FROM THE CHAIR
By Richard E. Climan

Our Committee will meet at the Fairmont Hotel in San Francisco on Sunday afternoon, August 10th, in conjunction with the Annual Meeting of the American Bar Association. Our Committee meeting will be preceded by separate task force and working group meetings throughout the day Saturday and on Sunday morning, including the inaugural meeting of our newest task force – the M&A Dictionary Task Force (chaired by David Katz) – on Saturday afternoon.

In an effort to expand the substantive content of our full Committee meetings, I have taken the liberty of extending the length of these meetings by an extra half hour, so that we will be able to devote more time to discussing current developments of interest to M&A practitioners. At the August meeting, Joel Greenberg will lead a discussion of the Third Circuit’s recent decision in AES v. Dow Chemical (which may affect the way auction sales of corporate subsidiaries are run); Mark Morton and Patricia Vella will lead a debate on the impact of the Delaware Supreme Court’s recent Omnicare decision on private company acquisitions; and Jon Hirschoff and Scott Whittaker (the co-chairs of our Subcommittee on Recent Judicial Developments) will lead a discussion of the ramifications of the recent Lawton and Neubauer...
decisions, which are summarized elsewhere in this issue.

Immediately following our full Committee meeting on August 10th, Henry Lesser, Keith Flaum, Steve Bigler and Dennis Garris will present a Committee Forum program entitled “What’s So Hot About Going Private? Going Private Transactions Involving Small-Cap Companies.” Our Committee is sponsoring or co-sponsoring three other programs in San Francisco: “Acquiring a European Business: Effective Negotiating Strategies”; “Ringmasters’ Secrets: Effective Partnering Between Inside and Outside Counsel on M&A Deals”; and “IP: Making or Breaking the Business Deal: Practical Methods for Overcoming Obstacles.” You can find descriptions of these programs in the report by Neal Brockmeyer, the newly-appointed co-chair of our Programs Subcommittee, elsewhere in this issue.

Our Committee cocktail reception and dinner will take place on Saturday evening, August 9th, in the upper reaches of the Bank of America Building on California Street. Unless the fog rolls in, those of you attending can count on a truly spectacular view of the City. Please submit your registration form if you have not already done so, as space is limited. Many thanks to Henry Lesser for organizing this event.

We will hold our Fall stand-alone meeting (and related festivities) at the Park Hyatt Hotel in Toronto on Friday, October 17th, and Saturday, October 18th. Our Toronto contingent, led by Alison Youngman, will provide additional details at our meeting in San Francisco.

See you in San Francisco.

FEATURE ARTICLE

ANALYZE THAT:
3rd ANNUAL DEAL POINTS STUDY

By
Wilson Chu and Larry Glasgow

You’re in the final stages of negotiating that acquisition agreement and your client asks: “So what’s ‘market’ for an indemnity basket?”

As we all know, there are four principal places from which to pull that answer. One obvious place you know about, and we prefer not discuss here for fear of offending. The second place is from your own anecdotal experience (i.e., what you are actually experiencing in your own deals). The third place has its roots in urban legend (i.e., from your general awareness of other peoples’ anecdotal experience). The fourth place is: our Deal Points Study, which hopefully is a kind of (what do you expect from a bunch of lawyers?) scientific study of middle market, private company acquisitions.

This is the third year of our Deal Points Study, in which we attempt to separate fact from fiction as to how certain acquisition deal points are really being negotiated. In this year’s Study (consistent with our studies for deals done in 2000 and 2001), we reviewed acquisition agreements

1 This article originally appeared in the April 2003 issue of The M & A Lawyer and is reprinted here with the publisher’s permission.
2 Wilson Chu is a partner in the Dallas office of Haynes and Boone, LLP. Lawrence E. Glasgow is a partner in the Dallas office of Gardere Wynne Sewell LLP. The authors gratefully acknowledge the assistance of Gardere partner, Patrick Kinder, Haynes and Boone associates Brandon Satterwhite, Paul Kirkpatrick, Jay Washburn, and Barrett Howell, and Gardere associates Kim Dennis, Gabe Vazquez, and Jeremy Williams.
from the *EDGAR* database, analyzing acquisitions of private companies by public acquirers that were completed in 2002 and that had transaction values ranging from $25 million to $150 million. This year’s sample yielded 88 deals that were suitable for our review.

Our Study analyzed numerous M&A deal points, ranging from MAC walk rights to escrows. For the purposes of this article, however, we will focus on only a few of the Study’s findings, as well as impart to you some of our humble observations. For the sake of brevity (and our sanity), this article will assume that the reader has better-than-pedestrian knowledge of M&A terms and concepts.

**Survival of Representations and Warranties**

One of the most critical deal points in any M&A transaction is the time period during which the seller’s representations and warranties survive the closing and the related post-closing time period during which the purchaser may assert an indemnification claim based on a breach of the seller’s representations and warranties. Our Study found that, in 2002, survival periods were again heavily weighted (about 66%) between 12 and 24 months, with 12 months being the most common and 24 months being the runner-up. This is consistent with the conventional wisdom that it is reasonable for the purchaser to have at least one full post-closing annual audit period to discover breaches, hidden liabilities, or other reasons for an indemnification claim.

As you know, the due diligence process regarding the target’s business is extremely important in the M&A arena. But how does the purchaser’s knowledge acquired in the due diligence process (or otherwise) affect the purchaser’s right to rely on the seller’s representation and warranties with regard to indemnification, walk rights, and other remedies?

Our Study shows that 59.1% of deals expressly reserved the right to rely on the seller’s representation and warranties to the purchaser - notwithstanding the purchaser’s knowledge of an inaccuracy in the seller’s representation and warranties. Because such provisions may be viewed by the cautious seller as an invitation for the purchaser to “close-and-sue,” these types of provisions are sometimes affectionately known as “sandbagging” clauses (the purchaser would, of course, prefer to call them “benefit-of-the-bargain” clauses). The following chart compares the results of three (2000, 2001, and 2002) studies on the effect of the purchaser’s knowledge:

Typical wording runs the gamut from stealthy provisos stating that “the seller’s representations and warranties survive the Closing and *any* investigation conducted by the purchaser” to the more detailed provisions that not only deal with issues such as constructive knowledge, but also stand out and say “HEY LOOK, COME NEGOTIATE ME!” such as:

“Effect of Investigation. Any due diligence review, audit or other investigation or inquiry undertaken or performed by or on behalf of Purchaser shall not limit, qualify, modify or amend the representations, warranties or covenants of, or indemnities by, any Seller made or undertaken pursuant
to this Agreement or any Related Agreement, irrespective of the knowledge and information received (or which should have been received) therefrom by Purchaser.” (Corvis Corporation/Algety Telecom S.A.)

An aggressive seller may attempt to include a so-called “anti-sandbagging” provision that precludes an indemnity claim by the purchaser for breaches known by the purchaser before closing. An example of such a clause is:

“Notwithstanding anything herein to the contrary, none of the Buyer Indemnified Parties shall be entitled to indemnity from the Escrow Account or otherwise under Section 9.01 hereof with respect to, and the Equityholders shall not otherwise be liable for, any matter (other than the HIG Dispute) of which Buyer had actual knowledge at or prior to the Closing.” (Integrated Circuit Systems/Micro Networks Corporation)

Our Study found 6 deals in 2002 (6.8% of the deals reviewed) with anti-sandbagging clauses compared with 5 deals (5.88%) in 2001 and only 1 deal in 2000. As such, we’ll stick our necks out with the observation that this slight upward trend may be an indication of sellers having more success at the negotiation table. Interestingly, about 34% of the deals in our Study were silent on this investigation-survival issue. Assuming that it is a virtually standard practice for the purchaser’s first draft to include a benefit-of-the-bargain provision, silence on this issue may still be a “win” for the seller because it could mean that the seller was successful at negotiating out that clause. At the very least, we can expect this issue to continue receiving more attention at the negotiation table.

For a detailed analysis of the legal and practical arguments regarding benefit-of-the-bargain and anti-sandbagging clauses, you would be well served to refer to the Commentary to Section 11 of the ABA’s new Model Asset Purchase Agreement authored by the ABA’s Committee on Negotiated Acquisitions.

**How Much Knowledge?**

M&A lawyers take great pride in riddling an acquisition agreement with knowledge qualifiers. Our Study examined the level of knowledge and investigation requirements actually negotiated into deals. We found that about 58% of the deals defined knowledge to mean actual knowledge. Out of this “actual knowledge” group, 38% required “reasonable investigation,” 21.6% required “due or diligent investigation,” and 31% did not specify any investigation requirement. The more aggressive “constructive knowledge” requirement only made it into about 14.8% of the deals. On the other hand, 29.5% of the deals used knowledge without a specific definition.

**Indemnity Baskets**

A deal is not a deal unless we have a heated debate about indemnification baskets. First, our Study found that, out of the agreements having baskets, 52% were of the deductible variety and 48% were of the first-dollar basket variety. An interesting trend that we observed was the increased use of “double-trigger” baskets, which effectively set two (or more) standards of materiality. The following is an example of a double-trigger basket:

“No amounts of indemnity shall be payable as a result of claims arising under Section 7.1(a)... (i) which involve Losses of less than $15,000 individually and (ii) unless and until all Losses in excess of $15,000 for which indemnification has been claimed pursuant to such section exceeds $250,000 in the aggregate, in which event (x) such Indemnified Parties shall be entitled to seek indemnity from the applicable Indemnifying Parties for the aggregate amount of all Losses in excess of $250,000 previously incurred and (y) all Losses incurred...
thereafter without regard to amount.” (C.M. Offray & Son, Inc./Berwick Industries, Inc)

Second, our Study continues to challenge conventional wisdom that baskets generally run 1% to 2% for middle market deals. In fact, our review found that 75% of the deals have baskets of 1% or less, with two-thirds of that subset being $\frac{1}{2}$% or less. Only 13.2% of the deals we reviewed were in 1% to 2% range. This is consistent with our studies for 2000 and 2001 deals.

**INDEMNITY CAPS**

So, are purchase price caps considered “market?” Yes – but only 22.6% of the time. Our Study found that within the deals-with-caps subset, 77.3% had caps that were less than the purchase price. The following chart shows the breakdown of caps as a percentage of transaction value:

Before you go out - with your seller’s hat on - to tell the world that purchase-price caps have gone the way of the dinosaur, keep in mind that our Study consists of a limited and skewed universe: public acquirers-private targets, with most deals having a significant stock consideration component. Falling back onto our anecdotal and urban legend evidence, we would not be surprised to see the purchase-price cap reigning supreme in an all-cash, private/private deal. That’s our story, and we’re sticking to it!

**SOMETIMES IT’S NOT OVER EVEN WHEN IT’S OVER**

Everyone knows that the best-laid plans will not prevent a deal from unraveling. So, when your client asks you if this transaction should have a termination fee - and if so, what size is reasonable, you can tell your client that the Study reveals that approximately 7.5% of the profiled transactions provided for termination fees. In answer to the second part of the question, as a percentage of the transaction value, the termination fees ranged from 1.7% to a sizable 14.8%, with the average termination fee being approximately 4.9% of transaction value. All of these percentiles remained generally consistent with last year’s numbers.

**REACTIONS TO RECENT CORPORATE SCANDALS**

In view of recent troubles harkened by the likes of Enron and WorldCom, we were on the lookout for any provisions that would appear to have been drafted in recognition of (or perhaps, in reaction to) those and similar recent events. Interestingly, we found very few specific instances where the issues giving rise to the recent meltdowns (e.g., off-balance sheet liabilities and revenue recognition) were addressed, leaving us to acknowledge that most properly drafted acquisition documents already address such issues and that, in reality, no amount of documentation can save you completely from full scale fraud. One transaction did address these issues in the financial statements representation and warranty in a fairly broad manner:

“Except for obligations and liabilities reflected in the Financial Statements, [the Company] has no material off-balance sheet obligation or liability of any nature (matured or unmatured, fixed or contingent) to, or any financial interest in, any third party or entities, the purpose or effect of which is to defer, postpone, reduce or otherwise avoid or adjust the recording of debt expenses incurred by [the
Yet another transaction took, in our opinion, a very specific approach to the representation and warranty addressing recognition of revenue in a software company deal:


(Oak Technology, Inc/Teralogic, Inc.)

We are not software company acquisition experts, but that seems pretty darn specific to us!

Conclusions? We Don’t Need No Stinkin’ Conclusions

What can you conclude from the Study? The specific conclusion would appear to be that each deal point analysis provides its own conclusion. As such, we encourage you to access, at no cost, a complete copy of the Study. Then you can draw your own conclusions in the areas that interest you. With that said, the only general conclusion that we can offer you is that we will be back next year with more of this riveting stuff and if you, like us, think this is riveting … well, that’s a conclusion in and of itself.

THE (NO LONGER) OVERLOOKED DUTY OF GOOD FAITH UNDER DELAWARE LAW

By: John F. Grossbauer
Nancy N. Waterman

Introduction

In the Delaware Court of Chancery’s recent opinion in the Walt Disney Company derivative litigation, the Court found that plaintiffs stated a valid claim of personal liability against the Disney directors in connection with their approval of employment and severance agreements with former president Michael Ovitz. This case is significant, not only because it is one of the few cases in which plaintiffs have successfully pleaded excessive compensation claims against a disinterested board, but also because the decision is one of the few cases that explores the duty of directors to act in good faith. The Disney case, together with other recent developments, suggests an increased focus by the Delaware courts on this duty. However, the contours of the duty of good faith have not been fully explored. This article will attempt to summarize the case law concerning the duty of good faith, and to make some general observations about the circumstances in which there may be a risk that the duty will be violated. The article

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If you would like a copy of the complete Study, please email either of us: Wilson Chu - Wilson.Chu@HaynesBoone.com or Larry Glasgow - lglasgow@gardere.com.
concludes that the duty of good faith continues to function as a “safety valve” to capture conduct by disinterested directors that is aberrational or that amounts to an abdication of their duty to oversee the business affairs of the corporation.

Fiduciary Duties Generally

In carrying out their central responsibilities, directors have an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of the corporation’s stockholders.\(^6\) Traditionally, those fiduciary duties were characterized as duties of due care and of loyalty. More recently, however, the Delaware Supreme Court clarified that this unyielding fiduciary responsibility involves a “triad” of duties: due care, good faith, and loyalty.\(^7\)

The duty of due care requires that directors act in a fully-informed manner and with the requisite level of care dictated by the particular circumstances.

The duty of loyalty requires that directors act unselfishly; the best interests of the corporation and its stockholders must take precedence over any interest possessed by a director personally and not shared by the stockholders generally.

The duty of good faith was recognized as a distinct directorial duty in Cede & Co. v. Technicolor, Inc.\(^8\) The duty of good faith requires that directors act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. Since that time, however, its contours have not been fully developed.

The Delaware Supreme Court has emphasized that this tripartite “fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its stockholders must be guided.”\(^9\)

The Increasing Significance of the Duty of Good Faith

The impetus for an increased focus on the duty of good faith is the availability of damages as a remedy against directors who are found to have acted in bad faith. Section 102(b)(7) of the Delaware General Corporation Law (the “DGCL”) authorizes corporations to include in their certificates of incorporation a provision eliminating or limiting directors’ liability for breach of the fiduciary duty of due care.\(^10\) However, Section 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith or breaches of the duty of loyalty.\(^11\)


\(^8\) 634 A.2d 345, 361 (Del. 1993).

\(^9\) Malone, 722 A.2d at 10.

\(^10\) 8 Del. C. § 102(b)(7).

\(^11\)Specifically, Section 102(b)(7) authorizes the inclusion in a certificate of incorporation of:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [dealing with the unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit....
Because corporate governance reforms initiated by stock exchanges (and, in some cases, mandated by the Sarbanes-Oxley Act) will require public companies to populate their boards with a predominance of independent directors, duty of loyalty cases may become more difficult to pursue. Thus, plaintiffs may be encouraged instead to explore duty of good faith claims as an alternative rationale for demand futility arguments.

A finding of a lack of good faith has profound significance for directors not only because they may not be exculpated from liability for such conduct, but also because a prerequisite to eligibility for indemnification under Section 145 of the DGCL is that the directors must have acted “in good faith and in a manner the person reasonably believed was in or not opposed to the best interests of the corporation.” Accordingly, a director who has breached the duty of good faith not only is exposed to personal liability, but also may not be able to seek indemnification from the corporation for any judgment obtained against her or for expenses incurred in (unsuccessfully) litigating the issue of liability. In contrast, it is at least theoretically possible that a director who has been found to have breached his or her duty of loyalty could be found to have acted in good faith and, therefore, be eligible for indemnification of expenses (and, in non-derivative cases, amounts paid in judgment or settlement) by the corporation.

8 Del. C. § 102(b)(7).

12 See Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (demand required prior to initiating derivative suit unless majority of board is interested or the decision was not the “product of a valid exercise of business judgment”).

13 8 Del. C. §§ 145(a) and (b).

14 See Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (directors found to have acted in good faith but nevertheless breached their duty of loyalty).

Thus, in cases involving decisions made by directors who are disinterested and independent with respect to a transaction (and, therefore, the duty of loyalty is not implicated), the duty of good faith provides an avenue for asserting claims of personal liability against the directors. Moreover, these claims, if successful, create barriers to indemnification of amounts paid by directors in judgment or settlement. However, given the paucity of case law focusing on the meaning of “good faith” (and the fact that good faith was not specifically identified as a separate fiduciary duty until 1993), claims of a lack of good faith have been only rarely litigated.

Renewed Focus on Good Faith.

In the wake of numerous corporate governance scandals, the duty of good faith has been the focus of renewed attention. This attention was heightened by public statements by sitting members of the Delaware judiciary, who have spoken of good faith as a potential avenue for plaintiffs seeking to challenge decisions made by facially disinterested and independent boards of directors.

Chief Justice Veasey, in remarks made in a roundtable discussion of CEO compensation, focused on the duty of good faith as offering a theory that potential plaintiffs might successfully present, at least at the pleading stage:

If directors claim to be independent by saying, for example, that they base [compensation] decisions on some performance measure and [then] don’t do so, or if they are disingenuous or dishonest

15 The availability of directors and officers liability insurance also may be brought into question by a finding of bad faith. Policies often contain exclusions that could be cited by carriers as a basis for denying coverage.
about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of ... good faith.16

Vice Chancellor Strine sounded a similar theme in a recent Business Lawyer article. In that article, the Vice Chancellor explored how the Enron debacle might exert pressure on courts to look more carefully at whether directors have made a good faith effort to accomplish their duties.17

Vice Chancellor Strine noted that, apart from its influence on the independent director debate, Enron will also generate increased pressure on courts to examine carefully the plausibility of directors’ claims that they were able to devote sufficient time to their duties to have carried them out in good faith.

It has, of course, become common for courts to examine board processes carefully in the high-profile context of fast-moving take-over contests. [citations omitted] But Enron and situations like it suggest to me that skillful plaintiffs’ lawyers will begin making common-sense arguments about the disconnect between the routine tasks directors undertook to perform and the effort they put into accomplish [sic] them.18

The Vice Chancellor noted that these arguments might sharpen the importance of “state of mind” determinations. He concluded that the most significant reason this is so is because of the prevalence of exculpatory charter provisions adopted under Section 102(b)(7). Because accounting fraud cases such as Enron’s usually arise after it is too late for prospective injunctive relief to be of much use, these provisions are important to litigators, because “in the absence of evidence that the outside directors had a financial interest in the underlying misconduct, they force plaintiffs’ counsel to challenge the state of mind (i.e., the good faith) of the outside directors.”19

The question, therefore, becomes: In what type of conduct must a director engage to be found guilty of a breach of the duty of good faith? Case law, including the recent Disney case, provides some guidelines (and some measure of comfort to reasonably attentive boards of directors).

Delaware Case Law Discussing the Duty of Good Faith.

Early Cases. The concept of “good faith” found expression in early Delaware case law. However, because the modern business judgment rule had not yet been fully developed, the concept of good faith was not separately explored. Rather, good faith was simply stated as a prerequisiste to a court’s deference to a board’s decision, which would only be disregarded in cases of “fraud.”

Thus, in Bodell v. General Gas & Electric Corp.,20 the Delaware Supreme Court, in language similar to the modern business judgment rule, stated that it would defer to board decisions unless they were tainted by fraud, “actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the Corporation and the rights of its stockholders.” Because there was no evidence that the directors did not “use their honest and best judgment,” the directors were found to have acted “in good faith, in the exercise of their best judgment, and for what they believed to be the advantage of the corporation and all its stockholders.”

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16 Useem, Overpaid CEOs? Try Suing the Paymasters, Fortune (Dec. 19, 2002).
18 Id. at 1385.
19 Id. at 1385-86.
20 140 A.2d 264, 267-68 (Del. 1920).
The use of “fraud” to describe the absence of good faith was also found in Allied Chemical & Dye Corp. v. Steel & Tube Co. of America.\(^{21}\) In that case, minority stockholders petitioned to enjoin a sale of assets promoted and approved by majority stockholders. Once again, while the Court approached the issue as one of “fraud,” it did so using language similar to more recent articulations of the business judgment rule. In denying the injunction, the Court reasoned that “so long as the [alleged] inadequacy of price may reasonably be referred to as an honest exercise of sound judgment, it cannot be denominated as fraudulent. When the price proposed to be accepted is so far below what is found to be a fair one that it can be explained only on the theory of fraud, or a reckless indifference to the rights of others interested, it would seem that it should not be allowed to stand.” Id. at 494.

A similar analysis was employed in Allaun v. Consolidated Oil Co.,\(^{22}\) which involved a challenge to the adequacy of consideration for a sale of assets: “The disparity must be sufficiently great to indicate that it arises not so much from an honest mistake in judgment concerning the value of the assets, as from either improper motives underlying the judgment of those in whom the right to judge is vested or a reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders including of course the minority.”

**Bad Faith as Overcoming the Business Judgment Rule.**

In more recent times, Delaware courts carried forward the theme of the early cases that inferred “fraud” from aberrational conduct. However, rather than characterizing such conduct as fraudulent, these decisions characterized conduct by disinterested directors that was sufficiently egregious or “irrational” so as to justify overcoming the deference normally accorded to informed decisions by disinterested directors pursuant to the business judgment rule as having been taken in “bad faith.”

Chancellor Allen’s analysis of a claim of bad faith conduct by disinterested directors in In re RJR Nabisco, Inc. Shareholders Litig.,\(^{23}\) provides some guidance as to the type of conduct that might constitute a breach of the duty of good faith. It illustrates the difficulty courts have in divining subjective motivation (good faith or bad faith) from objective facts, and suggests that conduct must be fairly egregious in order to rise to the level of “bad faith.”

In RJR, plaintiffs sought to enjoin the closing of a pending tender offer that was intended to be followed promptly by a merger. No member of the board appeared to have an interest in the transaction. Plaintiffs’ theory of breach of the duty of good faith was that the directors were in fact not motivated to try to achieve the best available transaction for the benefit of the shareholders but were inappropriately motivated to be seen publicly as repudiating the Company’s management because the directors sought to disassociate their names from the harsh criticism that management's actions had engendered.\(^{24}\) Thus, plaintiffs argued that the directors’ were inappropriately motivated to favor one bidder even if it allegedly meant not getting the best available transaction for the corporation’s shareholders. The directors’ financial advisors had told the directors that the two competing offers were substantially equivalent in value. The plaintiffs argued that if the directors had been properly motivated, they would have sought to break the tie between the two bidders instead of accepting the non-management offer.\(^{25}\)

The Court determined that the fact that the board was faced with what it could reasonably

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\(^{21}\) 120 A. 486 (Del. Ch. 1923).

\(^{22}\) 147 A.257, 261 (Del. Ch. 1929).


\(^{24}\) Id. at *2.

\(^{25}\) Id. at *15-16.
believe were bids that were essentially equivalent from a financial point of view was a relevant circumstance is assessing its good faith in acting as it did.\textsuperscript{26} The Court also found it especially relevant that the directors had been placed under severe time constraints by the non-management bidder (they had been given thirty minutes to accept the bid on pain of its being withdrawn.). Chancellor Allen concluded: “In the light of these circumstances, the decision not to attempt to break the tie but to accept one of the bids at that point and thus avoid the risk of the loss of that bid – no matter that my personal view might be that the risk was rather small – can in no event be seen as justifying an inference that those who made such a choice must have had some motivation other than the honest pursuit of the corporation’s welfare.”\textsuperscript{27} The Chancellor also determined that the decision to prefer the non-management bid could not be viewed “as so beyond the bounds of reasonable judgment as to raise an inference of bad faith…; the judgment reached does not, as indicated, appear so far afield as to raise a question of the motivation of the board.”\textsuperscript{28}

Chancellor Allen’s analysis of good faith attempted to harmonize the “fraud” cases with those focusing on the rationality of a board’s decision:

True irrationality is unlikely to be encountered when boards of directors of large enterprises act deliberately, after receiving the advice of professionals… It might be suggested that in such a setting, action that obviously is not ‘rationally’ designed to maximize corporate or shareholder interests, is best understood as a ‘rational’ breach of the duty to proceed in the good faith pursuit of appropriate interests.\textsuperscript{29}

So viewed, the limited substantive review that the business judgment rule contemplates “(i.e., is the judgment under review ‘egregious’ or ‘irrational’ or ‘so beyond reason,’ etc.) really is a way of inferring bad faith.”\textsuperscript{30}

In re J.P. Stevens & Co., Inc. Shareholders Litig.\textsuperscript{31} represents another articulation of an analysis in which a court pointed to “irrational” conduct as evidence of improper motivation that might also be characterized as having been taken in bad faith.

The Court noted that the policy of the business judgment rule prevents substantive review of the merits of a business decision made in good faith and with due care. “A court may, however, review the substance of a business decision made by an apparently well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.”\textsuperscript{32} The Court remarked that this “escape hatch” language has been variously stated in Delaware case law: “egregious” decisions are said to be beyond the protections of the business judgment rule, as are decisions that cannot “be attributed to any rational business purpose”, or decisions that constitute “a gross abuse of discretion.”\textsuperscript{33}

\textsuperscript{26} Id. at *17.
\textsuperscript{27} Id. at *17 (citing In re J.P. Stevens & Co., Inc. Shareholders Litig., 542 A.2d 770, 780, at n.5).
\textsuperscript{28} Id. at *18.
\textsuperscript{29} Id. at *21.
\textsuperscript{30} Id. at *22, n.13 (Del. Ch. 1989) (citing Allied Chemical & Dye Corp. v. Steel & Tube Co., 120 A. 486, 494 (Del. Ch. 1923); Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929)).
\textsuperscript{31} 542 A.2d 770 (Del. Ch. 1988).
\textsuperscript{32} Id. at 780-81 (emphasis in the original).
\textsuperscript{33} Aronson v. Lewis at 805 (“egregious" decisions); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (no rational purpose); Warshaw v. Calhoun, 221 A.2d 487 (Del. 1966) (gross abuse of discretion). See also Kaplan v. Goldsamt, 380 A.2d 556, 567 (Del. Ch. 1977); Gimbel v. The Signal Companies, 316 A.2d 599, 610 (Del.
In contrast, the decision of the Court of Chancery in In re Holly Farms Corp. Shareholders Litig.\textsuperscript{34} illustrates a judicial reluctance to infer improper motives from even aberrational conduct. In Holly Farms, a potential bidder for and certain stockholders of a target corporation sought a preliminary mandatory injunction to enjoin the effectuation of provisions for an asset option lock up, termination fee and expense reimbursement contained in a merger agreement. They also sought to compel the corporation to redeem a stock rights plan. The essence of the claim was that the board did not conduct an auction of the company and therefore failed to attempt to maximize shareholder value upon the sale of the corporation.\textsuperscript{35}

The Court found that because the board did not utilize proper procedures designed to maximize the value of the corporation after the board decided to sell it, a preliminary injunction was warranted. The Court found that the board did not make any serious effort to negotiate with another bidder who had expressed interest nor had it encouraged that bidder to put its best offer on the table. Especially significant to the Court was that the board refused to tell that bidder in the face of direct questioning whether the corporation was to be sold.\textsuperscript{36}

The Court concluded:

Even if the Board thought it was acting in good faith, the sale process itself was so substantially flawed that the Board’s actions, considering all the facts and circumstances, were not likely to have maximized the value of the corporation for its shareholders and, therefore, its actions cannot be viewed as being rational.\textsuperscript{37}

* * *

There may be some theoretical appeal to the proposition that unless a court can ascertain some subjective intention by a board to do wrong, a facially objective board should be given unfettered leave to conduct an auction as it pleases or displeases. I, however, have seldom been able to ascertain the subjective intent of board members except by reviewing the objective effect of their acts and I do not believe that it is possible for a court to meaningfully review an auction except by reviewing the objective procedures used.\textsuperscript{38}

In Cinerama, Inc. v. Technicolor, Inc.,\textsuperscript{39} the Delaware Supreme Court articulated good faith as one of a “triad” of fiduciary duties, the others being due care and loyalty. While the Court did not articulate in that case the standard by which good faith would be measured, the Court did cite Allaun, supra, which spoke in terms of “improper motivation,” or “reckless indifference” to the interests of all stockholders as being necessary to overcome a court’s natural deference to board decision making authority.

Post-Cinerama Cases.

In In re Caremark Intern. Inc. Derivative Litig.,\textsuperscript{40} the Court approved a proposed settlement of claims that members of the board breached their fiduciary duty of care in connection with alleged violations by company employees of federal and state laws and regulations. Specifically, the claim was that the directors allowed a situation to develop and

\begin{itemize}
  \item \textsuperscript{34} 1988 WL 143010 (Del. Ch. Dec. 30, 1988).
  \item \textsuperscript{35} 1988 WL 143010, at *1, 3-4.
  \item \textsuperscript{36} Id. at *5.
  \item \textsuperscript{37} Id. at *5 (emphasis added).
  \item \textsuperscript{38} Id. at *9 (emphasis added).
  \item \textsuperscript{39} 634 A.2d 345 (Del. 1993)
  \item \textsuperscript{40} 698 A.2d 959 (Del. Ch. 1996)
\end{itemize}
continue that exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance. While the claim was framed as involving due care, the Chancellor’s articulation of the standard for proving a breach of that duty (at least in cases involving the “duty to monitor” performance) was expressed in terms of good faith: “Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation..., in my opinion only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.”

The Court found that the breach of duty of care claim was extremely weak because the record did not support the conclusion that the defendants either lacked good faith in the exercise of their monitoring responsibilities or consciously permitted a known violation of law by the corporation to occur.

Vice Chancellor Strine articulated a similar view in his analysis of Caremark: “That opinion is most often cited to emphasize the duty of directors to exercise due care in monitoring the corporation’s compliance with legal standards—including standards of fair disclosure of the corporation’s financial health. But Caremark also suggests that directors should only be held personally liable for a failure to monitor if their laxity in oversight was so persistent and substantial that it evidences bad faith.”

The Vice Chancellor then posited the potential use of this standard by plaintiffs’ lawyers in the post-Enron environment: “[O]ne can see how plaintiffs’ lawyers might approach ‘duty to monitor’ cases somewhat differently in the near future. They might well ask courts to infer not only that audit committee members did not know enough about their company’s financial and accounting practices, but also that the committee members knew that their inadequate knowledge disabled them from discharging their responsibilities with fidelity. Stated crudely, the court will be called on to conclude that a director who is conscious that he is not devoting sufficient attention to his duties in not acting in good faith, and is therefore not entitled to exculpation from damages liability.”

In Strassburger v. Earley, 752 A.2d 557 (Del. Ch. 2000), a minority shareholder brought a derivative action claiming the board breached its fiduciary duty by arranging for the corporation to repurchase 83% of its outstanding stock, resulting in the transfer of control to the corporation’s president. The Court subjected the repurchase transactions to entire fairness review because the controlling stockholders and the directors stood on both sides of the transaction. However, in the course of his analysis, Vice Chancellor Jacobs engaged in a discussion of individual director culpability that may provide some guidance in distinguishing breaches of the duty of good faith from breaches of the duties of loyalty or due care.

Focusing first on the duty of loyalty, the Court found that the two directors nominated by one of the former controlling stockholders were not themselves unjustly enriched and did not otherwise obtain a personal benefit at the shareholders’ expense. “Nor is there evidence that the two directors conspired with [the president] in the sense that they acted intentionally and in bad faith

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41 Id. at 971 (emphasis added).
42 Id. at 972.
43 Strine, 57 Bus. Law at 1386 (citation omitted) (footnote omitted).
44 Id. at 1394 (acknowledging that courts will deal sensitively with arguments of this kind and err on the side of directors when close questions arise)
(emphasis added) to enable him wrongfully to benefit at the corporation’s expense.” Nonetheless, the Court found that they had breached their duty of loyalty in approving the repurchases. “Their sin was not one of venality, but rather, of indifference to their duty to protect the interests of the corporation and its minority shareholders. Stated differently, because their primary loyalty was to the interest of their employer, Triton [the controlling stockholder], in exiting [the corporation], [these two directors] were willing to subordinate those interests to [the president’s]. The inevitable consequence was that [the two directors] gave priority to Triton’s interest, and ignored their fiduciary obligation as [the corporation’s] directors to assure that all [the corporation’s] stockholders would be treated fairly.”

In analyzing the conduct of a director who was unaffiliated with either the former controlling stockholder or the president, Vice Chancellor Jacobs again equated bad faith with intentional conduct injurious to the corporation. The Court defined bad faith as deliberate action to benefit the majority stockholders at the expense of the minority and found that the director had not acted in bad faith. “Rather, [at best, [his] belief that he was furthering the interests of all [the corporation’s] shareholders was misguided, and at worst, it was misinformed, i.e., was not the product of due care.”

Thus, as in Caremark, the Court in Strassburger set a high standard for a finding of bad faith by an otherwise disinterested and independent director.

The Disney Opinion

In Disney, Chancellor Chandler refused to grant a motion to dismiss a complaint seeking to hold the directors of The Walt Disney Company personally liable for damages to the Company allegedly arising out of the hiring and termination of Michael Ovitz as Disney’s President. While the Court’s finding that the complaint adequately alleged facts overcoming the business judgment rule protection of a disinterested board of directors is unusual, the opinion is consistent with the views expressed in earlier cases and commentary, which suggested that “bad faith” only will be found in fairly egregious circumstances.

The amended complaint in the Disney case painted a picture of complete director abdication of authority on a subject of importance to the corporation: the hiring and firing of its President. The complaint alleged that, when Mr. Ovitz was hired, the Compensation Committee and the Board paid scant attention to the terms of his employment, leaving the details instead to be negotiated by Mr. Ovitz and his “close friend,” Michael Eisner, Disney’s Chief Executive Officer. The complaint alleged that the Compensation Committee and the full Board both failed to review any drafts of the employment agreement, spent very little time considering the agreement at their respective meetings, and neglected to obtain expert advice concerning the reasonableness of the generous terms granted to Mr. Ovitz. Moreover, while the final agreement differed materially from the terms

45 Id. at 581 (emphasis in the original).
46 Id. at 582.
47 Id.

48 The Disney opinion discussed above focused on an amended complaint filed by plaintiffs after their initial complaint was dismissed for failure to adequately plead breaches of fiduciary duty. Brehm v. Eisner, 746 A. 2d 244 (Del. 2000). The Supreme Court’s decision expressly found that a majority of the Disney board (including Michael Eisner) was disinterested in the challenged transaction, and prohibited plaintiffs from relitigating that issue. Thus, plaintiffs were required to plead facts sufficient to overcome the presumption of the business judgment rule.

49 The Chancellor expressly noted that the discussion of Mr. Ovitz’s hiring took up 1 ½ pages in the 15 pages of minutes of the meeting at which it was approved, and much of that discussion centered on a “finder’s fee” to be paid to another director. Disney, Mem. Op. at 23.
summarized for the Compensation Committee, in particular regarding termination, no further Board or Committee discussion occurred. With respect to Mr. Ovitz’s termination, the complaint alleged that the Board took a similar “ostrich-like approach.” Indeed, the complaint alleged there was no input from, or review by, either the Compensation Committee or the full Board of the terms of his departure, even after the termination arrangement was publicly disclosed and after the payout thereunder was accelerated by one month, and notwithstanding that Board approval was allegedly required for these actions. Instead, the Board “chose to remain invisible in the process.”

The Board’s allegedly willfully neglectful nature was key to the Court’s decision to deny the motion to dismiss. While the business judgment rule might have applied if “the board had taken the time or effort to review [its] options, perhaps with the assistance of expert legal advisors,” the allegations, if true, “imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.” In the Court’s view, when a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are to be viewed as either “not in good faith” or “involv[ing] intentional misconduct.” Accordingly, the Court concluded that the claims were sufficient to survive a motion to dismiss.

Conclusion

The duty of good faith requires that a director be motivated to act in the best interests of the corporation and its stockholders. While the Court’s review requires it to examine the board’s subjective motivation, the Court will utilize objective facts to infer such motivation. Like a duty of care analysis, such review likely will focus on the process by which the board reached the decision under review. Id. Consistent with earlier articulations of the level of conduct necessary to infer bad faith (or irrationality), more recent case law, including the recent Disney decision, suggests that only fairly egregious conduct (such as a knowing and deliberate indifference to a potential risk of harm to the corporation) will rise to the level of “bad faith.” Nevertheless, as the Disney decision evidences, the Delaware courts may be more willing now to seriously consider claims of bad faith by otherwise disinterested directors who are alleged to have abdicated their responsibilities or acted in a manner contrary to their professed rationale. As Chancellor Chandler’s opinion confirms, however, Delaware courts are likely to remain extremely reluctant to impose liability on disinterested directors who make genuine efforts to fulfill their duty to make informed decisions regarding matters of importance to the corporation.

50 Id. at 26.
51 Id. at 27.
52 Id. at 28.
53 Id. at 29 (quoting DGCL § 102 (b) (7)).
flexible on topics and format to make the meeting as helpful as possible to the bench. We acknowledged that the Delaware judges were likely to be interested in topics other than deal lockups, such as the role of the investment banker and fairness presentations, and might prefer a format where they could ask more questions. Mark will report at our August meeting.

Mark Morton then led a discussion of the Omnicare v. NCS decision from the Delaware Supreme Court issued on Friday, April 4, 2003 (and transmitted to all Task Force members). We also discussed the ramifications of the SEC's attorney conduct rules on M&A lawyers' practice given that the definition of a "material violation" includes a breach of fiduciary duty. Joel Greenberg then led a discussion of new IRS requirements that define a tax shelter to include any transaction where there is an agreement that restricts a taxpayer from discussing the tax treatment or tax structure after the earlier of signing the definitive agreement or the deal otherwise becoming public. We discussed the advisability of possible modifications to an NDA entered into as part of an acquisition. It appears that practice is evolving on this issue and we will revisit this in August.

Eileen Nugent then reviewed her plans for commentary for Section 1, including discussion of the exchange ratio generally, floating versus fixed ratios, caps and collars, and other issues relating to share issuance. We also concluded that the introduction should include a brief discussion on the types of issues that must be considered in a cash transaction.

Eileen then reviewed plans for the ancillary agreements. Sam Thompson volunteered to revise and distribute a summary of issues arising in acquisition transactions. We discussed the advisability of publishing a due diligence checklist and concluded that it would be helpful if it could be completed by publication. We agreed that the Covenants Group would provide commentary on the affiliates agreement, rather than including this commentary in Article I, and that we would not include "social" provisions in Article I.

Curt Hearn, Drew Fuller and Bill Payne then led a discussion of the covenants sections (Sections 4 and 5) and commentary, and agreed to make revisions for consideration at the August meeting in San Francisco. Also in August, we are expecting drafts of revised Section I with commentary, Sections 7, 8 and 9 (Conditions), commentary on the Covenants relating to the stockholders' meeting (Sections 5.2 and 5.3), revised Sections 4 and 5 commentary, and Delaware commentary on Section 9.

Our next Task Force meeting is in San Francisco on Saturday, August 9, 2003 from 9:00 a.m. to 12:00 noon. We have planned a wonderful Task Force dinner on Friday, August 8, 2003, with cocktails at 7:30 p.m. at the St. Francis Yacht Club, 700 Marina Blvd, San Francisco, CA 94123; (415) 563-6363. The San Francisco clubhouse of the St. Francis Yacht Club features outstanding dining and incredible vistas of the Golden Gate Bridge and San Francisco Bay. Special thanks to Henry Lesser and our friends at Marsh for arranging this special San Francisco venue. The cost of this dinner will be $100 per person. Please let Diane Frankle know as soon as possible if you plan to attend, so we can make final arrangements for this fun dinner.

Diane Holt Frankle
Stephen H. Knee
Co-Chairs

Task Force on the Dictionary of M&A Terms

The M&A Dictionary Task Force is moving forward with its project to develop a comprehensive dictionary for mergers and acquisitions that will include terms of art and of a generic nature used in the United States and overseas in the transaction context. We have a lot of new people who want to
assist in the project and we have received a number of excellent suggestions for additional terms to include. We want to include financial and legal terms, as well as terms of a historical nature. Our goal is to publish the first edition of the dictionary next year and we contemplate that we will update it from time to time as circumstances warrant.

At the upcoming ABA Annual Meeting, the Task Force will meet on Saturday, August 9, 2003 at 2:00 p.m. in the International Room at the Fairmont Hotel.

We would love to add new members to the task force or just receive suggestions on terms to include as well as their definitions. You can e-mail me at dakatz@wlrk.com, call me at (212) 403-1309 or fax me at (212) 403-2309. I look forward to working with you on our Task Force.

David A. Katz
Chair

International Transactions Task Force

At the Spring Meeting in Los Angeles, the International Transactions Task Force covered a number of different subjects.

The first part of our meeting focused on the current project of the Task Force - an international overview of a public company stock acquisition in a number of jurisdictions. Like our other projects, the basic objective is to provide an overview of the key issues in doing a cross-border public acquisition. We have decided, however, that this project will focus on fewer jurisdictions, but it will provide a more detailed overview of the key issues. A draft of the questionnaire, which we will use to generate our data, was discussed at length at our meeting and a number of suggestions were made that will be incorporated into the next draft of the questionnaire. A new draft questionnaire will be circulated and deemed final unless members provide comments within a specified period.

The meeting also focused on the next project of the Task Force, which is to create a new version of the Model Asset Purchase Agreement that could be used on deals in jurisdictions outside the United States. Daniel Rosenberg and Henry Lesser, who together with Howard Barnhorst are the vice-chairs of our Task Force, have been actively involved in developing and putting together the framework for this new project. We talked at some length about the aims and scope of the project generally and concluded that, before undertaking a detailed review of the Model Asset Purchase Agreement, we should develop a fact pattern that could be used as a framework for the project.

We also spent some time updating the Task Force on the next project in line for publication—the private company stock acquisition international overview. The form of questionnaire has been finalized and an editorial committee led by John Grossbauer is editing the responses. This project is intended to be a standalone project. We are currently about one year away from having a product ready for publication.

On the program front, we talked about the program that our Task Force will sponsor at the Annual Meeting. The substance of the program will be modeled along the lines of the institute format used by the Negotiated Acquisitions Committee, except the scope and substance will be international.

John W. Leopold
Guy-Martial A.X. Weijer
Co-Chairs
Joint Venture Task Force

The Joint Venture Task Force continues to move forward with the expectation that the Model Joint Venture Agreement and related commentary will be finished this Fall. The Joint Venture Task Force had an excellent meeting in Los Angeles, focusing on some of the final sections of the commentary. The Editorial Committee is incorporating the comments into the commentary. The San Francisco meeting will be focusing on the remaining open issues.

We appreciate all of the help from the various members of the Task Force and in particular that of our colleagues on the Editorial Committee.

Thomas B. Hyman, Jr.
Alison J. Youngman
Co-Chairs

Manual on Acquisition Practice and Process Task Force

At the Spring Meeting in Los Angeles in April, the Task Force had a large working group of 25 members present, including Jackie McGlamery from the ABA Publications Committee. Chairs Tom Thompson and Vince Garrity discussed the publication schedule for the Manual. The Publications Committee has set the end of 2004 for the submission of the Manual. To meet this aggressive goal, the Task Force will need to have first drafts of all chapters completed by the end of 2003.

Having substantially completed nearly all topic outlines at the February meeting, the Chairs had asked several authors of completed topic outlines to commence drafting chapters or subchapters under broad style guidelines developed by the Chairs and based on the Master Outline developed by Rob Ouellette.

The following Task Force members had submitted text for discussion at the meeting: Bill Payne on "Due Diligence," Norm Zilber on "Who is the Client," Bob Copeland on "Ethical Issues," Jon Hirschoff on "Valuation Issues," Neal Brockmeyer on "Auctions," Howard Barnhorst on "Management Presentations," Bob Copeland on "Dealing with Difficult Lawyers on the Other Side," Dave Albin on "Getting from Agreement to Closing," Ralston Steenrod on "Due Diligence-Fixing Responsibility" and Lori Lasher on "Post-Closing Strategy." The Task Force spent the bulk of the meeting discussing the text and style developed by the authors and the different presentation formats.

Deborah Telman presented a new outline on acquisition issues from the perspective of in-house counsel and Lori Lasher raised for discussion issues on post-closing strategies and tasks. Outlines on these topics are to be converted to text for the next meeting. The Chairs assigned a number of additional chapters to outline authors and established a timetable for submission before the August meeting.

Neal Brockmeyer, who is leading the development of the Lexicon for the Manual, reported that he had been in contact with Rick Climan and David Katz to coordinate the development of our Lexicon with the Dictionary of M&A Terms project.

The Task Force will meet again in August at the Annual Meeting in San Francisco.

Thomas M. Thompson
Vincent F. Garrity, Jr.
Co-Chairs
Task Force on the Model Stock Purchase Agreement

The Model Stock Purchase Agreement Task Force held very productive meetings at the Spring meeting prior to the meeting in Los Angeles. Members of our Working Groups (agreement revisions, seller’s response documents and ancillary documents) produced significant materials for review and comment. We had extended discussions on a number of topics and additional project assignments were made.

Although the Task Force met as a whole in Los Angeles, we will return to the Working Group format for meetings in San Francisco. On Saturday, August 9, 2003, the Working Group on Revisions to the Model Stock Purchase Agreement will meet from 8:00 to 11:00 a.m. On Sunday, August 10, 2003, the Working Groups on Ancillary Documents and the Seller’s Response Document will meet from 8:00 to 11:00 a.m. and 11:00 a.m. – 2:00 p.m., respectively. In order for our meetings to be productive, it is necessary for those members producing work product to submit it to their respective Working Group Chairs no later than July 10, 2003.

The Task Force is always seeking new members and we hope you will be able to attend our meetings in San Francisco. There are still plenty of assignments available so if you are interested in signing up or have any questions, please send me an email at rtharper@klettrooney.com.

Robert T. Harper
Chair

SUBCOMMITTEE REPORTS

Committee Forum Subcommittee

Title:
"What's So Hot About Going Private? Going Private Transactions Involving Small-Cap Companies"

Moderator:
Keith Flaum (a partner in the Silicon Valley office of Cooley Godward LLP)

Panelists:
Steve Bigler (a partner in Richards, Layton & Finger, P.A., Wilmington, Delaware)
Dennis Garris (a partner in the Washington D.C. office of Alston & Bird LLP)
Henry Lesser (a partner in the Silicon Valley office of Gray Cary Ware & Freidenrich LLP)

Description:
A confluence of factors and recent events, including the ever-increasing costs and other burdens created by Sarbanes-Oxley and the flood of related regulatory initiatives, the significant number of public companies that are trading at or below their cash value (and the related investor pressure to return "value" (cash) to stockholders), the steep drop in equity prices and concomitant reduction in the value of stock options as an employee incentive, and the increasing unavailability of research coverage, have led many small-cap companies to seriously consider "going private." In this program, a panel of leading M&A practitioners will discuss the myriad of issues that arise in connection with going private transactions. The discussion will
include commentary on structuring going private transactions, fiduciary and securities law implications of going private, and unusual features of acquisition agreements involving going private transactions.

Keith A. Flaum, Chair

**Membership Subcommittee**

After numerous *tête-à-têtes* with the Dalai Lama, epic bouts with your friendly, neighborhood Zen master, and a few re-runs of Dr. Phil, your Membership Subcommittee sought to answer the age-old question: *Who are we?* Here’s what we discovered (thanks to our crack summer associate, Thomas Urquidez):

The Committee has 929 members, which makes us the third largest Committee in the Section of Business Law (behind Federal Regulation of Securities and Cyberspace Law). To my surprise, the Committee actually has a membership list at [http://www.abanet.org/members/prelogin.html](http://www.abanet.org/members/prelogin.html). So like your mom always tells you, there’s no excuse for not keeping in touch!

We did an analysis of our membership data (back when we had 883 members), and here’s what we found: Most of us are in private practice (83%) as compared to in-house lawyers (12%) and all others (5%). Out of those of us in law firms, almost half (about 46%) of us are in firms with 100 or more lawyers. The next largest concentration is in law firms with 50-99 attorneys (about 21%). We also have a significant number (14%) of lawyers in law firms with 20-49 lawyers.

Geographically, our highest concentrations of members tend to be from the larger markets: New York (82), California (79), Pennsylvania (52), Illinois (50), and God’s country, *ummm*, I mean, Texas (50).

On the non-U.S. front, our Canadian colleagues lead with 42 members (anyone surprised?), with Western Europe coming in with a respectable 34. All other locations, such as Africa, South America, and Asia have only 1, 7, and 7 members, respectively.

While we have an impressive membership list, we still have room for growth – and lots of it. Some of the segments on which we intend to focus will be: (i) law firms in the middle of America; (ii) corporate counsel; (iii) foreign lawyers; and (iv) bankers and other non-legal deal types. Even in the larger markets, we can do better. In the next few months, we’ll be giving more thought to membership recruitment, and of course, your ideas and comments – and most importantly, your willingness to help – are welcome. Please feel free to call (214.651.5088) or email (Wilson.Chu@HaynesBoone.com) me - or better yet, catch up with me in San Francisco!

Lastly, as for the other age-old question of “*why are we here?*”, I’ll simply leave that one for those whose *Mensa*-rating exponentially increases with the number of glasses of vino consumed to ponder at our next Committee Dinner.

Wilson Chu
Chair

**Programs Subcommittee**

The Committee will be sponsoring or co-sponsoring three programs at the ABA’s Annual Meeting. On Sunday, August 10, 2003, from 8:00 a.m. to 10:00 a.m., the Committee will present “Acquiring a European Business: Effective Negotiating Strategies.” Through mock negotiations, the panel will highlight the potential opportunities and pitfalls in the purchase by a North American buyer of a privately-held business located in the United Kingdom and Germany. Nat Doliner and Henry Lesser will co-chair the panel.
comprising Ian Fagelson and Andrew Saul from London, Franziska Ruf from Montréal and Oleg de Lousanoff and Robert Wethmar from Frankfurt and Hamburg, respectively.

Also on Sunday, August 10, 2003, from 10:30 a.m. to 12:30 p.m., the Committee will co-sponsor with the Corporate Counsel Committee a program titled “Ringmasters’ Secrets: Effective Partnering Between Inside and Outside Counsel on M&A Deals.” The panelists, representing a cross section of in-house attorneys at corporations in a wide range of industries, together with M&A specialists from major law firms, will address some of the substantive and procedural issues confronting inside and outside counsel in preparing for, structuring, negotiating and executing M&A deals. Rick Climan will be moderator, and Gregg Alton, Michael Vaughn and Leigh Walton will represent our Committee on the panel.

Finally, on Monday, August 11, 2003, from 10:30 a.m. to 12:30 p.m., the Committee will co-sponsor with the newly-formed Intellectual Property Committee a program titled “IP: Making or Breaking the Business Deal: Practical Methods for Overcoming Obstacles.” The panel will address IP at the due diligence stage in both M&A and outsourcing transactions, focusing on international, antitrust and information technology issues, as well as the unique concerns of venture capital investors. Representing our Committee will be Freek Jonkhart.

Suggestions for programs will be welcome, as well as hearing from those who would like to be considered as panelists for future programs.

Neal H. Brockmeyer, Co-Chair
Elizabeth A. Dellinger, Co-Chair

Recent Judicial Developments Subcommittee

The Subcommittee on Recent Judicial Developments has completed our first annual survey of significant judicial decisions in the area of mergers and acquisitions, and the survey is scheduled for publication in the August 2003 issue of The Business Lawyer. We are now collecting 2003 cases for inclusion in our next annual survey, and we are asking all members of the Committee on Negotiated Acquisitions to send to us significant judicial decisions for possible inclusion in this survey. Submissions can be sent by email either to Scott Whittaker at swhittaker@stonepigman.com, or to Jon Hirschoff at jhirschoff@fdh.com. You also may fax cases either to Scott at (504) 596-0836 or to Jon at (203) 348-5777. If possible, please state in your email or on the fax cover sheet the significance of the case.

The first criterion for inclusion is that the decision must involve a merger, an equity sale of a controlling interest, a sale of all or substantially all assets, a sale of a subsidiary or division, or a recapitalization resulting in a change of control. The second criterion is that the decision must (a) interpret or apply the provisions of an acquisition agreement or an agreement preliminary to an acquisition agreement (e.g., a letter of intent, confidentiality agreement or standstill agreement), (b) interpret or apply a state statute that governs one of the constituent entities (e.g., the General Corporation Law of the State of Delaware, or the Louisiana Limited Liability Company Law), (c) pertain to a successor liability issue, or (d) decide a breach of fiduciary duty claim. We are currently excluding cases dealing with federal law, securities law, tax law, and antitrust law. But if you feel a case dealing with an M&A transaction is significant please send it, even if it does not meet the foregoing criteria.
Decisions to be Discussed at San Francisco Committee Meeting

A corporation whose management is considering or discussing the possibility that the corporation will be acquired must give particularly careful consideration to disclosure issues if at the same time it is purchasing its stock from minority stockholders. If the corporation is later sold for a per share price substantially higher than that paid to the minority stockholders, who then sue the corporation and its controlling stockholders, the disclosure to the minority stockholders will be judged with the benefit (or detriment, depending on one’s point of view) of hindsight.

This article discusses two recent cases that involve these issues in the closely held corporation context. The term “closely held” is used to identify corporations that are not publicly held. Although it is important to distinguish between closely and publicly held corporations for purposes of applying the “special facts” rule, there is no clear line between these categories drawn in the “special facts” cases. Courts sometimes use the terms “close corporation”, “privately held corporation”, and “closely held corporation” interchangeably, and without regard to the fact that in some jurisdictions the term “close corporation” denotes a special category of closely held corporations under the applicable corporation statutes.

In Lawton v. Nyman, the Court of Appeals discussed the fiduciary duties, under Rhode Island law, of majority stockholders, officers and directors to minority stockholders in connection with purchases of stock from minority stockholders by the corporation. In Neubauer v. Goldfarb, the California Court of Appeals discussed these issues under Delaware law, and also held that the fiduciary duties of a controlling stockholder in a closely held corporation could not be waived under California law. The cases will be the subject of discussion during our Subcommittee segment at our full Committee meeting in San Francisco.

Jon T. Hirschoff
Scott T. Whittaker
Co-Chairs

Lawton v. Nyman, 327 F.3d 30, 2003 WL 1964407 (1st Cir. 2003, 4/29/03)

In Lawton, the corporation redeemed minority shares of Class A (non-voting) stock in a series of transactions from November, 1995 through May, 1996 at prices ranging from $145.36 to $200.00 per share. During the same period, the directors issued themselves options at exercise prices of $200.00 to $220.00 per share and purchased Class A and Class B (voting) treasury shares for $200.00 per share.

In October, 1996, approximately five months after the purchases from minority stockholders were completed, the company opened discussions with a prospective purchaser that led to the signing of a letter of intent in June, 1997 and the closing in September, 1997 of a transaction in which the purchaser paid $1,667.38 per share for the Class A stock and $2,167.59 per share for the Class B stock.

Minority stockholders whose shares were redeemed during the prior two years sued the directors (who were also the officers and controlling stockholders) for breach of fiduciary duty, violation of federal securities laws and common law fraud, asserting that they were paid less than the stock’s true value, that the defendants “knew that the company might be sold”, and that material facts were misrepresented and not disclosed. A parallel suit alleged that the option grants and purchases of treasury stock diluted the ownership of the remaining minority stockholders.
The district court dismissed the securities law claims, but found a breach of fiduciary duty by the defendants. The court of appeals opinion dealt primarily with the court’s reasons for affirming the finding of a breach of fiduciary duty under Rhode Island law and with the appropriate measure of damages. The court found no direct Rhode Island precedent, but concluded that Rhode Island would be likely to adopt the “special facts” rule, under which officers or directors of a closely held corporation purchasing a minority stockholder’s shares must disclose all material facts affecting the value of the stock, known to them by virtue of their positions but not known to the selling stockholder.

On appeal, the issue of liability turned on the proper standard for determining materiality. The district court concluded that negotiations for a sale need not be underway for there to be a duty to disclose. Rather, the duty also encompasses transactions that the directors anticipate are reasonably likely to occur or that are something more than remote possibilities. The court of appeals recognized that the duty to disclose a possible sale or merger to selling minority stockholders is greater in the closely held corporation context than in the situation of a publicly held corporation because, among other reasons, premature disclosure by a publicly held target could lead to inflation of the target’s stock price and thus possibly prevent the transaction from occurring. On the distinction between the duties of publicly traded and closely held corporations for these purposes, see the opening paragraphs of Judge Easterbrook’s opinion in Jordan v. Duff and Phelps, Inc., 815 F. 2d 429 (7th Cir. 1987).

On the issue of materiality, the court of appeals acknowledged that if the finding of breach of fiduciary duty turned purely on the definiteness of the plan to sell, the issue would be difficult. Instead, the court emphasized, the case turned “on an interrelated series of non-disclosures and misrepresentations.” The court noted among other things that the redemption of the plaintiffs’ stock represented a marked departure from the company’s previous lack of interest in purchasing stock, that the defendants imposed artificial deadlines for stockholders to respond to redemption offers, that the defendants timed the redemption offers so that the plaintiffs would not have the audited financial results, and that the defendants decided to redeem the minority shares even though the corporation had a pressing need for cash and was laying off workers to conserve funds. The court concluded that the evidence supported the plaintiffs’ theory that the defendants engaged in a concerted, accelerating effort to buy up the minority stock at less than fair value, increasing the defendants’ ownership in anticipation of a sale of the corporation.

The risk of Lawton-type liability can be reduced by careful attention, with the participation of counsel, to disclosure issues whenever minority shares are being acquired, particularly if the situation involves isolated purchases from minority stockholders who initiate the transactions, rather than an effort by management to accumulate minority shares. But even if no sale is on the horizon at the time of purchase, management should take into account that a future sale of the company at a premium price will increase the likelihood of a lawsuit by minority stockholders, and that the adequacy of disclosure, as always, will be judged in hindsight. The importance of adequate disclosure is further heightened by the fact that a court may very well ignore any waivers of disclosure duties, as is discussed below in the summary of the Neubauer decision.

An important question for practitioners is how to identify the line between closely held corporations and publicly traded corporations for purposes of determining whether Lawton duties apply. In light of the rationale for the non-applicability of the “special facts” rule to publicly held corporations, as articulated in Lawton and in Jordan, it may be risky to construe “closely held” narrowly. Indeed, a selling minority stockholder plaintiff may argue that a corporation that has recently gone private and no longer files reports under the Securities Exchange Act of 1934, and still
has one or two hundred stockholders but no active market for its stock, is no longer “publicly held” and should be regarded as “closely held” for these purposes, because disclosure to a minority stockholder regarding a prospective sale of the company would not be likely to endanger the potential transaction.

Although it affirmed the district court’s liability finding, the court of appeals remanded the case for further proceedings on the appropriate measure of damages. Rather than measure damages by the usual rule (the difference between the value of the stock when sold and the price received by the seller), the district court awarded the plaintiffs the difference between the September 1997 sale price and the amount paid by the corporation upon redemption of the shares. The district court based this departure from the general rule on two rationales: that the plaintiffs, if informed about the possibility of sale, would have retained their shares until September, 1997, and that the September 1997 price was the best indication of the value of the shares sixteen months earlier. The court of appeals could find no evidence in the record to support either rationale.

The district court had not independently considered the possibility of using an unjust enrichment theory of damages, because it had, mistakenly in the view of the court of appeals, regarded the defendants’ profit as equivalent to the plaintiffs’ loss (the difference between the price paid by the corporation to redeem the shares and the September, 1997 sale price). The court of appeals directed the district court, on remand, to consider whether equitable relief would be appropriate, and if so, whether the defendants’ profits from the September, 1997 sale might be regarded as unjust enrichment.

With respect to the possibility of applying an unjust enrichment remedy, the court of appeals set some general parameters to guide the district court. First, the court considered cases holding that a misled seller who fails to repurchase shares once he has learned previously undisclosed facts may not show that the non-disclosure was a proximate cause of his failure to obtain the subsequent appreciation in value of the stock. The court distinguished those cases on the basis that in the closely held corporation context the seller has no opportunity to “cover” by repurchasing shares of the corporation. Second, the court pointed out that extraordinary gains attributable to extra efforts by the defendants may not be regarded as part of the defendants’ “windfall profits.” Third, the court cited cases for the proposition that unjust enrichment is usually applied when the subsequent resale follows fairly soon after the original purchase. The court also referred to the risks that the defendants took in their subsequent management of the corporation. The court mentioned the possibility that other models of equitable relief may be better suited for the facts of the case, if equitable relief is warranted at all. If the plaintiffs would have sold their shares even had they received the withheld information, any profit the defendants earned above the premium they would have paid the plaintiffs absent the fraud is not unjust enrichment. The court therefore suggested that another approach might be to rely on the premium that the plaintiffs would have extracted were the information disclosed, awarding plaintiffs “more than their loss” while not requiring the disgorgement of all of defendants’ eventual profit, “some of which may have been justly earned”.

Neubauer v. Goldfarb, 133 Cal.Rptr.2d 218, 2003 WL 1923329 (Cal.App. 2 Dist, 4/23/03)

In Neubauer, the court held under California law that waiver of corporate directors’ and majority shareholders' fiduciary duties to minority shareholders in closely held corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void. The court also held under Delaware law that a majority shareholder’s duty of "complete candor" includes a duty to disclose to a minority shareholder information that becomes known after the minority shareholder has agreed to sell the shares but before
the closing takes place, where the information affects the value of the minority shares and the agreement is being amended.

In 1989, Walther Neubauer and a family trust purchased 40% of the shares of HCC Industries, Inc. for approximately $1,000,000. The remaining 60% of HCC stock was owned by Andrew Goldfarb, President and CEO, his brother, Stephen, and Christopher Bateman, the CFO. In 1994, Neubauer and Andrew Goldfarb agreed that Goldfarb would begin to pursue the sale of HCC. In 1995, the Goldfarbs entered into negotiations with two potential acquirers, discussing potential purchase prices of $40,000,000 for 100% of HCC in one instance, and $25,000,000 for 50% in another instance. After these negotiations stalled, the Goldfarbs began discussions with a third potential acquirer and they informed Neubauer that he needed to sign an agreement to sell his shares for a specific amount because the acquirer was unwilling to put substantial work into due diligence unless it was assured Neubauer would follow through on the deal. The purchase price then being discussed with the suitor was $74,000,000, which would have resulted in a gross pro rata share to Neubauer of $22,000,000. This led to Neubauer’s execution, in October 1995, of an agreement giving HCC a two-year option to purchase his shares for $18,000,000. A few months later, the suitor reduced its offer to $64,000,000, and Goldfarb then told Neubauer that this new offer would require him to accept $14,000,000 for his shares. After some weeks of negotiations, the option agreement was amended to lower the option price for Neubauer’s shares to $15,000,000. During this period of negotiations, the proposed sale died.

After this third failed attempt at a sale, Stephen Goldfarb began negotiations with Neubauer over new financial terms on which HCC would exercise its option to purchase Neubauer shares. At the same time, Andrew Goldfarb was conducting meetings with two investment banking firms in a continuing effort to sell the company. Neither the meetings with the investment bankers, nor the range of potential sale prices being discussed by the investment bankers (from $85,000,000 to $160,000,000, depending on the assumptions used) was disclosed to Neubauer. The negotiations led to the company’s acquisition of Neubauer’s stock in mid-1996 for $13.5 million. The deal also included a "tail" which provided additional payments to Neubauer if more than 40% of HCC shares were sold before November 1, 1997 for more than $15,000,000. Three months later, a venture capital firm purchased 65% of HCC for $98.5 million. This triggered the "tail" payment under the amended option agreement and Neubauer received an additional $1,000,000, raising the total purchase price to $14.5 million for his shares, or $70 per share. The Goldfarbs and Bateman received $71.8 million for their shares, or approximately $347 per share.

The agreements executed by Neubauer, who was separately represented by counsel, contained a variety of provisions designed to prevent Neubauer from suing if the majority shareholders subsequently sold their shares for more than Neubauer received. The provisions quoted by the court in its opinion are as follows:

Seller acknowledges that neither HCC nor its officers, directors or controlling shareholders have any fiduciary duty to seller or HCC in connection with the execution of this agreement or a sale including, but not limited to, the fairness of the overall consideration or allocation thereof.

[s]eller . . . has requested and received such information in connection with the execution of this agreement as he believes to be necessary in order to make an informed decision to enter into this agreement and to bind himself as set forth herein.

[t]he provisions hereof have been thoroughly reviewed by all parties and have been the subject of negotiations.
Seller is desirous of having HCC sold and selling his stock, even if such sale results in his receiving a smaller amount per share than the other stockholders, in part because of his belief as to the contribution to the success of HCC made by the other stockholders.

Seller understands and acknowledges that certain of the other stockholders of HCC will receive, in a sale, compensation and payments both of their shares and otherwise that will have the effect of them receiving a proportionate amount of the aggregate consideration in the sale that is greater per share than seller will receive hereunder. Seller agrees, subject to the other conditions of this agreement being met, not to assert any claim, or to institute any legal, equitable, administrative or other proceedings against HCC or any of its affiliates or stockholders as a result of such difference.

Seller acknowledges and agrees that the final form of a sale may be substantially different from what has been disclosed to him as the present form of sale currently under negotiation, due to factors such as, but not limited to, negotiations, due diligence, tax restructuring, changes in the post-sale ownership of HCC by the other stockholders, and other factors, and that it could involve a different buyer. Such final structure may have the effect of being more favorable to individual stockholders of HCC than to seller.

So long as seller receives the cash amount contemplated by this agreement, seller will assert no claim against HCC or any of its affiliates or stockholders in connection herewith.

Neuberger sued the directors and the majority shareholders for breach of fiduciary duty, fraud, negligence and false statements in the purchase of securities. The trial court granted summary judgment in favor of the defendants. Neuberger appealed. On appeal, the court decided two general issues: first whether the release and waiver provisions of the contract were enforceable, and second whether the false or misleading statements and failure to disclose information alleged by Neuberger presented material issues of fact sufficient to require denial of defendants' motion for summary judgment. These issues were decided under the California and Delaware law, respectively, due to a bifurcated choice of law provision in the agreement.

The court held that under California law, all contracts that have for their object to exempt anyone from the responsibility for his own fraud or willful injury to the person or property of another, or violation of law, are against public policy and void. The court also stated that this public policy applies with added force when the exculpatory provision purports to immunize persons charged with a fiduciary duty from the consequences of betraying their trusts. Therefore, the court struck down the waiver provision set forth in first quoted paragraph above. The court interpreted the remainder of the provisions quoted above as irrelevant to the issue of whether the defendants breached a disclosure duty to Neuberger in negotiating the purchase of his HCC shares. According to the court, those provisions simply meant that Neuberger would not sue the Goldfarbs merely because they ultimately obtain more for their HCC shares than Neuberger received for his, and those provisions did not mean, as the defendants argued, that Neuberger was releasing the defendant’s from liability for breach of fiduciary duty, fraud or negligent misrepresentation. The defendants also argued that the facts presented no triable issue of fact regarding any misrepresentations or failure to meet any disclosure duty, because none of the facts allegedly misrepresented or withheld were material. The only alleged misrepresentation before the October 1995 option agreement was signed was the alleged misrepresentation that the $25,000,000 price discussed in the prior failed negotiation was for the
whole company, when in fact it was for 50%. The only alleged failure to disclose before the October 1995 option agreement was signed was the failure to provide Neubauer with 1996 profit projections. The court stated that such a misrepresentation and such a failure to disclose may indeed be found by the trier of fact to be material under Delaware law.

The defendants also argued that any alleged misrepresentations or omissions after the original buy-sell agreement in October 1995 should be disregarded as irrelevant, because Neubauer had at that time already reached his decision to sell his shares and thus any misrepresentations or omissions could not possibly have affected his decision to sell. The court rejected this argument, holding that "each renegotiation of the sale price during [the period between the original October 1995 execution of the option agreement and the July 1996 final amendment] triggered a new duty of complete candor on the Goldfarb's part."

This case points out that no amount of drafting can shield directors and majority shareholders from the consequences of a failure to disclose material facts, or the misrepresentation of material facts, in connection with the acquisition of stock from minority shareholders.