Buyer Beware: The Fiduciary Duties of a Buyer's Board

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The fiduciary obligations of a selling corporation's board of directors in the context of a corporate sale transaction, and the permissible scope of so-called "deal protection" measures in that context, have been the subject of frequent analysis in both case law and legal commentary. The fiduciary obligations of a buyer's board in connection with such a transaction, however, have until recently received scant attention.

A recent decision of the Delaware Court of Chancery, *Energy Partners, Ltd. v. Stone Energy Corp.*,[2] touched on the fiduciary duties of a buyer's board in agreeing to deal protection provisions that arguably restricted its ability to evaluate potential alternatives. While the Court concluded that the relevant provisions of the merger agreement were consistent with the fiduciary obligations of the buyer's directors, the decision nevertheless serves as an important reminder that directors and corporate practitioners should be sensitive not only to the fiduciary obligations of a seller's board in entering into a merger agreement, but also those of a buyer's board, particularly where a vote of the buyer's stockholders will be required.

I. Deal Protection Generally.

Generally speaking, deal protection measures are designed to address the risk of outside interference between the signing of a merger agreement and the closing of the merger. Typical deal protections include provisions prohibiting or restricting the solicitation of competing transactions and restricting the manner in which a party may permissibly respond to unsolicited competing proposals, as well as provisions that compensate one party or the other should the deal collapse under the weight of outside interference. From a buyer's perspective, deal protections that restrict the seller's ability to pursue other alternatives are necessary because the buyer will have invested significant time and resources, will have incurred substantial expenses, and will necessarily have foregone other potential opportunities in pursuing and committing to the transaction. The last thing a buyer wants is to be a "stalking horse" for competing proposals to acquire the seller, and without contractual deal protections a buyer would be far less willing to incur the burden and expense required to get the deal done.

A seller's board, on the other hand, will ordinarily seek to limit the scope of such deal protection provisions and to retain sufficient flexibility to evaluate and act upon late arriving offers and other changed circumstances that could impact whether the deal remains advisable. At the same time, the seller (like the buyer) has an incentive to seek deal protections that will enhance deal certainty and ensure that the buyer closes the deal. While the buyer does not want

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[2] 2006 WL 2947483 (Del. Ch. Oct. 11, 2006).

to be a "stalking horse," the seller does not want to be "put in play" and then lose its preferred deal simply because the buyer develops a case of cold feet.

II. The Fiduciary Obligations of a Seller's Board.

Directors of selling corporations and their counsel have long been sensitive to fiduciary limitations on the permissible scope of deal protections applicable to the seller. It is now generally understood that the fiduciary duties of the seller's board do not end with the signing of a merger agreement. Rather, the directors must retain the contractual flexibility to evaluate and possibly act upon competing offers and to keep stockholders informed as to all material matters pertaining to their vote.[3]

When stockholders challenge deal protection measures that arguably deter competing proposals to acquire the selling corporation, a Delaware court will closely scrutinize such measures for their reasonableness, consistent with the so-called *Unocal*[4] standard of review.[5] While that enhanced form of reasonableness review does not mean that a Delaware court will second-guess the good faith decisions of a seller's board in agreeing to specific deal protection provisions, it typically does involve a careful and contextually-specific assessment by the court as to whether the provisions at issue fall within a range of reasonableness in view of the particular circumstances facing the seller when the deal was signed.[6] Where a seller's board "has

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[3] *See*, *e.g.*, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 936 (Del. 2003) (holding that combination of deal protection measures in a merger agreement operated in tandem to irrevocably "lock-up" the merger and to preclude the target board from exercising its ongoing obligation to consider and accept higher bids and finding that such deal protection provisions "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction."); *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005) (discussed below); *Phelps Dodge Corp. v. Cyprus Minerals Co./Asarco Inc.*, 1999 WL 1054255, *2 (Del. Ch. Sept. 27, 1999) (Bench ruling) (finding that a "no talk" provision was the "legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care; that is, the duty to take care to be informed of all material information reasonably available."). Significantly, once the stockholders have approved a merger, the target board ordinarily has no further duty to consider competing bids. *See In re Mobile Commc'n Corp. of Am., Inc. Consol. Litig.*, 1991 WL 1392, at *7 (Del. Ch. Jan. 7, 1991).

[4] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

[5] *See*, *e.g.*, *Omnicare*, 818 A.2d at 934 (finding that deal protection measures designed to provide deal certainty for a buyer are defensive devices that "are subject to enhanced judicial scrutiny under a *Unocal* analysis"); *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1015 (Del. Ch. 2005) (engaging in the "close examination of the reasonableness of deal protections measures that is contemplated by the *Unocal* and *Revlon* standards"); *see also McMillan v. Intercargo Corp.*, 768 A.2d 492, 506 n.62 (Del. Ch. 2000); *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 (Del. Ch. 1999).

[6] *See*, *e.g.*, *In re Toys "R" Us*, 877 A.2d at 1015-16 (explaining that Delaware courts will engage in a context specific analysis of deal protection measures in an effort to determine, under the particular facts presented, whether the target board acted reasonably in accepting the deal protection devices at issue); *see also Louisiana Municipal Police Employees' Retirement System v. Crawford*, 2007 WL 582510, at *4 n.10 (Del. Ch. Feb. 23, 2007). Note, however, that the Delaware Supreme Court has held that certain deal protection measures (*e.g.*, those that result in a *fait accompli*) might be *per se* invalid under Delaware law. *See Omnicare*, 818 A.2d at 936.

actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end," more restrictive deal protection measures may be warranted.[7] However, "where a board has not explored the marketplace with confidence and is negotiating a deal that requires stockholder approval and would result in a change in stockholder ownership interests, a board's decision to preclude itself . . . from entertaining other offers is less justifiable."[8]

In its relatively recent decision in *Frontier Oil Corporation v. Holly Corporation*,[9] the Delaware Court of Chancery suggested that, regardless of the particular context (*e.g.*, the extent of the market canvass or the negotiating history between the parties), a merger agreement cannot restrict the fiduciary duty of the seller's board to reassess its recommendation to stockholders if circumstances change and to withdraw or modify that recommendation, if warranted, before the seller stockholder vote. *Frontier Oil* involved a merger agreement pursuant to which shares of the selling corporation would be converted into a mix of cash and buyer's stock. Following the execution of the merger agreement, it became apparent to the seller's board that certain potential liabilities of the buyer could have a significant impact on the value of the stock consideration to be received by the seller's stockholders in the merger. As a result, the seller indicated that it was reluctant to proceed with the transaction unless the merger agreement was amended to account for the increased liability.[10] In response, the buyer commenced suit, contending that the seller had repudiated and thus breached the merger agreement.

In rejecting the buyer's repudiation claim, the Court of Chancery found that the seller's statements did not rise to the level of a repudiation but, rather, amounted to no more than a suggestion that the seller's board would no longer recommend the transaction to its stockholders in the absence of modifications to the merger agreement. The Court emphasized that the merger agreement specifically contemplated that the seller could change its recommendation to stockholders prior to their vote, in which case the buyer would have had a termination right and might also have been entitled to a termination fee. Most importantly, for purposes of the present discussion, the Court stated that "[r]evisiting the commitment to recommend the Merger was not merely something that the Merger Agreement *allowed* the Holly Board to do; it was the *duty* of the Holly Board to review the transaction to confirm that a favorable recommendation would continue to be consistent with its fiduciary duties."[11] As discussed below, that principle should be equally applicable to a buyer's board.

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[7] *Ace*, 747 A.2d at 107 n.36.

[8] *Id.*

[9] 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

[10] The seller also was informed by its financial advisor that it had significantly undervalued certain of its assets and, therefore, the buyer had struck "a good, perhaps too good of a, deal." 2005 WL 1039027, at *11.

[11] *Id.* at *28 (emphasis added).

III. The Fiduciary Obligations of a Buyer's Board.

As noted, there is little case law or legal commentary specifically focusing on the fiduciary obligations of a buyer's board when approving an acquisition agreement and related deal protection provisions applicable to the buyer. Some guidance, however, can be gleaned from the case law dealing with the fiduciary duties of a seller's board.

For example, although *Frontier Oil* addressed the fiduciary duties of a seller's board to continue to assess its recommendation to stockholders prior to a stockholder vote, the authors believe that a buyer's board should be guided by the same principles in connection with any transaction in which a vote of the buyer's stockholders is required (whether by state corporate law, stock exchange rules, or otherwise). The reason a board (be it a seller or buyer board) has a fiduciary obligation to reassess its recommendation to stockholders in view of changed circumstances is that the directors have an obligation to keep stockholders fully informed with respect to matters on which they are requested to vote and must ensure that disclosures to stockholders remain truthful and not misleading. In that context, a buyer's board has no less an obligation to be truthful than does a seller's board.

The Delaware Court of Chancery's recent decision in *Stone Energy*, which dealt squarely with merger agreement restrictions on a buyer's conduct, provides some further guidance. While on one level, *Stone Energy* can be viewed as a straight-forward contract construction decision, the Court's analysis also has important implications with respect to the fiduciary obligations of a buyer's board of directors when entering into an acquisition agreement that contains deal protection measures designed to enhance deal certainty for the seller.

In *Stone Energy*, the Court of Chancery considered whether a restrictive covenant in a merger agreement should be construed to limit the ability of the buyer to engage in discussions with a third party bidder interested in acquiring the buyer. The proposed merger was structured as a stock for stock deal in which a vote of the buyer's stockholders was required by the rules of the national securities exchange on which the buyer's shares were listed. The covenant at issue was set forth in Section 6.2(e) of the merger agreement ("Section 6.2"), which provided, in pertinent part, that:

> Except as expressly permitted or required by this Agreement, prior to the Effective Time, neither [buyer] nor any of its Subsidiaries, without the prior written consent of [seller], shall:
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> (e) knowingly take, or agree to commit to take, any action that would or would reasonably be expected to result in the failure of a condition set forth in Sections 8.1, 8.2, or 8.3 [conditions to consummation of the merger] … or that would reasonably be expected to materially impair the ability of [seller], [buyer], Merger Sub, or the holders of Target Common Shares to

> consummate the Merger in accordance with the terms hereof or materially delay such consummation . . . .[12]

Following the execution of the merger agreement, a third party announced a hostile tender offer to acquire control of the buyer. As a result, a dispute arose between the buyer and the seller about the effect of Section 6.2. The buyer argued that the restrictive covenant in Section 6.2 should not be construed as a form of "no shop" provision because the buyer specifically refused to agree to a reciprocal "no shop" provision when it negotiated with the seller. Accordingly, while the merger agreement contained a standard "no shop" provision restricting the activities of the seller, it did not include a similar provision restricting the activities of the buyer. The buyer also argued that the parties had not intended for Section 6.2 to apply to the buyer's consideration of strategic alternatives. If it did, the buyer asserted, then such a provision would operate as a strict "no talk" provision and would be invalid as a matter of Delaware law because it would unconditionally preclude the buyer's board from communicating with potential acquirers and thus prevent the buyer's directors from fulfilling their fiduciary duties.

By contrast, the seller argued that Section 6.2 operated as written, and would not unduly restrict the buyer's activities so long as any negotiations, recommendations, or third party agreement did not materially delay or impair the merger. The seller argued, therefore, that the buyer was not unconditionally precluded from talking to third parties.

The Court interpreted the merger agreement in accordance with settled contract interpretation principles and found that the restrictions in Section 6.2 did not prevent the buyer from exploring the third party's proposal to acquire the buyer. Reading the merger agreement in its entirety,[13] the Court found that several other provisions of the merger agreement supported its construction. In particular, the merger agreement recognized that the buyer might withdraw or modify its recommendation in response to a "Third Party Acquisition Proposal."[14] In the event that the buyer were to do so, the merger agreement provided the seller with a remedy – *i.e.*, the right to terminate the merger agreement and to collect a termination fee. Therefore, the Court concluded that "the provisions indicate that the parties contemplated that just such an event as the [third party tender offer] might occur and that in reference to it, [the buyer's] board, ***consistent with its fiduciary obligations***, could investigate or pursue the Third Party Acquisition Proposal and potentially recommend against the . . . Merger."[15]

The Court also found support for its conclusion in the relevant extrinsic evidence and Delaware fiduciary duty law. As for the latter, the Court deemed the reasoning of *Ace Limited v. Capital Re Corporation*[16] to be persuasive, and determined that Section 6.2 should be

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[12] 2006 WL 29473483, at *2.

[13] In deciding to interpret the merger agreement in its entirety, the Court relied upon the preamble to the no impairment provision itself, which contained the phrase "[e]xcept as expressly permitted or required by this Agreement . . . ." *Id.* at *14.

[14] *Id.*

[15] *Id.* (emphasis added).

[16] 747 A.2d 95 (Del. Ch. 1999).

construed consistently with the parties' understanding of the board's fiduciary duties. The Court reasoned as follows:

> In interpreting the ACE-Capital Re merger agreement, the Court recognized that the parties to the transaction were aware of the scope of the directors' fiduciary duties and, in effect, construed the provisions of the agreement consistent with those duties. This conclusion comports with the record established in this case in terms of the . . . merger…. Accordingly, the Court construes the . . . Merger Agreement, in general, and Section 6.2(e), in particular, as being consistent with that understanding and permitting [buyer] to explore Third Party Acquisition Proposals, as long as it does so in good faith.[17]

The *Stone Energy* decision thus appears to confirm that the rationale of *Frontier Oil* – which dealt with a board's fiduciary obligation to reassess its recommendation to stockholders in view of changed circumstances – applies equally to a buyer's board of directors when a vote of the buyer's stockholders is required. But the *Stone Energy* decision also appears to take the rationale of *Frontier Oil* a step further. *Stone Energy* suggests that, in the circumstances there presented, the parties properly understood when they entered into the merger agreement that the buyer's board of directors had a fiduciary obligation to ensure that the agreed-upon provisions of the merger agreement would not unreasonably restrict its ability to explore third-party proposals to acquire the buyer, even if the pursuit of such a proposal might require the buyer's board to change its recommendation to stockholders with respect to the merger.

IV. Implications for Negotiated Acquisitions.

Based on the reasoning of both *Frontier Oil* and *Stone Energy*, it now seems clear that a board of directors – whether that of a seller or that of a buyer – has an ongoing obligation after entering into a merger agreement to continue to assess its recommendation to stockholders in view of changed circumstances and that a board's fiduciary obligations do not terminate merely because an agreement is signed. It further appears that there are some circumstances in which the board of directors of a buyer may, as a fiduciary matter, need to negotiate for appropriate contractual flexibility so that the merger agreement will not unreasonably deter, or preclude the buyer from exploring, potentially more favorable alternative transactions in which the buyer might seek to engage. *Stone Energy* does not, however, outline the circumstances in which a buyer's board will have fiduciary obligations of that sort or the types of contractual provisions that will be deemed to provide sufficient flexibility so as to comport with such obligations.

In many situations, an acquisition agreement may contain few restrictions on a buyer's conduct and possibly none that limit a buyer's flexibility with respect to the pursuit of other transactions. Oftentimes such restrictions will be unnecessary because, as a practical matter, the particular acquisition will not materially impair the buyer's ability to pursue other transactions, and the pursuit of other transactions will not materially impair the buyer's ability to

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[17] 2006 WL 2947483, at *16.

consummate the proposed acquisition. In other situations, however, the significant nature of an acquisition or the terms of an acquisition agreement might preclude or restrict a buyer's conduct as it relates to the pursuit of alternatives.

It is therefore incumbent upon a buyer's board of directors to carefully consider the impact (if any) that an acquisition (and the terms of an acquisition agreement) might have on the buyer's ability to pursue other transactions and carry out its long-term plans. Of course, nearly any significant decision that a board of directors makes will necessarily restrict to some degree the corporation's future flexibility with respect to alternative courses of conduct. As long as a decision to pursue a particular course of conduct is fully informed, however, it ordinarily will not be viewed as an abdication of future duty merely because such a decision effectively precludes or restricts other potentially available courses of conduct.[18] In our view, that settled principle should be generally applicable in the context of a decision to acquire another company.

That said, the directors of a buyer also must recognize that an acquisition of another company is seldom an ordinary course transaction and that such a transaction might have a profound impact on the nature of the buyer's business or might otherwise significantly affect stockholder ownership rights. The duties of care and loyalty will be particularly acute in that context.[19] Just as directors of a selling corporation must be especially diligent and well-informed when making a decision to sell control of the company,[20] directors of a buyer should be especially diligent when approving significant acquisitions that could implicate stockholder "ownership" rights – whether or not a stockholder vote on the transaction will be required.[21]

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[18] *See Grimes v. Donald*, 673 A.2d 1207, 1214-15 (Del. 1996) ("[B]usiness decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty.").

[19] *See Ace Ltd*, 747 A.2d at 105, 108-09 (emphasizing the "special importance" of the fiduciary duties of care and loyalty in circumstances in which a board of directors is making a decision concerning stockholder ownership rights, in contrast to an "enterprise" decision, such as what product to manufacture) (citing Paul L. Regan, *Great Expectations? A Contract Law Analysis For Preclusive Corporate Lock-Ups*, 21 Cardoza L. Rev. 1 (1999)); *Louden v. Archer-Daniels-Midland*, 700 A.2d 135, 147 n.47 (Del. 1997) ("There is an analytical distinction between 'ownership claim issues' and 'enterprise issues' facing a board of directors. 'Enterprise issues' are usually those involving management decisions affecting the enterprise and do not go to the heart of the individual stockholder's personal property interests. 'Ownership claim issues' involve board decisions that have an immediate and profound impact on stockholders' rights."); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 394 (1997) ("Enterprise issues raise questions such as: should we manufacture cars or widgets, and should the plant be in Perth or Pittsburgh? . . . There is little or no court interference in enterprise issues . . . . Ownership issues raise questions such as: should we merge . . . [or] fend off unwanted suitors who wish to take control by a tender offer to the stockholders? It is ownership issues which usually put corporate governance sternly to the test.").

[20] *See*, *e.g.*, *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994).

[21] In circumstances in which no vote of a buyer's stockholders is required, an acquisition still might raise "ownership" issues with respect to those stockholders. For example, stockholder ownership issues could

If a buyer's board of directors has carefully considered, in good faith, the impact that a particular acquisition might have on the buyer's ability to pursue other courses of conduct in the future and concludes that, notwithstanding any such impact, the acquisition is in the best interests of the corporation and its stockholders, there is no reason to expect that such a decision would not ordinarily be respected by the Delaware courts. Where, however, a merger agreement contains deal protection measures restricting the buyer's post-agreement conduct, the fiduciary duty analysis necessarily becomes more nuanced, especially where a vote of the buyer's stockholders will be required. In fact, if a buyer's stockholders were to challenge deal protection measures designed to restrict or deter potential alternative transactions in which the buyer might engage, a Delaware court may well scrutinize the board's decision with respect to such provisions under a contextually-specific reasonableness analysis, as contemplated by *Unocal*, rather than applying the more deferential business judgment rule standard of review. Enhanced judicial scrutiny is particularly likely if deal protection measures impose restrictions on a buyer's evaluation of alternatives in circumstances in which a vote of the buyer's stockholders will be required. In that situation, we know from decisions such as *Frontier Oil* and *Stone Energy* that the buyer's board, at the very least, must preserve the contractual freedom to reassess it recommendation to stockholders in view of any changed circumstances and to make full and truthful disclosure to its stockholders regarding such changed circumstances and their impact on the board's recommendation.

In some circumstances, the duties of a buyer's board might require the directors to negotiate for even more contractual flexibility. In keeping with the directors' duty of care and their ongoing obligation to ensure that stockholders are fully informed prior to their vote, a buyer's board might sometimes need to retain the ability to evaluate and pursue alternative proposals (at least unsolicited ones) that arise prior to the stockholder vote. Thus, if an acquisition will be conditioned on approval of the buyer's stockholders and the merger agreement contains a "no shop" provision applicable to the buyer (or otherwise includes significant restrictions impacting the buyer's ability to evaluate alternative proposals), the buyer's board should carefully consider whether it is appropriate to include "fiduciary outs" to such deal protection provisions, as is often done with respect to deal protection measures applicable to a seller.

There might even exist rare situations in which a buyer's board determines that it would be appropriate to negotiate for a fiduciary or "superior proposal" termination right. For example, where the buyer's board has determined that consideration of potential alternatives would be advisable but time constraints or other circumstances have necessitated that the buyer enter into a particular acquisition agreement before its board has had sufficient opportunity to fully explore other alternatives, the buyer's board might have a fiduciary obligation to ensure that the agreement does not unreasonably constrain its ability to consider and potentially accept such other alternatives, even where that might require terminating the existing deal.

On the other hand, there undoubtedly will be circumstances in which no vote of the buyer's stockholders is required and in which the buyer's board can reasonably conclude that

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be implicated where an acquisition would radically transform the buyer's business or increase its size in a way that is likely to deter, or possibly raise anti-trust concerns in connection with, potential future proposals to acquire the combined company.

it is appropriate to enter into an acquisition agreement that effectively "locks up" the buyer's obligation to close the deal with the seller. Indeed, the Court of Chancery observed in *Stone Energy* that such "lock ups" provide deal certainty for a seller and suggested that such provisions could be appropriate under many circumstances in which a vote of the buyer's stockholder will not be required.[22]

Thus, *Stone Energy* suggests that there is no "one size fits all" rule that Delaware courts will apply in evaluating whether a buyer's board has complied with its fiduciary obligations in entering into an acquisition agreement and in agreeing to deal protection measures in connection therewith. The important lesson from *Stone Energy* is that before entering into an acquisition agreement, a buyer's board should carefully consider all the relevant circumstances and should make an informed, good faith business judgment not only as to whether the acquisition is in the best interests of the corporation and its stockholders, but also as to whether any related deal protection measures that may restrict or deter alternative transactions for the buyer are reasonable under the circumstances. Where an acquisition will require a vote of the buyer's stockholders, the fiduciary analysis may be somewhat more nuanced and, at the very least, the buyer's board will have an ongoing fiduciary obligation to continue to assess its recommendation to stockholders and to change or modify that recommendation if the circumstances require.

CONCLUSION

While it has long been understood that a buyer's board of directors owes fiduciary obligations to the corporation and its stockholders when entering into an acquisition agreement, the case law has seldom specifically addressed the precise nature of those duties and their implications for the permissible scope of "deal protection" measures applicable to the buyer. Perhaps for that reason, such issues are sometimes glossed over by corporate directors and their counsel. The recent *Stone Energy* decision, however, serves as an important reminder that directors and their counsel should remain sensitive to the unique obligations of the buyer's directors in connection with acquisitions. Although increased sensitivity to such issues is unlikely to lead to significant change in the drafting of merger agreements, increased focus by a buyer's directors on their contextually-specific fiduciary obligations when entering into an acquisition agreement will better position them in the event that their decision is subsequently challenged in a Delaware court.

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[22] *See Stone Energy,* 2006 WL 2947483, at *11 n.102 ("Where no parent stockholder vote was required, the provisions similar to 6.2(e) conceivably could be construed as a type of 'lock-up' guaranteeing deal certainty for the target and prohibiting the parent from engaging in *any* activity, strategic alternative or not, that would materially delay or impair the transaction.").