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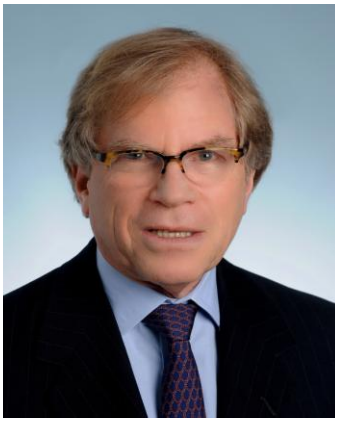
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

VC Laster, Fiduciary Duties And The Long-Term Rule



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Vice Chancellor J. Travis Laster has been writing for several years about the fiduciary duties of directors who represent the interests of a particular block of stockholders. In his opinion in the Trados Shareholder Litigation, he found that directors, elected by the venture capital investors who held Trados' preferred stock, had a conflict of interest in deciding on a sale of the corporation in which all the proceeds would be absorbed by the liquidation preference of the preferred and nothing would go to the common.[1] As a result of this finding, Vice Chancellor Laster applied the entire fairness standard of review to the Trados board's decision. He concluded that while the directors failed to follow a fair process, the transaction was fair because the common stock had no economic value before the sale and so it was fair for the common stock to receive nothing from the sale.[2]

In a recent Business Lawyer article, which he co-authored with Delaware practitioner John Mark Zeberkiewicz,[3] Vice Chancellor Laster extended his Trados conflict of interest analysis to other situations in which directors represent stockholder constituencies with short-term investment horizons, including directors elected by activist stockholders seeking immediate steps to increase the near-term stock price of the corporation. He states that such directors can face a conflict of interest between their duties to the corporation and their duties to the activists.

In both his Trados opinion and the Business Lawyer article, as well as his opinion in the Rural Metro damages award decided in October 2014,[4] Vice Chancellor Laster took the position that directors owe a fiduciary duty to maximize stockholder value over the long-term (the "long-term rule"). This was a fundamental underpinning to his conclusion that directors who represent venture capital investors and activists with short-term investment horizons face a conflict of interest.

As Vice Chancellor Laster and Zeberkiewicz stated in the Business Lawyer article, "the blockholder director's duties to the corporation require that the director manage for the long term, while the blockholder director's duties to the investor require that the director manage for an exit."[5]

The notion that directors are required to maximize value over the long term and that directors who represent stockholders with short-term investment horizons necessarily face a conflict of interest, if generally accepted, would represent a significant change in the law and would require a significant change in the procedural safeguards used by boards in discharging their fiduciary duties.

Today, the predominant view is that:

- Directors have discretion to determine the time horizon over which they seek to maximize stockholder value, and

- Absent special circumstances, a controlling stockholder (and by extension directors who represent such a stockholder on the board) do not have a conflict of interest in approving a transaction if such stockholder's shares are treated proportionately with those of other stockholders in the transaction.

The Long-Term Rule

The long-term rule can be viewed as a weapon to protect the other stockholders from directors who represent a particular faction in the stockholder base, such as the venture capitalists who were seeking a quick exit from their investment in Trados and the stockholder activists with a short-term investment horizon discussed in the Business Lawyer article.

The rationale that the authors put forward for the long-term rule, however, is based not on the interests and preferences of the corporation's other stockholders, but on the intrinsic nature of the corporation and its equity capital. Critical to their analysis is that the existence of the typical corporation is perpetual and the capital provided by common and preferred stockholders is permanent. From these basic characteristics the authors conclude that, "the directors' fiduciary duties ... require that they maximize the value of the corporation over the long term for the benefit of the providers of long-term (presumably permanent) capital." [6]

Notwithstanding these assertions, it is undeniable that the average holder of a corporation's common stock and preferred stock is not a permanent investor in the corporation. One of Chief Justice Leo Strine's articles dealing with the time frame issue cites a statistic indicating that the average annual turnover in the shares of public companies is approximately 100 percent.[7]

If we define a long-term holding period as five years or more, it seems likely that the holders of a large majority of the shares of most public corporations do not qualify as long-term investors. These stockholders have an interest in the pursuit of policies that permit them to exit their investment on advantageous terms that may very well be within five years or less.

However, under the long-term rule, directors could have an obligation to ignore this interest and manage the corporation exclusively to maximize its long-run profitability. It is hard to accept this position unless one takes the view that the directors' duties run not to the particular stockholders the corporation has when the directors are making their decisions, but to all the stockholders the corporation will have at that time and in the future. In addition, the long-term rule applied in its strictest form may require directors to take actions that alienate a substantial portion of the stockholder base, leading to the election of a new board with a weaker commitment to the goal of maximizing long-term value.

Vice Chancellor Laster has cited various authorities in support of the long-term rule which, among other things, suggest that William Allen, former chancellor on the Delaware Chancery Court, was a believer in this approach. However, the Delaware Supreme Court has never endorsed this view. Its leading position on the issue remains the opinion in Paramount v. Time, in which it stated:

While we affirm the result reached by the Chancellor [William T. Allen], we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation, 8 Del. Ch. § 141(a). This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of “long term” versus “short term” value is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, absent a limited set of circumstances defined under Revlon, a board of directors, while always required to act in an informed manner, is not under a per se duty to maximize shareholder value in the short term, even in the context of a takeover.[8]

While the Paramount opinion has its ambiguities, it clearly rejected the idea that directors must choose the long-term as the exclusive time frame for maximizing stockholder value.

In the Business Lawyer article, the authors invoke the harm that may be caused by short-term activist investors, citing articles by Chief Justice Strine and Martin Lipton expressing their concern. It is notable, however, that in his extensive writings on the time frame question Chief Justice Strine’s focus is on the duties of investment managers whom he would require to pursue their clients’ long-term investment goals, rather than attempting to redefine the fiduciary duties of corporate directors.[9]

Conflict of Interest

The authors treat a blockholder director’s conflict of interest as a logical corollary of the long-term rule. “The blockholder director’s duties to the corporation require that the director manage for the long term, while the blockholder director’s duties to the investor require that the director manage for an exit.”[10] If a court does not adopt the long-term rule, it is questionable that controlling stockholders with a short-term investment horizon, or directors representing other stockholders with a short-term investment horizon, have an inherent conflict of interest.

While it may be argued that short-term investors have a conflict of interest because they have a shorter investment horizon than some other stockholders, there is no single investment horizon that is broadly representative of stockholders generally, and existing case law supports the view that a short-term investment horizon does not alone create a conflict of interest in approving a transaction in which all shares are treated the same.

This point is illustrated by Chief Justice (then Chancellor) Strine’s opinion in Synthes Inc. Shareholder Litigation.[11] There, then-Chancellor Strine rejected a challenge to the sale of a large corporation, which was based on the premise that the aged controlling stockholder who engineered the sale had a conflict of interest because of his need for liquidity.

The court in Synthes found that when a stockholder who is also a fiduciary affords its minority stockholders pro rata treatment with itself, there is no disadvantage to the minority stockholders. However, Chancellor Strine added that there could be very narrow circumstances in which a stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment if such stockholder forced the sale of an entity at below fair market value. [12] Strine's refusal to see an inherent conflict of interest in the situation of a controlling stockholder seeking liquidity may be a further indication that he does not accept the long-term rule, although he has repeatedly demonstrated his concern over the ill effects of short-termism among corporate stockholders.

Effect of Adopting the Long-Term Rule

The adoption of the long-term rule could have numerous far-reaching effects, but three in particular stand out.

First, there would likely be a change in the process by which boards, with the assistance of their bankers, value a target corporation for purposes of deciding whether to approve a proposed acquisition of the corporation. Today, bankers typically utilize three principal financial analyses of which only one — discounted cash flow analysis — is primarily a measure of long-term value. The other two — comparable transactions and comparable companies analyses — use a target corporation's current or near-term operating metrics for purposes of determining such corporation's implied value.

Under the long-term rule, there would be pressure on boards to focus primarily on the discounted cash flow analysis, and boards could face criticism for approving transactions with a value that did not exceed, or fall high in the range of, the corporation's implied value based on a discounted cash flow analysis. However, deriving a corporation's implied value based on a discounted cash flow is also arguably the least reliable measure of value, given the inherent uncertainty of long-term projections on which a discounted cash flow analysis in based. A primary focus on a corporation's discounted cash flow may lead to result-driven analyses that are, in fact, less effective at policing the acquisition process than the present system that often gives equal or sometimes greater weight to comparable transactions and comparable companies analyses.

Second, adoption of the long-term rule could make activists and even hostile bidders wary of nominating board candidates who, because of a business relationship with the activists or bidder, might be deemed to have a conflict of interest. Should such candidates be elected to the board, they could be marginalized when the board considers the activists' proposals due to the perceived conflict of interest. For example, the conflict of interest could lead a board to establish a committee of independent directors to consider the activist's proposals, which committee would likely exclude board members who have a business relationship with the activist stockholder.

In fact, even without widespread adoption of the long-term rule, Vice Chancellor Laster's judicial opinions and other writings may cause activists to nominate only board candidates who could "pass" the independence test. Some may consider that a desirable result, but the absence of directors who truly represent the stockholders who nominated them would prevent the board from functioning as a forum in which such stockholders and management can seek to resolve their differences.

Third, it would eliminate the flexibility provided by the opinion of the Delaware Supreme Court in Paramount v. Time, which allows a board of directors to set a course of action which, in light of the particular circumstances of a corporation, it views as being in the best interests of the corporation and all of its stockholders. At present, boards of directors may develop a business strategy that pursues both short-term and long-term objectives. This more balanced approach may also align with the wishes of a substantial portion of the stockholder base.

In a letter sent last year to the CEOs of the public corporations in the S&P 500 index, Lawrence Fink, chairman and CEO of BlackRock, one of the largest investment managers, wrote:

Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. ... We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments — in innovation and product enhancements, capital and plant and equipment, employee development, and internal controls and technology — that will sustain growth.[13]

A board of directors that wants to follow this approach needs the flexibility of the law as stated in Paramount v. Time rather than the approach mandated by the long-term rule.

An Alternative Approach to Short-Termism

We do not believe the courts need to adopt the long-term rule in order to address abusive short-termism. Vice Chancellor Laster and Zeberkiewicz themselves identify an alternative means of dealing with this problem when they discuss the obligation of directors elected by a block of stockholders to promote the interests of all stockholders, not just those who elected them.[14] If, as in Trados, directors disregard the interests of the corporation or other stockholders in order solely to achieve the goals of the stockholders they represent, the courts could find a breach of the directors' fiduciary duty to act in the interests of all stockholders, without having to decide the time frame in which the board should seek to maximize stockholder value.

An important practical question in applying this principle is under what circumstances would directors or the stockholders who elected them have a sufficient conflict of interest for the courts to depart from the business judgment rule in deciding whether the directors are violating their obligation to act on behalf of all stockholders.

Recent cases, particularly then-Chancellor Strine's opinion in Synthes, suggest that the courts are still wrestling with this issue. [15] Should a court find that directors were acting to promote the narrow interests of a particular stockholder or stockholder block, which were in conflict with the interests of stockholders generally, it would be appropriate to find a conflict of interest and apply the entire fairness standard of review to determine whether there had been a violation of the duty of loyalty, with its serious consequences for the culpable directors. If, on the other hand, directors consider both the long-term and short-term objectives of a corporation because they are trying to do what is best for the corporation and balance the interests of different stockholder groups, including their varying time frames for exiting their investments, it seems inappropriate to find a violation of the duty of loyalty or any of the directors' other fiduciary duties.

—By Leonard Chazen, Jack S. Bodner and Donald Ross, Covington & Burling LLP

Leonard Chazen is a senior counsel, Jack Bodner is a partner and Donald Ross is senior of counsel in Covington & Burling's New York office.

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[1] In re Trados Inc. Shareholder Litigation, 73 A.3d 17, (Del. Ch. 2013).

[2] In finding that the board failed to follow a fair process, he concluded that the directors "failed to consider the common stockholders, and sought to exit without recognizing the conflict of interest presented by the Merger, ..." Ibid. 76.

[3] J. Travis Laster and John Mark Zeberkiewicz, "The Rights and Duties of Blockholder Directors," 70 Business Lawyer 33 (2014-2015)

[4] In Re Rural/Metro Corporation Shareholders Litigation, 102 A.3d 205, 253 (Del. Ch. 2014)

[5] Op. Cit. 50.

[6] Op. Cit. 49.

[7] Leo E. Strine Jr., "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?" 66, Business Lawyer, footnotes 30 and 32 (2010).

[8] Paramount Communications Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

[9] Leo E. Strine, Jr., Can we Do Better By Ordinary Investors? A Pragmatic Reaction To the Dueling Ideological Mythologists of Corporate Law, 114 Columbia Law Review 449 (2014).

[10] Op. Cit. 50.

[11] Delaware Civil Action No. 6452 (2012).

[12] Id. 1035-1037.

[13] These statements were quoted with approval by Martin Lipton in his article, Current Thoughts About Activism, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Aug 8, 2013, 9:15 A.M.)

[14] Op. Cit. 49.

[15] This approach could make use of the principle enunciated by the Delaware Supreme Court in Getty Oil Co. v. Skelly Oil Co., 237 A.2d 883, 887 (Del. 1970) recently cited by Strine in In re Synthes Shareholder Litigation. 50A.3d 1022, 1039 fn. 81 (Del. Ch. 2012) that, "A basic ground for judicial interference with business judgment on the complaint of the minority interests is an advantage obtained by the dominant group to the disadvantage of the corporation or its minority owners."