In a Leveraged Buyout With a Controlling Stockholder, Loyal Directors Must Actively Negotiate: *Louisiana Municipal Police Employees’ Retirement System v. Fertitta*

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A recent decision by the Delaware Court of Chancery reinforces the responsibility of a board of directors to assertively defend the interests of the noncontrolling stockholders when negotiating with a controlling stockholder in order to satisfy the board's duty of loyalty. In *Louisiana Municipal Police Employees’ Retirement System v. Fertitta*, No. 4339-VCL, 2009 WL 2263406 (Del. Ch. July 28, 2009), the court refused to dismiss claims against the board and the CEO of Landry's Restaurants, Inc. alleging breach of their duty of loyalty and waste of corporate assets in connection with a failed leveraged buyout of the company by the CEO. The court's decision hinged on three key factual aspects alleged in the complaint:

- the CEO's role in negotiating a financing agreement on behalf of the company as part of the buyout financing, and the board's acquiescence to that role;
- the board's "apparent and inexplicable impotence" in dealing with a creeping takeover by the CEO during the buyout negotiations; and
- the board's termination of the merger agreement, which eliminated the CEO's reverse-termination fee obligations.

In reaching its decision, the court distinguished *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), in which the Delaware Supreme Court held that an accelerated process for sale of the company did not constitute a bad faith breach of the board's Revlon duties. See here for our April 29, 2009 Update on the *Lyondell* case.

This update offers a summary of the key issues in the *Fertitta* case and offers practical guidance.

**KEY FACTS IN THE FERTITTA CASE**

**Fertitta Offers Management Buyout.** Landry's owned approximately 180 restaurants in 28 states, the Golden Nugget Hotel and Casino in Las Vegas and other properties. Tilman Fertitta, the CEO of Landry's, owned 39% of its outstanding common stock. Fertitta proposed a management buyout at $23.50 per share in January 2008—at a 41% premium. Landry's board set up a special committee of independent directors to evaluate the merger proposal and in June 2008, agreed to a merger at $21 per share. The merger agreement built in a 45-day "go-shop" period, contained a relatively standard right to terminate in the event of a material adverse effect, and specified that a $24 million reverse-termination fee would be paid to Landry's, personally guaranteed by Fertitta, if the buyers failed to close. Fertitta entered into a commitment letter with lending banks to finance the buyout.

On September 13, 2008, Hurricane Ike damaged Landry's restaurants in three Texas cities. The company's press release reassured the market that the losses were insured and forecasted minimal, if any, negative long-term effect. Nevertheless, Fertitta informed the special committee that he believed the lending banks would claim that a material adverse effect had occurred under the debt commitment letter, which would allow Fertitta to terminate the merger agreement. Fertitta suggested the merger consideration be reduced to $17 per share to persuade the lending banks not to assert a material adverse effect. The company had $400 million in debt coming due in February 2009 in an increasingly tumultuous credit market, and faced a bankruptcy filing if it could not refinance the debt, putting additional pressure on the board.

**Fertitta Renegotiates Merger Agreement and Debt Commitment Letter.** After three weeks of negotiations with Fertitta, on October 7, 2008 Landry’s announced publicly that the merger might not proceed. Landry's stock dropped to $8.44 per share. Then, on October 17, 2008, the company and Fertitta amended the merger agreement, agreeing to a new price of $13.50 per share, reducing the reverse-termination fee to $15 million and providing that Fertitta would not assert a material adverse effect for the hurricane-related events.

Concurrently with renegotiating the merger agreement amendment, Fertitta negotiated an amendment to the commitment letter with the lending banks in which the banks also agreed not to assert a material adverse effect for any event through the date of the amendment. As part of that agreement, Fertitta also negotiated, on Landry's behalf, a commitment to refinance the $400 million of Landry's debt that was coming due, if the merger was not consummated.

**Fertitta Engages in Creeping Takeover.** From mid-September through early December 2008, Fertitta purchased approximately 2.6 million shares of Landry's common stock on the open market, raising his ownership stake to 56.7% and obtaining control without paying a control premium. Although the amended merger agreement provided that any newly acquired shares were not
eligible to vote on approval of the merger agreement, the Landry board did nothing further to protect the minority stockholders from the impact of Fertitta's purchases of shares.

**Landry's Terminates Merger and Fertitta Avoids Paying Reverse-Termination Fee.** In late 2008, the SEC asked Landry's to make routine disclosures in its merger proxy statement relating to the financing of the deal. When the lending banks objected, Landry's terminated the merger agreement. In a January 2009 press release, Landry's explained that providing the SEC-requested disclosure over the lending banks' objections would violate the terms of the commitment letter, which would jeopardize both the buyout financing and the debt refinancing. By terminating the merger agreement, Landry's maintained the lending banks' obligation to fund the $400 million refinancing, but doing so also eliminated Fertitta's obligation to pay the $15 million reverse-termination fee.

COURT OF CHANCERY OF DELAWARE DENIES MOTION TO DISMISS CLAIMS FOR BREACH OF THE DUTY OF LOYALTY AND FOR WASTE

The Court of Chancery found that the allegations of the complaint, if taken as true, raised a reasonable inference that defendants breached their fiduciary duty of loyalty and engaged in corporate waste.

**Controlling Stockholder Owes Fiduciary Duties to Noncontrolling Stockholders—Court May Review Entire Fairness of Board's Decision.** A nonmajority stockholder in a Delaware corporation has fiduciary duties as a controlling stockholder if the stockholder's relationship with the corporation allows him to dominate the corporation through actual control over its actions. Fertitta did not have control of Landry's through majority ownership until December 2008, but he served as its Chairman and CEO, and he was also a 39% stockholder. In the court's view, these facts, in addition to his actions on behalf of Landry's in negotiating the debt refinancing, suggest that he was the controlling stockholder during those negotiations. Combining the refinancing and buyout commitments in a single agreement so that a breach under the buyout commitment would allow the lending banks to terminate the debt refinancing commitment provided Fertitta with additional leverage in negotiating with Landry's. Fertitta's direct role in negotiating the agreement created a reasonable inference that either he used his position as CEO or his influence as a controlling stockholder for his personal benefit to the detriment of the corporation and the noncontrolling stockholders.

Once he acquired 56.7% of the common stock, Fertitta clearly controlled the corporation but argued that he should not have been treated as the majority stockholder, even then, because the merger agreement prohibited him from voting his newly acquired shares to approve the merger. The sterilization of Fertitta's new shares for such a limited purpose was not sufficient, in the court's view, to keep him from controlling Landry's at that point. Consequently, the Landry's board's decision to terminate the merger agreement after Fertitta obtained majority control is subject to entire fairness review.

**Court Found Directors' Response to Creeping Tender Offer May Breach Fiduciary Duty of Loyalty.** The Landry's directors argued that plaintiffs' allegations amounted only to a breach of the duty of care and that Landry's charter exculpated directors from monetary damages for a breach of the duty of care. Therefore, the directors could not be held liable for monetary damages for such a breach unless, as the Delaware Supreme Court held in Lyondell, the breach was so egregious as to constitute bad faith. The court found that Lyondell was not applicable because it presented only allegations of gross failure of process by the Lyondell board. By contrast, plaintiffs here asserted a straightforward breach of the duty of loyalty, namely, that "the board knowingly preferred the interests of the majority stockholder to those of the corporation or the minority." A breach of the duty of loyalty cannot be exculpated under Delaware law.

Although Delaware courts have never required a board of directors to implement a poison pill, the court found that the failure to do so in the face of a clear threat to Landry's minority stockholders and the corporation, "together with other suspect conduct," supported a reasonable inference that the board breached its duty of loyalty.

**Court Found Directors' Failure to Require Reverse-Termination Fee Payment May Constitute Corporate Waste.** Plaintiffs alleged that the Landry's board committed waste by failing to require Fertitta to pay the reverse-termination fee in connection with the termination of the merger agreement. In decisions such as In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106 (Del. Ch. 2009), Delaware courts have set a high bar to prevail on a claim of corporate waste, namely, that "the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interest." See here for our April 2, 2009 Update on the In re Citigroup case.

The board announced that it had terminated the merger agreement to prevent a breach of the debt commitment letter, which breach would have given the lending banks the option to deny both the buyout financing and the debt refinancing. The board argued that this was the only rational alternative open to it because the company faced bankruptcy without the financing. The court was skeptical, wondering why the board and special committee did not challenge the lending banks on whether the SEC-requested disclosure would actually result in a breach of the debt commitment letter, and questioned whether terminating the merger agreement in order to preserve the debt financing commitment was necessary to prevent the company's bankruptcy. The court clearly felt that the board had not negotiated hard enough with Fertitta; the board could have turned the threat of bankruptcy into a bargaining chip to force Fertitta to terminate the merger agreement, leaving Landry's with the debt refinancing commitment intact and the reverse-termination fee of $15 million in hand. In the court's view, the special committee did not thoroughly consider that Fertitta (at that point, the majority stockholder) might have terminated the merger agreement to protect his existing $78 million to
$119 million investment in Landry's. The court found that the complaint raised a reasonable inference that the special committee's decision to terminate the merger agreement and forego the reverse-termination fee did not constitute the "rational exercise of business judgment."

**SOMETIMES SUBSTANCE OF BOARD'S DECISIONS TRUMPS GOOD BOARD PROCESS**

The *Fertitta* court's decision to deny the motion to dismiss is a reminder of the difficult duty of loyalty issues that can face a board of directors in negotiating with a controlling stockholder, especially one who is also the CEO. When Fertitta made his initial offer, the Landry's board did the right thing procedurally: it formed a special committee that

- hired its own legal and financial advisors,
- negotiated for six months before reaching a merger agreement that provided a premium to Landry's stockholders and contained a go-shop clause and a reverse-termination fee favorable to the company,
- negotiated actively with Fertitta for a month before agreeing to a revised merger agreement, and
- decided to terminate the merger agreement in the midst of an unprecedented financial crisis in the U.S. credit markets in order to preserve the company's debt refinancing commitment.

Nevertheless, the court faulted the special committee and the board for, among other things, failing to adopt a rights plan to protect against a creeping takeover and failing to play a game of high-stakes chicken with its controlling stockholder regarding who would terminate the merger agreement. A standstill agreement or adoption of a rights plan would have protected the status quo, but had to be negotiated at the outset. It is not clear whether the board asked for these terms but were refused, or failed even to ask. Without these protections, the board found itself without leverage when it came time to renegotiate the merger agreement. Many of the asserted errors of the board could also be characterized as errors of process rather than evidence that the board favored the controlling stockholder.

The case is a reminder that, if a board is negotiating with a controlling stockholder, its actions will be seen through the prism of possible dominance by that stockholder, and even good faith errors of process may appear to be driven by an improper intent to benefit the controlling stockholder.

**Practical Tips**

**Identify and Use All Possible Leverage When Negotiating With a Controlling Stockholder.** The court may change its view on a more complete record, but the current decision underscores one primary lesson in negotiating with a controlling stockholder: however little leverage the board thinks it has, it must test its assumptions about what terms the controlling stockholder (or other parties, such as the buyout lenders) will accept. With the help of sophisticated legal and financial advisors, the board must use any available leverage to negotiate the best terms possible for the noncontrolling stockholders.

**OVERSEE A CONTROLLING STOCKHOLDER WHO IS ALSO THE CHIEF EXECUTIVE OFFICER.**

Allowing Fertitta to negotiate refinancing of the company's debt on behalf of the company put him in a position to insert terms that increased his leverage in the buyout transaction. When an executive officer who would normally negotiate on the company's behalf has interests on both sides of the transaction, the board should replace that person with a disinterested party, such as an independent board member.

**ADDITIONAL INFORMATION**

This update is only intended to provide a general summary of the Delaware Court of Chancery's decision in *Louisiana Municipal Police Employees' Retirement System v. Fertitta*, No. 4339-VCL, 2009 WL 2263406 (Del. Ch. July 28, 2009). You can find discussions of other recent cases, laws, regulations and rule proposals of interest to public companies on our website.

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