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# Mergers And Acquisitions: Board of Director Responsibilities

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

I have written about mergers and acquisitions, including reverse mergers, extensively in the past, but as both traditional mergers and acquisitions and reverse mergers are a large part of my practice, it is a topic worth revisiting and drilling down on regularly. In fact over the past year, the M&A market has been booming with activity. A question that often arises involves the obligations of the board of directors during the merger process.

**Board of Directors' Fiduciary Duties in the Merger Process**

State corporate law generally provides that the business and affairs of a corporation shall be managed under the direction of its board of directors. Members of the board of directors have a fiduciary relationship to the corporation, which requires that they act in the best interest of the corporation, as opposed to their own. Generally a court will not second-guess directors' decisions as long as the board has conducted an appropriate process in reaching its decisions. This is referred to as the "business judgment rule." The business judgment rule creates a rebuttable presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (as quoted in multiple Delaware cases including Smith vs. Van Gorkom, 488 A.2d 858 (Del. 1985)).

However, in certain instances, such as in a merger and acquisition transaction, where a board may have a conflict of interest (i.e., get the most money for the corporation and its shareholders vs. getting the most for themselves via either cash or job security), the board of directors' actions face a higher level of scrutiny. This is referred to as the "enhanced scrutiny business judgment rule" and stems from the Unocal and Revlon cases discussed below, both of which involved hostile takeovers.

A third standard, referred to as the "entire fairness standard," is only triggered where there is a conflict of interest involving directors and/or shareholders such as where directors are on both sides of the transaction. Under the entire fairness standard, the directors must establish that the entire transaction is fair to the shareholders, including both the process and dealings and price and terms.

In all matters, directors' fiduciary duties to a corporation include honesty and good faith as well as the duty of care, duty of loyalty and a duty of disclosure. In short, the duty of care requires the director to perform their duty with the same care a reasonable person would use, to further the best interest of the corporation and to exercise good faith, under the facts and circumstances of that particular corporation. The duty of loyalty requires that there be no conflict between duty and self-interest. The duty of disclosure requires the director to provide complete and materially accurate information to a corporation.

As with many aspects of securities law, and the law in general, a director's responsibilities and obligations in the face of a merger or acquisition transaction depend on the facts and circumstances. From a high level, if a transaction is not material or only marginally material to the company, the level of involvement and scrutiny facing the board of directors is reduced and only the basic business judgment rule will apply. For instance, in instances where a company's growth strategy is acquisition-based, the board of directors may set out the strategy and parameters for potential target acquisitions but leave the completion of the acquisitions largely with the c-suite executives and officers.

Moreover, the director's responsibilities must take into account whether they are on the buy or sell side of a transaction. When on the buy side, the considerations include getting the best price deal for the company and integration of products, services, staff, and processes. On the other hand, when on the sell side, the primary objective of maximizing the return to shareholders though social interests and considerations (such as the loss of jobs) may also be considered in the process.

The law focuses on the process, steps and considerations made by the board of directors, as opposed to the actual final decision. The greater the diligence and effort put into the process, the better, both for the company and its shareholders, and the protection of the directors in the face of scrutiny. Courts will consider facts such as attendance at meetings; the number and frequency of meetings; knowledge of the subject matter; time spent deliberating; advice and counsel sought by third-party experts; requests for information from management; and requests for and review of documents and contracts.

In the performance of their obligations and fiduciary responsibilities, a board of directors may, and should, seek the advice and counsel of third parties, such as attorneys, investment bankers, and valuation experts. Moreover, it is generally good practice to obtain a third-party fairness opinion on a transaction. Most investment banking houses that do M&A work also provide fairness opinions on transactions. Furthermore, most firms will prepare a fairness opinion even if they are not otherwise engaged or involved in the transaction. In addition to adding a layer of protection to the board of directors, the fairness opinion is utilized by the accountant and auditor in determining or supporting valuations in a transaction, especially where a related party is involved. This firm has relationships with many firms that provide such opinions and encourage our clients to utilize these services.

## Delaware Case Law

As with all standards of corporate law, practitioners and state courts look to both Delaware statutes and court rulings to lead the way.

Stemming from Revlon, Inc. vs. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), once a board of directors has made the decision to sell or merge the company, it triggers additional duties and responsibilities, commonly referred to as the "Revlon Duties." The Revlon Duties provide that once a board has made a decision to sell, it must consider all available alternatives and focus on obtaining the highest value and return for the shareholders. The Revlon case focuses on duties in a sale or breakup of a company rather than a forward growth acquisition. A board of directors in a Revlon situation is, in essence, acting as an auctioneer seeking the best return. However, although the premise of Revlon remains, later decisions take into account the reality that the highest return for shareholders is not strictly limited to dollars received.

In the earlier case of Unocal vs. Mesa Petroleum, 493 A.2d 946 (Del. 1985), the court found that a board of directors may take defensive measures in the face of a hostile takeover attempt and may consider the preservation of corporate policy and effectiveness of business operations in defending against a takeover. However, once the board has made the decision that a sale or breakup is imminent, the Revlon Duties are invoked and preservation of corporate policy and operations is no longer a deciding factor.

In the seminal case of Smith vs. Van Gorkom, 488 A.2d 858 (Del. 1985), the Court found that the board was grossly negligent where it approved the sale of the company after only a few hours of deliberation, failed to inform itself of the Chairman's role and benefits in the sale, and did not seek the advice of outside counsel. Similarly in Cede & Co. vs. Technicolor, Inc., 634 A.2d 345 (Del. 1993), the court found that the board was negligent in approving the sale of a company where it did not search for real alternatives, did not attempt to find a better offer, and had insufficient knowledge of the terms of the proposed merger agreement.

On the other hand, the court in In re CompuCom Sys., Inc. Shareholders Litigation, 2005 Del. Ch. LEXIS 145 (Del. Ch. Sept. 29, 2005), upheld the board of directors' business judgment even though the transaction price per share was less than market value, as the board showed it was adequately informed, acted rationally and sought better deals.

In Family Dollar Stores, Inc. Stockholder Litigation, C.A. No. 9985-CB (Del. Ch. Dec. 19, 2014), the court continued to apply the Revlon Duties but supported Family Dollar Stores' decision to reject Dollar General Corp's higher dollar offer in favor of seeking a shareholder vote on Dollar Tree, Inc.'s offer. The court found that the board properly considered all factors, including an evaluation of the relative antitrust risks of selling to either suitor. The court upheld the board's process in determining maximum value for shareholders, and that such determination is not solely based on a price per share value.

**Exculpation and Indemnification**

Many states' corporate laws allow entities to include provisions in their corporate charters allowing for the exculpation and/or indemnification of directors. Exculpation refers to a complete elimination of liability, whereas indemnification allows for the reimbursement of expenses incurred by an officer or director. Delaware, for example, allows for the inclusion of a provision in the certificate of incorporation eliminating personal liability for directors in stockholder actions for breaches of fiduciary duty, except for breaches of the duty of loyalty that result in personal benefit for the director to the detriment of the shareholders. Indemnification generally is only available where the director has acted in good faith. Exculpation is generally only available to directors, whereas indemnification is available to both officers and directors.

To show that a director acted in good faith, the director must meet the same general test of showing that they met their duties of care, loyalty and disclosure. The best way to do this is to be fully informed and to participate in the process, whether that process involves a merger or acquisition or some other business transaction. As mentioned above, courts will consider facts such as attendance at meetings; the number and frequency of meetings; knowledge of the subject matter; time spent deliberating; advice and counsel sought by third-party experts; requests for information from management; and requests for, and review of, documents and contracts.

**Conflicts of Interest – the Entire Fairness Standard**

The duty of loyalty requires that there be no conflict between duty and self-interest. Basically, a director may not act for a personal or non-corporate purpose, including to preserve their job or position.

Some states, including Delaware, statutorily codify the duty of loyalty, or at least the impact on certain transactions. Delaware's General Corporations Law Section 144 provides that a contract or transaction in which a director has interest is not void or voidable if: (i) a director discloses any personal interest in a timely matter; (ii) a majority of the shareholders approve the transaction after being aware of the director's involvement; or (iii) the transaction is entirely fair to the corporation and was approved by the disinterested board members.

The third element listed by the Delaware statute has become the crux of review by courts. That is, where a director is interested, the transaction must be entirely fair to the corporation (not just the part dealing with the director). In determining whether a transaction is fair, courts consider both the process (i.e., fair dealing) and the price of the transaction. Moreover, courts look at all aspects of the transaction and the transaction as a whole in determining fairness, not just the portion or portions of the transaction involving a conflict with the director. The entire fairness standard can be a difficult hurdle and is often used by minority shareholders to challenge a transaction where there is a potential breach of loyalty and where such minority shareholders do not think the transaction is fair to them or where controlling shareholders have received a premium.

To protect a transaction involving an interested director, it is vital that all directors take a very active role in the merger or acquisition transaction; that the interested director inform both the directors, and ultimately the shareholders, of the conflict; that the transaction resemble an arm's-length transaction; that it be entirely fair; and that negotiations are diligent and active and that the advice and counsel of independent third parties, including attorneys and accountants, be actively sought.

A common question I am asked by directors is how to balance the interest of two competing classes of stock (such as common and preferred). In such a case, the business judgment rule will be used, as opposed to the entire fairness standard. Accordingly, a director who is not conflicted and who otherwise takes all measures required (in-depth involvement in the process, review of all documents, advice of outside professionals, seeking highest price for all classes of stock) will be protected from liability.

Delaware courts have emphasized that involvement by disinterested, independent directors increases the probability that a board's decisions will receive the benefits of the business judgment rule and helps a board justify its action under the more stringent standards of review such as the entire fairness standard. Independence is determined by all the facts and circumstances; however, a director is definitely not independent where they have a personal financial interest in the decision or if they have domination or motive other than the merits of the transaction. The greater the degree of independence, the greater the protection. As mentioned, many companies obtain third-party fairness opinions as to the transaction.

The duty to disclose (like other duties) only extends to material facts and circumstances: "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available" (TSC Indus., Inc. vs. Northway, Inc., 426 U.S. 438 (1976)). In the case of a merger or acquisition requiring shareholder vote, for instance, directors must provide shareholders with material information necessary to make an informed decision.

In In Re Pure Res., 808 A.2d 448, the court held that the directors had a duty to disclose to shareholders the substantive work performed and total involvement of investment bankers in pending merger transactions. The court reasoned that this information would assist an investor in determining whether the value being paid was fair. Other courts have concurred with this opinion and specified that shareholders are entitled to see valuation reports and financial projections prepared by investment bankers in a merger transaction, and it is the board of directors' duty to supply this information. Moreover, other courts have held that shareholders are entitled to be informed of financial advisors' roles and compensation in a merger or acquisition transaction.

A director's duty of disclosure is based in state law and is separate and distinct from a company's duty to disclose under both the Securities Act of 1933 and Securities Exchange Act of 1934. Whereas the state law duty to disclose supports private causes of action, including possible class action lawsuits, the federal duty supports both private causes of action (including class actions) and regulatory enforcement proceedings.

**Conclusion**

In advising the board of directors, counsel should stress that the director be actively involved in the business decision-making process, review the documents and files, ask questions and become fully informed. The higher the level of diligence, the greater the protection. Significantly, it is not important whether the decision ultimately turns out to be good or bad. Hindsight is 20/20. The important factor in seeking protection (via the business judgment rule, and through exculpation and indemnification) is that best efforts are made. Of course, directors should be careful to document their diligence.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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