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MERGERS & ACQUISITIONS UPDATE

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The Duties of an Acquiring Company's Board of Directors

On January 11, 2010, in *In re The Dow Chemical Company Deriv. Litig.*, the Delaware Court of Chancery dismissed breach of fiduciary duty claims brought against the directors of an acquiring company in connection with a completed merger. A stockholder of Dow Chemical Company ("Dow") had brought derivative claims challenging the Dow board's decision to acquire Rohm & Haas Company last year in an $18.8 billion cash merger. In finding that the plaintiff failed to establish demand futility, the court confirmed that "buy-side" decisions are properly vested with the acquiror's board of directors. It also emphasized that such decisions, regardless of the size of the transaction, will be protected by the deferential business judgment rule so long as they are approved by a majority of disinterested and independent directors.

Background

In December 2007, Dow entered into a memorandum of understanding with Kuwait's Petrochemicals Industries Company to form a joint venture, pursuant to which Dow would receive a $9 billion cash payment. In July 2008 and prior to closing the Kuwaiti joint venture, Dow announced that it had entered into a merger agreement with Rohm & Haas Company. The merger agreement, in which Dow would acquire Rohm & Haas for $78 per share in cash, did not contain a "financing out" and permitted Rohm & Haas to seek specific performance if Dow refused to close after its closing conditions were satisfied. The agreement also contained a "ticking fee" of $3.3 million per day payable by Dow if the closing was delayed. Dow confirmed publicly that the merger was not contingent on consummating the Kuwaiti transaction.

In December 2008, the Kuwait Supreme Petroleum Council rescinded its prior approval of the Kuwaiti joint venture. At the same time, changes in the economy and the chemical industry caused a sudden decline in Dow's stock price and a downgrading of its credit rating, leading many observers to question Dow's ability to finance the Rohm & Haas acquisition. Then, when Dow's closing conditions were satisfied on January 25, 2009, it refused to consummate the merger, citing "economic concerns and [the] viability of the combined entities." Rohm & Haas promptly brought suit in Delaware to specifically enforce Dow's obligation to close. While the litigation was pending, the parties entered into a settlement and the merger was consummated on April 1, 2009.

Stockholder Litigation

Dow stockholders brought a derivative suit against its directors for breaching their fiduciary duties in connection with the acquisition. The stockholders claimed, among other things, that the board should not have "enter[ed] a merger agreement without a financing condition" and had "placed Dow in a precarious position, facing potential financial ruin," if the court had granted Rohm & Haas's request for specific performance. The plaintiffs also alleged that the directors failed to monitor the company's officers, who allegedly misrepresented to the investment community whether Dow needed the funds from the Kuwaiti joint venture in order to consummate the Rohm & Haas merger.

The Court of Chancery dismissed the derivative suit, finding that the plaintiffs had failed to allege that the directors were incapable of considering a demand to initiate the litigation. The court found that at least a majority of Dow's board consisted of outside, independent directors. It also rejected the plaintiff's allegations that the outside directors were beholden to

Dow's chairman/chief executive officer because he had "handpicked" them for the board. The court observed that "the mere fact that a director played a role in nominating new directors does not mean that the new director is beholden to the nominating director."

The court then held that the plaintiff failed to allege particular facts that could raise a doubt as to whether the Rohm & Haas merger was entitled to the protections of the deferential business judgment rule. The court's analysis makes clear that substantive buy-side decisions, including not just the decision to acquire another company, but also how to structure the transaction and what terms to include in a definitive agreement, properly lie with the board of directors. It observed that

> the board was negotiating in a seller's market and [the target] demanded certain deal protections. Fearing that [the target] would walk away, Dow made a clear business decision to approve the R&H deal and sign the Merger Agreement without a financing contingency. Plaintiff's failure to address these facts is highly suggestive that they do not focus on the *process* but rather on the *substantive content* of the directors' decision. [emphasis added]

The court explained that the complaint was devoid of allegations that Dow's directors had "failed to put in the time and effort necessary to properly evaluate the risks and benefits of the transaction, or … that the board was unaware of any material terms of the transaction or failed to obtain the advice of experts before approving it." The court thus concluded that "substantive second-guessing of the merits of a business decision, like what plaintiffs ask the court to do here, is precisely the kind of inquiry that the business judgment rule prohibits."

The court also dismissed the plaintiffs' claims relating to Dow's public statements about its ability to finance the merger and close the Kuwaiti joint venture. There were no allegations reasonably suggesting that the Rohm & Haas merger was dependent on the joint venture such that Dow's public statements about its financing capabilities might have been false. Rather, the court concluded that the Dow board believed that it had financing adequate to close the merger independent of the joint venture. It also ruled that the plaintiffs failed to allege that the Dow directors failed their duty of oversight in supervising the company's management.

Implications and Conclusion

A decision to acquire another business is a quintessential exercise of business judgment that directors must make in executing a company's long-term strategy. Some acquisitions are extremely successful; others are not. For this reason, such decisions, when made by a majority of disinterested and independent directors, should not be second-guessed by courts.

Stockholders of acquiring companies have rarely been successful in challenging acquisitions for at least two reasons. First, these claims are derivative in nature and, consequently, require that a stockholder either demand that the board initiate the litigation or overcome the stringent test of demonstrating why demand is futile. Second, these claims are usually brought as breaches of the duty of care or oversight or as corporate waste claims, all of which are difficult to prove in light of the business judgment rule. In the 2000 decision of *Ash v. McCall*, for example, the Court of Chancery dismissed the plaintiff's allegations that the board had breached its duties and committed waste by failing to detect accounting irregularities at the target company during its due diligence investigation. Among other things, the *Ash* court explained that the acquiring company's board of directors was entitled to rely in good faith on the company's management and outside advisors.

Another potential source of liability comes from disclosure violations under state and federal law relating to the acquiror's public statements about the transaction. Though uncommon, such challenges are most likely to occur where the acquiror needs stockholder approval under applicable stock exchange rules because, for example, it plans to issue more than 20 percent of its outstanding shares in the transaction. Stockholder approval would also be necessary under state law if the acquiror needed to amend its charter in connection with the acquisition. Even where the acquiror is not seeking stockholder approval, however, Delaware law requires that all communications with stockholders be candid.

In most cases, like *Dow Chemical*, the acquiror's board of directors will be protected by the business judgment

rule, which is a presumption that the directors 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. *Dow Chemical* also makes clear that the business judgment rule should protect "buy-side" decisions regardless of whether they relate to a relatively small acquisition or a "'bet the company' transformational transaction" — "Delaware law simply does not support [a] distinction" based on the size of an acquisition.

Practical suggestions for directors of acquiring companies in fulfilling their fiduciary duties, which will vary depending on the size and complexity of a transaction, include:

- understanding the extent of the due diligence conducted on the target;
- examining the strategic rationale of the transaction;
- informing themselves with respect to the target's valuation;
- inquiring into the risks involved to the acquiror if the transaction is consummated;
- understanding the acquiror's contractual obligations to close the acquisition and the other material terms in the definitive agreement;
- relying on the advice of outside financial and legal advisors; and
- establishing a process in which the board receives all material information reasonably available and has the opportunity to deliberate and meet with management and the company's outside advisors to discuss the transaction.

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