Corporate and Securities Law Update

M&A Development: Emerging Communications—Court Finds Financially Sophisticated Director Personally Liable for $77 Million

NOVEMBER 9, 2004

Fenwick
FENWICK & WEST LLP

Introduction

The price and process fairness of business combinations are increasingly challenged in litigation. The risk of such litigation (and of director liability) is heightened in "going private" transactions in which the majority stockholder is on both sides of the deal, because those transactions are subject to an "entire fairness" review. If such a transaction is deemed unfair, directors seeking to avoid personal liability may, absent informed, disinterested board committee or minority stockholder approval, bear the burden of demonstrating that they have not breached their duty of good faith. The Delaware Court of Chancery, in its decision in the case *In Re Emerging Communications, Inc.*, effectively raised the bar for a showing of good faith director conduct that will be sufficient to avoid director liability. The case holds, as to a transaction subject to an entire fairness review, that a director with "specialized financial expertise" (such as an investment banker, venture capitalist, CEO or CFO) must vote and advocate against the transaction if the director knows, or reasonably should know, it is unfair. The case also makes clear that a director with the financial expertise to know that a transaction is unfair may not rely on a fairness opinion alone to carry the burden of showing that the director acted in good faith. This case underscores the importance of creating a record that demonstrates that directors, in reviewing and approving a merger, acted independently, thoughtfully, and in all stockholders' best interests, as opposed to a record that can be argued to suggest that directors may have rushed the deal process or ignored unfair aspects of a deal under pressure from a controlling stockholder.

Facts

Jeffrey Prosser indirectly held majority control of Emerging Communications, Inc. (ECM). He proposed a two-step going private transaction, resulting in a cash-out of ECM's minority holders for $10.25 per share. Stockholders challenged the fair value of the merger in an appraisal proceeding and sought recovery based on a breach of fiduciary duty by the ECM directors. A special committee of ECM's board had approved the transaction following limited negotiations and receipt of a fairness opinion from Houlihan Lokey Howard & Zukin (Houlihan), the committee's financial advisor. The court reviewed the transaction for "entire fairness," looking to the fairness of the price and whether Prosser and his affiliates had engaged in fair dealing with the committee and minority stockholders. The court determined that neither the price nor the course of dealings was fair. The court found that directors breached their duty of care and that Prosser and his affiliates, including his personal attorney (and ECM board member) John Raynor, had breached their duty of loyalty through self-dealing and failures to disclose. The court also found that ECM director Salvatore Muoio, an investment banker with "specialized expertise or knowledge" that was on par with that of Houlihan, had breached his duty of good faith because he "knew or had strong reasons to believe" that the proposed deal value was unfair, yet he failed to vote against the deal, make his concerns known to other directors on the record, or advocate that the Board reject the deal. Accordingly, the court ruled in favor of the plaintiffs in the appraisal proceeding (awarding them $38.05 per share plus interest) and found that Prosser, Raynor and Muoio were jointly and severally obligated to pay the minority stockholders approximately $77 million, representing the difference between the fair value of ECM determined by the court of $38.05 per share and the $10.25 cash-out merger price.

The full text of the opinion can be found online at: http://courts.state.de.us/opinions/(3b30ewrdou12h5umk5p2i3in)/download.aspx?ID=46470

Analysis

The court concluded that the transaction did not meet the entire fairness standard, as to either the fair price or fair dealing elements, which raised the question of whether directors would be personally liable for the harm caused by their failure to protect minority stockholders. The directors sought to avoid liability by asserting the exculpatory defense that Article Seven of ECM's charter (like the charters of most Delaware corporations) provided, in accordance with Delaware GCL Section 102(b)(7), that directors would have no liability absent a breach of duty of loyalty, receipt of an improper personal benefit or acts or omissions not in good faith (*i.e.*, directors could have no liability if at most they violated their duty of care). The court concluded that, because of the applicability of the entire fairness review standard and the lack of either an effective and informed special board committee process or informed minority stockholder approval, directors had the burden to demonstrate they had not committed a breach of their duty of loyalty or a breach of their duty to act in good faith.

In evaluating Muoio's conduct as a board (but not special committee) member, the court essentially held Muoio to a higher standard than less financially sophisticated directors as to demonstrating that he acted in good faith and was entitled to exculpation from liability.

The court noted that Muoio was not independent of Prosser and was beholden to him. Muoio was on an annual $200,000 retainer for providing financial advisory services and he viewed Prosser as a source of additional future lucrative consulting fees. In March 1998, Muoio sought up to an additional $2 million for serving as financial advisor on a separate potential ECM acquisition.

The court concluded that Muoio voted to approve the transaction even though he knew, or at the very least had strong reasons to believe, that the $10.25 per share merger price was unfair. The court concluded that Muoio possessed a specialized financial expertise and an ability to understand ECM's intrinsic value that was unique among the ECM board members. The court pointed to Muoio's extensive investment banking, securities analyst and portfolio fund management experience in the telecommunications sector, and to his being quoted in the financial press. Muoio's consciousness of the transaction's unfairness was further supported by Muoio's concession in testimony that the $10.25 price was at the low end of fair value and his suggestion to a special committee member that the committee might be able to obtain up to $20 per share.

In these circumstances, the court observed that it was incumbent upon Muoio, as a fiduciary, to advocate that the board reject the $10.25 price that the committee was recommending and go on record as voting against the transaction. Instead, Muoio joined other directors in voting, without objection, to approve the transaction.

Other outside ECM directors could plausibly argue that they voted for the transaction in reliance on Houlihan's fairness opinion. But Muoio had far less reason to defer to Houlihan's valuation, since his financial and industry expertise was equivalent, if not superior, to that of Houlihan.

The court concluded that even if Muoio believed that $10.25 was minimally fair, even if not the highest price available, that possibility is not sufficient, because to be exculpated from liability he must show that his failure to withstand an entire fairness analysis is unrelated to any breach of the duties of loyalty or good faith. The court held that Muoio had not met that burden.

The court ruled that Muoio's conduct in voting for and not advocating against a deal that he should have known was unfair was explainable in terms of only one of two possible mindsets. One would be that Muoio, to obtain more investment banking business, decided to exhibit his primary loyalty to Prosser and refrain from becoming the minority's advocate, which would be a breach of the duty of loyalty. The other would be that Muoio "consciously and intentionally disregarded his responsibility to safeguard the minority stockholders from a risk, of which he had unique knowledge, that the transaction was unfair," which would be a breach of his duty to act in good faith. In either case, the court concluded, Muoio's conduct amounted to a violation of his duty of loyalty and/or good faith under the principles of *In re Walt Disney Co. Derivative Litig*. 825 A.2d 275, 289 (Del. Ch. 2003)[1], and Muoio was personally liable as a result.

[1] The Chancellor in Disney questioned directors' actions in approving a severance package allegedly worth $140 million for former Disney President Michael Ovitz, observing that directors actionably violate their duty of good faith if they "knew that they were making material decisions without adequate information and without adequate deliberation, and . . . they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss." *In re Walt Disney*, 825 A.2d at 289.

There was no evidence that any of the ECM directors, other than Prosser, Raynor and Muoio, knew or had reason to believe that the merger price was unfair, knew they lacked material information or intentionally disregarded their duties. There was no suggestion of bad faith that other ECM directors had the burden to disprove, so they were exculpated from liability.

Defects in Deal Process

This case demonstrates that when a transaction may be subject to an enhanced level of review, such as for entire fairness, it is critical to establish and execute a negotiation and approval process that keeps the burden of proof on the plaintiffs. That requires conditioning the deal on the approval of an effectively functioning, truly independent and fully informed special board committee or of an informed majority of minority stockholders. The ECM directors achieved neither objective and exposed themselves to liability as a result.

The court found that the committee process was flawed in several specific respects:

- first and foremost, the committee, its counsel, and its financial advisor Houlihan were not given full and current financial information on ECM upon which to base their negotiations and their assessment of the fairness of the price. The committee had only March ECM projections, not the newer and more optimistic June projections that had been shared with Prosser, the buyer and the buyer's lender. This fact alone brought into question the fairness opinion and the board, committee and stockholder approvals, and it hampered negotiations, as the committee started price discussions at too low a level;
- the committee was not informed of other indicia of value; for example, the buyer's lender had concluded (based on the more recent June projections) that ECM was worth at least $28 per share and Prosser had valued ECM's assets at $13.25 per share in a prior split-off transaction;
- Prosser deliberately misled the committee as to the maximum deal price his financing would allow;
- the committee chair routed committee correspondence through Prosser's secretary, compromising the integrity of the bargaining process;
- the committee never negotiated with Prosser in person and never met in person;
- two committee members were not independent and were financially beholden to Prosser;
- the committee was never told about director Raynor's role in arranging the transaction and of Prosser's promise to pay him $2.4 million for past services after the transaction;
- the committee was deprived of effective assistance in the transaction, as the banker and counsel for ECM switched roles and became the banker and counsel for the acquiring entity controlled by Prosser, without objection by the committee;
- the committee never developed a viable alternative to the deal, so the best deal alternative was abandoning the transaction and allowing ECM's price to move to market levels;
- the negotiations, in which the price rose in small increments from $9.25 to $10.25, appeared timid and ineffectual and were impeded by the disabling factors described above; and
- the decision to change the transaction from the merger that Prosser originally proposed (which would not have cashed out minority holders) to the subsequently proposed minority cash-out structure reviewed by the court appeared principally motivated by Prosser's assessment that the public market currently undervalued newly-public ECM (which had not yet disclosed earnings or projections or developed analyst coverage), implying that a near term sale of ECM was inherently unfair from a timing perspective.

The court also found that the majority of minority stockholder approval was ineffective. The more recent June projections were not disclosed to stockholders, yet the proxy falsely implied that both the committee and the stockholders had been given the most recent available projections. Further, the proxy failed to disclose many factors indicating that directors were not independent, including Prosser's promise of $2.4 million to Raynor for past services, Prosser's promise to several ECM directors of board seats on the surviving company, Muoio's past and prospective banking fees, other consultancy and business relationships that made directors financially beholden to Prosser and that director fees represented a meaningful percentage of several directors' incomes. The court concluded that the proxy was misleading because of these omissions and because it gave the false impression that there was a special committee process that worked effectively and that the committee members and the stockholders had all relevant information.

As a result of these process defects, the burden of proving compliance with fiduciary duties remained with the directors rather than being shifted, by informed, disinterested committee or minority stockholder approvals, to the plaintiffs.

Directors are well advised to use these defects in the ECM deal process as a roadmap of mistakes to avoid when conducting a merger approval process, particularly one involving a related party transaction.

Conclusion

In re Emerging Communications should be viewed as limited to its facts, since most mergers outside the going private context will not be subject to an entire fairness review and since directors generally will be protected from liability by exculpatory charter provisions. Nevertheless, the case serves as a reminder of the difficulties directors may face when the merger negotiations and approval process they conduct is inadequate and they bear the burden of proving compliance with their duty of good faith in order to take advantage of an exculpation defense. At a minimum, directors who are investment bankers, venture capitalists, CEOs or CFOs should be aware that they may be called to a higher standard of "good faith" in reviewing a transaction's economic fairness to minority holders where their financial expertise gives them a unique ability to evaluate, and advocate against, unfair elements of the transaction.

For more information, please contact:

David Healy	Douglas Cogen
650.335.7266	415.875.2409
dhealy@fenwick.com	dcogen@fenwick.com