

Fiduciary Duties of Directors in M&A Transactions

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Agenda:

**Overview of Fiduciary
Duties for Delaware
Directors**

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**Fiduciary Duties in the
Context of M&A Deals**

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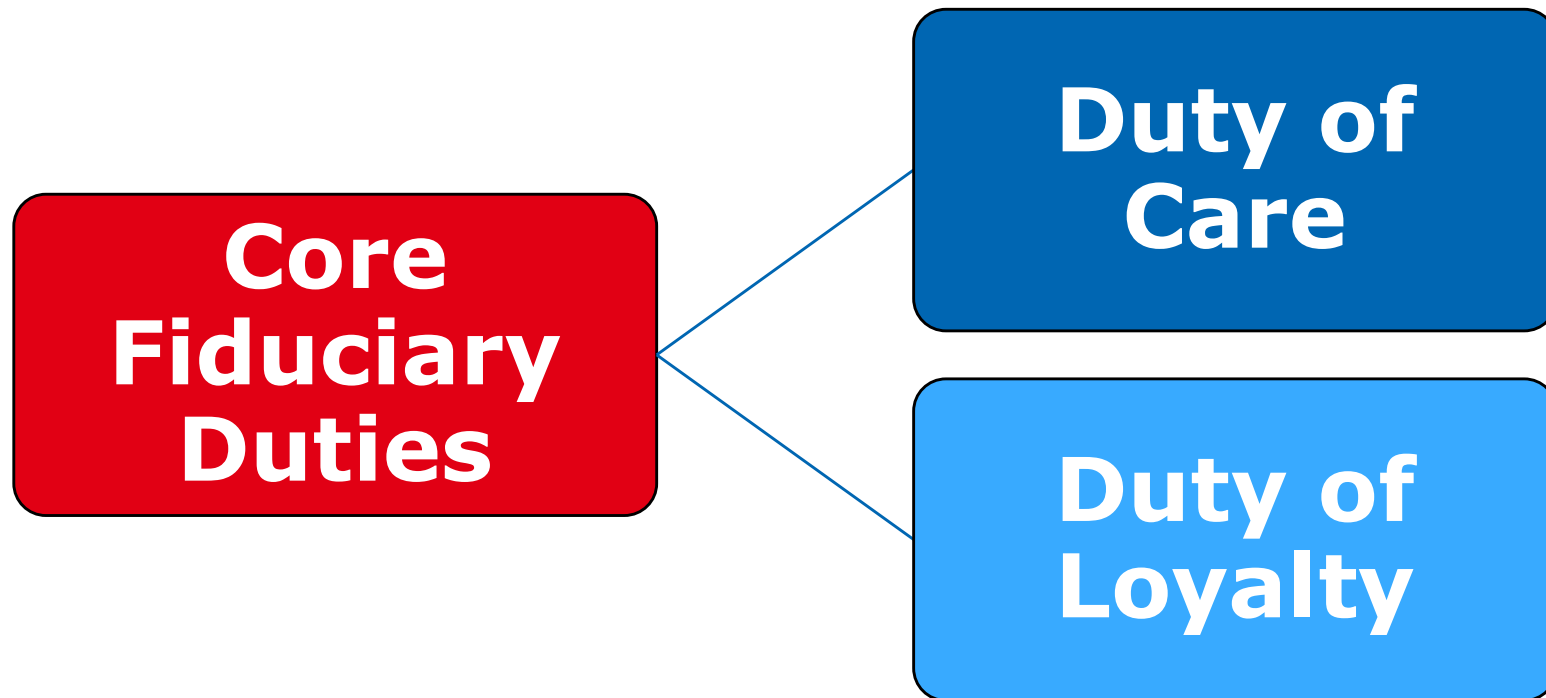
**European Overview of
M&A Fiduciary Duties**

Overview of Fiduciary Duties for Delaware Directors

Duties of Directors:

- Duties of directors of a corporation are governed by the corporate law of the corporation's jurisdiction of incorporation
 - We will cover duties of directors of a Delaware corporation in general
- Under Delaware law, the business and affairs of a corporation are managed by or under the direction of its board of directors
 - In this capacity, members of the board serve as fiduciaries of the corporation and its stockholders

Duties of Directors:



- Other duties, such as the duty of good faith, duty of disclosure and duty of oversight stem from the core fiduciary duties

Duty of Care:

- Requires a director to perform duties with the care that an ordinarily prudent person in a like situation would use under similar circumstances
- Duty is to act on an informed basis and in a deliberative manner
 - Directors have duty to inform themselves of all material information reasonably available to them and to then act with requisite care in discharge of their duties

Director Protections: Business Judgment Rule

- Directors are generally protected by the business judgment rule when making business decisions
 - The rule presumes that disinterested directors acted:



Duty of Loyalty:

- Directors are required to act at all times in a manner they honestly and in good faith believe to be in the best interests of the company and its stockholders
 - Bad faith implies more than bad judgment or gross negligence and relates to the state of mind of the director; includes an intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for duties
- Directors must refrain from self-interested conduct such as fraud, self-dealing and actions that serve to “entrench” them in office
- Directors should act without personal financial self-interest and without personal or private motive, even if non-financial in nature
- Directors’ decision-making is based on the merits of the matter before the board, rather than on outside influences (i.e., avoid conflict of interest and remain disinterested and independent)

Duty of Loyalty: Conflicts of Interest

- Directors may be interested in a transaction if they have a personal or business interest in the transaction. Interested directors to a transaction may lose the presumption of the business judgment rule
 - Disinterest and independence is determined on a director-by-director basis; board is generally entitled to business judgment rule if a majority of board approving transaction are disinterested and independent
 - A fully informed, disinterested majority of stockholders may ratify director-conflicted transactions, which restores presumptions of the business judgment rule

Fiduciary Duties in the Context of M&A Deals

Board Duties in a Merger:

- In a merger transaction the approval of the boards of directors of both buyer and seller are required.
- The responsibility for negotiating the merger agreement rests with the two boards of directors, and they are charged with negotiating a transaction that they can recommend to their stockholders (if stockholder approval is required) and doing so in a careful manner that is loyal to the interests of their respective companies.
 - Merger transactions for the change of control of a corporation are negotiated transactions.
 - Other mergers—short-form, squeeze-out, etc.—are sales of remaining pieces of ownership but do not involve a change of control and are therefore less controversial.

Delaware Standards of Review:

- The starting point for evaluating director actions and decisions is the business judgment rule.
- The business judgment rule is a presumption that in making the decision to effect a merger or sale of the target (or in the case of the buyer board, in making the decision to acquire the target), the directors and officers acted on an informed basis, in good faith, and in the belief that the action was in the best interests of their corporation.
 - Courts will not review the business decisions of boards absent sufficient evidence to rebut this presumption.
- If the presumption of the business judgment rule can be rebutted, then the board bears the burden of proving that it acted with due care (in the case of a duty of care claim) or that the board's decision was entirely fair to the company and its stockholders (in the case of a duty of loyalty claim).

Delaware Standards of Review:

- In acquisitions, Delaware has instituted a "threshold" requirement—often referred to as "enhanced review" or "heightened scrutiny" that must be met before the Delaware courts will afford business judgment rule protection to the target's board decisions in acquisitions.
- In a sale of control transaction, the Delaware courts will review the board's process to assess whether the target board took actions to achieve the best value reasonably attainable for the stockholders in the transaction.

Enhanced Scrutiny: Sale of a Corporation

Revlon Duties

- Directors must seek to obtain the best price and terms reasonably available to the shareholders of the target company
 - In the merger context, this typically means the board considered alternatives to the merger and took affirmative steps to maximize shareholder value
- Best price and terms – not just price
 - Timing of offer, including in comparison to other strategic alternatives
 - Whether the deal is fully financed
 - Whether the deal has material contingencies
 - Risk of not consummating other offers
 - Regulatory concerns, such as antitrust approval

Enhanced Scrutiny: Sale of a Corporation

Revlon Duties

- To trigger Revlon, a transaction must involve “sale” of control or breakup of the corporation, including when:
 - Buyer offers cash in exchange for a majority or more of the target company’s stock
 - A stock transaction where control of the combined business becomes concentrated in a few large shareholders (a controlled company), rather than a widely held company
 - Company initiates a bidding process seeking to sell itself to effect a business reorganization involving a clear break-up of the company
 - In response to a bidder’s offer, the company abandons its long-term strategy and seeks an alternative transaction also involving the break-up of the company
- Revlon does not apply where a majority shareholder is selling control (and therefore the sale of control is not under the direction of the target company board)

Enhanced Scrutiny: Defensive Mechanisms

Unocal Duties

- Triggered by the board's approval of:
 - Hostile takeover defenses to limit an acquirer's ability to obtain control of the company without negotiating directly with the board, such as a poison pill
 - Measures designed to protect a particular negotiated transaction from an interloper attempting to break up the transaction by making a superior offer, such as no-shop clauses and termination fees
- Poison pills – Delaware courts use a two-prong test to determine if the hostile takeover defense:
 - Protects the company from a cognizable threat, and
 - Is proportional to the threat posed

Enhanced Scrutiny: Defensive Mechanisms

Unocal Duties

- Protecting a negotiated transaction against interlopers – Deal protection measures should:
 - Protect the transaction from a legitimate threat, such as loss of the transaction; and
 - Not coerce the shareholders into voting for the transaction for reasons other than the merits of the transaction, and not unreasonably preclude the company from being sold for a higher price (*Omnicare v. NCS Healthcare, Inc.*)

Board Best Practices Under Enhanced Scrutiny:

Have a record of its knowledge and understanding of the target company's value, including advice and valuations performed by outside advisors

Show a process of having engaged with potential transaction parties

Show an understanding of transaction arrangements and alternatives considered by the board to show that the board made informed decisions about the relative costs and benefits of any preclusive transaction terms (exclusivity, no-shop, break-up fees, poison pills, etc.)

If appropriate, establish a special independent committee to consider the proposed merger transaction

Entire Fairness: Standard of Review for Conflicted or Interested Party Transactions

- This standard of review is used when:
 - Acquisitions of companies by controlling shareholders (so-called squeeze-out transactions)
 - Controlling shareholder receives different consideration from minority shareholders
 - Majority of board is not disinterested
 - Majority of board lacks independence from or is dominated by an interested party
- A conflicted or interested party must show:
 - Fair dealing: Procedural fairness of the transaction
 - Fair price: Fair consideration to be paid and received, considering all relevant factors that affect value

Standards of Review: Key Takeaways

Level of Scrutiny	Standard of Review
Business Judgment Rule (BJR)	<p>Presumption that in making the decision to effect a merger or sale, the directors and officers acted on an informed basis, in good faith, and in the belief that the action was in the best interests of the corporation.</p> <p>Decisions of disinterested and independent directors will not be second-guessed if the decision can be attributed to a rational business purpose.</p>
Enhanced Scrutiny	<p><i>Revlon</i>: Once a board decide to sell control of the company, board must obtaining the best terms reasonably available to stockholders.</p> <p><i>Unocal</i>: In responding to takeover threats, the board must demonstrate that (1) it had a reasonable ground to believe that there existed a threat to corporate policy and effectiveness, and (2) the defensive measure adopted by the board was reasonable in relation to the threat.</p>
Entire Fairness	<p>Requires a fair decision-making process and fair terms in the transaction. Applies when self-interested directors (1) are a majority of the board, (2) dominate or control the board, or (3) fail to disclose their interest in the transaction to the whole board.</p>

European Overview of M&A Fiduciary Duties

Overview:

Context

- European subsidiaries
- Joint ventures in Europe
- Minority investments with board seats
- Dealing with European counterparties

The Landscape

- Patchwork of rules based on national laws
- Limited harmonization even within the EU
- Legal entity forms and board structures vary – leads to different duties of directors and officers
- Substance at a basic level often similar to US-style duties, but differ in substance and form
- Often more formality in decision-making processes

The United Kingdom Regime:

Application

- Who is a Director?
- Shadow directors
- Non-executive directors
- Former directors

The Duties

- General duties under the Companies Act 2006
- Specific responsibilities under CA 2006 and constitution of the Company relating to management and governance
- Specific responsibilities under CA 2006 to undertake specific tasks on behalf of the Company
- Specific responsibilities under other legislation

General duties under the Companies Act 2006:

1. To act within powers
2. To promote the success of the Company
3. To exercise independent judgement
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. No to accept benefits from third parties
7. To declare an interest in a proposed transaction

Duty to promote the success of the Company:



Statutory duties:

Duty to promote the success of the company – s. 172 CA 2006

Definition of Success

- What constitutes “success” will be for the director’s good faith judgment
- In certain circumstances, the duty can be subject to the rule of law requiring directors to consider or act in the interests of the company’s creditors. If the company is insolvent, this duty is displaced and the directors must treat the interests of the creditors as paramount
- A breach of this duty can lead to **personal liability**, e.g. wrongful trading, fraudulent trading and misfeasance under the Insolvency Act 1986, and possible **disqualification**



“For most commercial companies, success will often mean a long-term, sustainable increase in value but traditional considerations such as profitability, viability and the financial effects on the company and its shareholders, remain of critical importance.”

**The Chartered Governance Institute Guidance
Note: Directors’ general duties under the
Companies Act 2006**

Directors Duties and M&A:

Buy-side
M&A

Sell-side
M&A

Financing
Rounds

Management
Buy-Outs

Directors' duties in Europe:

Summary

- Major European jurisdictions have well-developed rules that cover similar concepts to the US
- Directors should:
 - Be informed on local duties and liabilities if joining a board
 - Ask questions and obtain advance regarding any areas of uncertainty
 - Question any outcomes which seem illogical from a US perspective
 - Understand decision-making processes and required documentation
 - Ensure adequate protection against third party liabilities
- M&A and financing events will bring these duties into intense focus!

Questions?



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