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Keeping Management in the Game without Tainting the Sale Process

By Janine M. Salomone and Dawn M. Jones

The Court of Chancery has recently restated its skepticism with respect to sales processes that, while overseen by an independent board, may nonetheless be said to have been influenced by senior executives whose personal financial interests could be implicated, even tangentially, by the nature or terms of any resulting business combination. The concept itself is not entirely new, but it appears that in this most recent iteration, a little can go a long way. For example, in *In re El Paso Corporation Shareholder Litig*., C.A. No. 6949-CS, mem. op. (Del. Ch. Feb. 29, 2012), judicial suspicion was engendered with respect to the objectivity of a sales process where stockholders alleged that the CEO of El Paso Corporation, who had been commissioned by the company's independent board of directors to head up negotiations for the sale of El Paso to Kinder Morgan, failed to acknowledge to his board his expression of interest in pursuing a post-closing management-led purchase of an El Paso business unit that Kinder Morgan had declared an intention to put up for sale after the proposed merger. No secret deal or method by which the CEO would translate a less than rigorous negotiation of the merger into a discounted price for the asset post-closing was uncovered by plaintiffs. Yet the Court of Chancery found the nascent conflict sufficient to support the conclusion that plaintiffs' challenge to the fairness of the process would probably succeed at trial. Were it not for the absence of any challenge to the sufficiency of the disclosures, an unaffiliated stockholder constituency and the absence of a competing proposal, the transaction presumably would have been enjoined.

To similar effect was the Court of Chancery's decision in *In re Delphi Financial Group Shareholder Litig*., C.A. No. 7144-VCG, mem. op. (Del. Ch. March 6, 2012). The challenge to the proposed merger in *Delphi* was complicated by the fact that Delphi's CEO and controlling stockholder did not wish to sell his high-vote shares without receiving a control premium. Moreover, he was the sole beneficiary of certain contracts Delphi had entered into with entities that he owned and that would be reduced in value if the purchaser did not retain and extend them post-transaction. Given the fact that the process was being overseen by an independent committee of the board and that the CEO had no connection with the buyer, these potential conflicts with the interests of his fellow shareholders likely would have counted for little were it not for the fact that he was a central participant in the negotiation process. This invited the allegation that secret deals regarding the coincident contracts had been reached, an allegation that troubled the court even when the buyer flatly declared that no such deals existed.

From the board's perspective, a process that relies upon conflicted or potentially conflicted individuals, even where the target has an entirely unconflicted board, invites judicial scrutiny and suspicion and enhances the risk of an injunction precluding the deal or liability for potential claims for damages. This article examines recent opinions and rulings of the Court of Chancery scrutinizing the conduct of conflicted fiduciaries and provides some guidelines and alternative approaches a board and its advisors should consider to address management conflicts in a sale transaction and to ensure that management's personal interests do not undercut the board's duty to obtain the best available transaction for stockholders.

Benching Your Best Player?

At first blush, the solution for a board of directors may seem simple: "bench" the conflicted executives. Recently, this approach worked for Barnes and Noble. Its former CEO, Stephen Riggio, was dismissed from shareholder litigation regarding Barnes and Noble's purchase of a company controlled by his brother, Len Riggio. *In re Barnes & Noble Stockholder Deriv. Litig.*, C.A. No. 4813-CS (March 27, 2012). The board promptly identified Stephen Riggio as irretrievably conflicted in the transaction and essentially benched him from negotiations regarding the sale, assigning other members of management to communicate with the board's special committee when necessary. The court noted that this technique was a "sanctioned," "long-standing," and "responsible"

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method to prevent conflicted management from tainting the process. In the context of granting a motion for summary judgment, Chancellor Strine found that Stephen Riggio did not breach his fiduciary duties because there was no evidence that he influenced the flow of information to the special committee or otherwise inserted himself into the committee's process. He obeyed the board's instruction and stayed out of the negotiations completely. At the same time, there was no indication that he failed to remain available to address any inquiry from the special committee.

But, quarantining key management from a buyer, while a dependable means of preserving a pristine sale process, may not be simple and may not always be the best alternative for a corporation. From a legal perspective, excluding such members of management from the sale process may be sanctioned and responsible. From a business perspective, however, as the Chancellor recognized in *Barnes & Noble*, the CEO can be "a dangerous person to take out of the game," due, in large part, to the wealth of important business and financial information regarding the company that the CEO typically possesses.

Of course, senior officer involvement is often crucial to the negotiation process. A buyer often seeks access to a key executive's knowledge of the company, or in more delicate circumstances, a buyer may seek to purchase the executive's controlling interest, to retain the executive for a prominent role in the surviving entity, or to join in an endless array of post-closing side transactions. Thus, as negotiations unfold, the board must remain ever vigilant in probing those members of management on the front lines regarding the dynamics of the negotiations to prevent such overtures from tainting the sales process.

Establish Policies in Advance

As previously noted, it is not uncommon for a buyer, particularly a financial buyer, to seek to retain management for the surviving entity in exchange for a compensation package that may include an equity rollover. In *J. Crew*, for example, the company's long-time CEO and nearly 12 percent shareholder, Mickey Drexler, was viewed as an industry icon and indispensable to the company. *In re J. Crew Group, Inc. Shareholders Litigation,* C.A. No. 6043 (Del. Ch. Dec. 14, 2011). Recognizing that any purchase of J. Crew would necessarily require his support, an interested buyer met with Mr. Drexler for several weeks to discuss a potential going private transaction involving the rollover of Mr. Drexler's equity and an ongoing leadership role for him post-acquisition. After weeks of discussions, Mr. Drexler revealed the discussions to the J. Crew board. Immediately thereafter, the board launched a full sale process and promptly established an independent committee to negotiate with Mr. Drexler for the sale of his shares. The committee appropriately implemented guidelines that restricted Mr. Drexler from discussing retention or equity participation with potential buyers without committee authorization. Unfortunately, it was too late. By the time the board learned of the potential for a sale transaction and could establish an independent committee, the CEO had already discussed his own retention with the buyer, thereby potentially tainting the process.

While the board acted promptly and took appropriate steps to protect the process as soon as it was able, the court observed that the board should have been able to do so sooner. In fact, the court found that it was "outrageous for a board to be the last to know when the chief executive officer changes the fundamental strategic direction in his own mind." At the settlement hearing, the court explained that it should not be a surprise to directors that CEOs often initiate changes of control. For this reason, well before any strategic "chit chat" is even contemplated, the board should implement policies to prevent interested executives from usurping control of a sale process.

In particular, the Chancellor stated that it is "inexcusable" for a board not to have a policy in place that requires:

> when the CEO changes in his own mind that it's a viable option [to sell the company], the board hears first. The company's advisors belong to the company. You don't talk to employees. You don't share confidential information. You don't make promises to work for anybody else, or anything like that, without talking to us.

Implementing such policies on the front end will help ameliorate adverse litigation consequences.

Be Wary of Common Conflicts

Directors should be mindful of common recurring scenarios that create conflicts for management. In addition to negotiating the sale of the company, an executive may be negotiating (or hoping to negotiate) any combination of: (1) continuing employment (and new compensation) with the surviving entity, (2) a purchase of all or part of the target company, or (3) sale of a controlling interest.

Once the board becomes aware of an executive's conflicting self-interest, the directors should take immediate steps to rehabilitate the process. If a company adopts a policy that requires at least one disinterested and independent director or advisor to participate in every conversation between the buyer and management, it will be easier to protect against potentially troubling side negotiations. The absence of such a chaperone was cited repeatedly by the court as a troubling aspect of the process in *Delphi*. As noted above, however, this fact alone will not suffice to counter judicial suspicion if it is not instituted on a timely basis. Once the Delphi board recognized its CEO's conflict its special committee requested that a representative of the committee's financial advisor accompany him to negotiate with the buyer, yet the delay left room for concern. As noted above, it is important to anticipate such conflicts from the outset and to establish a policy that effectively addresses them.

Be Up Front About Conflicts

Frequently, the difficulty for the board can be identifying the conflict before management has an opportunity to taint the process. Thus, it is incumbent upon management to disclose any potential conflict to the board as soon as possible. A conflicted negotiator may make matters worse if he or she is not upfront about the potential conflict. When a key negotiator in a transaction

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conceals a potential conflict, the court will be less inclined to credit the party's later assertion that the potential conflict did not affect his or her judgment.

The presence of a self-interested executive can significantly affect the court's view of a deal, causing it to question whether a weak negotiator is intentionally calling plays that are bad for the stockholders because they are in the negotiator's best interest. Absent a conflict, the court tends to avoid second-guessing on the theory that reasonable minds are likely to differ at any given turn in a strategic process. Where a conflict presents, however, ordinarily "debatable" business choices are no longer afforded the court's deference and "must be viewed more skeptically."

Disclosure Can Disinfect a Flawed Process

Disclosures that detail negotiations, "warts and all," can serve to disinfect a flawed process, but only to a point. In *Delphi*, the court ultimately concluded that Delphi's disclosures sufficiently informed shareholders of the possibility that the negotiators left money on the table. Under these circumstances, the court concluded an injunction could do more harm than good, depriving shareholders of the ability to choose to receive the premium. Thus, adequate disclosure can cleanse a tainted process.

While adequate disclosure of the "warts" can avoid an injunction, it may not eliminate the personal liability risk faced by the alleged wrongdoers. At best, reputations can be tarnished; at worst, a conflicted negotiator may be liable for significant monetary damages. In *Delphi*, for example the court suggested "disgorgement" of any improper consideration its CEO reaped from the deal could serve as readily ascertainable post-closing damages.

In sum, the foregoing decisions provide a few valuable lessons for corporate boards and their advisors. First, before any strategic activity is on the horizon, implement a policy to keep the board promptly informed of any conversations touching on strategic options. Second, once strategic talks are on the horizon, be wary of common conflict scenarios. Third, monitor the negotiations. Fourth, management should be up front about any actual or potential conflicts. Finally, fully disclose the process, "warts and all," to shareholders.

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