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CLIENT MEMORANDUM

DIRECTORS' FIDUCIARY DUTIES DURING THE CREDIT CRUNCH: THREE RECENT CASES INVOLVING ACQUISITIONS OF FINANCIAL INSTITUTIONS

The past year has seen the acquisition of The Bear Stearns Companies Inc. by JPMorgan Chase & Co., Merrill Lynch & Co. Inc. by Bank of America Corporation, and Wachovia Corporation by Wells Fargo & Company. Stockholders challenged each acquisition on the grounds that target directors breached their fiduciary duties of care by hastily agreeing to the transaction and entering into onerous deal protection provisions. Although each case is factually and procedurally distinct, decisions in these cases confirm that, while courts are mindful of the widespread industry and economic consequences of enjoining transactions, they will scrutinize directors' actions in approving merger agreements and the deal protection devices in those agreements under established principles governing directors' duties.

The Merrill Lynch Case

In *County of York Employees Retirement Plan v. Merrill Lynch & Co., Inc.*, stockholders alleged that Merrill Lynch's directors "hastily negotiated and agreed to the Merger over a single weekend without 'adequately informing themselves' as to the true value of the Company or the feasibility of securing an alternative transaction." According to plaintiff, the "directors failed to conduct the proper due diligence for the transaction as a result of the speed with which it was put together and did not conduct a pre-agreement market check."

In an October 28, 2008 letter opinion, Vice Chancellor Noble of the Delaware Chancery Court granted plaintiff's motion to expedite discovery, finding through "an almost superficial factual assessment" that certain of plaintiff's due care and disclosure claims against the Merrill Lynch directors were colorable. The court evaluated the claims under the "deferential business judgment rule" because a stock-for-stock merger is not subject to heightened scrutiny under Delaware law absent a showing that the board acted without due care or loyalty. The court acknowledged the directors' contentions that "severe time-constraints and an impending crisis absent an immediate transaction" justified their approval of the merger, but reasoned that "[t]he interests of justice are served when such essential and critical facts are properly developed in a manner recognized and accepted for establishing a factual basis for judicial action." Although the court took judicial notice of "well-known market conditions" generally, it was more cautious about drawing conclusions based on Merrill Lynch's financial condition as reported in the media or in the proxy statement.

Plaintiff also challenged three deal protection provisions: (i) an equity termination fee capped at 4% of the transaction's total value, which the court noted was "an amount testing the high-end of the termination fees generally approved"; (ii) a "force the vote" provision requiring a shareholder vote even if the directors withdraw their support for the merger (e.g., in the event of a superior proposal); and (iii) a no shop provision that precluded the board from soliciting other offers after the agreement was signed. The court acknowledged that such provisions had been approved in other Delaware cases but noted that "deal protection devices must be viewed in the overall context; checking them off in isolation is not the proper methodology." Consequently, the court ruled that

"[i]n light of Merrill's choice to eschew a pre-agreement market check, and to conduct a truncated valuation of the Company, these provisions are suspect to an extent, and as such allow the Plaintiff to present colorable claims."

The Bear Stearns Case

On December 4, 2008, in *In re Bear Stearns Litigation*, Justice Herman Cahn in Supreme Court, New York County (Commercial Division), issued a decision applying Delaware law and dismissing all claims against Bear Stearns directors (and against JPMorgan Chase) arising from the merger of Bear Stearns with JPMorgan Chase. Unlike *Merrill Lynch*, the *Bear Stearns* decision was issued at the summary judgment stage, after significant document and deposition discovery. After plaintiffs withdrew their motion to enjoin the shareholder vote, the merger was approved by Bear Stearns' shareholders, and the case proceeded on a claim for damages.

Plaintiffs' "due care" claims were similar to those asserted in *Merrill Lynch*, predicated principally on the haste with which the merger was negotiated, although the Bear Stearns merger was renegotiated and amended after an initial agreement was reached. Plaintiffs also challenged three deal protection devices: (i) an agreement pursuant to which JPMorgan Chase would purchase 39.5% of Bear Stearns' outstanding common stock (to increase the likelihood of shareholder approval), (ii) a "no solicitation" provision preventing Bear Stearns from soliciting additional bidders but permitting the acceptance of a superior proposal if the directors' fiduciary duties so required, and (iii) an option permitting JPMorgan Chase to buy the Bear Stearns headquarters building for $1.1 billion.

Plaintiffs contended that the Bear Stearns directors did not adequately explore alternatives to the merger with JPMorgan Chase, including a spin-off, a partial bankruptcy or a sale of assets, any of which could have achieved a better result. Defendants' experts offered various reasons that those alternatives were not viable or were less attractive than a merger with JPMorgan Chase, leading the court to conclude that "[t]he dispute between the experts is clearly one involving business judgment, which was within the board's discretion to resolve."

The court found that the directors faced a "very real emergency" and "real time pressure" because "[t]he company could simply not continue to carry on its major operations . . . unless it had put some major financing, or a major transaction which would carry with it major financing, into place. No options appeared to be available other than the merger transaction with JPMorgan." The court found that (i) there were no other actual or potential bidders even though more than a dozen other parties had been contacted and Bear Stearns' financial distress was "extraordinarily well-publicized," and (ii) the directors were able to reject or moderate some of JPMorgan Chase's demands, including an option to purchase Bear Stearns' prime brokerage business unit and a proposal that Bear Stearns issue stock to JPMorgan Chase that would constitute 66% of its outstanding common stock (the parties ultimately compromised at 39.5%). Also, JPMorgan Chase increased the implied per share consideration from $2 in the initial merger agreement to $10 in the amended agreement.

The court held that, given Bear Stearns' very severe liquidity problems and its imminent bankruptcy, the directors' approval of the transaction satisfied the business judgment rule. The court noted that the board was comprised of a majority of independent directors and was assisted by teams of financial and legal advisors. There was no evidence that the board was acting out of self-interest or bad faith. In addition, on the factual record, the directors' actions would also withstand Delaware courts' heightened scrutiny tests, even if those tests applied: the *Unocal* test (requiring that any defensive measures be reasonable in relation to a perceived threat to corporate policy and effectiveness that touches upon issues of corporate control); the *Blasius* test (requiring a "compelling justification" for actions relating to director election contests and similar conduct); and the *Revlon* test (requiring directors to maximize stockholder value once a sale or change of control of a company is inevitable).

The court also rejected the specific challenges to the deal protection devices, finding, among other things, that the building purchase option was at fair value and the "no solicitation" clause that, like the no shop provision in *Merrill Lynch*, prohibited Bear Stearns from actively soliciting alternative proposals had not prevented the board from entertaining additional offers. The court found that the deal protections were "essential to ensure JPMorgan's willingness to undertake what it perceived as significant risks involved in guaranteeing Bear Stearns' obligations, and to assure customers and counterparties that the deal would go through."

The court also made an important observation regarding fiduciary duties owed to stockholders when a corporation is insolvent, noting that an insolvent company also owes duties to its creditors. Thus, the court stated that the consideration being paid to stockholders was "primarily an incentive to secure approval of the merger" and that "[i]n seeking to maximize shareholder recovery, the directors were thus entitled to consider that the greatest amount that they could demand might reasonably coincide with the lowest price sufficient to induce approval of the merger."

The Wachovia Case

In *Ehrenhaus v. Baker*, plaintiff sought an order preliminarily enjoining a vote on the stock-for-stock merger transaction with Wells Fargo. The challenge was similar to those in the *Merrill Lynch* and *Bear Stearns* cases: the Wachovia directors allegedly abdicated their fiduciary responsibilities to stockholders by entering into an inferior transaction rather than waiting for government assistance and by agreeing to deal protection devices that were preclusive and coercive, namely (i) an agreement under which Wells Fargo was issued new preferred stock constituting 39.9% of Wachovia's aggregate voting power, which stock could, in certain circumstances, not be redeemed by Wachovia for 18 months even if Wachovia's stockholders disapproved the transaction, (ii) a "no solicitation" provision that precluded Wachovia from soliciting other bids, and (iii) a "force the vote" provision that required the merger to be put to stockholder vote even if the directors did not recommend approval (for example, if Wachovia were to receive a superior proposal from another bidder).

In a December 5, 2008 order and opinion, North Carolina Judge Albert Diaz denied plaintiff's motion to preliminarily enjoin the merger vote. Applying North Carolina's business judgment rule, the court found that the deal protection devices – with one modification – did not constitute a breach of fiduciary duty. The court recounted the severe financial distress under which Wachovia was

operating, as well as the forced liquidation it faced, unless the merger with Wells Fargo (or another party) went forward. Noting Wachovia's lack of leverage given the absence of any superior merger proposals, the court stated that the Wachovia board had two options: (i) enter into a transaction with Wells Fargo, which insisted on the 39.9% stock issuance, and provide existing stockholders with "a voice in the transaction," albeit a circumscribed one, or (ii) do nothing and face the real prospect that the Wachovia stockholder equity would be wiped out. The court rejected plaintiff's position that the Wachovia board should not have proceeded with the Wells Fargo transaction and instead should have waited for the subsequently announced government bailout plan, observing that "it is precisely this sort of *post hoc* second-guessing that the business judgment rule prohibits, even where the transaction involves a merger or sale of control."

Furthermore, the court noted that although the 39.9% stock issuance to Wells Fargo created a "substantial hurdle" to defeating the transaction, it neither "precluded other bidders from coming forward" nor "forced management's preferred alternative upon the stockholders." It did not preclude other bidders because an absolute majority of shares required for approval of the merger was not "locked up," given that 60% of the shares could vote against the transaction. Nor was it "coercive" because there was no other offer except a proposal from Citigroup that the court characterized as "markedly inferior." The court also held that the "force the vote" provision was not problematic because the Wachovia board retained the ability to explain its rationale for withdrawing its recommendation, even if a shareholder vote took place in the face of a "superior proposal."

The court did provide some limited relief to plaintiff by striking down the 18-month tail period for redemption of the preferred stock issued to Wells Fargo. The court reasoned that if the Wachovia stockholders voted down the merger, "the Board's duty to seek out other merger partners should not be impeded by a suitor with substantial voting power whose overtures have already been rejected."

Conclusion

A year ago it would have been unthinkable that three venerable financial institutions, Bear Stearns, Merrill Lynch, and Wachovia, facing bankruptcy or government liquidation, would each be acquired over the course of several days. Delaware court decisions from earlier this year rejecting stockholder challenges to the Activision-Vivendi Games and the BEA Systems-Oracle transactions signaled that, because of marketplace disruptions, courts were increasingly reluctant to interfere with the completion of deals, particularly where there were no other viable bidders.[1] The three decisions in *Merrill Lynch*, *Bear Stearns*, and *Wachovia* confirm, however, that courts will nonetheless actively scrutinize quickly made decisions under well-established principles before giving target directors the benefit of the business judgment rule. Indeed, the *Merrill Lynch* court

[1] *See Wayne County Employees' Retirement System v. Corti, et al.*, C.A. No. 3524 (Del. Ch. Ct. July 1, 2008) (Chandler, C.) (denying plaintiff's motion for preliminary injunction because "where, as here, no other bidder has emerged despite relatively mild deal protection devices, the plaintiff's showing of a reasonable likelihood of success must be particularly strong"); *In re BEA Sys., Inc. Shareholder Litig.*, C.A. No. 3298 (Del. Ch. Ct. Mar. 26, 2008) (Lamb, V.C.) ("the disruptions in the marketplace that exist that make it more risky certainly for the court to undertake to interfere with the completion of a transaction . . . would give any judge even greater pause before moving to restrain a transaction unless very substantial grounds existed that required such action").

refused to accede to the target's request that it simply take "judicial notice" of the financial condition of Merrill Lynch and approve the deal protection devices that were generally customary under Delaware law.

The unique circumstances facing the financial sector undoubtedly impacted the courts' views of the substantive deal protection devices. Issuing nearly 40% of the target's voting power to the acquiror – as in *Bear Stearns* and *Wachovia* – to ensure that the transactions secured stockholder approval was clearly a function of the unique economic environment and a lack of any real leverage by the target board. But, in each transaction, the court found that there were no superior proposals, and there existed an urgent need to ensure deal certainty with an interested suitor. The lack of alternative proposals was a function not of the deal protection devices, but of the absence of any credible third-party interest.

While courts will give substantial deference to target boards operating in financially stressful situations, such deference is not without limit. Although the *Wachovia* court understood that Wells Fargo had demanded the issuance of the preferred stock as a *sine qua non* of any transaction, the court effectively second-guessed the board's decision to approve one aspect of the preferred stock (the 18-month tail provision). To some extent, this was inconsistent with the court's general approach not to second-guess the Wachovia board's decisions. Although in this instance the court's modification will have no practical consequence if Wachovia's stockholders approve the transaction later this month, targets and acquirors should both be mindful that courts may strike down provisions that potentially restrict stockholder ability to consider superior offers and that give the impression of overreaching in negotiations where one side has little leverage.

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If you would like copies of any of the decisions referenced or if you have questions about them, please contact Stephen Greiner (212-728-8224, sgreiner@willkie.com), Tariq Mundiya (212-728-8565, tmundiya@willkie.com), Joanna Rotgers (212-728-8695, jrotgers@willkie.com), or the attorney with whom you regularly work.

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