors may fear that in future litigation their genuine and sincere questions will be misconstrued as evidence of nefarious intent. In light of all of this concern, the board should ask outside counsel specific questions about how to protect the privilege, and then to follow the protocol outside counsel recommends.

Finally, in addition to having a good sales process, a board is well-served by *documenting* its sales process in a timely and diligent manner. A too-casual approach can result in few formal meeting minutes or worse still the exercise of approving minutes after litigation has commenced. The board will not want to appear casual if it finds itself in the midst of hotly contested litigation over the adequacy and diligence of its efforts.

7 *Netsmart at *18.*

2. Duty of Loyalty. The duty of loyalty requires that directors act in an independent manner and with regard only to the concerns of the shareholders. In the context of the sale of company, it is inappropriate to favor one buyer over another for reasons other than the maximization of shareholder value.

One way to violate the duty of loyalty is to give preferential treatment to a buyer that plans to keep current management and/or board members around after the sale has closed. The possibility that a potential buyer was treated more favorably by management due to promises made to keep management in place post-closing was exactly the conflict of interest issue that was brought to the Delaware Chancery court's attention in the earlier-described Topps transaction. In reviewing the facts of the case, the Chancery Court found that the bid of a potential acquirer that would likely have replaced management was treated less favorably compared to the treatment accorded another bidder that had promised to retain management.[8] This was part of the reason that the Court was unwilling to allow the merger vote to move forward without giving the badly treated potential buyer an opportunity to communicate directly with Topps' shareholders.
Forming a Special Committee of the board composed of outside directors to drive the sales process is a way to mitigate the potential conflict-of-interest issues with respect to incumbent management. If the board decides to go in this direction, the board should form the Special Committee sooner rather than later to get the maximum benefit of the Committee. One decision early in the process that is best undertaken by a Special Committee—and not management—is the scope of the types of offers and buyers the board will entertain.[9]

8 *Topps at 61 and 62.*

The Special Committee should avoid delegating too much authority to any member of the management team who has a conflict of interest. Doing so considerably weakens the protection that the formation of a Special Committee can offer. In its June 2007 decision concerning the sale of the Lear Corporation, the Delaware Chancery Court specifically addressed the issue of putting in charge of negotiations a CEO who had a clear personal interest in having a sale consummated. Although the Court ultimately decided that there was no evidence that putting this CEO in charge of negotiating this particular sale "adversely affected the overall reasonableness of the board's efforts to secure the highest possible value," the court still referred to the Special Committee's decision in this matter as " infelicitous." [10] In other words, the Special Committee got lucky with the Court's "no harm, no foul" ruling.

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3. Appropriate Disclosure. It is uncontroversial that directors have a duty to disclose to shareholders all information that is material to a shareholder's decision to vote on the sale of a company.[11] More specifically, directors are required to disclose

9 *Netsmart at *21.*

10 *In re Lear Corporation Shareholder Litigation, 2007 WL 1732588 (Del. Ch.).*

11 *Arnold v. Society for Savings Bancorp., Inc., 650 A.2d 1270, 1277 (Del. 1994).*

balanced, truthful, and materially complete information.[12] In the heat of a sale transaction, it can be all too easy for management and boards to neglect to adhere fully to this requirement.

This was an issue raised in the 2007 Netsmart Technology decision. The board and management's failure in this regard caused the court to require the company to provide more information to shareholders prior to holding a vote on a proposed merger. Specifically, the Chancery Court wanted to make sure that the shareholders had a chance to review the discounted cash flow analysis that the company's investment bankers prepared because the shareholders were being asked to rely on a fairness opinion that itself relied on these projections. In the words of the court, "[o]nce a board broaches a topic in its disclosures, a duty attaches to provide information that is materially complete and unbiased by the omission of material facts."[13]

What else can directors do to protect themselves?

Even the best board with a laser-like focus on its duties of care, loyalty and disclosure may find itself the target of a suit brought by disgruntled shareholders or perhaps a disgruntled bidder. A board's concern over such suits can result in excessive caution, which is not in the best interest of shareholders. Consequently, the natural next question is "what can board members do to protect themselves from personal liability?"

First and foremost—and well before any potential sale event—directors should update their personal indemnification agreements with their companies. Rather than rely on a contract that may be many years old, directors should ask someone who represents the board to review the indemnification agreement to ensure that they have the most protective language possible. This review should pay special attention to change-of-control provisions. For example, indemnification agreements should expressly require an acquiring company to assume the selling company's indemnification obligations in writing. This exercise of updating the board's indemnification agreements ultimately inures to the benefit of the company's shareholders by allowing the directors to put concerns of personal liability aside and focus instead on the business at hand. It is also consistent with public policy position expressed by Delaware corporate law. Delaware's corporate law allows companies to protect their directors with expansive indemnification protections.

Next, and again well before any potential sales event, directors should confirm that their D&O insurance policies are well-designed. If there has not been an independent check of the D&O policies for a number of years, conduct one. D&O policies are highly technical contracts, and can be properly analyzed only by an expert in the field. Among the provisions that should be analyzed are the change-of-control provisions, as well as provisions that prevent the knowledge and acts of another person—an officer, for example—from being attributed to a board member to his or her detriment.

Finally, when a company is ultimately acquired, the company's board will want to make sure that a "tail policy" is purchased for the acquired company's D&O insurance policy. Typically six years in duration, a tail policy holds open the acquired company's current D&O policy so that it will respond to new claims that are made against the acquired company's directors after the sales transaction has closed. The directors of the acquired company may not be in a position to demand protection from the acquiring company after the sale is closed. Consequently, it is essential that the board of the selling company put this protection in place before the sale is consummated. One way to do this is to have the directors' personal indemnification agreements include the right to a tail policy should the company be acquired.

In summary, the sale of a company is a high stakes event for shareholders, management, and directors. The role of the board is to seek an outcome that is the best available to the shareholders. To meet the demands of this role, directors must understand what is required with respect to the duties of (1) care, (2) loyalty, and (3) appropriate disclosure. In exercising their duties, shareholders are not served when directors act with excessive caution. Instead, shareholders are best served when directors can exercise judgment that is unclouded by the concern that, notwithstanding their good faith efforts, they will be faced with a shareholder suit. To alleviate this concern, directors should take proactive steps before a sale is even on the horizon to obtain state-of-art indemnification agreements and D&O insurance policies. With advance planning, a board will be well positioned to handle a sale in a way that effectively and properly promotes the interests of shareholders.

Priya Cherian Huskins, Esq. is a partner and senior vice president at Woodruff-Sawyer & Co., an insurance brokerage headquartered in San Francisco, California. Priya specializes in director and officer liability and its mitigation through both insurance and corporate governance solutions.

12 *Netsmart at *21*

13 *Netsmart at *24.*

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