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When Business Judgment Isn't Enough: The Impact of the Standard of Review on Deal Litigation

By Stephen B. Brauerman

Three recent decisions of the Delaware Court of Chancery, all written by Vice Chancellor Laster, demonstrate the importance and impact of the application of the standard of review to the success of post-transactional shareholder litigation. The decision in *In re Orchard Enterprises Inc. Stockholder Litigation*, C.A. No. 7840-VCL, 2014 WL 1007589 (Del. Ch. Feb. 28, 2014), holds that entire fairness review should govern the court's consideration at trial of the board's approval of a squeeze-out merger effected by the company's majority stockholder. The court's post-trial opinion in *In re Rural Metro Corp. Stockholders Litigation*, C.A. No. 6350-VCL, 2014 WL 1053140 (Del. Ch. Mar. 7, 2014), applies enhanced scrutiny review to hold the company's financial advisor liable for aiding and abetting the board's exculpated and previously settled breaches of fiduciary duty. In *Chen v. Howard-Anderson*, C.A. No. 5878-VCL, 2014 WL 1366551 (Del. Ch. Apr. 8, 2014), the court also applied the enhanced scrutiny standard to grant the directors defendants' motion for summary judgment in a challenge to a mixed cash and stock merger with a competitor at the expense of other, more lucrative transactions. In each of *Orchard*, *Rural Metro*, and *Chen*, the parties disputed which standard of review to apply and in each instance, the court's resolution of that procedural question had a dispositive effect. As Delaware law strives to provide greater flexibility and certainty to corporate decision makers, the standard of review continues and will continue to play an impactful, though often unappreciated, role.

A Brief Review of the Standards of Review

Delaware courts apply three standards of review to determine whether corporate fiduciaries have complied with their duties of care and loyalty: (1) the business judgment rule, (2) enhanced scrutiny, and (3) entire fairness. Under the deferential business judgment standard, the court will uphold director conduct unless such conduct cannot be attributed to any rational business purpose.

Enhanced scrutiny, Delaware's intermediate standard of review, applies to "specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors," and requires fiduciaries to show that their motivations were proper, not selfish, and reasonable in relation to their legitimate objective. Enhanced scrutiny most often applies when a board adopts defensive measures to protect against a hostile takeover (*Unocal*), or seeks a transaction to sell the company or cash out stockholders (*Revlon*).

Entire fairness review applies where the board has an interest in the transaction different from stockholders generally or a controlling shareholder stands on both sides of the deal. In such circumstances, the defendant directors must prove that the transaction is entirely fair – with respect to both process and price – to the corporation. The burden of persuasion may shift to the stockholder plaintiff if the influence of the controller or self-interested fiduciary is neutralized by the creation of a sufficiently authorized committee of independent and disinterested directors, or the transaction is conditioned on the approval a majority of independent stockholders after full disclosure of the extent of the conflicts. Even more deferential review is available if, from the beginning, a conflicted transaction is negotiated by a duly authorized independent committee and approved by a majority of the disinterested stockholders after full disclosure, where the business judgment rule will apply. *Kahn v. M&F Worldwide Corp.*, C.A. No. 334, 2013, 2014 WL 996270 (Del. Mar. 14, 2014).

The Application and Impact of the Standard of Review

Orchard involved a stockholder challenge to a squeeze out merger orchestrated by a majority shareholder (Dimensional) and approved by a special committee chaired by a director with ties to the controlling stockholder who obtained a consulting role worth nearly $300,000 per year with the post-merger entity. In addition to the conflicts of interest, which the court found troubling but not disabling in and of themselves, the court expressed concern with the special committee's process. First, the special committee (and its financial advisors) improperly included an inapplicable liquidation preference in favor of Dimensional in assessing the value and fairness of the majority stockholder's offer. Second, the special committee delegated to the controlling stockholder the negotiation of a competing expression of interest to buy the company from its former chief executive. Not surprisingly, Dimensional and the former executive could not reach an agreement, especially after the former executive declined to pay the full value of Dimensional's liquidation preference. Third, while the merger was conditioned on the approval of a majority of the company's disinterested stockholders, the proxy statement issued before the annual meeting contained a number of incomplete and inaccurate disclosures, which tainted the vote. Relatedly and in a separate appraisal action, the Court of Chancery determined that the fair value of the company's stock at the time of the merger was worth more than twice the closing price.

Under these facts, it is not surprising that the Court of Chancery determined on summary judgment to apply the extracting entire fairness standard at trial. Dimensional stood on both sides of the transaction, the special committee was not entirely independent, and a majority of the minority approval was based on inadequate and inaccurate disclosures. The application of the entire fairness standard of review impacts the availability of Section 102(b)(7) of the General Corporation Law of the State of Delaware's exculpatory protection. As the court explained, Section 102(b)(7) defenses are not available at the summary judgment stage "when a case involves a controlling stockholder . . . and where there is evidence of procedural and substantive unfairness." This is because at trial, the parties would need to litigate under the entire fairness standard, whether the board breached its duty of loyalty by favoring Dimension's interests over those of Orchard's minority stockholders. As the court explained, "it is premature in this case to make a determination regarding exculpation under Section 102(b)(7) without first determining whether the transaction was entirely fair, determining whether liability exists and on what basis, considering the evidence as a whole, and evaluating the involvement of each of the directors." The court nevertheless observed that exculpation remains a strong defense, even if the application of the entire fairness standard potentially delayed its application.

The *Rural Metro* decision has garnered a lot of attention because of the court's criticism of the actions of the company's financial advisor, RBC Capital Markets, LLC (RBC). Interestingly, the directors settled before trial, so the aiding and abetting claim against RBC proceeded without the underlying breach of fiduciary duty claims. Given the court's application of the enhanced scrutiny standard of review, the director's breaches would have been exculpated by Section 102(b)(7). The exculpatory statute does not, however, protect aiders and abettors, and consequently provided little help to RBC.

After receiving expressions of interest from potential acquirers and considering a possible acquisition itself (of rival EMS, which had put itself on the auction block), the Rural Metro board created a special committee to explore strategic alternatives. The special committee selected RBC as its financial advisor over two other candidates. Unlike the other candidates, RBC's presentation focused on a potential sale of the company. Although there is evidence that several members of the special committee also favored a transaction to sell the company, there was no evidence (and the stockholder plaintiffs did not contend) that the board's approval of a cash out merger to a financial acquirer implicated the directors' duty of loyalty.

The court was nonetheless critical of several aspects of the sale process. First, the special committee exceeded its authority because the board did not resolve to "put the company in play" until the sales process was well underway. Second, RBC and the special committee did not adequately consider the value of developing and executing the company's growth strategy before selling the company. Third, RBC and the special committee decided to sell the company when confidentiality restrictions from the EMS sale process precluded a number of logical buyers from participating in the Rural Metro auction. Fourth, the special committee failed adequately to supervise the RBC-led sales process. Fifth, RBC did not disclose its own self-interest in pushing a sale so it could participate in the buy-side financing of the EMS transaction and bolster its reputation as a financial advisor in the healthcare sector. Sixth, the board declined to extend the sale process after receiving an expression of interest from the company that had acquired EMS, thereby giving negotiating leverage to Warburg Pinkus, LLC, which ultimately acquired Rural Metro. Finally, the court criticized the board's failure to obtain a valuation of the company until just before it approved the transaction.

Because of the risks inherent in a cash-out merger (i.e., stockholders' final opportunity to maximize the value of their investment), Delaware courts must apply the enhanced scrutiny standard of review. Director defendants can satisfy this standard by demonstrating the reasonableness of their conduct. The court found that the board breached its fiduciary duty of care by neglecting adequately to inform itself about the transaction that it was asked to approve or the flaws in the RBC-led sale process and by failing to actively and directly oversee RBC's efforts. Since these breaches did not implicate the duty of loyalty, the application of the enhanced scrutiny would not have prevented the director defendants from availing themselves of the exculpatory provision in Rural Metro's charter.

In *Chen v. Howard-Anderson*, the court again applied enhanced scrutiny to review a stockholder challenge to a cash-out merger between two competitors in the broadband access equipment market. As in *Rural Metro*, the court considered actions that fell outside the range of reasonableness. First, the board favored a mixed-cash-and-stock deal over a substantially higher, all cash sale to a different competitor (Adtran). Second, the board gave Adtran a 24-hour ultimatum to make a bid when there were no justifiable business reasons for such a tight deadline. The court observed that this ultimatum drove Adtran away. Third, the board conducted a 24-hour market check during the July Fourth holiday and, even after receiving a number of expressions of interest, neglected to pursue any of them. Fourth, inadequate disclosures and incomplete valuation metrics also concerned the court.

Despite identifying these actions as outside the range of reasonableness, the court nevertheless gave the director defendants (save one who was personally interested in the transaction due to a change of control payment he was to receive) the benefit of the company's exculpatory charter provision. To apply the exculpatory provision, the court first had to determine whether the plaintiff's claims implicated the duty of loyalty, since only duty of care claims are exculpated. Under enhanced scrutiny, the court observed, the duty of loyalty is implicated if directors allow "interests other than obtaining the best value reasonably available for [the company's] stockholders to influence their decisions during the sale process." The most common such interest, in an arm's length transaction, is the board's desire to protect incumbent management or their directorships in the post-sale entity. Here, however, the court did not observe any improper interest even though the board failed to maximize shareholder value. Thus the court granted summary judgment.

Why it Matters

Though it is a fairly technical matter of procedure, the standard of review has several important substantive impacts to which corporate deal makers should pay attention. The standard of review is the first indication of the level of culpability in the conduct the court is evaluating. Although the standard of review is the mechanism by which the court analyzes compliance with the standard of care (i.e., a board's fiduciary duties), it also provides an independent qualitative assessment of the conduct being judged; the more troublesome the conduct, the higher the standard of review. Second, the application of the standard of review has important impacts on when defendant directors can avoid liability or exercise their indemnification or exculpation rights. For example, it is easier to win on a motion to dismiss when the standard is business judgment, while entire fairness virtually guarantees a trial with a difficult burden to overcome. Finally, the standard of review may dictate the availability of exculpation because the court more often finds loyalty breaches in the entire fairness context than it does under enhanced scrutiny or business judgment. While it is often difficult to tell whether the standard drives the result or the result drives the standard, the correlative effect between a higher standard of review and greater culpability is well established.

Conclusion

The Court of Chancery's review and application of different standards of review to different transactional conducts should remind corporate actors of the importance of obtaining a favorable standard of review. The standard of review can mean the difference between substantial personal liability and the protection of exculpatory charter provisions. *Orchard*, *Rural Metro*, and *Chen* highlight the complicated application of these standards and illustrate their potentially dispositive impact. These cases also demonstrate the necessity of a proper sale process and that reliance on highly compensated and qualified advisors is a poor substitute for oversight by engaged and informed directors.

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