Chancery Court Provides Another Lesson for a Reasonable Sale Process

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In a recent decision, *Chen v. Howard-Anderson*, the Delaware Chancery Court once again questioned the reasonableness of how a board conducted the sale of a company when it permitted stockholder claims to go to trial. The decision provides yet another reminder—if one is needed—that boards and their advisors need to ensure that a sale process is conducted in a manner that promotes a level playing field for all bidders and that disclosure to stockholders provides a fair and balanced description of the process.

Background

Former stockholders of Occam Networks Inc. are challenging the February 2011 merger of Occam and Calix Inc. in a cash and stock transaction. The stockholders are claiming that Occam's directors breached their fiduciary duties by conducting an unreasonable sale process which favored one bidder and by failing to make complete and accurate disclosure to stockholders in connection with the merger vote. Although the Court denied summary judgment and ordered to trial most of the claims, a very different picture of events could emerge at trial. Nevertheless, *Chen* is the latest in a string of recent Delaware decisions criticizing the conduct of sell-side boards and financial advisors, possibly heralding a period where the Delaware Chancery Court will not hesitate, with increased vigor, to force cases to trial or impose liability if evidence suggests improper motives and conflicts of interests that result in the interests of stockholders not being adequately protected.

Takeaways

1. <u>Sell-Side Boards and Advisors Cannot Appear to be Tilting the Playing Field</u>. The Court found evidence that the Occam board favored Calix at the expense of generating greater value through either a competitive bidding process or by remaining independent. For instance, while Occam waited five months to sign a non-disclosure agreement with another serious potential bidder, Adtran, Occam interacted regularly with Calix representatives and quickly signed a non-disclosure agreement, "barely negotiated over Calix's term sheet, agreed to exclusivity, and passively extended the exclusivity" three separate times; senior Occam executives met with Calix while Adtran was confined to meeting with the company's financial adviser; and in presentations

to the board, management portrayed Calix and Adtran's bids as equivalent even though the Adtran bid was an all-cash offer (as opposed to Calix's cash and stock mix) at an 11% premium over Calix's bid. Sellers and their advisors need to continually assess their handling of the sale process, including the seniority of persons interacting with potential acquirors, the impressions conveyed to bidders, the breadth and quality of information provided to bidders, and the extent and timing of the interactions, to ensure parity of opportunity among similarly situated potential buyers.

2. Courts Will Not Give Sellers Credit for Perfunctory Market Checks. Vice Chancellor Laster found that the board acted unreasonably and further tilted the scales toward Calix by conducting a "market check" that consisted of giving interested parties 24 hours over a summer holiday weekend to consider a bid for Occam. The Court noted that as early as June 2009, Occam's financial advisor recommended a competitive process and identified potential candidates. None was pursued aggressively. Then, on the Thursday before the July 4th weekend, the financial advisor emailed seven potential acquirers and, without mentioning Occam by name, imposed a 24-hour response deadline. Five of the seven expressed interest but asked for time, which was not provided. For a market check to support a sell-side board's process and decision, it needs to be meaningful and fair in providing a realistic prospect of generating a competing bid.

3. Directors' Breach of the Duty of Disclosure May Be Reviewed Post-Closing and Result in Damages. Citing another recent Chancery Court opinion, *In re Orchard Enterprises,* the Court rejected the argument that it was not possible to award a remedy for a disclosure breach because the merger had closed and was not a short-form merger or controlling stockholder transaction. If plaintiffs prove a non-exculpated breach of the fiduciary duty of disclosure, damages are recoverable in a quasi-appraisal proceeding. As explained in *Orchard*, quasi-appraisal damages award plaintiffs "the intrinsic value of [the corporation's] common stock using standards applied in an appraisal," less the merger consideration. The ruling confirms that disclosure claims continue to present a threat after a merger closes. Directors and their advisors need to ensure accurate and non-misleading disclosure of material facts, particularly involving the financial analyses supporting the directors' decision to approve the transaction.

4. Financial Projections and the Circumstances Surrounding Their Preparation Will Be Closely Scrutinized. The Court focused on the importance of financial projections in refusing to dismiss disclosure claims. Occam management produced three sets of projections for 2012, all of which predicted increased revenue and were higher than street projections on which the potential buyers based their bids. None was disclosed to stockholders in the proxy statement. While defendants argued that the projections were not reliable and therefore need not have been disclosed, the Court cited evidence that the 2012 projections were "carefully created and vetted by management" and created "side-by-side" with the 2010 and 2011 projections that were disclosed. The Court also observed that the 2012 projections were provided to the seller's financial advisor, which was later "told to disregard them." As in *Rural Metro*, Delaware

Courts will view with skepticism evidence of multiple financial valuations or analyses prepared and used for varying purposes in a sale process. Decisions that management projections are unreliable and need not be disclosed or utilized need to be justified and carefully vetted.

5. Director and Officer Conduct in a Sale Process Can Result in Personal Liability for Breach of the Duty of Loyalty. The Court held that directors and officers can be personally liable for breach of the duty of loyalty if it can be established that they acted unreasonably in conducting the sale process and allowed interests other than the pursuit of the best possible transaction for stockholders to influence their decisions. While the Court found evidence of an unreasonable sale process, it did not find evidence that Occam's independent directors did not act in good faith pursuit of the best value reasonably available for stockholders. It therefore dismissed the sale process claims against outside directors pursuant to Occam's Section 102(b)(7) raincoat provision, which precludes monetary liability against directors for breaches of due care. But the Court sent to trial the same claims against an inside director (Occam's CEO) and a company officer because under Delaware law raincoat provisions do not cover non-director officers or directors acting in an officer capacity.

6. Serving as a Dual Fiduciary Does Not Dilute a Director's Fiduciary Duties. In finding no evidence that directors acted in bad faith, the Court clarified the duties of directors who are also fiduciaries to large stockholders. Particularly, the plaintiffs claimed that one director was motivated by his position as a general partner of a fund that owned 15% of Occam's common stock because a quick cooperative deal with a company like Calix would help the fund in its alleged desire to wind down. While a desire to gain liquidity for an investment may result in a divergence of interests between a fund with which a director is affiliated and stockholders more generally, the Court found no evidence to support an inference that this director sought to manipulate the sale process to the detriment of the stockholders and was motivated other than by a desire to maximize stockholder value. The Court emphasized that where the interests of the company and a stockholder to which a director owes a duty are aligned, there is no breach of the duty of loyalty. Nonetheless, a director in such a position needs to carefully assess when, if ever, the company and the stockholders' interests diverge and take appropriate action, such as recusal from the relevant deliberations.

7. Proxy Disclosure Needs to Fairly and Accurately Describe the Sale Process. The Court noted that there was extensive evidence that the background of the merger section in the proxy statement "more closely resembled a sales document than a fair and balanced factual description of the events leading up to the Merger Agreement." For instance, early contacts with bidders and status of negotiations and the extent of dealings with other bidders need to be reviewed and evaluated to determine whether they are important to stockholders in deciding whether to approve the transaction. A fully informed stockholder vote, Vice Chancellor Laster suggested, could lower the standard of review for a sale process challenge to a business judgment rule standard.

For a copy of the full opinion, click here.

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If you have any questions, please contact any of the following attorneys or your Cadwalader contact:

Jason M. Halper	+1 212 504 6605	jason.halper@cwt.com
William P. Mills	+1 212 504 6436	william.mills@cwt.com
Martin L. Seidel	+1 212 504 5643	martin.seidel@cwt.com