The Delaware Supreme Court has been busy. In the first three months of the 2009, the state’s high court overturned and remanded two Chancery Court decisions. Both cases involve the application of some of Delaware’s iconic cases and statutes, the fiduciary duties of officers and directors, and the role of shareholders in approving board action. Says Cathy Reese of the Wilmington office of Fish & Richardson: “They are both unanimous en banc opinions, with all five justices weighing in. They are both rare reversals of the Court of Chancery in the M&A context.”


In Lyondell, the board adopted a wait-and-see approach for two months after a takeover approach from Basell AF and then conducted a one-week sale process with no other bidders involved, as Dechert LLP puts it in a memo on the case. In Gantler, the board itself put First Niles Financial up for sale. After getting three bids from potential buyers, the board decided not to pursue merger and voted instead to approve a reclassification plan proposed by the company’s senior management.

In Gantler, the Supreme Court decided that the board did not deserve the protection of the business judgment rule and that its actions should be scrutinized under the entire fairness standard. The court directly addressed the shareholder ratification doctrine, “restoring coherence and clarity to our law.” The justices also explicitly declared that officers owe the same duties of care and loyalty to the corporation as the directors themselves. This is not a surprising change of direction for Delaware M&A law, but it is a wake-up call for those corporations whose officers may not have been aware of their vulnerability, particularly as officers are not covered by Section 102(b)7 of the Delaware corporate statute, which allows corporations to exculpate their directors, but not officers, from personal liability for breaches of the duty of care.
Double Play
continued

In *Lyondell*, the Supreme Court ruled that the vice chancellor had wrongly imposed Revlon duties on the board before those duties had been triggered. What’s more, the justices declared that there is no single blueprint that a board must follow to fulfill its duties under Revlon and that they need not demonstrate “impeccable” knowledge of the market. Explains Fish & Richardson’s Ms Reese: “The process must only be reasonable. It doesn’t need to be perfect.”

Rather than restate the facts and rulings of each of these now famous cases, we turn to five experts to sample the M&A bar’s reaction to these two important rulings: Vice Chancellor Stephen Lamb of the Court of Chancery; William Lawlor of Dechert LLP; William G. McGuinness, the head of litigation at Fried, Frank, Harris, Shriver & Jacobson; and Michael Tumas of Potter Anderson & Corroon.

LYONDELL CHEMICAL COMPANY
V. WALTER E. RYAN, JR.

Vice Chancellor Stephen Lamb
The Court of Chancery

(An excerpt from his remarks at the 2009 Tulane Conference.)

This is an important decision from the Supreme Court. There are two things to say: You should read it; Number Two, it’s only twenty pages long so you can read it twice. And you can cite it without any fear of whatever is in the footnotes because you can read all those too.

It’s the last chapter in the story that in my mind goes back to January of 1985 when the Supreme Court issued the opinion in *Smith versus Van Gorkom*, holding independent outside directors in Delaware, disinterested directors in a Delaware company, liable post-transactionally for money damages for breach of the duty of care. That led reasonably promptly to the enactment of Section 102(b)(7) of the Delaware General Corporation Law, which might have been worded more felicitously as “*Smith v. Van Gorkom is Overruled*”. It could have said directors are exculpated from breaches of the duty of care, but rather it was written completely negatively. Duty of care doesn’t appear in 102(b)(7)—everything other than the duty of care appears in 102(b)(7). So it says you can be exculpated from money damages for breaches of fiduciary duty except everything other than the duty of care. I think that the backward nature of the amendment has led us on a twenty-plus-year voyage through the law about exactly what having such a duty means and how its presence would operate in a litigation context. *Lyondell* presents the relationship between Revlon duties, the duty of care, and bad faith violations of the duty of loyalty—much as *Smith v. Van Gorkom* did, but twenty years later, after the emergence of the concern about the presence in 102(b)(7) of the words “acts not in good faith” and the worrying about what “good faith” was and what “bad faith” was and whether they were distinct concepts; that is, if the absence of good faith is the same thing as bad faith, and so on.

Now, these issues were addressed by the Supreme Court not long ago both in the Disney case and *Stone versus Ritter* and I think it’s fair to say that the direction of those opinions was seen by many as strongly separating bad faith, or the absence of good faith, from merely inadequate—or even grossly inadequate—performance of the duty of care. In *Lyondell*, in this nice terse opinion by Justice Berger, the court strongly reaffirms that direction.

Let me read from page eighteen of the opin-

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ion, which is quite near the end. In summary, the court said: “If directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.” And then, again, on the same page, the court says, “The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price,”—which is, I think fair to characterize the way the opinion below was written—“the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.”

I think it’s probably right that the same analysis that is presented in Lyondell should apply in the 12(b)6 context as well in analyzing the well-pleaded allegations of the complaint.

Just as a very brief detour, one of the problems in Lyondell is that the motion is presented not as a motion to dismiss, but as a motion for summary judgment. And it was done at a time when discovery wasn’t complete and so I think the vice chancellor, quite understandably, took notice of the 56(f) affidavit and had some legitimate concerns about the record. Generally speaking, on a motion for summary judgment, you have to assume all facts in evidence in favor of the plaintiff. So, rather than allowing the discovery to be completed, which would have required several depositions, the court went ahead and ruled on the motion, using, as the Supreme Court said, the wrong analysis, focusing on what the board might have done if it had done everything imaginable. Instead, the question should have been whether, on the basis of the well-pleaded facts that are now in the record, there is any evidence that the board did anything. The Supreme Court really turned on a concern about loyalty. Instead of focusing on what the board might have done if it had done everything imaginable, the question should have been whether those directors utterly failed to attempt to obtain the best sale price.

Once you’re post-transaction, once the deal is done, and the question now is, suing directors personally for money damages not for an injunction, then 102(b)(7) comes to the fore, and the court’s business is now to look with careful scrutiny to see whether the board has done everything it should have done, but rather, as the Supreme Court says in Lyondell, to turn the focus quite differently—to see whether the board completely and utterly failed to do anything. That is set out and discussed in the footnotes in the Lear case, and cited approvingly in the opinion in Lyondell. Let me just read the language that the Supreme Court cited: “In the transactional context, an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.”

So, it’s an important development in that the Supreme Court recognizes that typical Revlon claims in arms-length transactions with disinterested director approval, that those claims are care-based, not loyalty-based. If you’re old enough, you’ll recall that Revlon, when it was decided, really turned on a concern about loyalty. David McBride is the person who took the deposition of a director of Revlon who in his deposition gave evidence that allowed the argument to be made that the Revlon board had acted disloyally in choosing the Forstmann Little transaction over the Perelman transaction. There has always been this issue of whether Revlon is always at least in part a loyalty-based claim. I think what we’re now seeing in the development of the law is the recognition that it is not. I think this opinion allows for great scope in the application of 102(b)(7) proceedings that will prevent these cases from being essentially non-dismissable.
Double Play

continued

Cathy Reese
Fish & Richardson

This case involved the all-cash merger between Lyondell and Basell, a privately-held Luxembourg chemical company, at a forty-eight-dollar per share, or thirteen billion dollar sale price, representing a forty-five percent premium over the closing share price on the last trading day before the public became aware of Basell's interest. Thirteen months before that, Lyondell had rejected an initial bid by Basell. The year after that rejection, a Basell affiliate filed a 13D, indicating a continued interest in acquiring Lyondell. The Lyondell board called a special meeting in response to the 13D and determined that the 13D signaled that Lyondell was in play, but, as the Chancery Court put it, the board chose to take a wait-and-see approach rather than initiate any kind of defensive measures or begin shopping the company.

A couple of months after the 13D, Basell's controlling shareholder, Apollo, met with the CEO of Lyondell to discuss Basell's interest in acquiring Lyondell at forty bucks a share. He later increased that offer to between forty-four and forty-five per share. Lyondell's CEO told him to put his best offer on the table before he went to the board because the company was not for sale. Later that day, there was a forty-eight dollar per share offer on the table, provided that Lyondell agreed to a four hundred million dollar breakup fee, 3.2 percent of the purchase price, and committed to sign the merger agreement by July 16, 2007. The next day, the Lyondell board convened to consider Basell’s offer. The meeting lasted about an hour. It concluded with the board instructing the CEO to obtain a written offer from Basell and to gather more information on Basell’s plan for financing the proposed transaction.

The next day, on July 11, the board retained Deutsche Bank as its financial advisor and instructed the CEO to negotiate with the controlling shareholder of Basell. On July 12, the Lyondell board met again to discuss the merger proposal and instructed the CEO to attempt to negotiate better terms, including a higher price, a go-shop provision and reduced breakup fee. The CEO apparently tried but was only able to get a slight reduction in the breakup from four hundred million to three hundred eight-five million.

During the three days from July 12 to July 15, the terms of the merger agreement were further negotiated as Basell conducted due diligence and Deutsche Bank prepared a fairness opinion. On July 16, the Lyondell board met again together with Lyondell management and its financial and legal advisors. Lyondell advisors reviewed the merits of the proposed transaction and explained that even though there was no-shop provision there was a fiduciary out that would allow the board to receive and consider superior proposals. Deutsche Bank opined to the board that the offer was fair to Lyondell shareholders and then reviewed a list of twenty other potential acquirors. Even though none of those other acquirors was actually contacted, Deutsche Bank went over the reasons why it believed none of those other potential acquirors were likely to top Basell’s offer. After these presentations, the Lyondell board approved the transaction with Basell and recommended that Lyondell shareholders approve it. The shareholders did approve it at a November 20, 2007 stockholders meeting, with more than ninety-nine percent of the voted shares in favor of the deal.

One of the shareholders who voted against the merger challenged it in a class action brought in the Court of Chancery, in which he alleged that the Lyondell directors breached their fiduciary duties of loyalty and care. The Lyondell board moved for summary judgment against the claims directed at the process by which the directors sold the company. The Court of Chancery denied the motion with respect to the loyalty claim directed at the process and held that there was an issue of material fact as to whether the board had acted in good faith in discharging its fiduciary duty in connection with the sale.

The Delaware Supreme Court granted the directors an interlocutory appeal. In its decision, the Supreme Court noted that the Court of Chancery had rejected all of the plaintiffs’ claims except those directed at the process Lyondell directors followed in selling the company, and the deal protection provisions in the merger agreement. The Supreme Court found that these claims essentially amounted to a Revlon claim that the directors failed to obtain the best available price for selling the company.

In its decision, the Supreme Court began with a summary of the current lay of the land with respect to when a failure to act in good faith establishes a breach of the duty of loyalty. In particular, it reviewed its 2006 decisions in Disney and Stone versus Ritter. A finding that the directors did not act in good faith would require a showing that the directors had an intent to harm,
or that they intentionally ignored their duties. Citing Stone, the court said that a breach of the duty of loyalty by failing to act in good faith requires a showing that directors “knew they were not discharging their fiduciary duties.” That is a high bar. The court found that, although the sale process had flaws, there was no evidence in the record from which it could infer that the directors ‘knowingly ignored their responsibilities thereby breaching their duty of loyalty.”

In reaching that conclusion, it found that the Chancery Court had erred in certain aspects of its decision. First, the court indicated that the lower court had erred in imposing Revlon duties on the Lyondell board before they had decided to sell the company or before the sale became inevitable. The vice chancellor had focused on the two months between the filing of the 13D and the time the board actually began to consider Basell’s offer, terming that period as one of “unexplained inaction” that created a reasonable inference that the board may have breached its duty of loyalty.

The Supreme Court ruled that Revlon duties did not apply during that period and that the board’s wait-and-see approach was protected by the business judgment rule. The Supreme Court focused instead on the period when the board first met on July 10 to consider the July 9 proposal made by Basell to Lyondell’s chairman and CEO, and determined that the board’s Revlon duties began as of that July 10 date and were triggered by that proposal. As a result, the Supreme Court focused its analysis beginning on that July 10 and the conduct of the board during the week in which they considered Basell’s offer rather than the two months of inaction prior to July 10, which were the focus of the Chancery Court’s analysis. That was the first error. The first error was critical to the final outcome.

Secondly, the Supreme Court rejected the idea that was embraced by the Chancery Court that, under Revlon, directors must conduct an auction, a market check, or otherwise demonstrate an impeccable knowledge of the market in order to satisfy their Revlon duties to ensure that the transaction represents the best available price. In rejecting the notion of legally proscribed steps for satisfying Revlon duties, the court emphasized its long-standing precedent that there is no single blueprint for satisfying Revlon duties. The court stated: “There is only one Revlon duty—to [get] the best price for stockholders at a sale of the company.” The court found that it is not the role of the court to tell the directors “exactly how to accomplish that goal.”

The court said that, in a good faith analysis, the court is to determine whether there was a conscious disregard by the board of its duty to get the best price for the shareholders. The court noted that failure to take specific steps in a sale process “could not have demonstrated a conscious disregard of their duty.” In determining that the directors did not breach their duty of loyalty by failing to act in good faith, the Supreme Court looked to the following facts: that the directors met several times to consider Basell’s offer; that they were generally aware of the company’s value in the chemical company market; that they solicited and followed the advice of financial and legal advisors; that they attempted to negotiate a higher offer even though the evidence indicated that the Basell offer was a “blow-out”; and that the board approved the merger agreement because “it was simply too good not to pass along for shareholder consideration.” Because nothing in the record showed that the board “knowingly failed to obtain the best sale price,” the Supreme Court concluded that summary judgment should have been granted in favor of the defendants.

The Lyondell decision was a reversal of the Chancery Court decision to deny summary judgment to the defendant on just a couple of issues and allow those issues to be further developed for trial. The basic issue on which the court denied summary judgment was whether the process employed in connection with the board’s decision on the merger was a breach of the duty of loyalty. The Chancery Court did not find that the board had acted in bad faith or breached their duty of loyalty. The Court of Chancery just refused to find on summary judgment that the board had acted in good faith and had not breached their duty of loyalty.

The vice chancellor used strong language to describe the two months of inaction: He found what he described as “two months of slothful indifference despite knowing that the company was in play,” time in which directors “languidly awaited overtures from potential suitors.” That’s because he was focusing on those two months of inaction, during which the Supreme Court found that Revlon duties were not triggered so it was perfectly legitimate for the board to take a wait-and-see approach. The Supreme Court focused on the one week of fairly significant action. That’s why the first error was critical to the final outcome, which was the decision as to when in the process Revlon duties are triggered.

There are three most significant aspects of the Lyondell decision. First, it clarified when a board’s Revlon duties are triggered, and it held
essentially that Revlon duties only kick in when a company embarks on a transaction that will result in a change of control, whether by initiating such a transaction or by responding to an unsolicited offer that would result in a change in control. Importantly, the court found that the board’s wait-and-see approach to the 13D filing, which arguably put the company in play, was not a breach and that the board didn’t need to proactively go out and shop the company or respond to the 13D to satisfy its duty of good faith.

The Chancery Court suggested that the actions or inactions of the board may have been a breach of the duty of care, but the company had a 102(b)7 exculpatory provision that exculpated directors for personal liability for duty of care breach. Some aspects of the Supreme Court decision suggest that the court didn’t disagree with the Chancery Court’s analysis that there may have been a breach of the duty of care here.

The second point of significance of this decision is that it reaffirms that there isn’t any single blueprint for satisfying the board’s Revlon duties in a sale context. The board doesn’t have to follow legally proscribed steps. There is discretion. The process must only be reasonable. It doesn’t need to be perfect. You don’t need to have an auction. You don’t need to have a market check. The process doesn’t have to be impeccable. The board doesn’t have to have impeccable market knowledge, so long as its process is reasonably geared under the circumstances to get the best price for shareholders at a sale of the company.

The third point is that it confirms the high bar that the plaintiff faces to establish a breach of the duty of loyalty based on a failure to act in good faith. Loyalty claims based on a failure to act in good faith are reserved for situations where the board “knowingly and completely” failed or “utterly” failed to undertake its responsibilities. It’s a knowing disregard of one’s duties. So essentially the Supreme Court found that the Chancery Court had misapplied the law in three aspects. It imposed Revlon duties before the board had determined to sell the company or before a sale had become inevitable; it wrongly determined that Revlon requires that the board meet certain requirements during the sale process; and third, it treated an arguably imperfect sale process as the same as “a knowing disregard of one’s duties sufficient to constitute bad faith.”

If you read the Delaware Supreme Court’s Lyondell opinion in a vacuum, you’d say, ‘Gee, what’s the big deal here. Sounds like a straightforward recitation of long standing fiduciary principles in the M&A context.’ However, at its root the Lyondell controversy addressed the growing friction in recent Delaware case law between the outer contours of the duty of care and the good faith component of the duty of loyalty. More bluntly, the Delaware Supreme Court in Lyondell decided to cabin the burgeoning plaintiffs’ bar practice of re-characterizing duty-of-care violations as duty-of-loyalty violations as a means of getting around 102(b)7 exculpatory provisions in corporate charters.

First, some background. Under bedrock Delaware corporate law, directors can be held personally liable for gross negligence, but not negligence per se. In 1985, the Delaware Supreme Court decided Smith v. Van Gorkom. That case reverberated throughout corporate boardrooms because it held that non-conflicted directors were grossly negligent, and therefore personally liable, with respect to their actions in approving the sale of a company in a high premium transaction that seemed fairly unremarkable to many observers. And after Van Gorkom came out, the insurance industry essentially priced D&O insurance out of the market as a result of the perceived greater risk of large insurance payouts. As a result, the Delaware legislature soon implemented a broad exculpation provision in the Delaware corporate code, Section 102(b) (7). It provides protection for directors against personal liability in duty-of-care cases. However, the section does not apply to, among other things, duty-of-loyalty violations, acts or omissions based on lack of good faith, intentional misconduct or knowing violations of the law.

As a result of this loophole in the exculpation coverage, in recent years the plaintiffs’ bar has brought more and more duty-of-good-faith cases. Three prominent cases—Caremark, Disney and Stone v. Ritter—addressed in varying contexts the vitality of this kind of claim. Despite the limited success of the plaintiffs in these cases, their net effect was to really breathe life into a new kind of claim apart from duty of care/gross negligence.

The raft of good faith cases, including the Caremark/Disney/Stone trilogy, generally focused on alleged lapses in board oversight over regulatory functions and compensation. But the M&A bar held its collective breath, waiting for the inevitable incursion of these claims in the deal
world. It didn’t take long. Enter *Lyondell*.

On the surface, *Lyondell* looked like a great defendant’s case—forty-five percent premium to market; a fully functioning independent disinterested board; ten members independent with the eleventh member the CEO; an all-cash deal; no conflicts of interest and good testimony from the target banker regarding the unlikelihood of a topping bid. Despite all this, the Lyondell plaintiffs were able to convince the lower court judge that because the deal was negotiated after only one week of deliberations by the board, because the CEO got out in front of the board and set the price, and because there was no market check despite a threatening Schedule 13D by the bidder many months beforehand, a triable issue existed as to whether the board had violated its duty of loyalty because of a lack of good faith. The motion for summary judgment by the target was denied and the case was set for trial. The defendants appealed.

The Supreme Court put the brakes on the plaintiffs’ bull-rush to the courtroom. They basically said from a policy perspective, ‘Hold on. This whole duty of good faith doctrine has gotten ahead of itself, and we are particularly concerned about its evolution in the M&A area where there is a fast-moving situation in which perfect conduct can hardly be expected to occur. We’re not going to permit what is really a duty-of-care case to masquerade as a duty-of-loyalty case so that a plaintiff can get around the exculpation provision in order to capitalize on settlement leverage.’ And they threw the case out.

It is going to be very difficult now for a plaintiff in a disinterested board/sale context to bring a claim after closing for damages where there is a 102(b)7 exculpation provision in the target’s charter. That’s the real bottom line. And it will be very interesting to see where the plaintiffs’ bar decides to go next. Some think there will be a renewed focus on officer misconduct and breach of fiduciary duty, which is not protected by Section 102(b)(7) as currently couched as noted by the Gantler court. However, this seems far fetched to me because ultimately key M&A decisions flow through the board. Others think the Lyondell case will spark more injunctions because the post-closing damage remedy has been effectively taken away. I’m not so sure about that either. The lower court judges in Delaware got a clear message from the Supremes that there has to be a conflict of interest here, or some other really bad fact concerning the board’s conduct, for such cases to have any chance of success. Just because the board didn’t do a perfect job will not be enough. Directors deserve a break. That’s really the message of this ruling.

**Leonard T. Gantler v. William L. Stephens**

*Cathy Reese*

*Fish & Richardson*

Let’s talk first about the facts. In August of 2004, the board of directors of First Niles Financial authorized a process to sell the company, and retained legal and financial advisors to assist in that process. Shortly after the process was initiated, management went to the board and advocated a going-private transaction and abandoning the sales process. The board rejected management’s proposal and moved forward with the sales process. That process generated three indications of interest from potential bidders. Two of those bidders said that if their bid resulted in a merger, they would terminate incumbent directors. The board ultimately determined to pursue two of the three bids, including one of the bids that had indicated that it would terminate the board.

The premiums offered by the bids ranged from 3.4 percent to 6.8 over the then-current share price. The board authorized management to permit the two bidders to move forward with due diligence. One of the bidders ultimately withdrew its offer because certain members of management failed to comply with their due diligence requests. Management also initially stone-walled some of the due diligence requests of the second bidder, but caved when the second bidder threatened to withdraw its bid. That second bidder moved forward with its bid based on the due diligence and actually raised its offer twice. The board’s financial advisor opined that the revised offers were within an acceptable range. Nevertheless, without further discussion or review, the board ended up rejecting that remaining bid at a special meeting and abandoning the whole process.

A few weeks later, the board renewed its discussions with management about the reclassification of approximately three hundred shares of common stock into a new series of non-voting preferred stock in an effort to take First Niles private. At a board meeting, at which there was only an oral presentation and no written materials and no advice from a financial advisor, the board determined that the reclassification plan was fair to all the shareholders and mailed out a proxy statement describing the reclassification and urging...
Double Play

continued

ing the shareholders to vote to approve the plan. The shareholders followed the board’s recommendation and approved the plan. Certain sharehold- ers sued, alleging that First Niles’ directors breached their fiduciary duties to shareholders both by rejecting the merger offer and abandoning the sale process, and through the mis-disclosures and non-disclosures in the proxy statement for the reclassification.

In the Gantler decision in the Court of Chancery, the court dismissed the stockholder suit alleging that the board of directors breached its fiduciary duties by initiating but later abandoning a sales process that had generated three fairly attractive offers. The Court of Chancery reached that decision by applying the business judgment rule to the board’s conduct rather than any heightened standard of review, either the Unocal or the entire fairness standard. In the decision below, the Court of Chancery explicitly rejected the Unocal standard, finding that the directors’ actions were not defensive in nature. Applying the business judgment presumption, the Court of Chancery found that the directors breached neither their duty of loyalty nor their duty of care. Therefore, the Chancery Court refused to undertake an entire fairness review of the board’s actions. The Delaware Supreme Court reversed the Court of Chancery’s decision. In particular, the Supreme Court found that the complaint did plead sufficient facts to overcome the business judgment presumption and therefore required judicial scrutiny of the board’s conduct under the entire fairness standard of review.

The Supreme Court’s review of the allegations that enabled the plaintiffs to overcome the business judgment presumption at the pleading stage provides a helpful primer to plaintiffs’ attorneys. It also provides guidance to transaction lawyers as to what actions or inactions may subject the board to heightened judicial scrutiny.

Let’s look at the two other notable holdings of Gantler: first, the fiduciary duty of officers. The Supreme Court explicitly ruled that officers of Delaware corporations owe the same fiduciary duties of care and loyalty to the corporation as those owed by directors of Delaware corporations. Based on that, the court applied the same standards of loyalty and care to First Niles’ officers as it did to First Niles’ directors and found that two of the officers breached their duty of loyalty by failing to respond to the bidder’s due diligence requests.

Most lawyers who practice consistently in the Court of Chancery have long understood that officers owe the same fiduciary obligations as directors, and so it’s remarkable to me that this aspect of the decision has received such widespread attention in the press that followed the Gantler decision. It may mean that officers themselves are not being adequately informed that they owe these fiduciary obligations. If so, Gantler may serve as a wake-up call to corporate officers. They may have insufficient knowledge of what their obligations are and what those obligations entail. One takeaway from the decision is that corporations may need to educate their officers better on this point, particularly as officers are generally more vulnerable than directors from a liability standpoint for breach of those duties because they are not encompassed within the 102(b)(7) provisions of corporate charters that shield directors from liability for a duty of care breach. Nothing in 102(b)(7) of the DGCL shields corporate officers from personal liability for breach of the duty of care. While case law has focused largely on actions of directors, this may give rise to more claims against corporate officers since the bar is lower for obtaining personal liability and damages against those officers for even duty of care violations, which present a much lower bar for plaintiffs than duty of loyalty violations.

Traditionally, officers were not included as defendants in shareholders suits in Delaware. This may have been for jurisdictional reasons. Delaware’s director consent statute was recently amended to include the implied consent of corporate officers to certain suits in Delaware. Officers may be vulnerable to shareholder suits now more than ever given this officers implied consent to jurisdiction together with the Gnantler Court’s recent confirmation that officers are subject to the same fiduciary duties as directors.

The third reason the case is important concerns the scope and application of the shareholder ratification doctrine under Delaware law. In this regard, the court emphasized that it wasn’t stating anything new, but it was “restoring coherence and clarity to our law.” First, the court noted that it was limiting the doctrine of ratification to its “classic” form, that is, “to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective.” The Court’s second point, equally well established but maybe not as well known, is that a ratification vote is only effective to “subject the challenged director action to business judgment review, as opposed to ‘extinguishing’ the claim
altogether (i.e., obviating all judicial review of the challenged action.).” Essentially, it shifts the burden on the action, assuming that it’s a fully informed vote and it’s not a vote that is otherwise required for the action to be taken. Ratification can, at best, create a business judgment presumption; it can’t extinguish the claim altogether.

So, applying this in Gantler, the court found that the ratification doctrine did not apply in the first instance to the First Niles shareholder vote on the reclassification plan because the plan required an amendment of the company’s certificate of incorporation, which, in turn, under the Delaware statute must be approved by the shareholders. The court went on to note that even if ratification were available in this case, “the complaint states a cognizable claim that the Reclassification Proxy was materially misleading” thereby eliminating “an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.”

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The board of directors of First Niles Financial, Inc. put the company up for sale in 2004. Three potential purchasers submitted bids, but following due diligence, only First Place Financial Corp. remained in the sale process. Thereafter, the board determined not to pursue a merger with First Place and voted to approve management’s reclassification proposal.

The reclassification was to be effected by a charter amendment, the effect of which was to give full voting power to holders of large blocks of shares who would retain common stock and to give small holders a new series of preferred stock with limited voting rights. The reclassification also would take the company private. Fifty-seven percent of the stockholders voted to approve the charter amendment/reclassification with only 50.28 percent of unaffiliated shares voting in favor.

Plaintiff stockholders alleged, among other things, that the defendant directors and officers breached their fiduciary duties of loyalty and care in rejecting the First Place offer and abandoning the sales process. Stockholders also alleged that First Niles’ directors and officers breached their fiduciary obligations in effecting the reclassification.

The Court of Chancery dismissed plaintiffs’ complaint as to all counts. On the rejection of the First Place offer, the court found that Unocal was inapplicable because there was no defensive action by the board. The entire fairness standard of review was also inapplicable. The Chancery Court applied business judgment because plaintiffs failed to allege facts sufficient to rebut the business judgment presumption. With respect to the disclosure claims, the Chancery Court held that allegedly misleading disclosures were immaterial. Finally, as to the approval of the reclassification, while the Chancery Court found that plaintiffs alleged facts sufficient to rebut the presumption of the business judgment rule, the court held that shareholder ratification of the reclassification revived the presumptions of the business judgment rule.

The Supreme Court reversed and remanded. As a preliminary matter, the Supreme Court held that the Court of Chancery properly refused to apply Unocal with respect to the board’s determination to reject First Place’s offer in favor of the reclassification, but misapplied the business judgment standard. Because the plaintiffs adequately alleged that a majority of the directors had a disloyal motive to retain control over the bank, the board’s conduct should have been reviewed under the entire fairness standard. Plaintiffs also pled facts sufficient to rebut the business judgment rule in respect of the officer defendants, whom the court confirmed were subject to the same set of fiduciary duties as directors.

The Supreme Court also found that the Court of Chancery erred in dismissing plaintiffs’ claims relating to the reclassification on stockholder ratification grounds. The court concluded that the doctrine of stockholder ratification should be limited to its “classic form”—“where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective.” Thus, because a stockholder vote was required to amend the charter, that approving vote could not also operate to ratify the reclassification. Moreover, the court held, stockholders can only ratify director action or conduct that they are “specifically asked to approve.” Importantly, the Gantler court also held that the cleansing effect of a proper ratifying stockholder vote is subject to the challenged board action to business judgment review.

Gantler confirms that officers of Delaware corporations are subject to the same fiduciary obligations as directors. It also narrows the doctrine of stockholder ratification. The doctrine of ratification will not apply when directors seek stockholder approval of a board decision that requires separate stockholder approval (e.g., Sections 242, 251, 271). The doctrine of ratification will only apply when the board presents a specific issue to stockholders for ratification.
Double Play
continued

respect to claims that directors lacked authority to take action that was later ratified, stockholder ratification does not extinguish the claim so as to preclude judicial review altogether. In light of the narrowing of the doctrine of shareholder ratification, a special committee of independent, disinterested directors should be considered as an alternative to shareholder ratification. *Gantler* appears to have no impact on the continued viability of using a majority of the minority vote to shift the burden of proof in a transaction involving a controlling shareholder.

**William G. McGuinness**
*Fried Frank*

Significant judicial opinions are not rendered in a vacuum. They tend to refract legal principles through the prism of the era in which they are written. *Gantler v. Stephens* may be one such opinion.

In the wake of the current financial scandals there is anger and suspicion directed toward the business leadership in our country. Thus it is noteworthy that the Delaware Supreme Court chose to issue *Gantler* at this moment. The case does break some new legal ground, and addresses some issues that have been lurking for a long while. But in significant respects, it applies legal principles that are familiar. What is interesting about the case is its tone. It suggests that the Delaware Supreme Court may now be inclined to examine the conduct of our business leaders a lot more closely, and a lot less deferentially. Is the Delaware Supreme Court sending the message: “The tie no longer necessarily goes to the director or officer.”

The stark difference between the Chancery and Supreme Court decisions may reflect an ideological schism between the two courts. It has been remarked that, historically, the Chancellors tend to take a more deferential view of the protections of the Business Judgment Rule than does the Supreme Court. The articulation of the Business Judgment Rule is similar, but the difference in application is striking.

Certainly one view of the pleaded facts is that the target directors didn’t commit egregious errors, although their conduct could certainly be cast in an unfavorable light. That Vice Chancellor Parsons was inclined to dismiss the case on the basis of the Business Judgment Rule certainly reflects a rational, albeit deferential, view of the target directors’ conduct. But what the Supreme Court ended up saying is: ‘Look, plaintiffs have also pled another side to this story—that is, those directors rejected a merger proposal on grounds that were basically selfish, self-interested and disloyal. Therefore we’re going to strip those directors the protections of the Business Judgment Rule, and give the plaintiffs a chance to develop their case.’

As to new ground, there had long been a question lurking as to whether corporate officers owe the same fiduciary duties of loyalty and care as do directors—and whether officers are entitled to the same protections of the Business Judgment Rule. It’s surprising that the issue has never been squarely addressed since it is so basic. Now the Supreme Court has said, “We’re going to clear the air on this and we hold that fiduciary duties apply with equal force to officers as well as directors.” The opinion does not, however, say that the Business Judgment Rule protections also apply with equal force. This leaves open an interesting question: Are officers—having the fiduciary duties, but perhaps not the protections of the Business Judgment Rule—more exposed to liability than directors. Thus, *Gantler* partially clears up one interesting issue that had been around for a long time, but brings another to the fore.

*Gantler* also addressed the question of shareholder ratification in an interesting way. There had been a view that if the shareholders on a fully informed basis ratified by vote what the directors had done—the phrase was—“cleansed the transaction”—then the directors were essentially immune from liability. The Supreme Court took a close look at this doctrine of shareholder ratification, and decided to limit the cleansing effect of shareholder ratification to only those transactions where shareholder vote was not required. It is an interesting result. Significant corporate transactions which require shareholder votes (such as mergers, spin-offs, sale of substantially all assets, etc.) are not “cleansed” by subsequent shareholder ratification.

The bottom line is that *Gantler* vectors in to the same conclusion from a number of directions: It’s going to be harder for corporate officers and directors to get cases dismissed at an early stage.
Busted Deals in Delaware
Another word for nothing left to lose?

Thomas A. Cole, Sidley Austin LLP

- MAE is a very high standard.
- Words matter—especially in specific performance clauses; on the other hand, where contract terms are unambiguous, words outside the contract don’t matter at all.
- Behavior, both pre-signing and after signing, matters.
- Exercising a fiduciary out is not repudiation.

IBP
(Del. Ch. 2001)
- Tyson acquisition of IBP for cash and stock, via merger.
- Tyson seeks to escape, due to “Buyer’s regret.”
- Principal legal rationale for escape—MAE.
- MAE analysis (applying NY law): Inquiry is whether company has suffered an MAE “that is consequential to the company’s earnings power over a commercially reasonable period, which one would think would be measured in years rather than months.
- Court found no MAE, but somewhat reluctantly ordered specific performance. While buyers typically make inadequate remedy at law argument based on uniqueness of acquisition opportunity, court did not find “any compelling reason why sellers . . . should have less of a right to demand specific performance than buyers.”

Frontier v. Holly
(Del. Ch. 2005)
- Frontier acquisition of Holly for cash, stock and CVR, via merger.
- Holly sought re-negotiation after learning the extent of Frontier’s potential exposure in toxic tort litigation (and that Holly had undervalued certain assets).
- After a period of renegotiation, Holly CEO stated that his board was “not prepared to recommend the transaction to their shareholders.” Merger agreement allowed a fiduciary out on the requirement to recommend.
- Frontier then sued Holly, asserting that its CEO’s statement was a repudiation. Thereafter, Holly claimed a Frontier MAE.
- MAE was not established.
- Frontier was found to have breached by declaring a Holly repudiation, but no damages beyond “nominal.”

United Rentals v. Ram Holdings
(Del. Ch. 2007)
- Ram Holdings acquisition of United Rentals for cash, via merger

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**Busted Deals**

*continued*

- Ram was an acquisition shell. Cerberus Capital Management gave Ram an equity commitment; United Rentals not a third-party beneficiary. Cerberus Partners (different entity) gave United Rentals limited guarantee of Ram’s obligations for termination fee.

- Ram repudiated Merger Agreement, offering United Rentals the alternatives of a renegotiation or the contract-stipulated termination fee.

- Merger agreement contained both a specific performance provision requiring Ram to fund if financing was available and a conflicting provision limiting URI’s recourse if Ram failed to fund a $100 million termination fee.

- Because both interpretations were reasonable but conflicting, court applied the “forthright negotiator” principle, which provides that a court “may consider the subjective understanding of one party that has been objectively manifested and is known or should be known by the other party.”

- Because Ram had been more consistent and clear in communicating its interpretations, URI recovery was limited to the $100 million termination fee.

- Alliance Data Systems v. Blackstone Capital Partners and Aladdin (Del. Ch. 2009)

- Aladdin acquisition of Alliance for cash, via merger

  - Aladdin was an acquisition shell. Neither BCP V nor Blackstone Group signed the Merger Agreement. BCP V gave Alliance a limited guarantee for the termination fee.

- Aladdin failed to obtain approval by Office of the Comptroller of the Currency (“OCC”) needed to consummate transaction; thereafter, it terminated the Merger Agreement under the “drop dead” date provision.

- OCC had refused to approve the deal unless Blackstone committed to provide extra capital and liquidity—Blackstone refused.

- Alliance sued for the $170 million termination fee but the Court dismissed its complaint.

- Alliance relied upon a negative covenant in which Aladdin promised that it would cause BVP V not to take or cause any action that would prevent or materially impair the merger.

- The court held that Alliance could not turn a negative covenant into an affirmative one, i.e., it could not read the negative covenant as a promise by Aladdin to cause BVP V to take reasonable actions to facilitate the merger.

**Hexion v. Huntsman**

(Del. Ch. 2008)

- Hexion acquisition of Huntsman for cash, via merger.

  —Hexion is 92 percent owned by Apollo

- Merger agreement contained no financing or insolvency out, and moreover, Hexion agreed that it would (i) used reasonable best efforts to consummate the financing it had arranged under a bank commitment letter; and (ii) that it would not take any action that could reasonably be expected to prevent consummation of the financing.

- The commitment letter required delivery at closing of a solvency certificate from either Huntsman’s CFO, Hexion’s CFO, or a reputable valuation firm as a condition to the financing.

- Merger agreement provided for uncapped damages in the event of a knowing and intentional breach of any covenant by Hexion.

- After Huntsman announced disappointing first quarter 2008 results, “Apollo and its counsel began to follow a carefully designed plan to obtain an insolvency opinion, publish that opinion (which it knew, or reasonably should have known would frustrate the financing), and claim Hexion did not “knowingly and intentionally breach” its contractual obligation to close (due to the impossibility of obtaining financing without a solvency certificate).”

- Hexion obtained insolvency opinion, then sued for a declaratory judgment that: (i)
Hexion would not be obligated to close if the combined entity were insolvent; (ii) its liability, if any, was limited to the $325 million termination fee; and (iii) Huntsman had suffered an MAE, excusing Hexion’s obligation to close.

• Huntsman filed a counterclaim seeking a declaratory judgment that Hexion had knowingly and intentionally breached the merger agreement, and an order directing Hexion to specifically perform its obligations under the merger agreement.

• Court found that the insolvency opinion was unreliable because it was produced with knowledge it would be used in litigation, was based on skewed numbers provided by Apollo, and was produced without consultation with Huntsman management.

• Court rejected claim that Huntsman had suffered an MAE:

—Court found it need only reach the issue of comparing Huntsman to peers in the chemical industry if it first found that Huntsman had suffered an MAE standing alone—no MAE could be established by proving it performed worse than its peers;

—Because acquirer “may be assumed to be purchasing the target as part of a long-term strategy [t]he important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonably period, which one would expect to be measured in years rather than months.”

• Court found that Hexion committed knowing and intentional breach of provisions requiring it to use reasonable best efforts to consummate financing, and prohibiting it from taking any action that could reasonably be expected to materially impair or prevent consummation of financing, by publicizing the insolvency opinion and filing suit rather than discussing concerns with Huntsman.

• Determination of solvency was not ripe, as it could be determined only at closing.

• Court ordered that Hexion specifically perform its obligations under the merger agreement, other than the ultimate obligation to close.

• Subsequently, the parties settled: In addition to paying the $325 million termination fee, Apollo invested $250 million in Huntsman and paid it $425 million (subject to return if Huntsman recovers over $500 million before trial from banks that delivered commitment letter).

“I know you have the law and the facts on your side, but I’m going with the dancing girls on this one.
The U.S. story is going to be a multi-year, in fact, maybe even a multi-decade, experience. We are coming off of a significant structural problem and that means we’re going to have a structural shift in our economy and as we try to deal with that, it means that things like the growth rates that we are accustomed to seeing in the United States are probably going to have to downshift.

The U.S. consumer basically got us into this mess. If you look at how U.S. GDP growth was being pushed forward, it was really a consumption story. It was not an investment story. It was not the dot.com bubble. It wasn’t even the U.S. banking sector, although we take our share of the blame for it, because we made this all possible. Rather, it was the simple fact that the U.S. consumer liked to spend an ever-increasing amount of money.

Unfortunately, the money they were spending wasn’t theirs. It was someone else’s. It was borrowed. Where were we borrowing it from? We were borrowing it from the rest of the world and we were borrowing it from banks and we were taking out loans, taking out mortgages, and buying all kinds of things that we really couldn’t afford in the long term.

This was a structural problem in the United States. Although it manifested itself in the housing story, this was current account balance story finally coming home to roost. So all those years you saw Congress talking about the current account balance and how it was finally going to catch up with the United States, and when it did there were going to be massive problems. And then they stopped talking about it and they started talking about housing. But what most people don’t realize is that they were really talking about two sides of the same coin. It’s just that economists tend to be decent marketers and so we just had to switch the tone away from talking about the current account story, which no one ever believed would be a problem, and started talking more about housing, which, at least for the first couple of years, no one actually thought was going to be a problem.

My boss, David Rosenberg—truthfully, he was a little early to the housing story, and he’d started earlier, he might not be chief economist at Bank of America Merrill Lynch. People might have gotten tired of listening to his warnings about the housing market. There are a number of examples like that throughout Wall Street, including, truthfully, most of the mortgage strategists on Wall Street who actually saw a lot of the problems with the mortgage market, it’s just that no mortgage trader or sell person really wanted to listen.

That massive debt load translates into massive debt service load. This is a problem, largely because what this tells you is that fourteen percent of everyone’s income in the United States is going to pay for past purchases. You can’t go to pay for future purchases without paying for the past. We’ve reached the level where so much of our money is going to pay for things we bought in the past that we trying not to spend so much money now. The problem is, we’re trying to not spend as much money, we’re trying to increase our savings, we’re trying to reduce our debt, and we’re still trying to consume, and obviously one of those is going to lose out. That’s the consumption story.

Let’s look at the changes that U.S. consumers are going to have to go through. The median U.S. consumer makes about $47,000 a year; they owe about $87,000 including their mortgage; they pay about $6700 a year to stay current on their debt; and they pay an average interest rate of around seven-and-a-half percent. If you want to get that debt service ratio back down to a more sustain-
able level where people can feel that they can continue to purchase new items and continue to enjoy new spending, you’ll either have to lower the debt loads by twenty-five percent, consumers in the United States have to see their incomes go up by thirty-three percent, or you need interest rates to drop by 190 basis points.

**Trying Again**

Now, the Feds tried the interest rate thing. It didn’t really work. They’re trying again. They’re trying everything they can to make sure the adjustment occurs on the far right hand side, because that’s the least painful thing that could possibly occur. As you can imagine consumer income isn’t likely to go up by thirty-three percent this year. In fact, consumer incomes are likely to drop by a lot. The most affluent U.S. consumers receive some form of variable compensation, or bonuses, which I guess is a bad term now. That accounts for twenty-five percent of total compensation in the United States. That is where the adjustment is taking place. Most firms are actually not cutting people’s salaries, not cutting people’s underlying wages. They’re just throwing out their variable compensation and so when you look at the employment report, what you’ll notice is that average hourly earnings keeps rising, and it doesn’t really matter what the employment rate is doing, that’s because no one really focuses on underlying wages any more. They’re focusing on changes to the variable compensation. But as you can see, most people’s variable compensation is not going to go up this year, and adjusting the income column is not going to happen, so what’s going to happen is people, with a lot less money, are going to pay down as much debt as they humanly can because they’re not going to get much help from the interest rate side of the story either. That is private sector wage growth. Obviously not moving in the direction we’d like it to move in. But as you can see, we’ve actually reached probably what is an all-time low, at least in the post-war period, and it doesn’t seem like that trend is going to reverse itself any time soon.

Interest payments continue to rise. And then of course we’re trying to do all this when our net worth is collapsing by an unprecedented amount.

And so if you look back to that little tiny blip that is in 2000/2001, that was an asset bubble bursting, which everyone at the time, economists included—in fact, I was working back then and I said “Ah, an unprecedented decline in wealth”—uh, well, I guess I’m glad I’m around still to discuss this unprecedented decline in wealth. But recovering from this is going to be very difficult. Just imagine: the median baby boomer right now is 52 years old. They’ve got ten years to make this up. It’s not going to happen from capital. It’s going to happen from a reduction in current spending. They have to start saving out of current income. We need to see a cultural shift in spending versus saving in the United States, because that’s how we got into this mess in the first place. We weren’t saving enough relative to the amount we wanted to spend, to the amount

*Road to Perdition*
we wanted to invest. We had to attract it from overseas. It created this huge imbalance. We took it, and ran with it. For every unit of GDP we were creating, it came at an ever-increasing cost in terms of the amount of debt we were creating to go along with it.

And so as you see, the U.S. consumer is, in fact, to trying to save more money. Every time the U.S. government sends them a check, they cash it, they put it in their bank accounts and they let it sit there. So one of the grand issues now is how effective is this stimulus package going to be. And quite frankly, we think because the U.S. government seems to think that this is some sort of temporary phenomenon, truthfully we don’t think it’s going to be all that effective. 2009, we’re boosting our GDP estimate by four tenths of a percent because of the stimulus package and in 2010 we’re boosting our economic outlook by a percentage point in the United States. Bearing in mind that our expectation, including the stimulus package, is for growth to contract by three percent this year and for growth to rise by one-and-a-half percent next year—two-thirds of that growth next year is from the stimulus package.

The U.S. economy is going to have a hard time getting on its feet. And that’s going to be a persistent problem as we move into the next decade. Now, the only good news is that housing seems to finally be in the process of bottoming. We may not have reached the bottom yet. We expect we probably have another fifteen percent to go in the decline in home prices. How do we get the fifteen percent? Simply put, we look at inventory levels. So these are the inventories of existing homes and these are inventories of new homes. This is the marginal supply of homes and the inventory levels are moving up. This is on a monthly basis. We don’t expect we’re going to get [to the bottom] until late this year.

Safety Net

Now, what does that do? Well, if you’re a bank and someone comes to your desk to take out a mortgage, you’re probably not going to lend them too much money, or alternatively you’re going to require a much bigger down payment because you have to assume—our forecast is for a fifteen percent decline in home prices—what kind of safety net do you want to put under yourself if you’re a bank lending against a home as collateral? Probably another ten, fifteen percent. So all of a sudden you’re talking about a down payment of not ten percent, as it used to be, or even no down payment, but something closer to thirty percent. And that is one of the main reasons why you continue to see bank-lending decline. The other reason bank lending is declining—and I didn’t come up here to defend commercial banking, but I will for a second—is, simply put, consumers don’t want the money. They’re over-leveraged to begin with, and when they’re over-leveraged to begin with and trying to boost their savings and take down their debt—

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<th>Recession Last 18 Months</th>
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<td>Duration (in Months)</td>
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Average back to 1855 = 18 months

Recessions Periods

Source: National Bureau of Economic Research, Banc of America Securities-Merrill Lynch
surprise, surprise—they’re not going to a bank and asking for new loans. And so when you hear people talk about, ‘Oh, there’s no credit being made available,’ simply put, it’s a supply story—banks don’t necessarily want to extend their balance sheets right now, and it’s also a demand story—consumers don’t want to extend their balance sheets either.

Everyone is in the process of de-leveraging and as long as that de-leveraging occurs, economic growth is going to be hard to come by. You can take the money supply from 1 trillion, 2 trillion, 3 trillion 4 trillion—if you have no velocity so no one is taking the money and turning around and doing anything with it, you’re simply not going to get growth in the economy. And so this year, for lack of a better way of putting it, is a write-off for the U.S. economy.

All this is occurring despite the fact that supposedly housing affordability is really high right now. It’s very easy to buy a home if you want one in the United States. No one seems to believe it because new home sales is collapsing. And of course this is one of the primary areas where consumers were spending their money. Consumers kept spending more and more money buying bigger and bigger homes that held fewer and fewer people.

What brings this all back into balance? Well, simply put, there’s a level of underlying demand in the housing market. And if you don’t believe me, just go back to the 1980s when mortgage rates were eighteen percent and look at home sales numbers. They’re positive. They’re not zero. People were buying homes when mortgage rates were eighteen percent. Why on earth would you possibly do that? Because if you want to have family, you can’t live in your parents’ basement. It’s as simple as that. There’s a cohort of people between 20 and 25, they are moving out of their parents’ homes. Some of them are getting married. There’s another cohort between 25 and 30—they get together, they get married, they have kids, they need to move somewhere, and there is underlying housing demand.

The only question really is, what price does the home clear at, and how big of a home are we talking about. In both cases, it’s got to be a lower price and it’s got to be a smaller home. So this is the transition we’re going through right now. Home prices will decline for a little while, but once we see home prices stabilize, then we can see bank-lending pick up again. At the same point, home prices stabilize or alternatively the current situation stabilizes and banks feel more comfortable lending money to you the consumer because they know you can pay it back. When bank lending picks up, the money supply numbers the feds have been pushing out will then begin to translate into real economic activity. The problem is getting there. Next year, we’re expecting negative nominal GDP growth. To put that into perspective, it means that if your company is doing everything right, your sales are probably going to contract next year. So that’s not a good sign for the stock market.

We started this recession in December 2007.

\[\text{Road to Perdition}\]
Road to Perdition

continued

The last couple of recessions we’ve had have actually been minor compared to this. The last one wasn’t even a recession. I still go by the two-quarters-of-negative-growth, which I know is not the official definition, but those are the ones you remember. We didn’t have two quarters of negative growth. But we called it a recession anyway, because we wanted to make ourselves feel that we were retrenching and going through something difficult, when in reality we weren’t going through much of anything at all. Unless you lived in San Francisco or New York, you probably didn’t feel the last recession.

Well, this time around, everyone is going to feel it. It’s going to last a lot a longer. A lot longer means 18 months, 24 months. It’s not going to be an abnormal recession. It’s actually just a normal one. It’s just something we haven’t been accustomed to. That means the S&P 500 is probably going to bottom sometime late this year. We try not to call a bottom, but, of course, we’re economists so we always do. We think somewhere around 660 on the S&P, but certainly you could go plus or minus—well, I guess not plus.

And of course, the U.S. is taking the rest of the world with us. The consumer growing and driving up GDP over time—a lot of that GDP growth and consumption was naturally occurring in terms of imported goods. In fact, in the United States today, one of the reasons we held on for so long after housing started to collapse was simply we found a way to import housing. We imported wood from Canada, we imported products and equipment from China, and we imported labor from Mexico. And when it all unwound, the trade numbers improved. And that was, of course, the current account story.

Now what does that mean for everyone else? How do we get out this? Well, we get out of this by bringing balance back to the world. Balance back to the world means countries with very high savings rates, and who were insulated from the credit chaps that we faced, are going to have to lead us out of this. Now, why do they have to lead us out of this, even the ones creating all the savings that made our over-spending possible? I’m not blaming them for sending us money, but at the same point, the fact that they were saving so much money, and they didn’t have anywhere to put it at home, and they were shipping it over here, and we were putting it to work at things that just made no sense—like ever bigger homes—that means we need higher consumption from these countries. We need higher consumption from China, we need higher consumption from India, we need higher consumption from Brazil, all of which have actual reasonably intact banking systems, because they never got involved in the esoteric products that we in the U.S. and the U.K. did, or even the western European banks. And as that savings rate falls, our savings rate will rise, and there will be a better balance in the world economy.

But the problem is, as our savings rate rises over time—you’re really talking about over the next ten years—there is a lower potential growth rate in the United States. So once we get out of this, and you get some sort of recovery that is not boosted by ever-increasing spending on the part of the U.S. government, we are going to be in a lower growth environment than we have been in the past—lower growth over all, maybe slightly higher inflation over time, and possibly slightly higher U.S. interest rates on a more sustained basis.

Stuck

So, the next decade doesn’t look all that great, truthfully. If I had another job that I was actually capable of doing, I’d do it, but I’m going to be stuck being an economist for a number of years.

If you look at Canada, in contrast, what you see is that Canada is going to have a period of negative growth this year. We think that negative growth is going to be minus two percent and change, but in 2110 there’s going to be a much better balance. It’s going to be about two-and-a-half percent, just a little under two-and-a-half percent plus. The main drag this year is going to come from consumption being slightly negative, but investment is actually dropping sharply in areas like housing and business equipment, in part because of the export contraction. On the rebound, consumption is going to pick up to more normal levels, somewhere around 2 percent for 2110. We’re going to see less disinvestment in terms of capital equipment expenditure, housing is going to remain weak, but the overall economy should grow by just under two-and-a-half percent.

The massive imbalances that existed in the United States don’t exist in the same proportion north of the border. And so that decade of problems that the U.S. is going to face is probably not going to be repeated north of us. And what that means, simply put, is that you’re talking about a slightly higher growth rate, maybe not beyond the trends, but something more trend-like in Canada, whereas in the United States, you’re talking about below trends for a long period of time.
Undoubtedly, the market will be seeing more target companies with accumulated net operating losses ("NOLs") for federal income tax purposes as a result of the current recession. Corporations generate an NOL to the extent that their current year tax deductions exceed their current year taxable income. Subject to certain conditions and limitations, federal income tax law permits a corporation that incurs an NOL in a given tax year to use that NOL to reduce taxable income in other tax years. Specifically, an NOL that is incurred in one year may be carried back to each of the preceding two tax years to offset taxable income reported in those years. The recently enacted Recovery Act extends the carryback period to five years for certain small businesses. Any remaining NOL after the carryback, or all of the NOL if the carryback is waived, is then carried forward to each subsequent tax year after the tax year the loss is incurred to offset future taxable income for up to 20 years.

Depending on the circumstances, the availability of these NOL carryforwards may be an important consideration in deciding whether to structure an acquisition of a target corporation as a stock deal or as an actual asset deal (or, as a stock deal that is deemed to be an asset deal for tax purposes, but that is a topic for another day). Deals structured as taxable asset sales will not have any NOL carryforwards transferred over to the buyer. Such NOLs will stay with the selling corporation and/or the selling corporation group and may be used to offset the selling corporation’s gain on the sale of its assets – assets which will now have a fair market value basis in the hands of the buyer with the resulting increased depreciation and amortization deductions. Therefore, if the target corporation’s NOLs are sufficiently large, the parties should consider whether it is more efficient to have the target corporation sell its assets and use its NOLs to offset any resulting income tax on such sale or instead for the buyer to purchase the stock (and in effect the NOLs) of the target.

Generally, where the parties settle on a stock deal, the NOL carryforwards of a target “C” corporation will transfer with and be available to the target corporation. Accordingly, a target corporation’s NOL carryforwards that exist as of the closing date represent an economic asset of the target – the possible reduction of future income taxes. Thus, these NOLs may be of some value to some buyers, even in this dismal market. However, our experience has shown that when deal makers are negotiating the purchase price for a target’s stock they will often either fail to address the potential value of these NOLs or at least fail to address the value early enough in the process to make a meaningful difference. In addition, if the issue does arise in price negotiations, buyers often argue that the market price for NOLs is “pennies on the dollar.”

Our experience is that many sellers are leaving a potentially significant portion of their business’ value on the table. The not-so-dirty little secret is that NOL carryforwards may be of significant value to certain buyers. Some of these buyers may actually reflect to varying degrees the true value of these NOLs in their bid prices, but some may not. Accordingly, should a seller sit idly by and let a buyer take a valuable asset without paying for it? On the other hand, should a buyer who takes into account the value of target’s NOLs in its bid price not ask for greater contractual safeguards regarding those NOLs?
NOLs

continued

This article discusses some of the many factors that may impact the value of the NOL carryforwards of a domestic C corporate target and then describes some negotiation tactics and contract provisions that buyers and sellers may wish to consider. This article assumes that the parties have already settled on a stock deal involving a target with NOLs that will transfer to the buyer and therefore should have some value.

Factors impacting the value of NOLs

The value of a target corporation’s NOL carryforwards as of the closing date should approximately equal the present value of the expected reductions in future cash tax payments from the utilization of the NOLs in later tax years. Assuming this is the proper valuation method, a number of factors impact this analysis. We will highlight the major ones.

Probability of Future Taxable Income. Perhaps the most significant factor impacting the value of NOL carryforwards is the probable amount and timing of future taxable income. Clearly, the sooner the NOLs are expected to be absorbed by future taxable income, the greater the value of the NOLs should be on a present value basis. However, the timing of future taxable income should be examined in light of the remaining life of the NOL carryforwards. Recall that NOLs may be carried forward 20 years from the year the losses were incurred (and NOLs generated in tax years ending prior to August 5, 1997 can only be carried forward for 15 years). Accordingly, a target corporation that incurred NOLs in different tax years could have various NOL carryforwards that are set to expire at different points in time. For example, a target corporation could have NOL carryforwards that are set to expire in two, five, and ten years from the closing date if the losses were incurred far enough back in time. If this target corporation (or its new consolidated group) is not expected to have much income for the first few years following its acquisition, the value of the NOL carryforwards with the two-year remaining life would be suspect, absent some creative tax planning.

A target corporation’s NOLs should be more valuable to a buyer if there is a strong probability that the target itself will absorb its own NOLs through its own future taxable income. However, even if the target’s ability to absorb the NOLs itself is questionable, the target’s NOLs may still be quite valuable to some buyers depending on the buyers’ particular circumstances and objectives. For example, tax law permits the NOLs of the target corporation, subject to limitations (see some limitations discussed below), to be used to offset the future taxable income of not only the target corporation, but also the future taxable income of other members of its consolidated group of corporations (even if they were not consolidated at the time that the loss was originally incurred). Thus, if the buyer is a member of a profitable consolidated group of corporations, the target’s NOLs may be of significant value to such buyer and its consolidated group even if the target’s own income projections are not particularly strong.

On the other hand, if a corporate buyer and its consolidated group have a weak profitability forecast or have their own NOL carryforwards, the buyer may be less interested in the target’s NOL carryforwards. Likewise, a buyer that is a partnership or an individual may place a lower value on a target corporation’s NOLs since tax law does not permit a target corporation’s NOLs to be used to offset the taxable income of an individual or a partnership.

This discrepancy explains why different buyers may bid very different amounts for the same target corporation solely on the basis of the buyer’s ability to utilize NOL carryforwards.

Amount and Accuracy of NOL Carryforwards. Another significant and obvious factor impacting the value of NOL carryforwards is the amount of the NOLs and the buyer’s comfort level with the accuracy of the purported amount of the NOLs. The amount of NOLs that a target reports on its tax return may be subject to IRS challenge. The target corporation may have erroneously understated income or overstated deductions in prior years. A buyer’s comfort level should increase to the extent the IRS has already audited the target corporation’s prior tax returns. We should point out, however, that buyers may not derive much comfort from the fact that the applicable statute of limitations has expired for the years in which the losses were incurred. While the IRS may not reopen tax returns for closed tax year for purposes of redetermining the target’s liability for those years, the IRS may nevertheless audit closed tax years for purposes of denying an NOL carryforward deduction taken in a later open tax year.

A buyer may also gain further comfort if the seller has elected to not carryback its NOLs. Such an election by the seller avoids a situation where a buyer’s purchased NOLs is ultimately reduced because a year prior to the year the NOL was incurred is determined to have more income than originally thought; therefore, more of the NOL must be carried back to that previous year before
it is carried forward to subsequent years and ultimately transferred to the buyer.

A buyer’s comfort level should also increase to the extent the buyer has conducted adequate due diligence procedures with respect to the target corporation’s NOL carryforward amount and remaining carryforward periods. Often, however, it is quite difficult to make these determinations in the due diligence process, at least not in the typical timeframe provided. Of course, a buyer’s comfort level should also increase to the extent the Seller provides contractual protections regarding the amount and accuracy of the NOLs (as discussed further below).

Section 382 Limitation. Another important factor impacting the value of NOLs is whether the use of NOLs is subject to any limitations under tax law. The most relevant limitation is the one imposed by section 382 of the Internal Revenue Code of 1986 (the “Section 382 Limitation”). In general, the Section 382 Limitation limits the extent to which a target corporation that experiences an “ownership change” may offset taxable income in any post-change taxable year by pre-ownership change NOLs. The Section 382 Limitation may also apply to the recognition in a post-change year of “built-in losses” in the target’s assets that existed on the change date. In general, the amount of income in any post-change year that may be offset by the target’s pre-change NOLs is limited to an amount determined by multiplying the value of the target corporation immediately before the ownership change by the long-term tax-exempt interest rate. The long-term tax-exempt rate has been averaging around five-percent in recent months.

Example. Assume a target corporation had a value of $20 million immediately prior to an ownership change. Accordingly, the amount of taxable income in a post-change tax year that may be offset by the target’s pre-change NOLs would be limited to $1 million (5% x $20 million). Since existing tax law sets a maximum carryforward period of 20 years, the value of any target NOLs in excess of $20 million in this example may be too speculative for the buyer to value.

We note, however, that if a target has an overall net built-in gain in its assets at the time of the ownership change, the annual limitation described above may be increased (subject to certain conditions and limitations) by the subsequent recognition of gains from the sale of the target assets to the extent the value of the asset exceeded its cost basis as of the change date. Thus, all things equal, a buyer may place more value on a target corporation’s NOL carryforwards to the extent the buyer expects to offload some of the target’s built-in gain assets. However, we note that the IRS has issued a notice which permits taxpayers to adopt an approach that may increase the annual Section 382 Limitation for an amount relating to built-in gain assets without actually having to sell such assets.

In general, a target corporation has an ownership change when one or more five-percent (or greater) shareholders increase their stock ownership in the target by more than 50 percentage points over the lowest percentage ownership of each such shareholder at any time during the preceding three year testing period. Thus, when a buyer acquires all the stock of the target corpo-
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ration, there is clearly an ownership change and the amount of post-closing income that may be offset by the pre-change NOLs will typically be subject to the Section 382 Limitation. In addition, some or all of the NOL carryforwards that exist as of the closing date may be subject to not only the Section 382 Limitation as a result of the ownership change that occurs on the closing date, but also to other Section 382 Limitations as a result of ownership changes that may have occurred prior to the closing date. If an NOL carryforward is subject to more than one Section 382 Limitation, the most restrictive limitation is applied.

Example. Assume target corporation incurs an NOL of $10 million in 2006. Assume there was no income in 2007, but target corporation had an ownership change on December 31, 2007 when the target corporation was worth $50 million. The pre-change NOLs would be subject to Section 382 Limitation of $2.5 million ($50 million x 5%). For 2008, assume target had taxable income of $8 million. Due to the earlier Section 382 limitation, only $2.5 million of the $10 million of NOL carryforwards could be used to offset the 2008 income. Assume target patented some valuable technology and a buyer paid $100 million to acquire all of the stock of target on January 1, 2009. The Section 382 Limitation for the January 1, 2009 ownership change would be $5 million (5% x $100 million). The unused NOL carryforward of $7.5 million, however, remains subject to the more restrictive $2.5 million Section 382 Limitation.

A buyer will place greater value on NOLs to the extent it is comfortable that the target corporation’s NOLs are not subject to a prior, more restrictive Section 382 Limitation. Again, a buyer can derive some comfort by performing due diligence procedures to ferret out any prior ownership changes and through contractual protections, some of which are described below.

Miscellaneous factors. Special issues arise when a target is a member of a consolidated group. Under the newly promulgated “unified loss rule,” the tax attributes of the target, including its allocable share of the group’s consolidated NOL, may be decreased after the transaction if the seller incurs a loss on the sale of its target shares and fails to elect to reduce its basis to eliminate the loss. It should also be noted that when a target corporation is purchased from a consolidated group, the target’s allocable share of the group’s consolidated NOL will not be ascertainable until the close of the group’s tax year, which often will not be ended by the purchase of target from the selling consolidated group. Thus, some or all of the target’s anticipated NOLs may be used to offset the income earned by other members of the selling consolidated group in the period from closing to the normal end of the selling consolidated group’s tax year.

Other potential factors impacting NOLs include limitations imposed by the alternative minimum tax and possible future changes to applicable tax laws (e.g., possible changes to the corporate tax rates and carryforward and carry-back periods).

Negotiation tactics and contract provisions

We believe that far too often the topic of NOLs is not discussed among the principals in a deal to any great extent or, if it is, at least not soon enough. However, we feel there are at least a couple of scenarios where the buyer or seller may want to address the issue head-on at an early stage of a deal.

First, a seller should consider taking a head-on approach where (1) the target corporation has significant NOLs; (2) the seller is confident about the quality and amount of the target’s NOLs (confident enough to stand behind the NOLS if need be with contractual safeguards as described below); and (3) it is reasonably likely that taking this approach will result in an increase in the purchase price. If the seller does not take this approach, it risks leaving money on the table. Before taking such an approach, however, a seller may wish to confirm the amount and quality of a target’s NOLs through its own due diligence.

Second, if a buyer is paying some amount for NOLs that is greater than “pennies on the dollar,” it may want to take a head-on approach in order to seek explicit contractual protections that it would not otherwise obtain. Unless the topic of NOLs is brought up early in price negotiations or explicitly mentioned as an assumption in a buyer’s bid, a buyer may have a more difficult time obtaining guarantees from the seller regarding the target’s NOLs when the parties’ tax lawyers begin negotiating the tax provisions of the purchase agreement. Often in deals where the topic is not broached soon enough, the most a buyer can hope for is a representation that the target has not undergone a prior ownership change for purpose of the Section 382 Limitation. In these cases, we believe it is unusual for a buyer to get any explicit assurance regarding the amount and remaining life of a target’s NOL carryforwards. Indeed, a seller may even insert a provision explicitly carving out any guarantees regarding
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the amount and quality of the NOLs. Note that sellers may want to include such a provision because certain standard seller representations – such as the representation that the target’s tax returns are materially correct – are broad enough to arguably provide the buyer with more protection than the seller intended.

One would expect some correlation between the amount and type of contractual protections to be provided and the price being paid for the NOLs. As discussed, if the buyer is paying pennies on the dollar, it should expect to receive an equivalently low level of protection from the seller. If the buyer is paying something more, but less than full value, perhaps a seller should, for example, agree to provide representations regarding the amount and quality of NOLs, but with some ceiling on damages.

Perhaps a better, but more complicated approach, is for the parties to eschew representations for which damages may be open-ended for more clearly defined purchase price adjustment mechanisms. For example, the parties could agree to make purchase price adjustments based on an agreed formula that takes into account any changes to specific underlying assumptions (e.g., assumptions regarding the amount of closing date NOLs that will leave with a target corporation, the lack of prior Section 382 Limitations, and the remaining carryforward periods for the NOLs).

If the future utilization of the target’s NOLs is questionable (for example, because the future taxable income of the target or its new consolidated group is difficult to forecast) another approach is to have the buyer pay the seller as a purchase price adjustment some agreed amount or percentage of future tax savings if and when the NOLs are actually utilized. In this case, sellers at least have a shot at benefiting from the target’s NOLs and preventing a possible windfall to the buyer should future earnings prove favorable. The approach may of course be attractive to buyers since buyers would not have to come out of pocket until they actually realize the tax savings. It also has the added benefit of keeping both parties’ interests aligned in the use of the NOLs since they both benefit from maximizing the buyer’s use of the NOLs.

Since NOLs may be carried forward for 20 years, few buyers and sellers will want to be entangled for this long. Accordingly, the parties may want to consider adding a sunset provision on any such purchase price mechanics. Because the time value of money is one of the most important factors, perhaps most of the value may be captured in a relatively short sunset period. However, if a seller wants more of a clean break at closing, it should be prepared to accept a lower purchase price for the NOL carryforwards from the buyer.

Conclusion

As described above, depending on the circumstances, buyers and sellers may find it beneficial to specifically raise and discuss the value of a target’s NOL carryforwards and related contract provisions early in their price negotiations. To do otherwise may result in a lower purchase price to a seller or an overpayment by a buyer. In any event, this is yet another reason to involve your tax lawyer as early in a deal as possible.

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