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Delaware Court Rejects Claim That Directors Acted in Bad Faith by Selling Company Facing Activist Threat

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Delaware Court Rejects Claim that Directors Acted in Bad Faith By Selling Company Facing Activist Threat

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Reaffirms high bar for proving that directors acted in conscious disregard of their obligations

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INTRODUCTION

It should be news to no one that activist investors now play a major role in corporate America. In fact, in the realm of public M&A, activist investors have become significant players both in encouraging (or forcing) public companies to seek acquirers and in blocking or causing public M&A transactions to be renegotiated. This phenomenon

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has, in turn, spawned litigation requiring the Delaware Court of Chancery (the "*Chancery Court*") to apply existing standards of judicial review to new fact patterns.[1]

Recently, in *In re MeadWestvaco Stockholders Litigation*,[2] the Chancery Court encountered an allegation that otherwise independent and disinterested corporate directors essentially " 'flew blind' and left behind $3 billion of value" when they approved a merger agreement with a competitor rather than face an activist threat to their board positions.[3] Chancellor Andre G. Bouchard rejected this claim, reflecting the high bar that stockholders face when they seek damages from directors alleged to have acted in bad faith. The elements of board conduct cited by the Chancellor in support of his ruling demonstrate that good process remains a solid "safe haven" against claims that directors breached their fiduciary duties, even when they are reacting to threats from activist investors.

I. FACTUAL BACKGROUND

MeadWestvaco Corporation ("*MeadWestvaco*" or the "*Company*") is a global packaging company that also operates a segment producing "specialty chemicals for automotive, energy, and infrastructure businesses."[4] In March 2014, a stock analyst suggested a merger between MeadWestvaco and another packaging company, Rock-Tenn Company ("*RockTenn*"), theorizing that RockTenn's billion-dollar pension deficit could be offset in part by MeadWestvaco's pension surplus (exceeding $1 billion).[5] The two companies' CEO's engaged in "preliminary discussions" concerning a potential business combination the next month. Around this same time, Starboard Value LP, an activist investment firm, began accumulating MeadWestvaco stock, eventually becoming one of the Company's largest stockholders.[6]

1. For instance, in *In re Ebix, Inc. Stockholder Litigation*, C.A. No. 8526-VCN, 2016 WL 208402 (Del. Ch. Jan. 15, 2016) [hereinafter "*Ebix*"], the Chancery Court applied the lenient business judgment standard of review rather than enhanced scrutiny to a board's decision to settle a dispute with an activist investor by granting the investor board seats in exchange for the investor's agreement to support the board's other nominees. For a more detailed discussion of the *Ebix* Court's analysis, see Robert S. Reder & Stanley Onyeador, *Delaware Court Addresses Entrenchment Claims Brought Against Directors Under Activist Hedge Fund Attack*, 69 VAND. L. REV. EN BANC 209 (2016).

2. *In re* MeadWestvaco Stockholders Litig., 168 A.3d 675 (Del. Ch. 2017) [hereinafter "MeadWestvaco"].

3. *Id.* at 678.

4. *Id.*

5. *Id.* at 679.

6. *Id.*

Starboard soon began to flex its muscles. In June, Starboard sent a letter to MeadWestvaco's board of directors (the "*Board*") complaining that "the Company was not operating at its full potential and demand[ing] an overhaul . . . through cost cutting and the sale of its specialty chemicals business."[7] In reaction, the Board—all of whose members (save one) were considered independent—directed the CEO to accelerate the discussions with RockTenn.

Although the two CEOs met several times over the next six months, RockTenn refused to budge from its opening bid for a premium-free, stock-for-stock merger with an exchange ratio based on the then-market price of MeadWestvaco's stock. At this point, the Board instructed the CEO to abandon negotiations with RockTenn and turned instead to consideration of a spin-off of the specialty chemicals business into a separate, publicly-traded company (the "*Spin-Off*"). When Starboard announced in December that it had increased its ownership stake to 6.1% and signaled a potential proxy fight for control of the Board, MeadWestvaco publicly announced a plan to proceed with the Spin-Off. The market reacted favorably, triggering a 5.8% increase in MeadWestvaco's stock price.

Then, in early January 2015, the Company and RockTenn resumed discussions of a potential stock-for-stock merger. The negotiators reached a preliminary agreement on January 14 calling for MeadWestvaco stockholders to receive 0.78 shares in the combined company in exchange for each Company share. This exchange ratio implicated a 9.1% premium for MeadWestvaco stockholders, who would receive just over 50% of the shares of the combined company. The new entity would have a fourteen-member board, of which eight members would be RockTenn appointees and six would be MeadWestvaco appointees. The proposed merger agreement between the companies gave the Board a "fiduciary-out" to accept a superior transaction, subject to matching rights for RockTenn and a relatively modest "termination fee equating to less than 3% of the value attributed to the Company in the transaction."[8] Finally, the Spin-Off would be delayed until after the merger.

On January 25, after receiving fairness opinions from all three of its financial advisors, the Board approved the transaction. In due course, both of the leading U.S. proxy advisory firms recommended the transaction to MeadWestvaco stockholders, who approved the merger on June 24 by an affirmative vote of 98% of the shares voting. No

7. *Id.*
8. *Id.* at 682.

competing bidders for the Company surfaced in the five-month period between signing and closing.

Several MeadWestvaco stockholders challenged the transaction after the first public announcement, alleging that the Board members breached their fiduciary duty by acting "in bad faith in reaction to a threatened proxy contest."[9] While plaintiffs claimed that Starboard's activism was the "impetus" for the Board's approach to RockTenn, "they 'd[id] not argue that Starboard created a disabling conflict [or] that the looming proxy fight with Starboard prevented the Board from appropriately conducting their duties.' "[10] Plaintiffs initially sought, but then abandoned its effort, to preliminarily enjoin the transaction, relying instead on a post-closing damages action against the MeadWestvaco directors. The directors moved to dismiss.

II. THE CHANCERY COURT'S ANALYSIS

Because there was no dispute that the Board was both disinterested and independent,[11] and given that MeadWestvaco's certificate of incorporation contained the provision authorized by the Delaware General Corporation Law exempting directors from personal liability for breach of their duty of care,[12] Chancellor Bouchard noted at the outset that "plaintiffs' case thus rests entirely on the board's alleged failure to discharge its duties in good faith."[13] According to plaintiffs, the directors "knew [various Company] assets were undervalued by the market and 'deprived MeadWestvaco's shareholders of at least $3 billion of additional value' by 'flying blind' and doing 'virtually nothing' to meet their fiduciary duties."[14] The directors countered that these allegations failed to "plead a viable claim for bad faith."[15] The Chancellor concurred, granting the directors' motion to dismiss.

9. *Id.* at 678.

10. *Id.* at 683.

11. *Id.* at 683–84.

12. *See* Del. Code Ann. tit. 8, § 102(b)(7) (West); *MeadWestvaco*, 168 A.3d at 683.

13. *MeadWestvaco*, 168 A.3d at 684. Initially, Chancellor Bouchard pointed out that "[g]iven that the merger was a strategic combination of two publicly-traded, widely-held companies without any controllers, and that the consideration MeadWestvaco stockholders received consisted entirely of stock of the combined entity, the merger [wa]s not subject to an entire fairness review *ab initio* or enhanced scrutiny under *Revlon*." *Id.* at 683. As a result, the Chancellor explained, the Board's "decision to approve the merger presumptively is governed by the business judgment rule." *Id.*

14. *Id.* at 684.

15. *Id.* The directors also argued that even if their behavior constituted bad faith, "the board's decision to approve the merger was cleansed under *Corwin v. KKR Fin. Holdings, LLC* [125 A.3d 304 (Del. 2015) [hereinafter "*Corwin*"]] and its progeny by virtue of the stockholders' overwhelming approval of the merger." *Id.* Because Chancellor Bouchard dismissed plaintiffs' bad faith allegations on substantive grounds, he saw no need to address the *Corwin* argument. For a more detailed discussion of *Corwin* and subsequent decisions, see (i) Robert S. Reder, *Delaware*

Chancellor Bouchard, noting that the bad faith claim is a particularly "difficult standard to meet,"[16] explained that establishing bad faith requires a showing of *either* "[1] an extreme set of facts to establish that disinterested directors were intentionally disregarding their duties or [2] that the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[17]

- *Intentional Disregard of Duties.* In determining that the directors had not intentionally disregarded their duties, the Chancellor focused on several elements, including (i) the nine-person Board included eight concededly independent and disinterested directors; (ii) the relatively lengthy nine-month period over which the transaction was negotiated; (iii) the Board, aided by experienced legal and financial advisors, met frequently to receive updates on the process and "numerous valuations of the Company," and asked "probing questions" regarding the transaction; (iv) the rigorous "on-again off-again" negotiating process, including the Company CEO's interruption of negotiations not once, but twice, due to unsatisfactory bids from RockTenn, ultimately yielding "a 9.1% premium for MeadWestvaco's stockholders"; and (v) the merger agreement's inclusion of a termination provision "to afford stockholders the opportunity to receive a superior proposal."[18]

Chancellor Again Invokes Corwin in Granting Directors' Motion to Dismiss Breach of Fiduciary Duty Claim, 70 VAND. L. REV. EN BANC 209 (2017); (ii) Robert S. Reder, *Delaware Chancellor Refuses to Invoke Corwin to "Cleanse" Alleged Director Misconduct Despite Stockholder Vote Approving Merger*, 70 VAND. L. REV. EN BANC 199 (2017); and (iii) Robert S. Reder & Tiffany M. Burba, *Delaware Courts Confront Question Whether "Cleansing Effect" of Corwin Applies to Duty of Loyalty Claims*, 70 VAND. L. REV. EN BANC 187 (2017).

16. *MeadWestvaco*, 168 A.3d at 684.

17. *Id.* (quoting *In re* Chelsea Therapeutics International Ltd. Stockholders Litig., 2016 WL 3044721, at *7 (Del. Ch. May 20, 2016)). For a more detailed discussion of *Chelsea Therapeutics,* see Robert S. Reder & Tiffany M. Burba, *Delaware Court Dismisses Duty of Loyalty Claim Against Disinterested, Independent Directors*, 69 VAND. L. REV. EN BANC 235 (2016). As an example of the high bar to establishing directorial bad faith, Chancellor Bouchard noted that "even one 'plausible and legitimate explanation for the board's decision' would negate a reasonable inference that the decision was 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' " *Id.* (quoting *In re* Alloy, Inc., C.A. No. 5626–VCP, 2011 WL 4863716, at *12 (Del. Ch. Oct. 13, 2011)).

18. *Id.* at 685–86. In response to plaintiffs' argument that delaying the Spin-Off until after the merger, in effect, robbed Company stockholders of additional value, the Chancellor noted that this delay likely was factored into the ultimate exchange ratio. *Id.*

- *Adequacy of Price*. To prevail on this prong of their bad faith claim, plaintiffs "must [have] overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."[19] Chancellor Bouchard cited four factors supporting his conclusion that "the merger consideration here is nowhere near so 'egregious,' so 'irrational,' or 'so far beyond the bounds of reasonable judgment' as to be 'inexplicable on any ground other than bad faith'"[20]: (i) the premium and majority stake in the combined entity obtained for MeadWestvaco stockholders; (ii) the three independent fairness valuations received by the Board in support of its decision; (iii) the reasonableness of the "deal protections" negotiated in the merger agreement and the absence of any competing bids during the five month pre-closing period; and (iv) the favorable recommendations published by the independent proxy advisors, coupled with "overwhelming" support from MeadWestvaco stockholders including, notably, Starboard.[21]

CONCLUSION

MeadWestvaco demonstrates the difficulty faced by stockholders in wresting damages from independent, disinterested directors on the ground they acted in bad faith in negotiating the sale of their company, even when they act in the shadow of activist investor threats. Chancellor Bouchard's opinion instructs that the advice that legal practitioners traditionally have given to corporate directors engaging in public M&A transactions remains much the same even though the players have changed: good process and diligence and reliance on the advice of experienced financial and legal advisers generally will shield directors from personal liability. As the Chancellor reminds us, plaintiffs claiming that directors acted disloyally must prove bad faith. This indeed "is a difficult standard to meet"[22] because, "[a]s long as a board attempts to meet its duties, no matter how incompetently, the directors [do] not consciously disregard their obligations."[23]

19. *Id.* at 686 (quoting White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001)).
20. *Id.*
21. *Id.* at 686–88.
22. *Id.* at 684.
23. *Id.* at 686.

It also is interesting to note that Chancellor Bouchard decided to analyze the sustainability of the bad faith claim rather than to consider whether the MeadWestvaco stockholder vote approving the transaction "cleansed" the Board's actions under Corwin.[24] This may very well mean the Chancery Court believes it is more difficult for defendant directors to establish satisfaction of the full disclosure and lack of coercion standards of Corwin than to show they did not act in bad faith. On this basis, one might surmise that Corwin will not have the pervasive impact on stockholder litigation that some commentators have postulated. On the other hand, there are Chancery Court decisions in which the Court tackled the Corwin issue initially and, after determining that Corwin cleansing was not available, asked the parties to develop the record further before the Court could rule on the substantive bad faith claim. [25]

24. *See supra* note 15.

25. *See, e.g.*, Sciabacucchi v. Liberty Broadband Corporation, C.A. No. 11418-VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017).