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Client Alert

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DELAWARE CHANCERY COURT ALLOWS BOARD TO "JUST SAY NO" TO A TAKEOVER PROPOSAL

Board's Action Examined Under the Business Judgment Rule

In *Gantler v. Stephens*,[1] the Delaware Chancery Court recently dismissed a claim by shareholders of First Niles Financial, Inc., that the First Niles Board of Directors had breached its fiduciary duty by abandoning a sale process, despite receiving offers that its financial advisor had found to be "within a range supported by its financial models". This decision reaffirms a Delaware board's right to "just say no" to acquisition proposals, and is noteworthy in the Court's application of the business judgment rule to the Board's conduct.[2]

In August 2004, the First Niles Board authorized a process to sell the company, and retained financial and legal advisors to assist with this process. The Board's financial advisor contacted six prospective bidders, three of whom submitted bids, and two of which were pursued by the Board. One bidder, Cortland Bancorp, offered $18 per share in a mix of cash and stock, representing a 3.4% premium over First Niles' share price. The other bidder, First Place Financial Corp., offered $18 to $18.50 per share in a stock-for-stock transaction, representing a 3.4% to 6.3% premium over First Niles' share price. Based on these bids and the advice of its financial advisor, the Board decided to continue the process. Cortland later withdrew its bid, however, due to the alleged failure of management to permit due diligence on a timely basis. First Place, on the other hand, was able to conduct due diligence and raised its offer to a price representing an 11% premium. Despite this increase, the First Niles Board, by a 4-to-1 vote, rejected First Place's offer and abandoned the sale process. Subsequently, the Board elected instead to pursue a reclassification transaction to privatize the company.

In November 2006, the plaintiffs filed suit against First Niles and several of its directors and officers claiming, among other things, that the individual directors

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[1] *See Gantler v. Stephens*, No. 2392-VCP, slip op. at 20–21 (Del. Ch. Feb. 14, 2008).
[2] "The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company". *See Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). If the business judgment rule is applicable, the court will not substitute its judgment for that of the board if the latter's decision can be attributed to "any rational business purpose".

had breached their fiduciary duty to First Niles shareholders by rejecting First Place's offer and abandoning the sale process. The first issue confronted by the Court was whether to apply the business judgment rule to the Board's actions. Due to the absence of a hostile takeover attempt or any threatening action to indicate that the Board's actions were "defensive" in nature, the Court rejected plaintiffs' argument that the applicable standard of review should be enhanced scrutiny under Delaware's *Unocal* doctrine.[3] According to the *Gantler* Court, "in the context of a board's rejection of a merger offer, as opposed to taking a defensive measure against a tender offer, unexceptional entrenchment allegations of the kind made here are insufficient to take the challenged decision out of deferential business judgment review."[4]

Having decided to apply a business judgment rule analysis, the Court was faced with two questions: did the First Niles Board reach its decision to abandon the sale process "in good faith pursuit of legitimate corporate interests" and, if so, did it do so "advisedly." The first question bears on a board of directors' *duty of loyalty*, while the second addresses the board's *duty of care*. With respect to the first question, the Court found no evidence that the defendant directors were acting for the primary purpose of entrenching themselves in office. In this regard, the Court distinguished its decision in *Chrysogelos v. London*, where the directors' actions beyond "just saying no" to an unsolicited merger proposal did appear to be defensive in nature and "provided much greater cause for suspicion than the facts alleged in this case."[5] With respect to the second question, the Court found that the extensive discussions between the Board and its financial advisor concerning the bids, as well as the involvement of specially retained outside counsel as part of the sales process, rendered the facts alleged insufficient to infer that the Board did not act with due care.[6]

Accordingly, it would appear that the "just say no" doctrine remains available to directors of Delaware corporations, at least where they act with the proper motives in mind and with due care. In light of the *Gantler* decision, it is worth noting that in recent weeks, shareholder suits have been filed against the directors of two much bigger companies – Take-Two Interactive Software, in response to its outright rejection of Electronic Arts' offers and the corresponding approval by its board of directors of significant increases in the compensation that management would receive in a takeover, and Yahoo, in connection with its rejection of Microsoft's offer without seeking to negotiate a better deal. It will be interesting to see, if these companies continue to "just say no" and the judicial process continues, whether the *Gantler* analysis will lend the shield of the business judgment rule to either of these boards.

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

[4] The Court also rejected application of the more exacting entire fairness standard, which would have required the defendant directors to prove both fair price and fair dealing, a very difficult standard to achieve. First, since the challenged action was the Board's decision *not* to accept a merger proposal, there was no transaction to subject to an entire fairness analysis. In other words, how could the Court examine the fairness of a price when no price was actually paid? Second, the Court determined that application of the entire fairness standard would be "anomalous in that it would subject the Board's action *not to do a merger* to more demanding review than [the *Unocal* enhanced scrutiny review of] a defensive measure adopted for the express purpose of thwarting a hostile tender offer." [emphasis added]

[5] *Chrysogelos v. London*, 1992 Del. Ch. LEXIS 61 (March 25, 1992). In *Chrysogelos*, the defendant directors, among other things, also adopted a shareholders rights plan and then reduced the triggering ownership threshold of that plan, purchased a sizeable block of stock on the market at a "substantial premium" and approved "golden parachutes" for management in the event of a change in corporate control.

[6] Interestingly, the Court reached this conclusion despite the shortcomings with the due diligence process, the fact that the financial advisor concluded that the bids were adequate, a showing that the Board's decision to abandon the sale process was taken without any deliberations and the fact that the alternative course pursued, a reclassification resulting in privatization of First Niles, was orchestrated and decidedly favored by management.

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