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Corporate Governance Group

Client Alert

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DELAWARE COURT OF CHANCERY FINDS THAT PLAINTIFF STATES “COLORABLE” CLAIM THAT DIRECTORS FAILED TO SATISFY THEIR *REVLON* DUTIES

The Delaware Supreme Court’s recent decision in *Lyondell Chemical Company v. Ryan*¹ provided directors of Delaware corporations with a measure of comfort in approaching sale-of-control processes in which a strategic bidder has made a particularly attractive offer. Although generally reassuring, the *Lyondell* ruling, given its fact-specific application, left many questions unanswered with respect to what measures, both pre- and post-signing, a Delaware board in “*Revlon* mode” must take to carry out its sole fiduciary obligation: to ensure the maximum reasonable value for its shareholders. Because, as the *Lyondell* and other Delaware Courts have observed, there are “no legally prescribed steps that directors must follow to satisfy their *Revlon* duties,” such questions are inevitable and challenges to actions taken by boards in sale-of-control transactions will continue.

One such challenge recently came before the Delaware Court of Chancery in *Police & Fire Ret. Sys. of the City of Detroit v. Bernal, et al.*², in which plaintiff, a shareholder of Data Domain, Inc., sought to enjoin application of seemingly typical deal protection devices contained in a merger agreement between Data Domain and NetApp, Inc. In granting plaintiff’s motion for an expedited hearing on its injunction action, the Court found that plaintiff stated a colorable claim that the target company’s directors breached their fiduciary duties by “favoring one bidder over others” through application of the deal protection devices. The Court’s decision suggests that when there is more than one bidder present in the process, Delaware

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¹ *Lyondell Chemical Company v. Ryan*, C.A. No. 3176 (Del. Supt. Ct. 2009). For a discussion of *Lyondell*, see our Client Alert entitled “Delaware Supreme Court Overturns Court of Chancery Decision in *Ryan v. Lyondell*; Determines That *Revlon* Duties Do Not Prohibit Acceptance of a Compelling, Pre-emptive Bid From a Strategic Buyer”, dated April 13, 2009.

² *Police & Fire Ret. Sys. of the City of Detroit v. Bernal, et al.*, C.A. No. 4663-CC (Del. Ch. June 26, 2009).

courts will take a closer look at the board's actions in light of *Revlon* and perhaps notwithstanding *Lyondell*. Furthermore, if there is evidence that the board has favored one bidder over another, courts will likely carefully scrutinize deal protection devices and question the board's failure to conduct a robust sale process.

Background

In March 2009, Data Domain and NetApp, two Delaware corporations specializing in data storage and management services, began discussions of a possible business combination. In May 2009, the Data Domain board of directors was informed that another company in the industry, EMC Corporation, also was interested in acquiring Data Domain. As a result, a meeting between Data Domain and EMC was planned. A week before the scheduled meeting, however, Data Domain and NetApp entered into a merger agreement pursuant to which Data Domain shareholders would receive a combination of cash and NetApp stock worth approximately \$25 per Data Domain share.

Not surprisingly, the merger agreement contained a number of deal protection devices. In particular, NetApp was granted a five-day window to amend its offer to match a superior proposal from any third party bidder. In addition, Data Domain agreed to a "no-solicitation" provision and, in the event the Data Domain board accepted a superior proposal, a termination fee was payable to NetApp. Further shoring up the deal, the Data Domain directors and executive officers, holders of approximately 20% of Data Domain's stock, pledged to vote their shares in favor of the merger.

Upon learning of the merger agreement, EMC initiated an all-cash tender offer for Data Domain at a price of \$30 per share. Two days later, NetApp increased the cash component of its offer so that the aggregate merger consideration matched the value of EMC's offer. In response, the Data Domain board rejected EMC's bid and accepted NetApp's amended offer, citing the deal protection devices contained in the merger agreement and its concern over losing the NetApp transaction.³

Plaintiff's Claims

Frustrated with the actions of the Data Domain board of directors, plaintiff filed a motion in the Court of Chancery to enjoin application of the deal protection devices in the merger agreement with NetApp in order to permit Data Domain to negotiate with EMC. Plaintiff also asked the Court to hold an injunction hearing on an expedited basis.

Plaintiff claimed that the Data Domain board, upon deciding to sell the company to NetApp, had a fiduciary duty under *Revlon* to maximize the sale price of the company, a duty that it failed to satisfy. According to plaintiff, the directors failed "to take any steps to secure the best price reasonably available, by granting preclusive deal protection measures that deter any other bidders," and by failing to consider other options which might deliver even greater value to the Data Domain shareholders, namely, the EMC offer.⁴

³ On July 8, after the Court granted plaintiff's motion, EMC raised its bid to \$33.50 per share, which NetApp elected not to match. Consequently, Data Domain terminated the merger agreement and paid NetApp the \$57 million termination fee.

⁴ Plaintiff also claimed that Data Domain's officers and directors were to receive benefits separate and apart from the shareholders, namely: (i) the assumption and conversion of their options, (ii) indemnification from liability for matters arising in connection with the merger and (iii) for some of them, positions with the merged company. None of these was particularly unusual for a transaction of this nature.

The Data Domain directors answered these allegations by arguing that their actions were “reasonable, and will result in the highest reasonably available value for the Data Domain shareholders.” The directors also claimed that the deal protection measures included in the NetApp merger are “common, permissible features of merger agreements,” and not preclusive lock-up devices. The directors pointed to EMC’s bid as evidence that the merger agreement with NetApp served to advance the interests of the Data Domain shareholders.

Court of Chancery’s Analysis

The only issue before the Court was whether plaintiff’s request for an injunction should proceed on an expedited schedule, such that an injunction hearing could take place before the merger closed. The Court noted that plaintiff need only state “a sufficiently *colorable* claim to justify proceeding on an expedited schedule.” Ultimately, the Court determined that plaintiff’s request for an expedited schedule should be granted.

In considering whether plaintiff’s claim merited an expedited schedule, the Court first turned to the substantive standard that a board must follow in a sale of control transaction. According to the Court, a board “must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise.”⁵ The Court proceeded to explain that “there is no blueprint that a board must follow” to satisfy its *Revlon* duties. In a somewhat conclusory fashion, based presumably on the limited nature of the motion before it, the Court found that plaintiff had stated a colorable claim that the Data Domain board “is favoring one bidder over others, thereby deterring bids from third parties that could provide greater value to Data Domain shareholders.”

The Court went on to determine that plaintiff also had established a sufficient likelihood of irreparable injury, bolstering plaintiff’s argument that an expedited schedule to hear its claim for injunctive relief is necessary. According to the Court, the harm that could result from the deterrence of other bids “is incalculable,” and “it would be impossible to ‘unscramble the eggs’ by attempting to unwind the merger once it has been completed.” The Court also dismissed the directors’ theory that a shareholder vote on the merger would allay any concerns because “a shareholder vote sometime in the future ... does not address the alleged current deterrent effect of the deal protection measures.”

Rounding out its analysis, the Court noted that Data Domain had adopted a provision exculpating its directors from personal liability for monetary damages due to breaches of the duty of care, in accordance with Section 102(b)(7) of the Delaware General Corporation Law. Thus, if the merger was to be consummated, shareholders would be limited to seeking monetary damages for a breach of the board’s duty of loyalty. Citing *Lyondell*, the Court noted that shareholders will succeed on such a claim “only if [the directors] knowingly and completely failed to undertake their responsibilities.” The Court further noted that because this burden is so difficult to meet, “injunctive relief may be the only relief reasonably available to shareholders” in plaintiff’s position.

⁵ *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 239 (Del. 2009) (quoting *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001)).

Conclusion

Lyondell confirmed that directors may aggressively pursue a transaction that they determine in good faith to be beneficial to shareholders, despite the absence of an auction process, so long as their actions are reasonable and aimed at obtaining the best available price for shareholders. However, although it might not be prudent to draw sweeping conclusions from such a limited ruling as whether to grant a motion to expedite, the language used by the Court in *Bernal* certainly suggests that when a company has attracted more than one bidder, the best way for a board to satisfy its *Revlon* duties and maximize shareholder value is to follow a robust sale or auction process that avoids taking actions that could be perceived as favoring one bidder over another. As Court of Chancery decisions in recent years have demonstrated, when only one bidder exists, Delaware Courts are reluctant to upset the deal and risk losing an attractive opportunity for target company shareholders.⁶ In contrast, when more than one bidder is involved, Delaware Courts are more comfortable scrutinizing a deal and taking steps to permit an auction to continue.⁷

⁶ See, for example, the discussion of the decisions in *In re Netsmart Technologies, Inc. Shareholders Litigation* and *In re Lear Corporation Shareholder Litigation* contained in our previous Client Alerts entitled “*Netsmart*: Delaware Court Again Stresses Several Important M&A Issues While Criticizing Company’s Auction Process,” dated April 10, 2007, and “*Topps & Lear*: Delaware Chancery Court continues Recent Trend of Delaying Stockholders’ Meetings Due to Inadequate Proxy Disclosures”, dated September 10, 2007.

⁷ See, for example, the discussion of the decision in *In re The Topps Company Shareholders Litigation* contained in our previous Client Alert entitled “*Topps & Lear*: Delaware Chancery Court continues Recent Trend of Delaying Stockholders’ Meetings Due to Inadequate Proxy Disclosures”, dated September 10, 2007.

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