BRACEWELL

INSIGHTS

Delaware Court Clarifies Director and Officer Liability in M&A Transactions

June 11, 2014

*By: **David J. Ball***

In *Chen v. Howard-Anderson*, 87 A.3d 648 (Del. Ch. 2014), the Delaware Court of Chancery (Laster, V.C.) held that directors and officers can be held liable for their participation in a change-of-control transaction if their decision-making was impacted by a "non-stockholder-related influence." Significantly, the Court recognized that corporate directors can be personally liable even in the absence of evidence supporting an inference that they "consciously disregarded" their duty to achieve the best price for the company's shareholders. The Court clarified that certain conflicts – including change-of-control incentives that are not uncommon – may be sufficient to support a duty of loyalty claim that falls outside the scope of the standard director exculpation permitted by Delaware law.

While this holding raises red flags for corporate directors, it is perhaps even more disconcerting for corporate officers who are not exculpated from mere duty of care violations. Directors and officers participating in change-of-control transactions should be mindful of any financial incentives or other interests that may be viewed to be in tension with their duty to maximize shareholder value in an M&A transaction. To the extent there is even the specter of a conflict of interest, directors and officers are well-advised to consider delegating responsibility to independent outside directors or an independent committee.

Background

In 2009, Occam Networks, Inc., a NASDAQ-listed Delaware corporation, began to consider a possible sale or merger. Occam hired Jeffries & Company as its financial advisor for the project and reached out to potential partners such as Calix, Inc., Keymile International GmbH and Adtran, Inc. Occam's President and CEO, Robert Howard-Anderson, who also served as a director, and Jeanne Seeley, Occam's CFO, were integrally involved in the sale discussions.

During the course of the company's sale discussions, the board instructed Howard-Anderson to allow only a 24-hour window for Adtran to submit a formal offer. Adtran refused to proceed under that deadline. The board also authorized Jeffries to conduct a market check to determine if other potential bidders existed but required that it be completed within a 24-hour period. Five of the seven contacted companies expressed an interest in a possible transaction but stated that the 24-hour timeframe was insufficient to allow a formal response. The board then authorized Occam to enter into an exclusivity agreement with Calix.

After agreeing to exclusivity, Occam realized that its third quarter financial results were trending upward and exceeding earlier predictions. When the exclusivity agreement with Calix lapsed, the board elected to simply renew exclusivity rather than resume sale talks with Calix and other companies in light of the improved financials.

In September 2010, the company announced that it had entered into a merger agreement with Calix, which provided that Occam's shareholders would receive stock and cash at a value that represented a significant premium over the company's current share price. As a result of the merger, Howard-Anderson received more than $800,000 pursuant to a change of control severance agreement.

Shortly after the merger, a group of Occam shareholders filed suit against the directors, Howard-Anderson and Seeley alleging breach of fiduciary duty relating to (1) the sale process and (2) disclosures in the post-merger proxy statement. The plaintiffs' sale process claims alleged that the defendants breached their fiduciary duties by failing to maximize shareholder profit by either demanding a higher sale price from Calix or pursuing alternative transactions given Occam's improved financials. The plaintiffs' disclosure claims alleged that the defendants failed to disclose the full internal projections in the company's proxy statement.

After extensive discovery, the defendants moved for summary judgment.

The Court's Analysis

A. Standard of Review

The Court rejected the plaintiffs' contention that the transaction should be evaluated under the elevated "entire fairness" standard of review, concluding that the majority of the defendants were susceptible only to situational conflicts, rather than actual conflicts sufficient to trigger "entire fairness" scrutiny. Thus, the Court held that the transaction would be reviewed under the "enhanced scrutiny" standard established by the Delaware Supreme Court in its landmark decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* *Revlon* enhanced scrutiny imposes a heightened reasonableness review, which is more searching than the more relaxed rationality review applied to non-interested party transactions under Delaware's business judgment rule standard. Under the *Revlon* standard, defendants bear the burden of demonstrating "both (1) the reasonableness of the decision-making process employed by the directors, including the information on which the directors based their decision, and (2) the reasonableness of the directors' action in light of the circumstances then existing." *Chen*, 87 A.3d at 673. The Court emphasized, however, that *Revlon* requires only a reasonable decision, not a perfect one, and thus courts should not substitute their own business judgment for that of the directors provided the directors' decisions fall within a range of reasonableness.

B. The Defendants' Conduct Falls Outside The Range of Reasonableness

The plaintiffs principally argued that the defendants' conduct fell outside the range of reasonableness because they favored the winning bidder, Calix, over other bidders and failed to adequately pursue alternatives that may have produced higher value for the company's shareholders. In particular, the plaintiffs focused on two specific board decisions: (1) the decision to impose a 24-hour ultimatum on Adtran, and (2) the decision to conduct a 24-hour market check.

The Court first determined that the "record supports a reasonable inference that the [Occam board] favored Calix at the expense of generating greater value through a competitive bidding process." *Id.* at 674. The Court pointed to evidence suggesting a contrast between the directors' and officers' relationship with Calix and their relationship with Adtran. For example, the Court highlighted the fact that negotiations with Calix involved senior Occam executives while negotiations with others involved only Occam's financial advisor. It also cited the board's decision to enter into an exclusivity arrangement with Calix despite the existence of other possible bidders. In addition, the Court found the evidence supported an inference that the board failed to vigorously pursue other bidders. In particular, the Court noted that the narrow, 24-hour window for Adtran to submit a formal proposal and the rushed market check that concluded with a failure to follow up on any resulting interest.

C. The Impact of the Company's Exculpatory Provision

Having concluded that the evidence supported a reasonable inference that the defendants had breached their fiduciary duties, the Court turned to the question whether dismissal of the claims against the directors nonetheless was appropriate given the exculpatory provision in Occam's certificate of incorporation. The company's exculpatory provision tracked Section 102(b)(7) of the Delaware General Corporation Law, which authorizes corporations to exculpate directors for violations of the duty of care but not violations of the duty of loyalty. In order for the exculpatory provision to apply, the director defendants had the burden of demonstrating that the factual basis for the claims against them *solely* implicated a violation of the duty of care.

Relying on the Delaware Supreme Court's decision in *Lyondell v. Ryan*, the director defendants argued that the plaintiffs' allegations were insufficient to support a non-exculpated duty of loyalty claim because they did not establish that the directors "utterly failed to attempt to obtain the best sale price," or, stated differently, "consciously disregarded known obligations imposed by *Revlon*." The Court rejected the defendants' position and clarified that "conscious disregard" is not the only way to establish a non-exculpated claim against directors in a change-of-control transaction.

The Court held that the plaintiffs properly relied on another line of Delaware precedent, which provides that a fiduciary's lack of good faith can be established by demonstrating that he or she acted with a purpose other than advancing the best interests of the corporation. The Court reasoned that this line of precedent is consistent with the underpinnings of enhanced scrutiny, which was created in recognition of the inherent conflict placed on corporate fiduciaries faced with a change-of-control transaction. Indeed, the Court suggested that the plaintiffs' attempt to cabin director liability to a "conscious disregard" of known duties is rooted in a flawed construction of *Revlon* because it assumes the existence of a "specific plan or roadmap" to comply with *Revlon* duties that does not exist. The Court further reasoned that imposing a "conscious disregard" standard would "get things backward" because it would render the enhanced scrutiny test more lenient than the management-friendly business judgment rule. The Court therefore concluded that the plaintiffs could state a non-exculpated claim against the directors if the evidence supported a reasonable inference that they favored interests other than those that would maximize shareholder value.

Applying this standard, the Court acknowledged that a jury could find that some of the directors' conduct fell outside the range of reasonableness, but it concluded that the evidence

did not support an inference that any of the directors acted for an improper purpose, with the exception of Howard-Anderson. Thus, the Court granted summary judgment to the outside directors. As to Howard-Anderson, however, the Court found that the benefits he received pursuant to the change-of-control severance provision were sufficient to support a non-exculpated claim against him.

Moreover, the Court emphasized that Howard-Anderson played a role in the sale process not only as a director, but also as the company's CEO. Likewise, Seeley participated in the sale process not as a director, but as the company's CFO. The Court held that the evidence supported an inference that both Howard-Anderson and Seeley engaged in favoritism toward Calix, the winning bidder, that was consistent with their personal financial interests rather than the pursuit of maximal shareholder value. Because Section 102(b)(7) does not authorize exculpation for officers, the Court held that this evidence was sufficient to support a claim that survived summary judgment.

Conclusion

This decision clarifies existing Delaware law by rejecting "conscious disregard" as the sole basis for establishing a non-exculpated duty of loyalty breach. The decision establishes that directors and officers may be liable to the extent they were motivated by an influence that is not consistent with the maximization of shareholder value. This is a troubling development for corporate officers and directors alike, though the risks may be more acute for corporate officers since Delaware law does not authorize them to be indemnified for due care violations.