Clients&FriendsMemo

Director who led merger negotiations, without disclosing details of a lucrative pay package he was offered to lead the post-merger company, must face fiduciary duty claims

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The Delaware courts have not been shy about warning of the dangers that can arise when merger negotiations are handed over to conflicted directors who fail to keep their boards fully informed about their divided loyalties. Over the last two years, the Delaware Supreme Court has faulted a director for lining up a buyer without disclosing that he had negotiated a lucrative equity roll-over deal on the side,[1] and the Court of Chancery chastised a director (and his hedge fund sponsor) for engineering a quick sale of a company without disclosing to the rest of the board that he had been tipped off to the price the buyer had in mind.[2] Directors have an "'unremitting obligation' to deal candidly with their fellow directors," the Delaware courts have stressed,[3] and that is no more true than when they are entrusted to lead merger negotiations.[4]

Just how much disclosure is required regarding a director's conflicts can be difficult to discern, but a recent decision from the Delaware Supreme Court serves as yet another warning to directors who are running merger negotiations—and the suitors on the opposite side of the table—to err on the side of greater disclosure. In *City of Fort Myers General Employees' Pension Fund v. Haley*,[5] the Delaware Supreme Court reinstated claims against the Chairman and CEO of Towers Watson & Co., who led negotiations on a 2016 "merger of equals" with Willis Group Holdings Public Limited Company. The Towers board knew, when it handed over negotiations to its CEO, that if the merger closed, he was in line to helm the combined company—and likely see a significant pay increase as the head of a combined company that would be twice the size of pre-merger Towers. But the CEO failed to inform the Towers board that, during negotiations, a Willis director and CIO of a major

1 *Morrison v. Berry*, 191 A.3d 268 (Del. 2018).

2 *In re PLX Tech. Inc. Stockholders Litig.*, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018), *aff'd*, 211 A.3d 137 (Del. 2019).

3 *Morrison*, 191 A.3d at 284 (quoting *HMG/Courtland Props., Inc. v. Gray*, 749 A.2d 94, 119 (Del. Ch. 1999)).

4 Boards of directors involved in merger discussions also have obligations to attempt to identify and address conflicts on the part of their financial advisors, and the failure to do so may in itself constitute a breach of fiduciary duty. *See RBC Capital Markets LLC v. Jervis*, 129 A.3d 816 (Del. 2015).

5 ___ A.3d ___, 2020 WL 3529586 (Del. June 30, 2020) (en banc).

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Willis stockholder, ValueAct Capital Management L.P. (the "Fund Manager"), which allegedly was agitating for the merger, detailed what that pay bump would look like: a package offering a more than five-fold increase over his pay as CEO of stand-alone Towers.

The Court of Chancery "summarily discounted" that revelation as insignificant to the other Towers directors' approval of the merger and dismissed the suit. But in the Delaware Supreme Court's view, the other Towers directors would have found this undisclosed information "significant" in their evaluation of the merger agreement the CEO struck.[6] As a result, the Supreme Court reinstated the claims against the Towers CEO, along with aiding and abetting claims against both the Fund Manager and its CIO.

Directors and their advisers should take note of the robust standard of transparency Delaware expects of directors who lead negotiations on behalf of a company. Director-negotiators should not assume that as long as their fellow directors are aware of the general contours of potential conflicts, they do not need to keep them apprised of new details that emerge during the course of negotiations—particularly when the merger discussions touch on their future role and compensation. And on the other side of the table, counterparties must ensure that when they broach the subject of potential individual benefits for the negotiator across from them, they are not participating in a breach of loyalty.

Background

According to the complaint, during the years following the 2008 financial crisis, Willis—which was in the global advisory, brokering, and solutions business—was unable to shake itself out of a slump. Around that same time, the Investment Fund—an asset manager for institutional investors with approximately $15 billion in assets under management—took a 10% stake in Willis. After a few more years of stagnant performance, the Fund Manager's CIO—who sat on the Willis board and served as a member of its compensation committee—grew impatient and began to urge Willis to consider strategic alternatives. To that end, Willis's CEO met with his counterpart at Towers, John Haley, who also chaired the Towers board, to float the idea of a merger. Towers was a professional services firm that consulted on risk management, human resources, and actuarial and investment matters, and the transaction was couched as a potential strategic merger of equals.

But Towers and Willis were not equals. While Towers had outperformed the S&P 500 by 143% from 2010 to 2015, Willis underperformed the S&P over that same period by 47%. Nonetheless, discussions between the two sides continued. During those early discussions, Moody's downgraded Willis's debt, putting Willis at risk of tripping leverage covenants in its debt

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[6] *Id.* at *16.

agreements if it did not shore up its equity position. Moody's, presciently, observed that one option available to Willis was to try to bolster its earnings through an acquisition.

Discussions between Willis and Towers intensified, and Haley proposed a structure that would give the Towers stockholders majority control of the combined company, but Willis proposed basing the terms on certain financial metrics that had the effect of giving the Willis stockholders control. Around that same time, one of the other Towers directors proposed to Willis that Haley be chosen to lead the combined company, and Willis agreed. The Towers board allegedly was generally aware that, as CEO of a combined company that would be twice the size of Towers, Haley would be in line for a pay bump, but despite that potential conflict of interest, the Towers board left negotiations in Haley's hands.

Within weeks, Haley had given up pressing Willis for Towers stockholders to have control of the post-merger company, proposing instead that the transaction include a special dividend to Towers stockholders to bridge the gap between the two companies' valuations. The two sides also discussed the composition the combined company's board. Haley allegedly had reason to believe that the Fund Manager's CIO—who was currently serving on the Willis board's compensation committee—would be one of the directors chosen for the combined company board and "perhaps" would even be on the combined company's compensation committee.[7]

After a period of negotiations, Haley and his counterpart at Willis agreed to terms that would give Willis stockholders 50.1% of the combined company, with Towers stockholders in line for a special dividend worth $337 million. Haley took the agreement to the Towers board. Their bankers opined that the deal was fair to Towers, even though the merger consideration—including the special dividend—valued Towers shares at a 9% discount to their unaffected trading price. Nonetheless, the board approved the transaction. On the day the merger was announced, Towers stock dropped nearly 9%, with one analyst writing that Towers investors were "somewhat taken aback" by the way the deal favored Willis.[8]

A few months later—as the stockholder votes on the merger were approaching—the Fund Manager reached out to Haley and presented him with a pay proposal for his role as combined-company CEO. The package stood to net Haley upwards of $140 million over the first three years—more than five times the $24 million he earned over the prior three years at Towers. The Fund Manager's CIO checked in on Haley later that month, writing: "I hope it was informative how we work with our

[7] *Id.* at *4.

[8] *Id.* at *5.

companies. We are excited about working with you and the new board. I forgot to mention we have purchased $50 million in [Towers] as an expression of this excitement."[9]

Around that same time, a Towers stockholder commenced a vocal vote-no campaign against the merger, which included reaching out to the company to express concern about the relationship between Haley and the Fund Manager. Both ISS and Glass Lewis then recommended that Towers stockholders reject the deal. With opposition mounting, the Fund Manager took a greater role in the process, including working with Haley to convince major Towers stockholders to support the deal. But given the uncertainty now surrounding the vote, the two sides began renegotiating the merger terms. This time, rather than work with his counterpart at Willis, Haley negotiated with the Fund Manager's CIO.

The result they reached was to roughly double the special dividend while leaving the exchange ratio untouched. But that still left Towers stockholders with merger consideration valued at 7% less than the unaffected share price. The Towers stockholders who later challenged the deal claimed that this bump to the special dividend was "not . . . the best deal [Haley] could get for Towers stockholders," but rather "the minimum amount necessary to secure the Stockholder Approval he needed to push the Merger through so he could secure the massive compensation Proposal [the Fund Manager's CIO] had promised him."[10] Nonetheless, the Towers board approved the terms, and 62% of Towers stockholders approved the merger.

The other Towers directors did not learn that Haley and the Fund Manager had discussed a pay package—or its magnitude—until after the merger closed. One of the Towers directors testified in a post-closing appraisal action that "he would have wanted to know that Haley had been discussing his compensation at the future company with [the Fund Manager and its CIO], but did not receive such information, let alone information as to the magnitude of the raise that Haley stood to receive."[11]

The merger spawned a number of lawsuits, including one in the Court of Chancery by Towers stockholders claiming that Haley breached his duties to Towers by failing to disclose the secret pay discussions to the board and that the other Towers directors breached their duties by failing to properly oversee Haley's negotiations. They also claimed that the Fund Manager and its CIO aided and abetted Haley's breach by dangling the pay package in front of Haley in the midst of negotiations and pressuring Towers stockholders to approve the deal.

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[9] *Id.*

[10] *Id.* at *7.

[11] *Id.* at *8.

The Court of Chancery dismissed the suit in its entirety, and the stockholders appealed as to their fiduciary duty claims against Haley and their aiding-and-abetting claims against the Fund Manager and its CIO.[12]

Takeaways

1. Directors charged with negotiating on behalf of their companies must keep their boards fully informed—particularly about their own conflicts and particularly if those conflicts deepen over time. In reversing the Court of Chancery, the Delaware Supreme Court emphasized that it is "firmly embedded" in Delaware law that directors must disclose all material information about their potential conflicts to the board.[13] The court observed that directors' duty of candor is "unremitting" and bars them from using their "position of trust and confidence to further their private interests."[14] Despite those "uncontroversial" points of Delaware law,[15] the defendants—and the Court of Chancery—believed that Haley had no obligation to disclose the details of the pay package because the Towers board already knew, in a general sense, that Haley would be in line for a pay increase if the merger closed. But to the Supreme Court, Haley should have informed the board of the "deepening of the potential conflict" that occurred when the Fund Manager presented him with concrete figures showing a more than five-fold pay increase—particularly given the uncertainty about whether the merger was truly in Towers's best interests on the terms proposed by Willis.[16] That much was "evident," the Court said, from the fact that one of the Towers directors testified that he "would have wanted to know" about those pay discussions, and the fact that the Towers stockholder who had been campaigning against the deal had reached out to Towers to inquire about whether Haley's relationship with the Fund Manager may have impaired his ability to negotiate in good faith. The Court's conclusion was unchanged despite the non-binding nature of the compensation proposal because the mere "prospect" that the proposal may have swayed Haley's decision-making was enough to require it to be disclosed.[17]

   This decision is a strong statement of the duty to deal candidly with fellow directors, and directors entrusted with the power to negotiate should heed this decision as a warning to err on the side of disclosure. Directors must keep their boards informed of the course that

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[12] The stockholders did not appeal their claims against the other Towers directors for failing to properly oversee Haley.

[13] *Id.* at *12.

[14] *Id.* (quoting *Guft v. Loft*, 5 A.2d 503, 510 (Del. 1939)).

[15] *Id.* at *12.

[16] *Id.* at *14.

[17] *Id.* at *15.

negotiations take—particularly if negotiations broach the subject of individual benefits for the negotiator—and should not assume that as long as their boards have a general sense of their potential conflicts, no further information has to be disclosed.

2. While directors must keep their boards fully informed about their conflicts, the fact that they may have a personal interest in a transaction does not disqualify them from negotiating on the company's behalf. While the Court chastised this director for keeping the details about his potential pay package to himself, the Court was careful to note that there is "nothing inherently wrong with a Board delegating to a conflicted CEO the task of negotiating a transaction" as long as the conflict is "adequately disclosed" and the board "properly oversee[s] and manage[s] the conflict."[18] In that sense, the Court echoed its decision in *RBC Capital Markets LLC v. Jervis*,[19] a case we have previously discussed,[20] in which the Court affirmed the Court of Chancery's determination that the directors of Rural/Metro Corporation breached their fiduciary duties by relying on a financial advisor whose "advice was overly biased by its financial interests" because the board took "no steps to address or mitigate [the advisor's] conflicts."[21] Here, the Court reiterated, as it said in *RBC*, that "a board may be free to consent to certain conflicts" provided that the directors are "active and reasonably informed when overseeing the . . . process, including identifying and responding to actual or potential conflicts of interest."[22] That said, a board that chooses to cede authority to a conflicted representative must "be especially diligent in overseeing [that person's] role" and should have a framework in place to ensure that "conflicts that might impact the board's process are disclosed . . . throughout the . . . process."[23]

3. The Court resisted the opportunity to align Delaware's materiality standards, but recognized that they often lead to the same result. The issue of "materiality" arises in two key contexts: when, as here, a director allegedly withholds information from the rest of the board, and when a company withholds information from its stockholders. The former can undermine a board's decision-making process, while the latter can undermine stockholders' ability to vote and make other investment decisions on an informed basis. In *Brehm v. Eisner*—which famously concerned the Disney board's approval of Michael

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[18] *Id.* at *14 n.69.

[19] 129 A.3d 816 (Del. 2015).

[20] *See* Jason Halper et al., *A 24% stockholder of seller and seller's board must face fiduciary duty claims due to flawed sales process and inadequate merger-related disclosures* 7–8 (July 8, 2019), https://www.cadwalader.com/uploads/cfmemos/4a0797b8d5c73871eb9286f920390c48.pdf.

[21] *RBC*, 129 A.3d at 850, 855.

[22] *Haley*, 2020 WL 3529586, at *14 n.69 (quoting *RBC*, 129 A.3d at 855).

[23] *RBC*, 129 A.3d at 855–56 nn.129 & 130.

Ovitz's severance package—the Court made a point of cautioning that the term "material," when used in the context of whether a fact would have been "important to directors" in their decision-making process, "is distinct from the use of the term 'material' in the quite different context of disclosure to stockholders."[24] That statement led to a dispute in this case about whether lines of decisions involving the materiality standard in one context are relevant to the other. While the Court maintained that the "materiality inquiry is different in those two contexts,"[25] it acknowledged that in many cases, Delaware courts have found the same information material in both contexts and have looked to cases from both contexts to resolve materiality disputes. And so it was here: the Court concluded that Haley's potential pay package "would be material in either context," which meant that not only should Haley have disclosed that information to the board, but also that stockholders should have had the benefit of it when voting on the merger.[26] Careful advocates will continue to acknowledge the distinction between these two lines of cases, but given that the materiality inquiry is heavily fact-specific, advocates should not shy away from leveraging authority across both lines of cases to seek out authority with closely analogous facts.

4. No *Corwin* cleansing—again. After the Delaware Supreme Court decided *Corwin v. KKR Financial Holdings, LLC*—holding that, under most circumstances, approval by a majority of fully-informed, uncoerced stockholders mandates deferential business-judgment-rule review—some expressed concern that, when combined with other limitations the Court has placed on stockholder remedies, like appraisal, the "pendulum [had] swung . . . too far" in the direction of director-defendants.[27] But as we have previously discussed,[28] the Delaware Supreme Court has shown a willingness to temper the impact of *Corwin* by finding—in an increasing line of cases—that stockholder votes that appeared to cleanse transactions in fact were not fully informed. This case marks the latest in that line: having concluded that Haley's potential pay package would have been material to stockholders weighing whether to approve the transaction, the Court refused to apply *Corwin*.[29] The

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[24] 746 A.2d 244, 259 n.49 (Del. 2000).

[25] *Haley*, 2020 WL 3529586, at *14.

[26] *Id.*

[27] *See* Halper et al., *supra* note 20, at 5 (quoting Jeff Montgomery, *Stuart Grant Retires With A Warning For Delaware's Future*, Law360 (July 27, 2018), https://www.law360.com/articles/1067865/stuart-grant-retires-with-a-warning-for-delaware-s-future).

[28] *See* Halper et al., *supra* note 20.

[29] *Haley*, 2020 WL 3529586, at *14 n.67 ("Because the omitted information is material to both the Towers Board and stockholders, we need not consider Appellees' alternate ground for affirming the Court of Chancery, namely, that *Corwin* 'cleansing' applies."). The proxy statement disclosing the merger mentioned only that Haley had been chosen to lead the combined company—it "did not mention the [pay] Proposal, any discussions about management's post-merger compensation, or the extent of [the Fund Manager's] role in the merger process." *Id.* at *6.

Court's rejection of the defendants' *Corwin* defense demonstrates that not only must conflicted directors be careful to keep their boards fully informed to avoid individual liability, but boards must ensure that if they delegate negotiations to a conflicted director, they fully inform themselves of those conflicts and fully disclose them to stockholders. Otherwise, they risk losing the powerful *Corwin* defense against potential post-deal litigation.

5. A fuller picture is emerging of Delaware's post-*Corwin* materiality inquiry. In a footnote, the Court "reject[ed] any contention . . . that the Delaware standard" of materiality in the context of shareholder disclosures differs from the federal standard[30]—an apparent shot across the bow against any argument that, post-*Corwin*, the Court has lowered the standard for materiality. But the Court has also said that "[c]areful application of *Corwin* is important due to its potentially case-dispositive impact," and cases where the *Corwin* defense is at play have prompted careful scrutiny of whether stockholders voted "on materially incomplete or misleading information." [31]

Certain themes have emerged from these post-*Corwin* inquiries into the materiality of alleged misstatements or omissions. As seen in this decision and the Court's earlier decision in *Morrison v. Berry*, the Court is closely scrutinizing failures to disclose director conflicts. In *Morrison*, where a director who lined up a private equity buyer failed to disclose that he had privately negotiated with the prospective buyer for an equity roll-over—an omission the Court deemed "serious"—the Court engaged in a careful, word-by-word comparison of the company's 14D-9 disclosure to internal company emails to highlight information that was omitted.[32] Despite the fact that some of the details about that director's private agreement—which were omitted from the company's 14D-9 filing—may have been discernible from other filings made in connection with the transaction, that did not, in the Court's view, remedy the misleading "impression" left by the 14D-9 or suggest that the failure to disclose that information in the 14D-9 did not alter the "total mix" of information stockholders had available.[33]

In *Appel v. Berkman*, the Court repudiated a line of Court of Chancery decisions that had suggested that an individual director's specific reasons for abstaining or dissenting from a vote on a transaction may be per se immaterial.[34] It was not enough in that case, the Court said, to disclose that the company's chairman had abstained from voting on the company's sale and had not yet decided whether to tender his shares. While stockholders may have

[30] *Id.* at *13 n.61.

[31] *Morrison*, 191 A.3d at 274.

[32] *Id.* at 277.

[33] *Id.* at 284.

[34] 180 A.3d 1055, 1061–62 (Del. 2018).

been able to infer from that information that the chairman had misgivings about the transaction, the Court emphatically held that "proxy statements are not intended to be mysteries solved by their audience," and "stockholders should not be expected to speculate" about facts of that importance.[35]

Together, these cases demonstrate a particular post-*Corwin* solicitude for ensuring—before applying *Corwin*—that stockholders were fully informed of the process their boards followed and the role each of their fiduciaries played. The omissions in *Morrison*, the Court explained, would have allowed stockholders to make a "materially more accurate assessment of the probative value of the sale process,"[36] while in *Appel*, the Court made clear that stockholders must be given a "[f]ull and fair" picture of a board's deliberations—not one in which the "imperfections and inconsistencies" are "airbrushed away."[37] These cases all echo the Court's note of caution in *Corwin* itself that *Corwin*'s "cleansing" power is not to be applied if it turns out that "troubling facts regarding director behavior were not disclosed"[38] and highlight an area of disclosures to which the Delaware courts are paying particularly close attention.

6. Merger counterparties, too, must be careful when negotiating with conflicted fiduciaries. Because the Court of Chancery dismissed the claims against Haley, that court never reached the question of whether the Fund Manager and its CIO may be liable for aiding and abetting Haley's breach, and the Delaware Supreme Court declined the plaintiff-stockholders' invitation to weigh in before affording the lower court the opportunity. But given the Court's conclusion that the plaintiff-stockholders pleaded viable breach-of-fiduciary-duty claims against Haley, the stockholders needed only to show that the Fund Manager or its CIO knowingly participated in that breach to pursue them for liability. While that standard is undoubtedly "defendant-friendly,"[39] counterparties who are aware that they are dealing with a potentially-conflicted fiduciary should use caution when broaching any subjects that relate to that fiduciary's conflicts—particularly in the oft-recurring scenario of discussing future combined-company roles for existing executives—and guard against the possibility that the negotiator may be self-dealing.

Please click here for the full opinion.

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[35] *Id.* at 1064.

[36] 191 A.3d at 284.

[37] 180 A.3d at 1062.

[38] 125 A.3d at 312.

[39] *Singh v. Attenborough*, 137 A.3d 151, 152 (Del. 2016) (ORDER).

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