

| To Sell, or Not to Sell

By Marita Makinen

Marita Makinen reviews the board's duties in deciding whether to sell or hold, and the legal standards by which the board's conduct will be judged.

Valuations based on EBITDA multiples have remained robust in many industry sectors. With uncertainty around the corner, boards might ask whether it is the right time to sell. The sell or hold question can move front and center following a strategy review, a stockholder inquiry, an unsolicited bid from a potential acquirer or the sale of a competitor.

Most directors understand that *Revlon* duties apply when a company has been put on the auction block. Directors may feel less confident about their duties in deciding on the timing of a sale—or whether to sell at all. Will they be second guessed, or even personally liable, if they miss a historic valuation window?

This article will review the board's duties in deciding whether to sell or hold, and the legal standards by which the board's conduct will be judged. Delaware corporate law, under which directors owe duties of care and loyalty to the corporation and its stockholders, is assumed to apply.

Duty of Care

The duty of care is principally focused on the board's decision-making process, including the process by which it determines whether to sell or hold. The duty of care requires a director obtain all reasonably available information material to a business decision, and consider it with due deliberation. In making a decision, directors are entitled to rely in good faith on the advice of qualified advisors and management, must remain actively involved, and may not delegate their duties to others. A breach of the duty of care can be characterized as gross negligence in decision-making. See *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. Supr. 1985).

Duty of Loyalty

The duty of loyalty requires each director to act in good faith and in the best interests of all stockholders, and not out of any personal interest not shared by stockholders generally. In considering whether to sell or hold, a director may have personal

interests due to an employment or other commercial relationship, ownership of debt or equity securities, or duties owed to a fund or other investor who appointed her to the board. While a director's fiduciary duties to a corporation normally require the maximization of its long-term value, personal interests can create a short-term focus or a focus on preserving personal benefits, in either case resulting in a breach of the duty of loyalty. See *In Re Trados Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013) and *Gantler v. Stephens*, 965 A.2d 695 (Del. Supr. 2009)

Importantly, directors may be exculpated against liability for monetary damages from a breach of the duty of care, but not the duty of loyalty. Del. Code Ann. Tit. 8 §102(b)(7). In addition, directors who did not act in good faith or the best interests of the corporation may not be entitled to indemnification. Del. Code Ann. Tit. 8 §145. Accordingly, breaches of the duty of loyalty carry the added risk of personal monetary liability.

Business Judgment Rule

Delaware law presumes that, in making a business decision, the directors were disinterested and acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. This presumption is known as the "business judgment rule," and a stockholder challenging the board's decision bears the burden of rebutting the rule's applicability. In essence, absent a showing that the board breached its fiduciary duties, a Delaware court will not substitute its judgment for a board decision that can be "attributed to any rational business purpose." *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (quoting *Sinclair Oil v. Levien*, 280 A.2d 717 (Del. 1971)).

In the context of the sell or hold decision, a board's decision to hold is entitled to a "strong presumption" in its favor, and its "decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework." *Gantler*, supra; see also *Kahn v. MSB Bancorp*, 24 Del. J. Corp. L. 266 (Del. Ch. 1998). Despite this positive jurisprudence, directors must be mindful of their bedrock duties of care and loyalty in the context of the sell or hold decision. Under Delaware law, the analysis of a board's "hold" decision under the business judgment rule is two pronged. "First, did the board reach its decision in the good faith

pursuit of a legitimate corporate interest? Second did the board do so advisedly?" *Gantler*, citing *In re TW Servs. Sholder Litig.*, 14 Del. J. Corp. L. 1169 (Del. Ch. 1989).

A Well-Prepared Board

In order to reach a decision in the good faith pursuit of a legitimate corporate interest, the board must be prepared to ask tough questions and discover potential conflicts of interests early, before they taint a decisional process. When discovered, conflicts can be addressed by disclosure, and actions such as the formation of a disinterested committee, recusal of certain directors, or approval by a majority of the disinterested directors.

Conflicts of interest in the context of a sell or hold decision can arise from:

- An employment relationship that could be jeopardized by a sale;
- A commercial contract that could be jeopardized by a sale;
- Ownership of securities that would benefit from a sale disproportionately in comparison to common stock;
- A liquidity crisis suffered by a stockholder with board representation; or
- The short-term investment horizon of a stockholder with board representation.

While the actions of directors who are or represent large stockholders are often scrutinized, Delaware courts have recognized that a director's significant common stockholdings ordinarily evidence a strong alignment of interests with stockholders generally, not the opposite. See *In re Synthes Shareholder Litig.*, 50 A.3d 1022 (Del. Ch. 2012).

With conflicts adequately identified and mitigated, the board needs to ensure it has acted advisedly in the context of a sell or hold decision. The board must follow the basics by actively pursuing and reviewing information, asking questions and challenging assumptions. A board must not rush important decisions or stifle debate. See *McMullin v. Beran*, 765 A.2d 910 (Del. 2000); *Citron v. Fairchild Camera & Instrument*, 569 A.2d 53 (Del. 1989); *Smith*, supra. Some useful questions are:

- How recently has the board reviewed a business plan with projections for the next three to five years?
- Does the board know the value of the company based on those projections?
- Has the board questioned management's projections, and received a detailed explanation of the underlying assumptions?
- Does the board receive regular reports on risks and growth opportunities in the business?

- Does the board receive reports on recent transactions and multiples in the industry?
- Has the board received presentations on valuation trends from investment banks?
- Do meeting minutes contain sufficient detail to establish that the board has asked for relevant information, received it, and discussed it fully?

If the protection of the business judgment rule is lost, the board's decision will be subject to the stringent entire fairness standard, under which the directors must establish that the process and outcome were fair to the company's stockholders. See *Gantler* ("Although it may be problematic to determine the fair price of a transaction that was never finalized, our decisions have applied the entire fairness standard in a non-transaction context.").

Defensive Actions

A no-sale decision will be subject to additional scrutiny if the board takes defensive actions, such as the adoption of a poison pill, in reaction to an unsolicited bid. Under *Unocal* and its progeny, the courts will apply enhanced scrutiny prior to the business judgment rule being made available to protect defensive actions, considering whether the directors acted reasonably and in proportion to a perceived threat to corporate policy. *Unocal*, supra. Even under enhanced scrutiny, the Delaware courts have accepted that if a company is not for sale, it is not in *Revlon* mode and the board is free to "just say no" and pursue its long run goals. *Air Products & Chemicals v. Airgas*, 16 A.3d 48 (Del. Ch. 2011). Importantly, judicial deference is premised on the directors faithfully adhering to their fiduciary duties. *McMullin*, supra.

Revlon Duties

If a board decides to sell the company, its actions will in most cases be governed by the standard set forth in *Revlon* and its progeny. *Revlon v. MacAndrews & Forbes Holdings.*, 506 A.2d 173 (Del. 1986). Under *Revlon*, once a company initiates an active bidding process or undertakes a transaction that will result in a change of control or a break-up of the corporate entity, the board must seek the transaction offering the best value reasonably available to stockholders. *Paramount Communications v. QVC Network*, 637 A.2d 34 (Del. 1993). A "transaction" may not necessarily include a sale and "the option could be remaining independent and not engaging in any transaction at all." *In re PLX Technology Stockholders Litigation*, C.A. No. 9880-VCL (Del. Ch. Sept. 3, 2015).

In evaluating a board decision implicating *Revlon* duties, courts will defer to the board's business judgment, but only after scrutinizing whether the directors have acted reasonably. In this regard directors must be "especially diligent," *Paramount*, supra, and their decision will not initially be entitled to the protection of the business judgment rule if they fail to obtain all material information reasonably available in making a decision. *Smith*,

supra (Note that post-*Corwin*, a fully-informed disinterested stockholder vote on a transaction not presumptively subject to entire fairness review has the effect of irrebuttably restoring the business judgment standard of review. See *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015) and *Larkin v. Shah* 2016 WL 4485447 (Del. Ch. Aug. 25, 2016)). Accordingly, taking due care to obtain and evaluate adequate information about standalone growth prospects and risks, in the context of a well-considered sell or hold decision, lays the groundwork for surviving enhanced scrutiny under *Revlon*.

Conclusion

As discussed above, the Delaware courts have deferred to the judgment of boards that have followed good principles of preparedness. History tells us that, even in situations implicating enhanced scrutiny, the Delaware courts will rarely second-guess a careful, non-conflicted board's decision to hold rather than sell. The board's actions following a sale decision will generally continue to be judged by the standards set forth by *Revlon* and its progeny.

Marita Makinen is co-chair of Lowenstein Sandler's transactions and advisory M&A group.

Article Link:

<https://www.law.com/newyorklawjournal/sites/newyorklawjournal/2017/10/27/1030ss-makinen-to-sell-or-not-to-sell/>

Reprinted with permission from the October 27, 2017 edition of the New York Law Journal© 2017 ALM Media Properties, LLC. All rights reserved.

Further duplication without permission is prohibited.

ALMReprints.com – 877-257-3382 - reprints@alm.com.

Contact

Please contact the listed attorney for further information on the matters discussed herein.

Marita A. Makinen, Esq.

Partner and Co-Chair, Transactions & Advisory Group, Chair, Mergers & Acquisitions

T 212.419.5843 | mmakinen@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.