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# MERGERS AND ACQUISITIONS

## Protecting Target Directors Who Approve a Cash Merger When the Debt Incurred in the Merger Causes the Target to Fail

*Directors of a target company can face potential liability for damages if they approve a cash merger financed in substantial part through borrowing and the target then fails. There are, however, steps that directors can consider taking to provide them with some protection against this risk.*

**by Scott J. Davis and William R. Kucera**

The aftermath of the recent acquisition of Lyondell by Basell provides a striking example of the risk that directors face if they approve a cash merger financed in substantial part through borrowing and the target then fails. The deal was characterized as an "absolute home run" by Lyondell's financial advisor.[1] But less than 13 months after the closing of the merger in December 2007, Lyondell filed for bankruptcy. A litigation trust established by the bankruptcy court to marshal the debtor's assets has sued Lyondell's former directors, seeking damages on the theory that the merger, while beneficial to Lyondell's shareholders, unlawfully mistreated Lyondell's creditors by causing the company to become insolvent.[2] The case is pending. To add to the directors' problems, the excess directors' and officers' insurance carrier has declined coverage on several grounds, among them that, because the litigation trust stands in Lyondell's shoes, this is an "insured v. insured" matter not covered by the D&O policy.[3]

Ironically, the same directors were sued before the closing by shareholders who asserted that the directors breached their duty under *Revlon, Inc. v. McAndrews & Forbes Holding, Inc.,* to take reasonable steps to obtain the best short term value for shareholders once the board had decided to pursue a change in control transaction.[4] In *Ryan v. Lyondell Chemical Co.*, the Delaware Chancery Court denied the directors' motion for summary judgment, concluding that it was possible for the plaintiffs to establish that the directors were liable in damages for not acting in good faith because they inadequately complied with their duties under *Revlon*.[5] The Delaware Supreme Court reversed the Chancery Court, holding that the shareholders could not establish facts entitling them to damages.[6] But the argument that the directors did well enough for shareholders is now being used against the directors by the litigation trust, which is alleging that the directors improperly favored the shareholders at the expense of the creditors by approving the Basell merger.

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## Legal Theories Used Against Former Directors

In general, debtors have sought damages against their former directors for approving a merger in circumstances in which much of the money used to pay shareholders in the merger was obtained through borrowing. In these transactions, often called leveraged buyouts (LBOs), the debt used to finance the deal is placed on the balance sheet of the target at the closing of the transaction. Though the lending banks will have consented to having the target be the exclusive source of repayment for this debt, the additional debt may be bad news for the target's existing creditors, who have not given their approval, because it may increase the risk that the target will fail.[7] If the target does fail and files for bankruptcy, those creditors sometimes cause the target, now a debtor, to sue its former directors for damages for authorizing a transaction that allegedly saddled the target with more debt than it could handle.

Debtors typically base these claims on a variety of legal theories, one of which is that authorizing the payments to shareholders in the merger constituted an unlawful distribution for which the directors are liable for damages under the applicable state statute governing distributions. These statutes, which were enacted for the protection of creditors, generally provide that a distribution may only be authorized if its effect will not be to leave the corporation effectively insolvent.[8] In making this determination, directors may rely on records of the company or information, including opinions, provided by management or outside experts.[9]

An important case supporting the theory that directors can potentially be liable in damages for authorizing an unlawful distribution when they approve a merger that causes the company to become insolvent is the Eleventh Circuit's decision in *Matter of Munford, Inc*.[10] The *Munford* court agreed with the reasoning of the bankruptcy judge below that, given the substance of the transaction, it was appropriate to equate the LBO at issue to a distribution and therefore hold the directors responsible for complying with the relevant distribution statute.[11] The Eleventh Circuit rejected the reasoning of the Fourth Circuit in *C-T of Virginia, Inc. v. Barrett*, which held, invoking the doctrine of independent legal significance, that the action of directors in approving a merger could not be challenged under the distribution statute because a "corporate acquisition, structured as a merger, is simply a different animal from a distribution."[12] The split between the Fourth and Eleventh Circuits on this issue remains unresolved.

Debtors bringing damages claims against directors also often assert that the directors breached their fiduciary duty to creditors or the company by approving a merger that placed too much debt on the company's balance sheet.[13] An advantage of this theory is that it does not require the court to characterize what occurred in the merger as a distribution, thereby eliminating the objection expressed by the Fourth Circuit in *C-T of Virginia* that such a recharacterization violates the doctrine of independent legal significance.

However, a fiduciary duty claim may be subject to certain defenses that the unlawful distribution theory avoids. First, directors may be able to assert that such a claim is barred by the exculpatory provision contained in most companies' charters prohibiting the company from obtaining damages awards against directors for a breach of their duty of care.[14] Second, directors may be able to assert that such a claim is barred because the company was not insolvent when they authorized it to enter into the merger agreement and, at least under Delaware law, directors do not owe a fiduciary duty to the company's creditors until the company is insolvent.[15]

Finally, debtors suing directors in connection with mergers that allegedly left the company insolvent often also assert that the merger violated state or federal fraudulent transfer or conveyance statutes.[16]

## Recent Examples of Claims Against Former Directors

There are several recent examples of debtors bringing claims against their former directors for approving mergers that allegedly led to the debtor becoming insolvent.[17] Though these claims may very well be resolved without any liability for the directors, the existence of these claims nonetheless underscores the potential risks to target directors in approving an LBO.

First, as noted above, claims have been brought against the former directors of Lyondell who approved the leveraged buy out of Lyondell prior to Lyondell's bankruptcy.[18] These claims include that (1) the directors breached their fiduciary duties, including the duties of good faith, loyalty, and due care,[19] (2) the payment of the merger consideration to the Lyondell shareholders in connection with the merger constituted illegal *de facto* dividends or redemptions under Delaware law,[20] and (3) the directors violated various fraudulent transfer statutes.[21]

Second, in connection with the bankruptcy of Tribune Company following an LBO, the Official Committee of Unsecured Creditors filed a complaint that included a number of claims against Tribune's former directors.[22] The complaint alleges that the directors "turned a blind eye" to the foreseeable consequences of the LBO.[23] It then goes on to make a number of wide-ranging claims against the directors, including that (1) the directors breached their fiduciary duties of good faith, care and loyalty,[24] (2) the payouts in the transaction amounted to unlawful dividends or unlawful stock repurchases,[25] and (3) the transaction violated applicable fraudulent transfer statutes.[26]

The Extended Stay bankruptcy provides another recent example of claims against former directors in a connection with a bankruptcy following an LBO. In June 2007, Blackstone sold Extended Stay to Lightstone Holdings in a leveraged deal. Approximately two years later, Extended Stay filed for bankruptcy protection. Various claims ensued, including those made by a litigation trust formed to pursue claims on behalf of the Extended Stay estate against various individual officers and directors of various pre-LBO Extended Stay entities.[27] These included (1) claims for breach of duty of care, loyalty, and good faith[28] and (2) claims for illegal distributions under applicable state law.[29]

## Possible Steps to Protect Directors

The vast majority of LBOs do not result in bankruptcy and, for the few LBOs that do lead to such a result, it is far from a sure thing that claims will be brought against the former directors of the target. However, the examples cited above show that directors run a real-world risk of being sued for damages if they approve a merger in which a substantial portion of the purchase price will be borrowed, with the debt placed on the target's balance sheet, and the target then fails. And while the sustainability of these claims as a matter of law is uncertain, directors should not assume that purely legal defenses to these claims will be successful or that reimbursement of any losses they suffer will be available from third parties.[30]

But even if a company goes bankrupt after an LBO and claims against directors are brought and they cannot be dismissed as a matter of law, directors should seek to retain the ability to mount an effective defense on the basis of the applicable facts. To our knowledge, no court has ever suggested that target directors are per se liable when the target fails following an LBO. Rather, the directors of the target should have a strong defense if they are able to establish that at the time they approved the transaction they had reasonable grounds for believing that debt placed on the surviving company in the merger would not cause it to become insolvent.[31]

Consequently, directors and their advisors contemplating a cash merger should consider whether to take steps to establish a factual defense to a potential claim against the directors in the event that the target subsequently fails. The need for actions, and what actions to pursue, will depend on the applicable circumstances. There are situations in which nothing may need to be done. For example, there may not be a significant risk of the type we have discussed in a transaction that does not call for any debt to be placed on the balance sheet of the target at the closing.

In situations in which the risk cannot be dismissed, there are a variety of steps that directors can take to obtain reasonable grounds for believing that debt placed on the surviving company in the merger would not cause it to become insolvent. For example, the target board could ask the buyer to provide a representation, either formally in the merger agreement or through some other means such as a closing delivery, as to the post-closing viability of the target.

***Directors should not assume that purely legal defenses to these claims will be successful.***

The target board also could ask the target's chief financial officer or another member of management who is sufficiently expert on the subject to analyze the proposed capital structure and provide the board with advice about its viability. In order to be in a position to provide the board with this advice, the target's management would need an understanding of the debt that the buyer proposed to put on the target in connection with the transaction as well as other relevant information about the buyer that may impact the financial viability of the target after the transaction is consummated. The target's board or management might be able to piggyback, to some extent, on an analysis of the post-closing capital structure that is already being done by the buyer or its lenders.

Another method available to directors for attempting to establish that they had a reasonable basis for believing that the debt undertaken in the merger would not cause the target to fail is to require that they or the target receive a solvency opinion to that effect from a well-known outside firm as a condition to closing the merger. This opinion would be dated as of a date close to the closing and would be based, in part, on projections and other inputs from the buyer and the target's management. Even if, viewed in hindsight, the opinion turned out to be incorrect,[32] it is likely that it would significantly help the directors assert later that, at the time of the closing, they had the requisite reasonable basis.[33]

***The target board could ask the buyer to provide a representation as to the post-closing viability of the target.***

It is worth noting that it presently is not general practice for directors of the target to require a solvency opinion as a condition to closing a cash merger in which the target is a public company. We examined a sample of 66 cash merger transactions of at least $100 million since January 1, 2011, in which the target was a public company and the buyer was a strategic acquirer and 47 cash merger transactions of at least $100 million since June 30, 2010, in which the target was a public company and the buyer was an affiliate of a private equity firm. It is likely that there was substantial debt placed on the target's balance sheet in a number of the strategic acquirer transactions and virtually all of the private equity acquirer transactions. Nevertheless, we found no examples of solvency opinions as conditions to closing among the strategic acquirer transactions and only two examples of solvency opinions as conditions to closing among the private equity acquirer transactions.

## Conclusion

We reiterate that it depends on the applicable circumstances which, if any, steps target directors should take to establish reasonable grounds for believing that debt placed on the surviving company in a merger would not cause it to become insolvent. Whether a reviewing court would conclude that what a target board did was sufficient to establish such reasonable grounds also would turn on the applicable circumstances. But we recommend that the board and its advisors at least consider these questions before signing off on a merger.

## Notes

1. *See Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 239 (Del. 2009).

2. *See* Amended Complaint, *Weisfelner v. Blavatnik (In re Lyondell Chemical Co.)*, Adv. Pro. No. 09-1375 (Bankr. S.D.N.Y. Sept. 29, 2011), ECF No. 09-10023.

3. *See* Complaint, *American Casualty Co. of Reading, Pa. v. Gelb et al.*, dated October 25, 2011, Index No. 652935, Supreme Court of the State of New York, County of New York.

4. 506 A.2d 173, 182 (Del. 1986).

5. 2008 Del. Ch. LEXIS 105 (Del. Ch. July 29, 2008).

6. *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 239 (Del. 2009).

7. For a good description of the prejudice to creditors that LBOs can produce, *see* John H. Ginsberg, M. Katie Burgess, Daniel Czerwonka, and Zachary R. Caldwell, "Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts," 19 American Bankruptcy Institute Law Review 71 (2011).

8. Section 6.40(c) of the Revised Model Business Corporation Act provides that a corporation may not make a distribution if, following the distribution, (1) it would be unable to pay its debts as they become due or (2) its "total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution." The Revised Model Act is the basis for the statute governing distributions or dividends in a large number of states. *See* Jesse N. Silverman, "*In re Munford* and the Trustee in Bankruptcy: Should Georgia's Distribution Statute Apply to Leveraged Buyouts?," 15 Emory Bankruptcy Developments Journal 519, 532 (1999).Delaware law generally prohibits dividends except out of the corporation's surplus (the amount by which the current value of total assets exceeds the current value of total liabilities, less the corporation's capital (generally at least the aggregate par value of all of the issued and outstanding shares)) or out of recent net profits. *See* Delaware General Corporation Law sections 154, 170, 173, and 174.

9. Section 6.40(d) of the Revised Model Business Corporation Act provides that a corporation's board of directors, in determining whether a distribution is permitted under Section 6.40(c), may rely "either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."

Section 172 of the Delaware General Corporation Law provides that the board of directors "shall be fully protected in relying in good faith upon . . . opinions, reports or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation, as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid . . . ." *See also Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 154-56 (Del. 1997), upholding a board's reliance on a solvency opinion in determining that the corporation's total assets exceeded its liabilities.

10. 97 F.3d 456 (11th Cir. 1996).

11. *Id*. At 459. Other courts have also concluded that directors can be sued for damages under the relevant state's distribution or dividend statute for approving an LBO that renders the company insolvent. *See Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 1000-01 (S.D.N.Y. 1991) (denying motion to dismiss debtor's claim that its directors violated the Delaware dividend statute following their approval of and participation in merger transactions); *In re Buckhead America Corp.*, 178 B.R. 956, 969-74 (D. Del. 1994) (holding that debtors properly stated a claim that directors violated the Delaware dividend statute by authorizing a LBO transaction in which the target subsidiary financed the acquisition of its parent company's outstanding shares); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 510-12 (N.D. Ill. 1988) (denying directors' motion to dismiss debtors' claim that its directors violated the Illinois distribution statute by approving merger transactions).

12. 958 F.2d 606, 611 (4th Cir. 1992).

13. A breach of fiduciary duty claim against the target 's directors was brought in each of the cases cited in note 11 *supra*.

14. In most states the statute authorizing these exculpatory charter

provisions contains an exclusion prohibiting exculpation of the directors for authorizing unlawful distributions or dividends. *See* Bernard Black, Brian Cheffins, & Michael Klausner, *Outside Director Liability*, 58 Stanford Law Review 1055, 1090-91 n.128 (2006) ("Twenty-eight states have enacted provisions based on Delaware's section 102(b)(7). Fourteen states have adopted the Model Business Corporation Act's . . . provision, which allows a company charter to eliminate a director's liability 'except liability for . . . (C) [an improper dividend or share repurchase].'") (brackets in original).

However, the exculpatory charter provision will arguably bar claims by or on behalf of the debtor. The provision might not bar direct claims by creditors against the debtor's directors, but those claims may be otherwise prohibited by state law. *See, e.g.*, *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) ("The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors.").

15. *See Gheewalla*, 930 A.2d at 103 (rejecting the argument that directors owed a duty to creditors when the company was in the zone of insolvency). A distribution does not raise this issue because the distribution statutes assume that the company was solvent before the distribution was authorized and prohibit authorizing a distribution that renders the company insolvent.

16. A fraudulent transfer or conveyance claim against the target 's directors was brought in each of the cases cited in note 11 *supra*. It is unclear that damages against the directors would be available pursuant to such claims. "[C]ourts have generally held that, at least under federal bankruptcy laws, a fraudulent conveyance is recoverable only from the transferees thereof, and not from parties that may have approved or facilitated the fraudulent conveyance." Martin Lipton & Erica H. Steinberger, "Takeovers & Freezeouts," 5A-124 to 5A-125 (2003).

A good summary of fraudulent conveyance law as it applies to companies that failed following LBOs is contained in Ginsberg *et al.*, *supra* note 7, at 81-88.

17. As of the publication of this article these claims against the directors were still pending.

18. *See* Amended Complaint, *Weisfelner*, *supra* note 2.

19. *Id.* at 119.

20. *Id.* at 128.

21. *Id.* at 117, 119.

22. See Complaint, *Official Comm. of Unsecured Creditors of Tribune Co. v. Fitzsimmons (In re Tribune Co.),* Adv. Pro. No. 10-54010 (Bankr. Del. Nov. 1, 2010), ECF No. 08-13141.

23. *Id.* at 53.

24. *Id.* at 77.

25. *Id.* at 94.

26. *Id.* at 96, 98.

27. *See* Complaint, *Extended Stay Litig. Trust v. Blackstone Group (In re Extended Stay, Inc.)*, Adv. Pro. No. 11-02254 (Bankr. S.D.N.Y. June 14, 2011), ECF No. 09-13764.

28. *Id.* at 123.

29. *Id.* at 138.

30. The directors' right to be indemnified pursuant to the merger agreement, or the debtor's charter or bylaws, may be of limited use since the debtor is bankrupt. And as the Lyondell situation demonstrates, D&O insurers may contend that this potential liability is not covered by the applicable policy.

31. As the District Court of Delaware has recognized with respect to dividends, "directors can easily insulate themselves from liability …by demonstrating that they relied on the reports of employees, committee of the board, or experts 'selected with reasonable care by or on behalf of the corporation as to the availability of surplus.'" *Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Inv. P'Ship*, No. 98-358-SLR, 2000 U.S. Dist. LEXIS 1303, at *12 (D. Del. Feb. 9, 2000, *rev'd on other grounds*, *Color Tile Inc. Official Comm. of Unsecured Creditors v. Reliance Ins. Co.*, 2004 U.S. App. LEXIS 2315 (3d Cir. 2004).

32. The ability of the directors to rely on a solvency opinion may be challenged if the information supplied to the opinion provider was allegedly inaccurate or incomplete, especially if the debtor asserts that that inaccuracy or incompleteness was the result of deliberate misconduct.

33. Delaware law expressly permits the directors to rely on the opinions of experts, both generally and in connection with the payment of dividends. *See* Delaware General Corporation Law Sections 141(e) and 172, and note 9 *supra*.