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Virginia Corporate Law Update: Federal Court Rules in Favor of Virginia Corporation in Public Company Merger Litigation

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On December 2, 2014, in *Malon v. Franklin Financial Corp.*, the United States District Court for the Eastern District of Virginia denied a motion to enjoin a merger of two publicly-traded, Virginia-based banks. Judge Henry E. Hudson held that the plaintiff did not have a reasonable probability of success in proving the target company's board of directors had breached its fiduciary duties under Virginia law in approving the merger. He also found that the plaintiff was unlikely to prevail in showing the target company's proxy statement contained false or misleading statements in violation of federal securities laws. There are only a handful of Virginia court decisions addressing directors' duties in the context of a merger – and this is the first opinion in the modern era in which nearly every merger involving a publicly-traded corporation results in shareholder litigation. As a result, *Malon* is a significant decision under Virginia corporate law, and it provides comfort to Virginia corporations and their boards of directors by confirming the process-oriented focus articulated by prior court decisions.

Background

Malon involved a shareholder lawsuit challenging a pending stock-for-stock merger in which Franklin Financial Corporation ("Franklin") would be acquired by TowneBank. The plaintiff owned 373 shares of Franklin and was represented by a well-known, New York-based plaintiffs' law firm that focuses on challenging public company mergers. The plaintiff alleged (i) state law claims that Franklin's board of directors was conflicted and breached its fiduciary duties in approving the merger and (ii) federal law claims that Franklin's proxy statement contained material omissions. The plaintiff also alleged that the trading prices of Franklin's and TowneBank's common stock had declined since the announcement of the merger, thus reducing the transaction's value from $275 million to $216 million, and that Franklin's board of directors had breached its duties by failing to include a "collar" on the exchange ratio in the merger agreement. The court issued its decision on the day before Franklin's shareholder meeting.

The Federal Court's Decision

1. Balance of Hardships Did Not Tip in Favor of Plaintiff

At the outset, the court held that the plaintiff was not entitled to an injunction because the balance of hardships did not tip in his favor. The court explained that "postponing the shareholder vote would entail significant hardship to Franklin, which has undoubtedly expended considerable money and time to arrange the process." The court further stated that "[t]here is no assurance in a fluctuating market that the [merger] opportunity will remain available on the terms negotiated."

2. No Clear Showing of Irreparable Harm

The plaintiff also failed to show irreparable harm needed to obtain an injunction. The court did acknowledge the potential threat to shareholders from casting an uninformed vote in the event of a disclosure violation. But it reasoned that the plaintiff was but "a single disgruntled stockholder with a *de minimis* ownership interest" who had "no warrant to cast his claim as one on behalf of all the stockholders." In a footnote, the court also said that, given the plaintiff's small ownership stake, a "compelling argument" could be made that he had an adequate remedy at law through monetary damages.

3. No Reasonable Probability of Success

The court then held that the plaintiff did not have a reasonable probability of success in pursuing his state law fiduciary duty or federal securities law claims.

A. Breach of Fiduciary Duty Claims

The court confirmed that the decision of a Virginia corporation's board of directors is not measured by "what a reasonable person would do in similar circumstances" but, rather, whether those directors exercised their "good faith business judgment of what is in the best interests of the corporation." Citing the Supreme Court of Virginia's decision in *Willard v. Moneta Bldg. Supply Inc.*, 258 Va. 140 (1999), the court further stated that "section 13.1-690 does not require a director to maximize profits by accepting the highest bid when selling the assets of a corporation." Instead, "[t]he wisdom of the Board's action is contextually viewed with all aspects of the deal factored into the equation."

Applying this standard, the court concluded on the current record that "the Franklin Board's recommendation of the merger agreement appears to be a defensible business decision premised on their good faith perception of the best interests of the corporation." Among other things, the court noted that (i) Franklin's board of directors met numerous times for strategic planning and to consider the merger, (ii) the board of directors engaged a financial advisor and formed a merger committee, (iii) Franklin's management and its financial advisor discussed a potential transaction with at least six other potential counterparties, and (iv) the board of directors negotiated an increase in the merger consideration. "The record evidence at this stage," the court

said, "does not demonstrate that the Franklin Board failed to engage in an informed decision-making process or cast sage judgment into the wind."

The court also said the plaintiff's claim that Franklin's board of directors was "tainted" by conflicts of interest "appears to stand on equally tenuous footing." The court explained that many of the merger benefits for directors and officers, such as severance obligations and accelerated vesting of equity awards in the merger, arose from "pre-existing contractual obligations." It further observed that the challenged "benefits," which also included several seats for Franklin directors on the TowneBank board of directors, "do not appear atypical of a transaction of this type and the disclosure in the Proxy appears sufficient to place voting stockholders on notice of any potential conflicts of interest."

B. Disclosure Claims

Next, the court held that the plaintiff did not have a reasonable probability of success in proving that Franklin's proxy statement violated federal securities laws. As a threshold matter, the court said it had to distinguish "critical information" from "that which would simply be nice to know." It then turned to the plaintiff's specific challenges, most of which attacked the summary of Franklin's financial advisor's analysis and management's internal projections.

The court stated that, "[a]lthough the Supreme Court of Virginia has never addressed this issue directly, under Delaware law, which Plaintiff urges this Court to follow, stockholders are entitled to no more than a fair summary of the financial advisor's work." It then concluded that this standard was met. In doing so, the court held that "[s]tockholders are not entitled to the extensive financial data necessary to create the financial advisor's determination of fair value." The court also observed that several of the purported disclosure violations related to assumptions or projections of Franklin's future performance, which are necessarily subject to uncertainty and thus often considered immaterial.

The court also rejected the plaintiff's claim that the proxy statement failed to sufficiently describe the financial advisor's fee structure. Citing Delaware precedent, the court stated that the proxy statement adequately disclosed that the financial advisor would receive a fee equal to 1% of the deal consideration and that a majority of its fee was contingent on the closing of the merger. The court held that Franklin did not need to quantify the exact amount payable to the financial advisor at closing.

There were several other disclosure claims that were similarly rejected by the court. For example, the court said the proxy statement did not need to disclose why the merger agreement did not have a collar around the exchange ratio. The court also said additional disclosure regarding the identity of the other potential counterparties contacted by Franklin's financial advisor "pushes Plaintiff's perception of Proxy requirements beyond the outer limits" and that such disclosure would be "immaterial under any reasonable standard of measure." Finally, the court said Franklin did not have to disclose media reports of potential improprieties at TowneBank, which reports consisted of "unsubstantiated allegations" and were already available in the public domain.

Implications for Virginia Corporations

Malon is a significant case for Virginia corporations. Virginia courts have ruled on several fundamental issues arising under the Virginia Stock Corporation Act, such as directors' duties in the context of a sale or in responding to an unsolicited takeover proposal, but none have addressed public company mergers in the modern era. Although the court did not specifically rule on the "deal protections" in the merger agreement, it recognized correctly that the no-solicitation, notice, and matching right provisions in the merger agreement, as well as a commitment by Franklin's directors and officers to vote their shares in favor of the merger, "are apparently common in merger agreements."

More importantly, the court reviewed the directors' conduct under the statutory standard of conduct set forth in Section 13.1-690 of the Virginia Stock Corporation Act consistent with Virginia precedent, which has focused on the process followed by the board of directors rather than the substance of its decision. In that regard, the court recognized that Franklin's board of directors met on numerous occasions, engaged an outside financial advisor, and considered alternatives to a merger with TowneBank. While the court did not specifically refer to the "business judgment rule," it clearly refrained from second-guessing the board of directors' decisions in structuring the sale process, agreeing to various terms in the merger agreement, and failing to obtain a collar on the exchange ratio, among other things. The court's deference to the board of directors in the absence of a collar is particularly noteworthy given the plaintiff's allegation that the transaction's value had decreased from $275 million to $216 million due to a drop in stock price. The court also recognized that option acceleration, severance payments, and similar "benefits" to corporate insiders were not out of the ordinary in M&A transactions. The court's well-reasoned analysis thus provides guidance for future corporate transactions.

Relying on the Supreme Court of Virginia's decision in *Willard*, the court held that the board of directors did not have a duty to maximize profits. This decision was clearly correct in that, unlike Delaware, Virginia courts have not applied enhanced judicial scrutiny to determine whether directors acted "reasonably" in a sale of the corporation or in response to a takeover attempt. Still, in any proposed merger, the board of directors of a Virginia corporation should focus closely on the price as well as the corporation's strategic alternatives in exercising its "good faith business judgment" of the best interests of the corporation. Indeed, the *Willard* court was focused on the fact that the board of directors in that case was weighing a facially higher offer against the likelihood of completing that transaction. *Willard* was thus making clear that the directors could consider various factors that undermined the bid. As we have previously observed:

> in the context of a change in the control of a public Virginia corporation, the directors' beacon should be the maximization of shareholder value, even if the board would not be compelled to follow the auction process that in limited circumstances would be required by *Revlon*. One might argue that, in the context of a sale of control, *a director's good faith business judgment generally requires the board to obtain the best price reasonably available, even if the Virginia Stock*

Corporation Act precludes the enhanced judicial scrutiny imposed under Delaware law in such transactions.[1]

Moreover, Virginia corporations should remember that the Virginia Stock Corporation Act does not contain a so-called constituency statute that expressly permits a board of directors to consider extraneous interests in managing the corporation.

The court's rulings on the plaintiff's disclosure claims are also important, even though they were brought under federal securities laws. The court reviewed the claims relating to the financial advisor's analysis under Delaware's "fair summary" standard, but it acknowledged this issue has not been addressed by Virginia courts. More generally, the court refused the plaintiff's attempt to impose additional disclosure burdens on target companies, noting that Franklin had filed a 200-page proxy statement with the Securities and Exchange Commission and that shareholders are not entitled to information allowing them to re-create the financial advisor's analysis.

It is now well-documented by empirical research that nearly every merger involving a public company results in shareholder litigation. Often, multiple complaints are filed in different venues. These lawsuits are brought by plaintiffs who typically have immaterial economic stakes in the targeted companies and are driven by an entrepreneurial plaintiffs' bar, often using the threat of an injunction to extract attorneys' fee awards through a settlement. One might infer from the *Malon* opinion that Judge Hudson was appropriately skeptical of these "strike suits." He did note in his analysis that no other shareholders brought suit; however, in the absence of a complaint filed by a large shareholder with a significant economic stake in the company, we do not believe the presence of additional plaintiffs, without more, would have affected the court's analysis.

In summary, Judge Hudson's ruling is thoughtful, well-reasoned, and consistent with Virginia precedent. Importantly, Section 13.1-690 of the Virginia Stock Corporation Act does not include a "reasonable man" standard; instead, it is based on the directors' good faith. The statute also includes a safe harbor providing that a director shall not be liable for acts or omissions taken in accordance with the statutory standard of conduct. More broadly, Virginia law employs a strong director-centric approach to corporate governance. Directors of Virginia corporations should thus remain focused on making decisions in good faith, in an informed and deliberative manner, with the assistance of competent advisors when appropriate, and with the understanding that any judicial review will look at the directors' <u>process</u> rather than the reasonableness of the action ultimately taken.

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[1] Allen C. Goolsby & Steven M. Haas, GOOLSBY & HAAS ON VIRGINIA CORPORATIONS § 9.7 at 216 (5th ed. 2014) (emphasis added).