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Client Alert

April 2014

Delaware Court Addresses Merger Claims in *Chen v. Howard-Anderson*

On April 8, 2014, the Court of Chancery issued a noteworthy decision in *Chen v. Howard-Anderson* with respect to a post-closing challenge to the sale of a public company. The court granted the director-defendants' motion for summary judgment on certain sale process claims because (i) the plaintiff failed to show the directors had acted for reasons other than obtaining the best price reasonably available and (ii) the directors were exculpated from liability for breaches of the duty of care. Nevertheless, the court said the record supported a reasonable inference that the directors' actions fell outside the "range of reasonableness" under *Revlon*. The court also denied summary judgment to the company's officers, who cannot be exculpated for due care violations under Delaware law. In addition, the court found there were material issues of fact remaining as to whether the alleged disclosure violations constituted a breach of the defendants' duty of loyalty.

Key Take-Aways

- As reflected in the recent decisions in *Rural Metro* and *Koehler v. Netspend Holdings*, Delaware courts continue to scrutinize change-of-control transactions to determine whether the board of directors' actions fell within a "range of reasonableness."
- According to *Chen*, an "utter failure" to obtain the best possible price is not the only way a plaintiff can establish bad faith. Rather, *Chen* holds that a plaintiff can also show a director "acted with a purpose other than that of advancing the best interests of the corporation," even if that purpose falls short of "pure self-dealing."
- Nevertheless, in the absence of a material personal interest in a transaction, outside directors generally will be exculpated from liability even if a court second-guesses the reasonableness of their decisions.
- In the post-closing setting, full disclosure to stockholders may result in the protection of the business judgment rule rather than enhanced judicial scrutiny under *Revlon*.
- Officers cannot be exculpated from liability for due care violations under Delaware law.

Background

Chen involved the 2011 sale of Occam Networks, Inc. ("Occam") to Calix, Inc. In the post-closing litigation, the former Occam stockholders alleged, among other things, that the board of directors improperly favored Calix over other strategic buyers and sold the company at an inadequate price (the "sale process claims"). The plaintiffs also alleged that Occam's board of directors committed disclosure violations by, among other things, failing to disclose certain internal management projections (the "disclosure claims").

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Court of Chancery's Ruling

The court granted summary judgment in favor of the director-defendants on the sale process claims. The court first held that the directors' conduct was reviewable under *Revlon*, which applies enhanced judicial scrutiny to determine whether the directors obtained the best price reasonably available.[1] The court then concluded that the record supported a reasonable inference that the directors' actions fell outside a "range of reasonableness." Among other things, the court said the board of directors appeared to have "favored Calix at the expense of generating greater value through a competitive bidding process or by remaining a stand-alone company and pursuing acquisitions." The court also stated that a last-minute ultimatum given to another bidder and a "24-hour market check" in which Occam's financial advisor contacted other potential suitors before entering into the merger agreement with Calix seemingly "fell outside the range of reasonableness."[2]

The court then addressed the directors' argument that they were entitled to summary judgment because they were exculpated from liability pursuant to Section 102(b)(7) of the Delaware General Corporation Law ("DGCL").[3] The court rejected the defendants' claim that, under the Delaware Supreme Court's decision in *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009), the plaintiffs had to show the directors "utterly failed to attempt to obtain the best sale price." The court reasoned that *Lyondell* only addressed a claim that directors had breached their duty of loyalty by consciously disregarding their duties in the sale of a company. It then contrasted the plaintiffs' claims in *Chen*, explaining that:

> The loyalty issue in this case is whether the directors allowed interests other than obtaining the best value reasonably available for Occam's stockholders to influence their decisions during the sale process, given that they made decisions falling outside of the range of reasonableness.

The court concluded, however, that the plaintiffs failed "to offer any plausible non-stockholder-directed motive" necessary to show a loyalty violation. Thus, while the directors may have breached their fiduciary duties by acting unreasonably, they were entitled to summary judgment because it would amount to only a breach of the duty of care.[4]

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[1] In a prior ruling in the litigation, the court held that *Revlon* applied where the merger consideration was split evenly between cash and stock. *See Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL, trans. ruling (Del. Ch. Jan. 24, 2011); *see also In re Smurfit-Stone Container Corp. S'holders Litig.*, C.A. No. 6164-VCP, mem. op. (Del. Ch. May 24, 2011).

[2] The decision did not explain the extent to which Occam's board of directors could rely on its ability to respond to unsolicited proposals after it signed the merger agreement (commonly referred to as a "post-signing market check"). *Cf. In re Plains Exp. & Prod. Co. S'holder Litig.*, Consol. C.A. No. 8090-VCN, mem. op. (Del. Ch. May 9, 2013) (denying motion for a preliminary injunction where target negotiated with a single bidder and did not have "onerous" deal protection devices that would "unduly impede a [post-signing] competing bid").

[3] Section 102(b)(7) allows a corporation to include a provision in its certificate of incorporation that eliminates the personal liability of its directors except (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 Section 174 of the DGCL; or (iv) for any transaction from which the director derived an improper personal benefit.

[4] The court noted that, with the exception of the CEO, none of Occam's directors were "interested" in the merger. In particular, the court found that two directors who were affiliated with venture capital funds that held large amounts of Occam stock were not interested. Although the court noted that a need for liquidity could create a conflict of interest, there was no evidence in this case to create a reasonable inference that any such conflict existed.

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Importantly, Section 102(b)(7) authorizes exculpation only for directors.[5] For that reason, the court refused to grant summary judgment in favor of Occam's chief executive officer (who was also a director) and its chief financial officer (who was not a director) to the extent they allegedly breached their fiduciary duties as officers. Among other things, the court said the plaintiff had cited evidence supporting "a reasonable inference of favoritism towards Calix consistent with [the officers'] personal financial interests rather than the pursuit of maximal value for the stockholders."

As to the disclosure claims, the court held there was insufficient evidence to grant the defendants' motion for summary judgment. Among other reasons, issues of fact remained as to whether:

- certain omitted projections were reliable such that they were material and should have been disclosed;[6]
- certain disclosed projections that were described as representing Occam's future financial performance on a stand-alone basis had actually been adjusted to take the merger into account;
- Occam's financial advisor's fairness opinion accurately stated that certain projections did not exist; and
- the background section omitted material information about the last-minute "market check" and details suggesting Calix had always been Occam's preferred bidder.

In each case, the court noted that it was unable to determine at the summary judgment stage whether the alleged disclosure violations resulted from a breach of the duty of loyalty or care. Importantly, the court also noted that the merger likely would have been reviewed under the business judgment rule if there had been a fully-informed vote by the stockholders.[7]

Implications

Chen is a notable decision because it suggests the directors of a public company may have breached their duties under *Revlon* in connection with a third-party sale transaction. It also comes on the heels of Vice Chancellor J. Travis Laster's March 2014 ruling in *Rural Metro*, where he held that directors had breached their duties under *Revlon* and that the company's financial advisor aided and abetted that breach.

From a doctrinal perspective, *Chen* rejects the notion that the Delaware Supreme Court's decision in *Lyondell* definitively addressed the scope of bad faith claims against outside directors in third-party mergers. *Chen* holds that a plaintiff is not held to *Lyondell*'s "utterly failed to attempt" standard; instead, a plaintiff can prove a breach of the duty of loyalty by showing a director acted for a purpose other than that of advancing the best interests of the corporation.

Chen should be a cause for concern among corporate officers, who are not exculpated from liability for due care violations under Delaware law. It is clear that officers owe fiduciary duties,[8] but few Delaware decisions have parsed the actions of a director who is also an officer in connection with a sale

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[5] *See, e.g., In re Rural Metro Corp. S'holders Litig.*, Consol. C.A. No. 6350-VCL, mem. op. (Del. Ch. Mar. 7, 2014).

[6] *See In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *16 (Del. Ch. Aug. 18, 2006) (holding that projections must be "reliable" in order to be material).

[7] *See Chen*, mem. op. at 33; *see also In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 793 n.113 (Del. Ch. 2011); *In re Morton's Rest. Group, Inc. S'holders Litig.*, 74 A.3d 656, 663 n.34 (Del. Ch. 2013).

[8] *See Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

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transaction.[9] In most situations, a disinterested and independent board majority that approves a transaction would seemingly shield an officer from stockholder claims relating to that transaction. Here, however, the board of directors was found to have acted unreasonably, which then required the court to analyze the conduct of each individual defendant and determine whether summary judgment was warranted.

Finally, the decision shows the potential importance of full disclosure. Unfortunately, due to federal securities laws, Delaware court rulings, and the proliferation of stockholder litigation, proxy statements have become voluminous documents. For that reason, directors undoubtedly rely on their outside advisors and management to prepare appropriate disclosures. Nevertheless, *Chen* reminds directors of the need to review proxy statements carefully and to be mindful of their disclosure obligations.

In addition, Vice Chancellor Laster expressed his view that a fully informed vote by Occam's stockholders might have resulted in judicial review under the deferential business judgment rule rather than enhanced scrutiny under *Revlon*. This echoes comments that then-Chancellor (now Chief Justice) Leo E. Strine, Jr. has made in recent cases. This would result in a significant benefit in post-closing litigation (*i.e.*, a more deferential standard of review) for companies that can show all material information was, in fact, disclosed to stockholders.

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[9] For competing arguments on whether officers are protected by the business judgment rule, compare Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005), with Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005).

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