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KIRKLAND **M&A UPDATE**

November 2014

Before the Clouds Roll In – Advantages of Board Actions on a "Clear Day"

Actions taken by boards are more likely to weather judicial scrutiny if the ground rules are established well in advance of, rather than in reaction to, a particular perceived threat.

In its landmark 1971 *Chris-Craft* decision, the Delaware Supreme Court observed that "inequitable action does not become permissible simply because it is legally possible." This quote aptly captures the two-stage inquiry that Delaware courts will apply when reviewing a challenged board action – first determining the legality of the action, and second appraising the equity, or fairness, of the act and its application under the specific circumstances.

A number of recent cases challenging a so-called "defensive measure" taken by a board of directors highlight the fact that courts, in assessing the equity of such an action, will be more deferential to the directors' judgment if the action is taken on a "clear day," that is before a real and present threat that the defensive provision is meant to address. With boards facing increasingly crowded agendas and showing an understandable reluctance to take steps that often trigger reflexive negative reactions from the governance community, it is hardly surprising that some boards prefer to avoid enacting even reasonable defensive measures until their hands are forced. However, boards should be aware that courts are generally willing to let a board set reasonable governance ground rules before the game begins but apply closer scrutiny when they perceive that the rules are being changed in the middle of the contest.

An outline of some of these cases is instructive:

- **Forum Selection Bylaws.** In the aftermath of the Delaware Chancery decision in *Chevron* upholding the facial validity of board-adopted forum selection bylaws that mandate Delaware's courts as the exclusive jurisdiction for intra-corporate litigation, a series of decisions in other states (including California, Illinois, Louisiana, New York and Texas) showed that many courts were prepared to dismiss duplicative M&A litigation filed in those states where forum selection bylaws setting Delaware as the exclusive forum were in place. In a recent decision in Oregon (*TriQuint*), however, a court refused to dismiss the local litigation in large part because the Delaware forum selection bylaw was unilaterally enacted by TriQuint's board at the very same time it approved the sale agreement that was the subject of the court challenge. The Oregon court, making much of the fact that the *Chevron* decision only spoke to facial validity of the bylaw (and seemingly ignoring the fact that the absence of an actual dispute about its application to a specific controversy made it impossible and unnecessary for the *Chevron* court to speak more broadly), relied heavily on the reasoning in a pre-*Chevron* 2011 California federal court decision (*Berg*) that refused to honor Oracle's forum selection bylaw because it was adopted after the alleged conduct being tested in the litigation and by the very same directors being challenged. The Oregon court emphasized that while it respected as a matter of law the legality of the bylaw, its assessment of the inequity of its application to a challenge to the proposed merger was influenced by the "closeness of the timing of the bylaw amendment to the board's alleged wrongdoing." In the court's view, this proximity also meant that shareholders were not given sufficient time to accept or reject the board's judgment, by having an opportunity to vote to overturn or confirm the board's unilateral bylaw adoption.

- **Advance Notice Bylaws.** Most public companies include in their bylaws minimum advance notice periods (usually 90-120 days) as well as practical procedural requirements for shareholders seeking to bring director nominations or shareholder proposals before a meeting of stockholders. These provisions help bring order to potential proxy contests, and serve to narrow the annual window for challenges to the company's board. Courts have routinely upheld these requirements, with VC Noble noting in a 2011 case (*Goggin*) that it was unlikely that even a 150-day advance notice period was unreasonably long or unduly restrictive. He noted

that this was especially true because it was implemented on a "clear day," before the insurgent began communicating his dissatisfaction to the company. An opposite result occurred in a 2000 case (*Chesapeake*) where the court invalidated bylaw amendments adopted by a target board that was at the time facing a hostile tender offer seeking to make a proxy contest by the bidder more difficult. The court applied the more stringent *Unocal* and *Blasius* standards and found that the bylaws were unreasonable in relation to the threat and an unjustified interference with the shareholder franchise.

- **Long-Range Strategic Plan and "Just Say No."** In his 2011 decision upholding Airgas' use of a poison pill to fend off a hostile bid by Air Products, Chancellor Chandler offered a detailed review of the continued viability under Delaware law of the "just say no" defense. The court cited the Delaware Supreme Court's dicta in *Paramount* to the effect that "directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." In evaluating Airgas' defense, the court took particular note of the existence and regular updating of a standing long-term five-year plan endorsed by the Airgas board, the pursuit of which the board continued to favor over a sale to Air Products. The court was clearly impressed by the board's commitment to the pre-existing plan and noted with approval that the plan had not been "tweaked" in light of Air Products' hostile bid and that the Airgas bankers were satisfied with the assumptions underlying the model. While unclear whether decisive of the outcome, the court's view was clearly influenced by the fact that the target was being asked to abandon a long-standing plan adopted long before a hostile bidder arrived rather than an alternative stand-alone vision hastily thrown together once the bidder is already at the transom.

- **Fee-Shifting Bylaws.** In a 2014 decision relating to a non-stock, member corporation (*ATP*), the Delaware Supreme Court opened the door to the possibility of corporations adopting fee-shifting bylaws which seek to deter meritless shareholder litigation by requiring a losing plaintiff to pay the company's defense fees. An attempt by the Delaware legislature to outlaw such bylaws soon after was scuttled, and further legislative action was deferred until at least next year. In light of this uncertainty, many companies have remained hesitant to test the waters with a bylaw of this kind. However, it seems self-evident that a court is more likely to uphold the application of such a bylaw to a particular case if it is in place before, and not after, a lawsuit is filed. In late summer, this very issue came before Chancellor Bouchard in a Delaware case where plaintiffs challenged the validity of a fee-shifting bylaw adopted by a small distressed biotech company, Hemispherx. The case had begun in 2013 and involved a challenge to bonuses paid to executives in 2012. In July 2014, the Hemispherx board adopted a fee-shifting bylaw which was promptly challenged by the plaintiffs in the bonus case. In the face of this challenge and questions from the court, Hemispherx decided to concede that the fee-shifting bylaw would not apply to the ongoing bonus litigation. While the court was not necessarily prepared to address the broader question of the validity of this type of bylaw in a corporate setting, it did indicate that it was open to considering the equity of applying it to an ongoing lawsuit.

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To be clear, we are not recommending that any particular company should, or should not, take any specific action, including those discussed above – any such decision is a function of the particular circumstances at hand. We are not suggesting that taking any of these actions on a "clear day" assures a board that its actions will withstand all challenges or that resorting to any of these actions in the midst of a live situation will automatically or even likely result in the action's disqualification upon court review. What is indisputable is that actions taken by boards, whose judgments are given substantial deference by the courts of Delaware and other states, are more likely to weather judicial scrutiny if the ground rules are established well in advance of, rather than in reaction to, a particular perceived threat.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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