Document hosted at JDSUPRA
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

M&A Law | manatt

August 19, 2009

Delaware Court Reinforces High Standard to Establish Breach of Duty of Loyalty in a Sale of Control

David Grinberg
Matthew O'Loughlin
Sarah Fergusson

On July 24, 2009, the Delaware Chancery Court issued a ruling in connection with the July 2008 acquisition by Vivendi S.A. of a majority of the voting stock of Activision, Inc., producer of such well-known video games as *Guitar Hero, Call of Duty,* and the *Tony Hawk* series.[1]

Vivendi combined its subsidiary, Vivendi Games, Inc.,[2] with Activision through a series of transactions, including Vivendi's contribution of Vivendi Games in exchange for newly issued stock of Activision, Vivendi's purchase of additional newly issued Activision stock for cash, and a post-closing tender offer to the remaining Activision stockholders for up to 50 percent of the remaining Activision stock not owned by Vivendi. A stockholder class action brought by the Wayne County Employees' Retirement System survived the acquisition, challenging the actions of the Activision board of directors in connection with the transactions as breaching its fiduciary duty of loyalty.

In one of the first applications of the Delaware Supreme Court's decision in *Lyondell Chemical Company v. Ryan*,[3] clarifying the scope of directors' *Revlon*[4] duties arising in a sale of control, the Delaware Chancery Court dismissed all stockholder claims. In doing so, the court reinforced the "process-based" rather than "outcome-based" approach in evaluating director action used in *Lyondell* to determine whether the directors satisfied their fiduciary duties. Importantly, the court also reinforced and emphasized that "there is no 'blueprint' that directors must follow to satisfy their fiduciary obligations in a change of control transaction." Rather, how they must act "depends on the circumstances in which the director is acting."

Newsletter Editors

David Grinberg
Partner
dgrinberg@manatt.com
310.312.4238

Matthew S. O'Loughlin
Associate
moloughlin@manatt.com
714.338.2710

Our Practice

Manatt's Mergers and Acquisitions (M&A) Practice Group represents acquirers and sellers in negotiated and contested merger and acquisition transactions involving publicly held and private companies. Our core group of M&A attorneys draws upon the expertise ... more

Practice Group Overview

Info & Resources

Subscribe
Unsubscribe
Newsletter Disclaimer
Manatt.com

Document hosted at JDSUPRA
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

Transaction Background

The plaintiff's complaint focused on the role of two Activision senior executives, Robert A. Kotick and Brian G. Kelly, in negotiating the combination, arguing that these executives, who were also directors and significant stockholders, had a conflict of interest because they participated in negotiating the combination at the same time their employment agreements were being renegotiated with Activision. Beginning in late 2006, the two executives began exclusive, nonpublic discussions with Vivendi. They advised the Activision board of these discussions on April 30, 2007, and the board officially authorized negotiations with Vivendi. On May 11, 2007, the board initiated the involvement of its Nominating and Corporate Governance Committee (the "Committee") in the sale process due to the board's concerns over the executives' potential conflicts of interest. The board authorized the Committee to retain its own legal and financial advisors, although the Committee instead relied on Activision's advisors. The Committee also permitted the executives to participate in negotiations and the Committee's meetings.

The Committee initially recommended that Activision seek a control premium for stockholders in the event of a change of control, as well as seek to protect existing stockholders should Activision's common stock trade below the per-share transaction price after closing. But after Vivendi rejected this proposal, the Committee relinquished its demand for a control premium, instructing Activision management to instead seek a tender offer for a minimum of 50 percent of Activision's stock. Although the two executives played a prominent role in the negotiations in the ensuing months, the board met on several occasions to review these discussions. Ultimately, the board approved the proposed combination on December 1, 2007 after receipt of a fairness opinion, and Activision's stockholders approved the transaction on July 8, 2008.

The Wayne County Employees' Retirement System class action lawsuit asserted, among other claims, that (1) the two executives breached their duty of loyalty by favoring their own interests in obtaining employment benefits over the interests of Activision's stockholders; (2) Activision's other directors breached their fiduciary duty of loyalty by allowing the two executives to control the negotiations with Vivendi and Activision's advisors; and (3) Activision's directors breached their *Revlon* duties through their conduct in negotiating the sale of control of Activision. The plaintiff asserted three theories regarding the directors' breach of the duty of loyalty: (1) they allowed the two executives to control the negotiations and advisors irrespective of their conflict of interest; (2) they conducted no independent market check during the negotiations; and (3) they failed to obtain a control premium or other "protective devices"[5]. The court noted that in order to survive dismissal, the plaintiff had to allege facts sufficient to state a claim that the directors were disloyal or acted in bad faith in connection with the

Document hosted at JDSUPRA
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

transaction.

Maximizing Stockholder Value: A "Process-Based" Approach

Boards of directors have a duty under *Revlon* in the context of a company sale to have a "singular focus on seeking and attaining the highest value reasonably available to stockholders." Highest value is seen as not necessarily simply accepting the highest dollar bid but can include other deal terms that maximize the value to stockholders.

Generally, an analysis of whether a board's duties have been discharged begins with the application of the business judgment rule, which provides that so long as the directors of a corporation act on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company, the court will respect their judgment. However, in the context of a change of control for cash, the actions of the target board are subject to a higher standard of review than the business judgment rule. Specifically, the court may examine the board's decision-making process (including the information they relied upon) as well as its actions in light of the circumstances then existing. A perfect process is not required, but a target board must adopt a process that demonstrates its reasonable effort to advance the interests of the target's stockholders.

In reviewing the Activision board's compliance with its *Revlon* duties, the Delaware Chancery Court rejected the claims that the directors were interested or lacked independence, because no facts indicated that the board allowed the two executives to control the transaction or that the two executives were themselves interested in the outcome of the transaction. The court pointed out that the Committee was aware that the two executives had an interest in their management role in the combined company, met regularly throughout the negotiations, received updates on the status of the negotiations from the two executives and instructed them on negotiating deal points, and received advice from financial and legal advisors. In the court's eyes, the two executives were not themselves interested because their jobs were never in danger, no bidder ever threatened to take Activision over and replace management, and there was no threat that they would be replaced if Activision did not pursue a transaction with Vivendi. Furthermore, as 7.5 percent stockholders in Activision, the two executives had an incentive to obtain a higher price for Activision stock. The court thus reaffirmed that while a board cannot "completely abdicate its role," "in certain circumstances it is appropriate for a board to enlist the efforts of management in negotiating a sale of control."

Although the plaintiff argued that the outside directors forming the Committee breached their duty of loyalty by failing to retain independent advisors, the court did not attach special significance either to the board's authorization to hire such advisors or the Committee's failure to ultimately

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

do so. The court merely stated that the plaintiff's failure to state a claim that the outside directors breached their duty of loyalty by allowing the executives to play a significant role in negotiating with Vivendi also alleviates concerns over the failure of the Committee to retain separate advisors. It follows, however, that had the two executives been found to have a conflict of interest, the board's authorization and the Committee's retention of independent advisors would likely have been more significant to the court.

The court also dismissed the plaintiff's claims that the board breached the good faith component of the duty of loyalty, in the process affirming the high bar set by *Lyondell* for such a claim to survive summary judgment. In establishing bad faith, "the relevant question is whether the director defendants '*utterly failed to attempt* to obtain the best sale price'" (emphasis added). To demonstrate the lack of bad faith in this case, the court pointed to the board's process and active involvement. Significantly, the court did not find it relevant that the board failed to "probe for alternatives," pointing out that the *Revlon* duties do not prescribe specific steps that a board must take prior to selling control of a corporation.

Lastly, the court rejected the plaintiff's claim that the board's failure to obtain a control premium or other protective device constituted a breach of the duty of loyalty, dismissing the notion that a board must obtain separate consideration in a sale of control to avoid breaching its fiduciary duties. The court emphasized that the order of inquiry is to first evaluate whether the directors breached their fiduciary duties, and then, if the facts support a claim of breach of fiduciary duty, scrutinize the adequacy of the consideration and evaluate whether there is a "control premium." As long as the process followed by the board is independent and disinterested, a plaintiff cannot state a claim for a breach of the duty of loyalty by merely alleging that the directors failed to obtain a control premium.

Conclusion - "Take Aways"

The Delaware Chancery Court applied the *Lyondell* decision to dismiss any *Revlon* claims suggesting that directors must follow a series of specific steps to satisfy their *Revlon* duties, confirming that a board has flexibility to decide what path to take to seek the best price reasonably available in a sale of control.

The ruling, together with the *Lyondell* and *Revlon* decisions, provides a number of lessons for boards of directors of targets when constructing deal processes and documenting their observance of fiduciary duties. Although the court emphasized that there is no "blueprint" or "specific steps" a board can follow to avoid breaching its fiduciary duty of loyalty, the decision does confirm certain practices as useful for boards of directors of targets to utilize in discharging their *Revlon* duties:[6]

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

Thoroughly vet any potential or actual conflicts of interest in individuals at the forefront of negotiations. Where potential conflicts of interest exist, ensure adequate oversight of negotiations by either separating conflicted individuals from the process or appointing a committee of outside directors to oversee the process and those individuals' involvement.

Meet regularly to review the progress of negotiations. Receive regular updates from individuals involved in negotiations, as well as professional financial and legal advisors. Most importantly, maintain a clear record of this involvement in the process, including any directions given to individuals at the forefront of negotiations.

Although not specifically required by the *Wayne County* decision, when a board appoints a committee of independent directors to oversee a business combination process, the board should authorize the committee to retain independent financial and legal advisors, and the committee should consider retaining these outside advisors early on to independently evaluate the transactions and any alternatives to them.

Carefully consider what pre- and post-signing market check mechanisms (e.g., "top-up" or "go-shop" provisions) should be required as part of the transaction and document the negotiating process for those mechanisms finally agreed to.

back to top

---

[1] *Wayne County Employees' Retirement System v. Robert J. Corti, Ronald Doornink, Barbara S. Isgur, Robert A. Kotick, Brian G. Kelly, Robert J. Morgado, Peter J. Nolan, Richard Sarnoff and Activision Inc.*, C.A. No. 3534-CC (Del. Ch. July 24, 2009).

[2] Vivendi Games, Inc. produces the well-known online multiplayer game *World of Warcraft.*

[3] 970 A.2d 235 (Del. 2009).

[4] *Revlon, et al. v. McAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

[5] Activision's charter contained a typical exculpatory provision as permitted under Section 102(b)(7) of the Delaware General Corporation Law, limiting the personal liability of Activision's directors to the corporation or its stockholders for monetary damages for breach of fiduciary duty claims, subject to exceptions, including breaches of the duty of loyalty or bad faith acts or omissions.

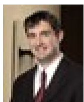
[6] Directors of corporations with a charter that does not contain the permitted exculpatory provision

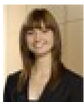
Document hosted at JDSUPRA
http://www.jdsupra.com/post/documentViewer.aspx?fid=1fc555c6-8f1c-4181-a22b-40ef2ea9029c

under Section 102(b)(7) of the Delaware General Corporation Law can also face breach of duty of care claims.

For additional information on this issue, contact:

David Grinberg Mr. Grinberg's practice focuses on mergers and acquisitions, including tender offers, proxy contests, hostile takeovers and special committee representation, and underwritten securities offerings, including initial public offerings and public and private offerings of equity and debt.


Matthew S. O'Loughlin Mr. O'Loughlin's practice focuses on securities regulation, capital markets transactions, and mergers and acquisitions. He also provides general corporate advice and transaction assistance for emerging companies through exchange-traded entities.


Sarah Fergusson Ms. Fergusson is an associate with the Corporate & Finance practice group in the Los Angeles office. Her practice focuses on a broad range of corporate and securities matters, including mergers and acquisitions, SEC and exchange listing compliance, and other general corporate advisory matters.

ATTORNEY ADVERTISING pursuant to New York DR 2-101(f)

Albany | Los Angeles | New York | Orange County | Palo Alto | Sacramento | San Francisco | Washington, D.C.

© 2009 Manatt, Phelps & Phillips, LLP. All rights reserved.