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MeadWestvaco *Highlights the Extremely High Bar to Personal Liability of Disinterested Directors*

In *In re MeadWestvaco Stockholders Litigation* (Aug. 17, 2017), the Delaware Court of Chancery dismissed claims against target company directors for breach of the duty of loyalty based on allegations that they had acted in bad faith in approving a merger.

- **The decision—in which the court suggests that the standards of "waste" and "bad faith" are equivalent—highlights the extremely high bar to potential liability of disinterested target company directors**. We note that if, under *Corwin*, business judgment review applies in a post-closing action for damages, the only basis on which a transaction can be successfully challenged is that it constituted "waste"; and that if *Corwin* does *not* apply, then, given the effect of the exculpation statute, the only route to a successful post-closing action for damages is that the directors' conduct in approving the transaction was so egregious that it constituted "bad faith." In *MeadWestvaco*, the court indicated that the two standards are essentially equivalent—and virtually impossible to meet.

- **Non-controller, non-*Revlon* transactions (like the stock-for-stock merger in *MeadWestvaco*) continue to be subject to business judgment review both pre-closing and post-closing**. We note that *Corwin*—which when applicable transforms the standard of review post-closing to business judgment (regardless of what the standard was pre-closing)—should have no practical impact on non-*Revlon* transactions.

- **Although the court did not address the issue, *MeadWestvaco* may signal that there remains some uncertainty whether *Corwin* "cleanses" bad faith by directors.** As discussed below, although one early post-*Corwin* decision stated that *Corwin* does cleanse bad faith, and a number of decisions since then have stated that *Corwin* cleanses breaches of the duty of loyalty (of which, we note, the duty of good faith is a part), *MeadWestvaco* may signal that some uncertainty remains as to whether *Corwin* would cleanse director action that is "so 'egregious,' so 'irrational,' or 'so far beyond the bounds of reasonable judgment' as to be 'inexplicable on any ground other than bad faith.'"

Background

MeadWestvaco Corporation and Rock-Tenn Company combined in 2015 in a $9 billion stock-for-stock merger of equals. The merger was approved by 98% of the stockholders. The plaintiffs alleged that the directors, "flying blind" and "doing virtually nothing to meet their fiduciary duties," left $3 billion of value on the table, as they had entered into the transaction in reaction to a threatened proxy contest by an activist

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investor. Their claim was that the board acted in bad faith by intentionally failing to discharge its duties. They did not allege that the directors were not independent or otherwise had conflicts of interest. The defendants countered that the alleged facts did not support a claim of bad faith and that, even if they had, the board's decision to enter into the merger was cleansed under *Corwin* and its progeny by virtue of the stockholder approval. Chancellor Bouchard found that the plaintiffs' allegations did not support a reasonable inference of bad faith and dismissed the case.

The opinion highlights the extremely high bar to potential liability of target company directors. We review that, as has been long established, directors have fiduciary duties of due care and loyalty. Breaches of the duty of care are exculpated under corporate charters, as permitted by the Delaware statute; whereas, by statute, breaches of the duty of loyalty or good faith cannot be exculpated. Under *Cornerstone*, claims of breach of fiduciary duties that are exculpated are dismissible at the pleading stage of litigation. Therefore, directors generally have neither personal liability, nor exposure to a lengthy trial, for duty of care claims. The duty of loyalty requires: that directors (i) act in the interest of the corporation and the stockholders rather than for their own benefit (the loyalty prong); and (ii) act in good faith (the good faith prong). While duty of loyalty claims are not exculpated, there is an extremely high bar to making a valid claim of breach of the duty of loyalty. The Chancellor reiterated in *MeadWestvaco* that "bad faith" is very difficult to establish: "[A] plaintiff must show either [1] an *extreme* set of facts to establish that disinterested directors were *intentionally* disregarding their duties or [2] that the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially *inexplicable* on any ground other than bad faith" (emphasis added).

The opinion underscores the court's view that directors' failure to meet their duties must be *intentional* for their conduct to constitute bad faith. Addressing the plaintiffs' claims of bad faith based on the directors allegedly having "done nothing" and having achieved only a very low premium for the stockholders, the Chancellor amplified that:

- "As long as a board *attempts* to meet its duties, *no matter how incompetently*, the directors did not consciously disregard their obligations";
- "An extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties, and *even one plausible and legitimate explanation for the board's decision* would negate a reasonable inference that the decision was so far beyond the bounds of reasonable judgment that it seems essentially *inexplicable* on any ground other than bad faith";
- "Our Supreme Court has equated showing that the substance of a board's decision is an act of bad faith to meeting the onerous burden of proving a waste claim: To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was *so egregious or irrational* that *it could not have been* based on a valid assessment of the corporation's best interests";
- "Even if one assumes, *arguendo*, that the individual [directors] '*failed to take any specific steps* during the sale process,' that would not be enough to demonstrate 'a *conscious disregard* of their duties,' even in the *Revlon* context, which is not the case here"; and
- "Even if it were true that the premium was low, there is no rule that a low premium represents a bad deal, much less bad faith" (emphasis added in each case).

The court found that the plaintiff's allegations "fell far short" of supporting a reasonable inference of bad faith. According to the court, the record indicated that:

- Eight of the nine directors were outside directors whose independence and disinterestedness were unquestioned;
- Nothing about the "presence of an activist," even if it were the "impetus" for the merger, necessarily rendered the directors not independent and disinterested or created "a disabling conflict of interest" for any of them;
- The board was actively engaged in the process—it had negotiated on-and-off for nine months, held six board meetings, received numerous valuations of the company, and was represented by independent legal counsel and financial advisors;
- The merger agreement—which included a fiduciary-out and "a concededly reasonable break-up fee of less than 3% ($230 million)—afforded stockholders the opportunity to receive a superior proposal (and the court noted that the $3 billion in value that the plaintiffs asserted was "left on the table" was about "*thirteen times*" the size of the break-up fee";
- During the five months between signing of the merger agreement and the stockholder vote, no other suitor emerged;
- The merger price represented a 9.1% premium after the directors had rejected the acquiror's proposals for an "at market" transaction and, notwithstanding that the transaction "did not involve a sale of control," but was "a strategic merger between two widely-held companies" where the target stockholders obtained 50.1% of the combined entity even though the target contributed less than 50% of the combined company's revenue, net income and EBITDA;
- Three nationally recognized financial advisors, none of which were alleged to be conflicted, opined that the merger was fair to the target stockholders;
- The merger had received favorable recommendations from two leading proxy advisory firms;
- The complaint did not suggest that the activist expressed any opposition to the merger price; and
- The merger was approved by 98% of the votes cast (at a meeting held after the plaintiffs took discovery and waived their disclosure claims).

Reflecting the same skepticism of unexplained "extreme market failure" that the court recently expressed in *Clearwire*, the Chancellor wrote: "At bottom, plaintiffs' theory that the concededly disinterested and independent directors...intentionally disregarded their fiduciary obligations to leave $3 billion of additional value on the negotiating table—equating to *one-third* of the $9 billion implied value of the Company in the merger, or about one-quarter of what plaintiffs apparently believe the Company should have been valued at for purposes of the merger ($12 billion)—is simply not credible."

The decision underscores that disinterested directors will not have post-closing personal liability absent egregious facts that indicate bad faith. By way of review:

- Business judgment is the default standard of review (*i.e.*, it applies unless a higher standard is applicable).

- The stringent "entire fairness" standard of review applies in the event that (a) the transaction is with a conflicted controller (unless the transaction provides the minority stockholder protections prescribed by *MFW*, in which case the business judgment rule would apply) or (b) there are well-pled allegations that the directors who approved the transaction breached their duty of loyalty.

- *Revlon* applies, pre-closing, in the case of a sale of control (*i.e.*, generally, in cash mergers but not stock-for-stock mergers such as the transaction in *MeadWestvaco*).

- If *Corwin* applies, the standard of review, post-closing, will be business judgment regardless of what the standard was pre-closing.

- *Corwin* applies when a transaction that is not subject to the entire fairness standard of review was approved by the stockholders in a fully informed, uncoerced vote—and post-*Corwin* Court of Chancery decisions have held that *Corwin* does *not* apply to transactions that are subject to entire fairness on the basis that they are conflicted controller transactions, but does apply to transactions that otherwise would be subject to entire fairness on the basis that the directors breached the duty of loyalty.

When business judgment review applies under *Corwin*, the only route to successful post-closing challenge is that the transaction constituted "waste"—which the court has repeatedly characterized as only a "theoretical" standard that essentially never results in liability. As *MeadWestvaco* demonstrates, even when *Corwin* is inapplicable for any reason, business judgment review still will apply in a non-controller situation so long as the director conduct was not so egregious as to constitute "bad faith." By indicating in *MeadWestvaco* that the standards of "waste" and "bad faith" are essentially equivalent, the court appears to be highlighting the extremely remote possibility of personal liability for disinterested directors under the current Delaware framework (whether *Corwin* applies or not).

The opinion may signal some uncertainty as to whether *Corwin* would cleanse bad faith acts. As discussed, the likelihood of a successful bad-faith claim is highly remote. Even if a bad-faith claim is successful, however, it has been thought that *Corwin* would in any event cleanse the bad faith (subject only to the uncertainty arising from the fact that the Delaware Supreme Court has not addressed the issue). This conclusion has been based on the decision in *OM Group* (Oct. 12, 2016), in which Vice Chancellor Slights stated that *Corwin would* cleanse bad faith acts. (Vice Chancellor Slights therefore found it unnecessary to decide in *OM* whether the directors' conduct there constituted bad faith—although he characterized the allegations as providing "a disquieting narrative" and suggested that they would have supported a valid pleading-stage claim of bad faith). Further, this conclusion has been reinforced by a series of subsequent decisions in which the Court of Chancery has stated that *Corwin* cleanses breaches of the duty of loyalty. As bad faith is a part of the duty of loyalty (and not a separate duty), these cases appear to establish that *Corwin* should cleanse bad faith. (These cases are: *Columbia Pipeline*, March 7, 2017, Vice Chancellor Laster; *Merge Healthcare*, Jan. 30, 2017, Vice Chancellor Glasscock; *Solera*, Jan. 5, 2017, Chancellor Bouchard; and *Larkin v. Shah*, Aug. 25, 2016, Vice Chancellor Slights.)

We note, however, that each of these post-*OM* cases involved breaches that related to the "loyalty prong" of the duty of loyalty, not the "good faith prong." Indeed, with the sole exception of *Columbia Pipeline*, in each case the allegation was only that the directors were not independent. Only *Columbia Pipeline* involved an allegation of actual self-interest by directors (and the plaintiffs did not fashion their claim as a bad faith claim—in fact, their argument was only that *Corwin* did not apply because the self-interest had

not been disclosed, rendering the stockholder vote not fully-informed). Notably, *none* of these post-*OM* cases involved a claim of bad faith.

In *MeadWestvaco*, the Chancellor did not address whether *Corwin* cleanses bad faith—he stated only: "Because the first issue is dispositive [(i.e., that the allegations did not support a bad faith claim)]…, I do not address the second issue [*(i.e.*, whether, if there had been a valid claim of bad faith, *Corwin* would have cleansed it)]." Conceivably, one might have expected that—if there were no question as to whether *Corwin* cleanses bad faith in all cases—the court would have dismissed *MeadWestvaco* based on *Corwin* rather than making the factual findings necessary to determine that the allegations did not support an inference of bad faith (particularly as, in this case, there were no allegations that raised any issue as to the applicability of *Corwin*). The court's having chosen to address the sufficiency of the bad faith claim and to "not address the issue" of the applicability of *Corwin*, may signal a possibility that the court seeks to reserve some "wiggle room" going forward to find that *Corwin* cleansing would not apply in a case involving facts that are "so 'egregious,' so 'irrational,' or 'so far beyond the bounds of reasonable judgment' as to be 'inexplicable on any ground other than bad faith.'"

In any event, as discussed, given the high bar to pleading bad faith, whether *Corwin* does or does not cleanse bad faith, disinterested directors should neither have personal liability nor face trial beyond the pleading stage except in the case of truly egregious facts. Of course, notwithstanding the remoteness of liability, it continues to be in directors' (and their advisors') interests to adhere to best practices—for reputational reasons, to avoid pre-closing injunction of a transaction, and to achieve the best result for stockholders.

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