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COZEN O'CONNOR

Chen v. Howard-Anderson: A Study in the Standards of Review and of D&O Conduct in the Merger Context

Litigation over challenges to corporate mergers has swelled in recent years, exposing directors, officers and their D&O insurers to large amounts of defense costs and potentially great liability. The Delaware Chancery Court recently issued an opinion analyzing and explaining the various standards by which courts review challenges to director decision-making in the merger context, which provides a thorough summary for all interested parties. In *Chen v. Howard-Anderson*, No. CIV.A. 5878-VCL, 2014 WL 1366551 (Del. Ch. Apr. 8, 2014), the court issued an 80-page scholarly opinion reviewing the three well-known levels of review for evaluating director decision making, namely the business judgment rule, enhanced scrutiny and entire fairness, and explained when each applies.

The court also declined to allow an exculpatory provision to protect officers and directors equally pursuant to Section 102(b)(7) in a corporate charter. The court split the defendants, granting summary judgment to the directors under the exculpatory provision, but allowing those claims to proceed against the corporate officers. The directors were not given a complete pass, however. The court allowed claims to proceed regarding disclosure allegations. Ultimately, the court made important clarifications regarding the standards of review and the duty of disclosure.

The Facts

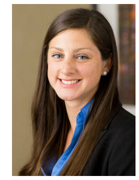
The facts of this case were extensive. As the court itself noted, the record in the case thus far has "filled many binders." In brief, in September 2010, Occam Networks, Inc. announced an agreement and plan of merger with Calix, Inc. The merger agreement called for Calix to acquire Occam through a merger in which each share of Occam common stock would be converted into the right to receive 0.2925 shares of Calix common stock and $3.83 in cash. The merger closed in February 2011.

As a result of the merger, shareholders holding approximately 19 percent of Occam's common stock filed suit against the corporation's directors and officers in the Delaware Court of Chancery. The plaintiffs claimed that the directors and officers breached their fiduciary duties by deciding to sell Occam to Calix. The suit alleged that certain actions taken by the directors and officers during the sale process – ultimately unreasonably favoring Calix over other logical bidders – breached their fiduciary duties. The plaintiffs also alleged that the directors and officers breached their fiduciary duty to disclose by making inaccurate disclosures and failing to include material information in the proxy statement.

The defendants moved for summary judgment, asking the court to find as a matter of law that they did not breach their fiduciary duties. Alternatively, the director defendants contended that the evidence could, at most, support a breach of the duty of care, for which a provision in Occam's certificate of incorporation exculpates them from liability.

Ultimately, the court separately analyzed the position of each defendant. Defendants Robert Howard-Anderson, Steven Krausz, Robert Abbott, Robert Bylin, Thomas Pardun, Brian Strom and Albert Moyer constituted Occam's board of directors (the board). Howard-Anderson also served as Occam's president and CEO. The other six directors were facially independent and disinterested outsiders. Two directors —Krausz and Abbott — were affiliated with investment funds that together held approximately 25 percent of Occam's common stock. The court found that this stock ownership aligned them with, rather than against, the shareholders generally.

Legal Arguments



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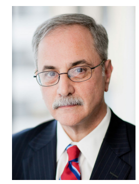

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Because the court was hearing the case on a motion for summary judgment, it reviewed all the evidence in a light most favorable to the plaintiffs. The defendants asked the court to determine as a matter of law that they had not breached their fiduciary duties by deciding to sell Occam to Calix instead of to a higher bidder; or, in the alternative, that they were protected by the exculpatory provision.

The court began its analysis by addressing the standard of review. It made a point to distinguish between the standard of review and the standard of conduct. “The standard of conduct describes what directors are expected to do and is defined by the content of the duties of loyalty and care. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct.”

The court explained that the applicable standard of review depended on a multitude of factors, including whether the board members:

> “(i) were disinterested and independent (the business judgment rule);
>
> (ii) faced potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations (enhanced scrutiny);
>
> (iii) confronted actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent Board majority (entire fairness).”

The court also noted that the standard of review could also be affected by whether the directors took steps to address the potential or actual conflict, such as by creating an independent committee, conditioning the transaction on approval by disinterested stockholders, or both. In any event, the court acknowledged that “the standard of review is more forgiving of directors and more onerous for stockholder plaintiffs than the standard of conduct.”

The defendants argued that once the merger was complete, the standard of review should be relaxed to the business judgment rule. Unsurprisingly, the plaintiffs argued that the standard of review should escalate to entire fairness review. The court, however, ruled that “the fact that the transaction has closed does not cause the standard of review to relax from enhanced scrutiny to the business judgment rule.” But after reviewing the plaintiff’s contentions with respect to each defendant, the court also ruled that the claims were to be evaluated under the enhanced scrutiny analysis because plaintiffs had not questioned the independence of enough directors to trigger the heightened standard of review mandated by the entire fairness standard.

Enhanced Scrutiny Analysis

In the merger context, enhanced scrutiny requires that the defendant fiduciaries show that they “acted reasonably to seek the transaction offering the best value reasonably available to the stockholders, which could be remaining independent and not engaging in any transaction at all." To meet this test, the defendants must demonstrate both (i) the reasonableness of “the decision-making process employed by the directors, including the information on which the directors based their decision,” and (ii) “the reasonableness of the directors' action in light of the circumstances then existing.”

Ultimately, the court evaluated these duties under a reasonableness standard. However, reasonableness does not permit the court to substitute its own judgment for that of the directors.

The plaintiffs contended that the defendants’ actions were unreasonable. Specifically, they contended that the defendants favored Calix as a bidder and failed to pursue other alternatives that may have been a better deal for stockholders. Although favoritism of a bidder is allowed if the board of directors believes in good faith that shareholder interests would be advanced, “a Board may not favor one bidder over another for selfish or inappropriate reasons.”

Here, the court looked to the contrast between Occam’s interactions with Calix as opposed to interaction with other bidders. Evaluated as a whole in the light most favorable to the plaintiffs, the court found that there was a reasonable inference that the board improperly favored Calix.

The Exculpatory Provision

Section 102(b)(7) of the Delaware General Corporate Law allows corporations to include provisions in their certificate of incorporation exculpating directors from liability. Occam took advantage of this option, and included a provision that exculpated directors from monetary liability for duty of care violations.

Though the defendants argued that the potential application of the exculpatory provision should be evaluated under the business judgment rule, the court applied enhanced scrutiny, looking to whether "there is a basis for concern that directors without a pure self-dealing motive might be influenced by considerations other than the best interests of the corporation and other stockholders." This standard is applied to the sale of a corporation, as courts are concerned that a "board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders."

Because enhanced scrutiny applied, and because the directors took unreasonable actions, the plaintiffs asked the court to draw an inference of bad faith. However, the court found that the record did not contain sufficient evidence of an improper motive, as all of the directors except one were disinterested and independent. Because the plaintiffs did not cite any other evidence that would question the motives of the non-interested board members, summary judgment was entered in their favor as they were protected by the exculpatory provision.

Howard-Anderson, the interested director, also served as an officer. He was not protected by the exculpatory provision because section 102(b)(7) does not authorize exculpation for officers. With respect to Howard-Anderson, and one other officer-defendant who was the CFO, the plaintiffs cited evidence regarding actions they took "as officers that could support a reasonable inference of favoritism towards Calix consistent with their personal financial interests rather than the pursuit of maximal value for the stockholders." Because the exculpatory provision did not protect officers, both Howard-Anderson and the CFO were denied summary judgment on the claims against them arising out of the sales process.

The Disclosure Claim

The defendants also sought a determination as a matter of law that the disclosures in the proxy statement were accurate and the allegedly omitted information was either disclosed or immaterial. Directors are required to disclose fully and fairly all material information within the board's control. Information is material if a reasonable shareholder would consider it important to his vote.

The plaintiffs argued that the defendants omitted relevant revenue projections. The defendants contended that the projections were immaterial because they were unreliable. Both the plaintiffs and defendants submitted evidence regarding the reliability of the projections. Because there was conflicting evidence, the court could not determine as a matter of law that the projections were unreliable and did not need to be disclosed. Thus, summary judgment was denied on the disclosure claim.

The plaintiffs also argued that the defendants' description of management projections was inaccurate and misleading. Finding evidence to support this position, the court also denied summary judgment on this claim.

The defendants argued that the exculpatory provision shielded them from the plaintiffs' disclosure claims. But the court found that the exculpatory provision bars any damages recovery for disclosure claims resulting from a breach of the duty of care, and at this stage in the litigation, it was unclear whether the disclosure violations in the proxy statement resulted from a breach of the duty of loyalty or the duty of care. Under these circumstances, summary judgment was denied.

Conclusion

M&A litigation has become extremely frequent in recent years with one study finding that more than 90 percent of mergers are met with increasingly expensive challenges in litigation. Directors, officers and their insurers should understand the different standards that courts apply to such litigation and the extent of the protections afforded by exculpatory provisions. The *Chen* case provides an excellent tutorial on the standards of conduct and the standards of review applicable to director and officer decision-making in the merger context, as well as an analysis of the limits of the protection afforded by exculpatory provisions.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Angelo G. Savino at (212) 908-1248 or asavino@cozen.com or Kristy Z. Miller at (212) 453-3722 or kmiller@cozen.com.