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M&A Update

Chancery Court Provides Lessons on Conflicts of Interest in a Sales Process – Holds Only Financial Advisor Open to Liability

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In an October 1st decision (*In re Zale Corporation*), the Delaware Chancery Court dismissed claims that Zale Corporation's directors breached their fiduciary duties in connection with Zale's agreement to merge with Signet. The Court, however, permitted a claim to proceed against Merrill Lynch, Zale's financial advisor, for aiding and abetting a breach of fiduciary duty by Zale's board of directors. In so holding, the Court sent yet another stern warning that financial advisors are well-served to disclose all potential conflicts of interest to their client in order to mitigate any potential aiding and abetting liability. The decision also offers valuable lessons with respect to potential director and stockholder conflicts of interest.

Background

In September 2013, Merrill Lynch was engaged by Zale and Golden Gate Capital, a significant stockholder of Zale, as the lead underwriter for a secondary offering of Zale shares held by Golden Gate. In October 2013, Signet's CEO approached Golden Gate's designees on the Zale board to discuss a potential merger between Signet and Zale. One day after this approach, representatives of Merrill Lynch pitched Signet's CEO and CFO on a possible acquisition of Zale at a value between $17 - $21 per share. On November 7, 2013, Signet made a formal acquisition proposal to the Zale board of directors. The Zale board then retained Merrill Lynch as its financial advisor to evaluate a potential transaction with Signet, and Zale ultimately agreed to be sold to Signet for a purchase price of $21 per share. Following completion of the transaction, former stockholders of Zale brought suit for post-closing damages against each of the Zale directors, Signet and Merrill Lynch.

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Takeaways

The decision addresses several key issues related to conflicts of interest and directors' fiduciary duties in the context of a merger transaction under Delaware law.

1. A Financial Advisor Will Be Responsible for Disclosing Its Own Conflicts. The decision reiterates lessons learned in *In re Rural Metro* that a financial advisor may be held accountable for aiding and abetting a board's violation of its duty of care if a financial advisor does not disclose to the board all conflicts of interest that may be presented by the financial advisor's engagement. In this case, the Court refused to dismiss the claim against Merrill Lynch because the plaintiffs sufficiently alleged that Merrill Lynch "knowingly participated" in the board's breach of its duty of care. The Court noted that a representative of Merrill Lynch was a member of the team that pitched Signet as well as the team that advised Zale, and the representative made a conscious decision not to disclose the conflict to Zale's board prior to execution of the merger agreement. The Court further held that reliance by the conflicted employee on the advice of Merrill Lynch's conflicts clearance department does not absolve Merrill Lynch of liability. The decision emphasizes the importance of disclosing to the board in advance of an agreement all potential conflicts of interest to further a financial advisor's chances of success at the motion to dismiss phase, no matter how immaterial or "ordinary course" the actions underlying the conflict may seem.

2. A Board Is Responsible for Investigating Its Financial Advisor's Conflicts. Even though the Zale directors were exculpated from liability for a breach of the duty of care under DGCL §102(b)(7), the Court considered whether the Zale directors breached their duty of care for purposes of evaluating the aiding and abetting claims against Signet and Merrill Lynch. The Court found that it is reasonably conceivable that the Zale directors breached their duty of care by not acting in an informed manner in approving the transaction due to the non-disclosure of Merrill Lynch's conflict of interest prior to execution of a merger agreement. In this regard, the Court noted that Merrill Lynch's ability to negotiate a purchase price in excess of $21 per share on behalf of Zale may have been hampered by its previous presentation to Signet in which it suggested that Zale could be acquired for a maximum purchase price of $21 per share. As previously highlighted in *In re Rural Metro*, "part of [a board] providing active and direct oversight is acting reasonably to learn about actual and potential conflicts faced by their…advisors." While the Court acknowledged that the Zale board "generally considered" Merrill Lynch's potential conflicts, it also offered practical guidance for uncovering potential conflicts, including by including relevant representations and warranties in the engagement letter, asking probing questions regarding previous relationship with potential counterparties, and interviewing and considering numerous financial advisors.

3. Director Actions Underlying Financial Advisor Aiding and Abetting Liability Generally Will Not Be Reviewed under the Heightened Revlon Standard If a Majority of Informed and Disinterested Stockholders Approved the Transaction. At the time of this decision, the Delaware Supreme Court's decision in *Corwin, et al. v. KKR Financial Holdings LLC.*, *et al.* (regarding whether a post-merger damages claim should be reviewed under the business judgment rule if the transaction were approved by a fully informed vote of the disinterested stockholders) remained pending. Thus, the Court reviewed the directors' actions under the heightened Revlon standard to determine whether they fell within a range of reasonableness with the ultimate goal of maximizing the Company's sale price. However, only a day after this decision was handed down, the Delaware Supreme Court found in KKR that a fully informed stockholder vote did result in business judgment rule review of a post-closing damages claim. Thus, Merrill Lynch's success on appeal likely will now be predicated on whether Zale's directors acted in accordance with the less stringent business judgment rule, as opposed to the enhanced Revlon standard.

4. Disclosure of a Conflict Prior to Stockholder Approval May Not Cleanse the Conflict. Merrill Lynch eventually did disclose the potential conflict of interest to the Zale board and disclosure of the conflict was included in the proxy statement distributed to Zale stockholders. However, the Court found that such post-signing/pre-stockholder approval disclosure did not necessarily cleanse the conflict, noting that certain financial advisor conflicts may not, as a matter of law, be waived by a board and that the stockholders may have suffered damages or "left some money on the table" during the negotiation of the transaction which occurred prior to the conflict disclosure and approval.

5. An Unsupported Allegation of a "Need for Liquidity" Does Not Support a Finding of Stockholder Conflict. As noted above, under KKR, a post-merger damages claim will be reviewed under the business judgment rule if the transaction has been approved by a fully informed vote of the disinterested stockholders. Zale's former stockholders argued that Golden Gate, a significant stockholder and holder of Zale debt that would be prepaid in the transaction, was an interested stockholder because it was to receive unique, material benefits in the form of liquidity. However, the Court rejected these arguments, noting that the complaint included only conclusory allegations of Golden Gate's desire to liquidate its position in Zale and did not provide any evidence that Golden Gate had an exigent need for liquidity. Alleging that a stockholder has a "desire to sell quickly" by itself is not sufficient to defeat a motion to dismiss. Indeed, Golden Gate had an alternative path for liquidity in the form of the proposed secondary offering. Furthermore, as a large stockholder, Golden Gate was incentivized to maximize the value of its stock just as all other stockholders had been.

6. A Majority of the Board Must Be Interested in the Transaction or Controlled by Interested Members to Implicate the Duty of Loyalty. Because Zale's certificate of incorporation contained

an exculpatory provision pursuant to §102(b)(7) of the DGCL, the Zale directors would be subject to liability only if the Zale directors breached their duty of loyalty. One way in which the duty of loyalty may be implicated is if the transaction were not approved by a board consisting of a majority of disinterested directors. The Court rejected the argument that a majority of the directors were not disinterested, explaining that only four of the nine directors were even allegedly conflicted and that these four did not so dominate the sales process that the majority of the board could be found to be interested. Indeed, the Court noted that even if a conflicted director participates in a sale process, the process is not tainted if the conflicts are disclosed to the board (which in this case, they were) and the "board is fully committed to the process." The Court further noted that the two Golden Gate nominees were not interested in the transaction because, even if their nominees were deemed to be beholden to Golden Gate, the liquidity that Golden Gate would receive in the transaction did not form the basis of a material conflict (as discussed above). Furthermore, the Court found that the other two directors were not interested due to the vesting of their restricted stock in the transaction, as such vesting is a "routine aspect of merger agreements," "the accelerated vesting of options does not create a conflict of interest because the interests of the stockholders and directors are aligned in obtaining the highest price," and the complaint did not include any discussion as to whether the alleged conflicts were material to the applicable directors. The Court, however, did find it conceivable that one director, who stood to double his employment compensation if the transaction were to occur, was interested.

7. Bad Faith by Directors in a Sales Process Is a Difficult Standard to Prove. Alternatively, a breach of the duty of loyalty can be found if the directors acted in bad faith with respect to the sale transaction. Bad faith, in the Revlon context, consists of "conscious disregard for duty" or actions that are "so far beyond the bounds of a reasonable judgment" that they are "inexplicable." In alleging bad faith, the stockholders accused the Zale board of, among other things, undervaluing Zale's stock, favoring Signet in the merger process, agreeing to an unreasonable merger price and unreasonable deal protections, relying on a conflicted financial advisor, and catering to Golden Gate's need for liquidity. The Court analyzed each of these allegations and found that the Zale directors did not act in bad faith in agreeing to the sale. Specifically, with respect to Zale's reliance on a conflicted financial advisor, the Court held that "making an inquiry initially to discover a financial advisor's conflicts, and later, upon being advised of a possible conflict, considering the implications of and remedies for that conflict…hardly constitutes [bad faith]." This highlights the fact that certain allegations may not rise to the level of bad faith on the part of a director defendant but may still form the underlying basis for an aiding and abetting claim against a conflicted financial advisor.

8. Views of Significant Stockholders and Proxy Advisory Firms May Be Taken into Account in an Analysis of Bad Faith. In arguing that the Zale board acted in bad faith by agreeing to an unreasonable merger price, the former Zale stockholders pointed to, among other things, the

objection to the transaction by several large stockholders and Glass Lewis, a proxy advisory firm. However, the Court rejected this argument, noting that Golden Gate, a significant stockholder, and ISS, a proxy advisory firm, supported the transaction. The Court's consideration of ISS's and Glass Lewis's views in this context further evidence the significant role that proxy advisory firms can play in today's M&A environment.

For a full copy of the opinion, click here.

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