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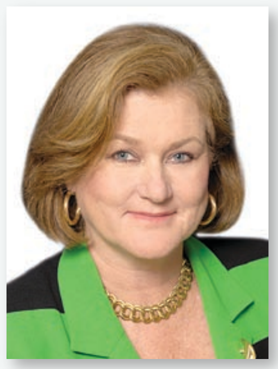
Distressed Mergers & Acquisitions

Buyer's Dream Turns Into Nightmare for Everyone



BY CORINNE BALL

Recently, in *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings Inc.)*,[1] United States Bankruptcy Court Judge Peter J. Walsh for the District of Delaware denied a motion to dismiss claims of breach of fiduciary duties brought against corporate officers and directors and a very experienced and nationally recognized restructuring professional in connection with a sale of substantially all of the company's business. As a consequence of the company's subsequent bankruptcy filing, all derivative claims, such as those asserted in this case, became property of the chapter 11 estate. Unless derivative claims are specifically preserved under a chapter 11 plan to be pursued on behalf of creditors, often by a trust or similar vehicle, they would be released. In this situation the claims were preserved and assigned to the plaintiff, the liquidating trust.

In this action the trust alleged that an abbreviated and uninformed sale process resulted in a true "fire sale" of the company's assets for grossly inadequate consideration. The trust also alleges that the company was sold to the buyer without a competitive process. Rather than pursue other bidders, the trust alleges that the company pursued only one potential buyer. The trust points out that even though the company received an unsolicited offer from at least one other potential acquirer, the company continued in its pursuit of the solitary buyer and failed to meaningfully respond or even consider the competing offer. The gravamen of the complaint is the alleged failure of the company's directors to properly discharge their responsibilities to the company. This case focuses on inaction. What may have started as the directors' deference to the restructuring professional ripened into abdication of their fiduciary duties.

Bridgeport takes into consideration recent developments in Delaware law on corporate governance in the context of distressed M&A, notably *North American Catholic and Production Resources*[2] in assessing the culpability of the board, the role of exculpatory charter provisions, and an alleged breach of the duty of loyalty by virtue of a failure to be reasonably informed and act in good faith. Of course, the decision brings into focus the lingering question in every distressed transaction: should the buyer take the creditors' rights risk associated with getting a favorable out-of-court deal without an auction, as opposed to insisting on a sale under section 363 of the Bankruptcy Code following the filing of a bankruptcy petition. This case exemplifies how such a risk affects the officers and directors of the seller as well as threatening the buyer's "too-good-to-be-true" deal. Moreover, this decision underscores that good board process throughout the sales process is the best, if not only, insurance against the risk.

Core Facts

Following a series of developments indicating ever-increasing financial distress and an initial meeting with CDW Corporation, as a potential buyer, the company retained a nationally recognized crisis manager on Aug. 19, 2003. Soon thereafter, the company exclusively pursued and, on Sept. 9, 2003, consummated a sale of substantially all of its domestic assets to CDW for a purchase price of $28 million. The next day, the company filed for chapter 11 protection. While there are references to telephone calls placed to competitors and the submission of an unsolicited competing offer, there is no indication

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of a market test or other evidence that the company's directors took action to confirm that the process followed or price obtained was fair. Given the company's financial distress, these directors should have focused their actions on "maximiz[ing] the value of the insolvent corporation for the benefit of all of those having an interest in it."[3]

The Sale

After nearly three months of repeated urgings by its secured lenders, the company hired Alix Partners as its restructuring advisor in August 2003, appointing one of its senior partners as the company's Chief Operating Officer on Aug. 19, 2003. The week before, the company's chairman met with a major competitor, CDW, to explore the possibility of a transaction. The plaintiff trust alleges that within 72 hours, the COO had determined to sell substantially all of the company's U.S. assets to CDW. There was no competitive bidding process and no investment bank was engaged to confirm the fairness of the transaction. Instead, the trust alleges that the COO seized upon the chairman's prior discussion with CDW.

CDW made its first offer on Aug. 28, 2003. Over the following Labor Day weekend, there were negotiations culminating in a "handshake deal" on Sept. 2, 2003 coupled with an exclusivity agreement. The trust alleges that there were no serious efforts during this time period to identify or contact any other potential buyers. Although the COO did contact one other potential acquirer, PC Connection, the trust alleges that PC Connection obtained only limited information and had inadequate time for diligence prior to the company's determination to proceed exclusively with CDW. Nonetheless, PC Connection submitted an offer comparable to and arguably superior to CDW's. The trust notes that the COO made cursory calls to two other companies to assess interest in a transaction, but failed to seriously consider either as a potential purchaser. The trust also alleges that other competitors were not contacted and that the COO failed to inform two other interested direct competitors that the company was for sale.

The board of directors approved the sale of substantially all of the U.S. assets to CDW on Sept. 4, 2003 on the basis of a term sheet establishing a purchase price of $28 million. Following CDW's announcement of the deal, its stock price increased by more than 12 percent, raising its market capitalization to nearly $500 million. Prior to closing, PC Connection wrote three more offer letters, which the trust alleges were ignored.

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A Stark Disparity

Prior to this proceeding, the trust brought an action to set aside the CDW sale as a fraudulent conveyance under relevant Bankruptcy Code provisions and applicable state law. Following mediation and an amended complaint, Judge Walsh denied CDW's motion for summary judgment identifying as the key issue whether the $28 million purchase price was reasonably equivalent to the value of the assets purchased. Judge Walsh also acknowledged the legitimacy of the alleged deficiencies in the sale process. While the valuation issue was not tested because the parties settled before trial, a discounted cash flow analysis that CDW performed in 2003 prior to purchasing the assets quoted a value of $126 million. Not surprisingly, CDW argued that the $126 million figure was not a valuation but a projection. Yet the stark disparity between its $126 million number and its $28 million purchase price cannot be ignored. Ultimately, CDW settled, paying $25 million to the trust.

The Case Against Directors

Allegations against the directors included a breach of the duty of care and failure to act in good faith predicated on inaction and a lack of oversight, which the trust alleged amounted to a breach of the duty of loyalty. Upon retaining Alix Partners, the trust alleged that the directors and officers abdicated crucial decision-making authority regarding the sale to CDW, making no effort to assure a fair process or confirm that a fair price was going to be paid. While it may be advisable for directors of financially distressed companies to rely upon expert advice in their deliberations, they are not excused from discharging their fiduciary duties of care and loyalty. The facts, as alleged, established that the directors disregarded their duties to the company when they abdicated their decision-making authority to the COO, despite his role as an expert restructuring professional. Citing *Stone v. Ritter*[4] for the proposition that a fiduciary acts in bad faith when he fails to take action in the face of a known duty to act, Judge Walsh explained that the trust's allegations supported the claim that the company's directors "breached their fiduciary duty of loyalty and failed to act in good faith by abdicating crucial decision-making authority to [the COO], and then failing to adequately monitor his execution of a 'sell strategy.'"

The directors moved to dismiss the breach of duty of care claim relying on the exculpation provision in the company's charter as permitted by section 102(b)(7) of Delaware General Corporation Law. Relying on *Alidina v. Internet.com Corp.*, Judge Walsh denied the motion, stating that the directors' reliance on the exculpation clause was misplaced because exculpation becomes ineffective when a breach of the duty of loyalty has been adequately pled.[5] In denying the motion to dismiss with respect to the breach of the duty of care, Judge Walsh concluded that neither the exculpatory provision nor the business judgment rule vitiated the claim.

Conclusion

Companies typically face significant time constraints when distressed. Unfortunately, there are occasions when the board of a financially distressed company discovers far too late that the only viable option is a sale, thus finding themselves at the helm of an involuntary seller. Yet even in that circumstance, the board has to act responsibly, albeit quickly and without the best information. If time is of the essence or the financial distress is so severe that a company has insufficient liquidity to support itself during a competitive sale process, proper board processes must still be implemented.

A quick decision to sell is not necessarily wrong, especially when the directors' review of the facts and consideration of the opinions of experts support their determination that signing a deal is the best course of action available. However, even in that case, it is advisable to undertake a concerted post-agreement market check or other action to assure that the transaction is fair. Accommodating that objective within the potentially severe constraints of distress often leads boards to seriously consider a sale through the bankruptcy court. In bankruptcy, a company can file a motion to sell its assets under section 363, with its chapter 11 petition. If liquidity is a pressing issue, it is not unusual for the putative buyer to provide funds to bridge the bankruptcy court's approval of the sale and subsequent closing. While the Bankruptcy Rules provide for 20 days' notice of a section 363 sale, for good cause shown the bankruptcy court has the authority to shorten notice. There may be good reason to proceed without a bankruptcy and confirm the fairness of the transaction in another way. At a minimum a board is well advised to consider whether a section 363 sale is viable option, establishing another indication of good board process.

Largely because *Bridgeport* reflects the record of a motion to dismiss where all the allegations of the complaint are taken in the light most favorable to the plaintiff, it leaves many questions about the circumstances leading to the sale unanswered. Yet, the record of the prior fraudulent conveyance proceeding likely colors Judge Walsh's approach to this breach of fiduciary duty action. Presumably the buyer knew that it was getting a deal that was "too-good-to-be-true," and also knew that a fraudulent transfer action could ensue. Valuation informs that risk assessment. This case, however, leaves the impression that the directors did not see themselves at risk in following the recommendations of a nationally recognized, experienced crisis manager. Nonetheless, the directors are at risk because they failed to implement an adequate board process to monitor and examine the recommendation of the COO.

Generally the risk of director liability is managed through operating within the protection of the business judgment rule. Even boards of insolvent corporations such as Bridgeport are entitled to the protection of the business judgment rule when they are disinterested, reasonably informed and act in good faith in the honest belief that the decision they are making is in the best interest of the corporation. However, adequate board process is the predicate for disinterested directors being able to retain the benefit of the business judgment rule. This case squarely confirms that the guideposts of good governance and process apply in the face of distress and are not overcome or replaced by uninformed or near blind reliance upon expert advice. Although boards are entitled to rely on qualified expert advice, *Bridgeport* makes clear that such reliance only informs the boards' deliberations, it does not replace them.

1. 388 B.R. 548 (Bankr. D. Del. 2008).

2 . See *North American Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (making it clear that while creditors of an insolvent corporation do not have standing to sue corporate officers and directors directly for breach of fiduciary duties, creditors do have standing to maintain derivative claims against directors on behalf of the corporation for breach of fiduciary duties); *Production Resources Group, LLC v. NCT Group Inc.*, 863 A.2d 772 (Del. Ch. 2004).

3. *North American Catholic*, 930 A.2d at 103.

4. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (holding that bad faith conduct results in a breach of the duty of loyalty and explaining that a failure to act in good faith may be shown by acting with a purpose other than that of advancing the best interests of the corporation, with the intent to violate applicable positive law or intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for fiduciary duties).

5. *Alidina v. Internet.com Corp.*, No. 17235, 2002 WL 31584292 at *8 (Del. Ch. Nov. 6, 2002) ("When a duty of care breach is not the *exclusive* claim, a court may not dismiss [the duty of care claim] based upon an exculpatory provision.") (emphasis in original).