DIRECTORS' AND OFFICERS' LIABILITY
ENTIRE FAIRNESS AND INTERESTED MERGERS

JOSEPH M. MCLAUGHLIN
SIMPSON THACHER & BARTLETT LLP

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Under Delaware law, a cash-out merger transaction with a controlling shareholder is subject to the entire fairness standard of judicial review, encompassing fair dealing and fair price. *In re Cysive, Inc. Sh. Litig.*,[1] is the most recent Delaware Court of Chancery pronouncement on the rigorous standard of fiduciary conduct applicable when a controlling shareholder seeks to acquire the minority's stake in a negotiated merger, and the burden-shifting framework of entire fairness review which Vice Chancellor Strine described in the decision as "passing strange." The decision demonstrates that while entire fairness review is demanding, it does not require perfection. It also offers guidance on when a non-majority shareholder will be deemed a controlling shareholder with attendant fiduciary obligations, and illustrates the qualities of a transaction and process conducted by a special committee of the board that meets the exacting entire fairness standard.

Controlling Shareholders and Entire Fairness

A Delaware shareholder who owns a majority interest in or exercises control over the business and affairs of a corporation assumes fiduciary duties to the minority.[2] A shareholder holding less than a 50% interest is not a controlling shareholder, with the fiduciary obligations accompanying that status, unless the minority shareholder held a dominant position and exercised control over the business affairs of the corporation.[3] The most common situation in which a controlling shareholder's fiduciary duty is implicated is when it allegedly engages in self-dealing, often by standing on both sides of a transaction. In *Kahn v. Lynch Comm. Sys.*,[4] the Delaware Supreme Court held that a controlling shareholder seeking to acquire the remainder of the company's shares in a negotiated merger bears the burden of proving the entire fairness of the proposed transaction.[5] In contrast, in the context of a tender offer followed by a short-form merger, (not at issue in *Cysive*), "the inherent coercion that *Lynch* found to exist when controlling stockholders seek to acquire the minority's stake is not even a cognizable concern," so that "in the tender offer context . . . [Delaware] courts consider it sufficient protection against coercion to give effective veto power to a majority of the minority."[6]

The initial burden of establishing entire fairness in the "interested negotiated merger" context rests with the controlling shareholder, which must demonstrate fair dealing and fair price. "Fair price" examines the substantive terms of the transaction, and "fair dealing" encompasses the conduct of the corporate fiduciaries in effectuating the transaction, including how the purchase was initiated, negotiated, structured and the manner in which director approval was obtained. The test is not bifurcated; the court considers all aspects of the transaction before making a unitary determination.[7]

The controlling or dominating shareholder may shift to the plaintiff-shareholder the burden of demonstrating that the transaction complained of was *not* entirely fair by showing either (a) the transaction was approved by an independent committee of directors with real bargaining power that could be exerted in negotiating with a majority or controlling shareholder, or (b) an informed majority of minority shareholders approved the transaction.[8] Regardless of where the burden lies, and even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, entire fairness remain the standard of judicial review.

Cysive

In *Cysive*, plaintiff shareholders challenged a management buy-out proposed by Nelson Carbonell, the founder, Chairman, CEO and largest shareholder of Cysive, principally a provider of technology consulting services. After successful initial public and secondary offerings in 1999-2000, Cysive's consulting business foundered in the wake of the widespread decline in the technology sector in 2000. In an effort to adapt to a changing market environment, Cysive shifted its focus to the development of a software product called Cymbio. Although Cymbio showed promise, by late 2002 it had failed to attract a single customer, and Cysive's five-member board – which included three outside directors with no real ties to management – decided that the company's flagging stock price with no immediate prospect of turnaround warranted consideration of a possible sale of the company or a strategic alliance.

The board hired Broadview International as its financial adviser. Incorporating information provided by Cysive management and contained in public filings, Broadview developed a brief written presentation containing information about Cysive for use with potential buyers. The board determined that a non-public sales process was in Cysive's best interests, and Broadview therefore approached several entities it thought might be a good fit. Carbonell also suggested some potential buyers, which the court determined he did in good faith because of his keen interest in securing a high bid for Cysive. The court noted that Broadview appropriately told potential buyers during the sales process that non-public information would be provided only if the potential buyer signed a confidentiality agreement because "[a] serious seller . . . would not send such information to the world in the first instance," but rather would require a signed confidentiality agreement.

Broadview's earnest efforts to find a buyer did not yield even one serious expression of interest. It continued its sales efforts, but recommended that the board consider a management buy-out or a liquidation. Carbonell continued to believe in Cysive and its prospects, and wrote to the three outside directors that he intended to form a company led by Cysive management to pursue an acquisition of the company. He recognized that the outside directors would appoint a special committee of the board, which would retain its own financial advisor and counsel, to consider a forthcoming acquisition proposal from the management group. The court noted with approval that Carbonell acknowledged from the outset of the need to deal at arm's length with a special committee, and sought to maintain the confidentiality of any proposal he made in order to avoid upheaval among Cysive's employees and not to upset the stock price. The outside directors established a special committee composed of two of the outside directors, excluding the third in an abundance of caution because he had expressed potential interest in remaining with Cysive if Carbonell took it private. Recognizing Broadview's familiarity with the sales process, the special committee retained Broadview to represent the committee in negotiations with Carbonell. Because Broadview had no other relationship with Carbonell, the court saw no infirmity with the new arrangement. The court also noted favorably that the committee undertook to balance a financial incentive for Broadview to prefer a sale to a liquidation by retaining an additional advisor to perform a liquidation valuation for the company.

Carbonell's acquisition vehicle offered to pay $3.01 per share for all Cysive shares, based on Carbonell's belief that the price exceeded a preliminary estimate of Cysive's liquidation value by fifteen cents per share. Carbonell's advisors accompanied the offer with a draft merger agreement containing a $4 million termination fee and strict no-shop provisions. The offer was made public, which provoked expressions of interest from other potential buyers, including one that made a competitive bid. The special committee also negotiated vigorously with Carbonell, whom it persuaded to make an offer of at least $3.20 per share, a price that exceeded the committee's working estimate of a liquidation value, and the offer ultimately was increased to $3.22. The committee also successfully reduced the proposed termination fee to $1.65 million, and rejected the proposed no-shop provision, leaving Carbonell only with the right to match any superior offer within 48 hours, but allowing the committee to have unfettered discussions with other potential buyers.

The process was not unblemished. When Broadview undertook to evaluate Cysive's revenue estimates as part of its analysis of the fairness of the Carbonell offer, it asked Cysive's CFO for budget and revenue information on a current and forward-looking basis. Cysive's CFO had updated revenue projections that reduced a prior estimate from $6 million to $4.48 million, but failed to supply them to Broadview. The court rejected the CFO's explanation that the figures were withheld because they were unreliable, holding that "[h]is duty as a director and CFO was to provide the special committee and its advisors with all the information they asked for, because they were entitled to all the information the company had." The court concluded that the failure to provide the updated information did not "impair the functioning of the special committee," however, because all Cysive's revenue projections were unreliable and "[a]s important, any downward revision he would have given them would not have made the special committee advisors more optimistic . . . it would have made them less so."[9]

In May 2003, the committee received a liquidation valuation of $3.16 per share from its financial advisors, and voted to recommend the merger with Carbonell's acquisition vehicle to the board. The board then voted three to zero to approve the merger, with Carbonell and the CFO abstaining. The announcement of the signed merger agreement (which permitted the committee to entertain competing offers) provoked purported class litigation seeking to enjoin the merger. The court conducted an expedited trial, denied the request for injunctive relief and dismissed the case.

The court noted that the "first order of business" was to determine the standard of review, and stated that Delaware "law has so entangled" this determination with the merits that "the two inquiries are inseparable." The court agreed with plaintiffs that the entire fairness standard applied to the proposed merger between a controlling shareholder and the controlled company, and that this exacting standard applied even where (i) the target board consisted of a majority of independent directors; (ii) an empowered special committee negotiated and approved the merger; and (iii) a majority of the company's disinterested shareholders approved the merger. The court noted that Delaware law acknowledges the benefits of these protective devices, however, by giving defendants the benefit of the burden shift enunciated in *Lynch* if any of them are present. It then questioned the utility of the burden-shifting approach, asserting that the "practical effect" of the shift in the burden of persuasion "is slight." Moreover, the court suggested, the fact-intensive nature of the factors underlying burden-shifting inquiry makes it essentially impossible for defendants to secure the benefit of the shift without developing and presenting at trial the evidence needed to trigger the shift. Given "[t]hese realities," the court suggested "that the *Lynch* doctrine, if it is to be perpetuated, could be usefully simplified" by placing the burden of proving fairness or unfairness at all stages on either the plaintiff or the defendants: "The effect of either of these alternatives would be to focus the energy of the litigants and the court on the decisive question . . . and to avoid time-consuming questions that are of little practical importance."

The court next considered whether Carbonell, who did not own a majority interest in Cysive, was a controlling shareholder sufficient to trigger the entire fairness standard instead of the business judgment standard that ordinarily applies to an independent special committee's good faith and fully informed recommendation. Noting that the evidence of whether a shareholder is controlling usually overlaps with evidence regarding the fairness of the merger process, the court suggested that it is most efficient "to try the questions at the same time because the defendants' attempt to show that the independent directors acted freely and assertively . . . without being controlled by the large block holder is evidence both that the large block holder was not in control and that the merger was negotiated fairly." The court concluded that Carbonell's non-majority stake and lack of control over the special committee were outweighed by the combination of his control of 40% of Cysive's voting equity with his status as a hands-on Chairman and CEO. The formidable combination of the largest stock voting power in the company and managerial authority, the court reasoned, compelled the conclusion that Carbonell was a controlling shareholder who must satisfy the entire fairness standard.

Turning to the fairness of the merger process and its financial terms, the court noted several factors supporting the conclusion that the transaction was entirely fair. The committee, which consisted of two independent directors with relevant expertise, met 21 times during the process. It recommended accepting Carbonell's proposal only after an active search for a third-party buyer conducted by an experienced investment bank which reported directly to the committee. Most importantly, the committee "took its responsibilities seriously." It "bargained hard, . . . holding out to get a better price and ensuring that the committee retained the flexibility to accept a higher bid." Across the bargaining table, Carbonell refrained from "threats" and "strong-arm" tactics, giving "the committee the leeway to fulfill its fiduciary duties." The existence of a majority of independent directors reinforced the conclusion that a fair process was conducted for the benefit of minority shareholders. The court also emphasized the inclusion in the merger agreement of provision for a post-signing market check, of which the committee actively availed itself, negotiating with seven potential bidders after the merger agreement was signed. Assessing the financial fairness of the transaction, the court held that the failure of a competing bid to emerge and the fact that the merger price exceeded by 37 cents per share the stock price on the day before Cysive announced it was in discussions with Carbonell were powerful indications of a fair price, regardless of which party had the burden of persuasion.

Cysive confirms that liability does not inevitably follow application of entire fairness review, and offers guidance on the characteristics of an interested merger that may withstand scrutiny. An informed, independent, active special committee empowered to engage in arm's length negotiation with a controlling shareholder, and which can and does say no to any transaction that is not fair to the minority shareholders and not the best transaction available, should ensure fairness regardless of which party has the burden of persuasion.

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[1] 2003 WL 21961453 (Del. Ch. Aug. 18, 2003).

[2] *Kahn v. Lynch Comm. Sys., Inc.*, 638 A.2d 1110, 1113-1114 (Del. 1994).

[3] *Emerald Partners v. Berlin*, 787 A.2d 85, 94 (Del. 2001); *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999) (stating that domination requires "literal control of corporate conduct"), *aff'd*, 746 A.2d 277 (2000).

[4] 638 A.2d 1110 (Del. 1994).

[5] *Id.* at 1115 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)).

[6] *In re Pure Resources, Inc., Sh. Litig.*, 808 A.2d 421, 438 (Del. Ch. 2002).

[7] *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1172 (Del. 1995).

[8] *Emerald Partners v. Berlin*, 726 A.2d 1215, 1222, 1223 (Del. 1999); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-38 (1985).

[9] *Cysive*, 2003 WL 21961453, at *12.