

Delaware Supreme Court Reverses Court of Chancery's Ruling Dismissing Breach of Fiduciary Duty Claims and Emphasizes Importance of Director's Duty of Candor Regarding Undisclosed Conflicts of Interest

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In this appellate opinion, the Delaware Supreme Court reversed the Court of Chancery's dismissal of the plaintiffs' claims for breach of fiduciary duty and aiding and abetting breach of fiduciary duty, highlighting the need for directors to be cognizant of any potential conflicts of interest that may arise when negotiating a transaction involving their company.

In the underlying Court of Chancery litigation, the plaintiffs, certain stockholders of Towers Watson & Co., challenged the fairness of a merger between Towers and Willis Group Holdings Public Limited Company. The plaintiffs asserted claims for breach of fiduciary duty against John J. Haley, Towers' CEO and chairman, among others, based on an alleged material conflict stemming from a lucrative compensation proposal Haley received from Willis that he failed to disclose to Towers' board of directors. Despite this apparent conflict, Haley continued to spearhead the merger negotiations on behalf of Towers.

The Delaware Supreme Court concluded that the Court of Chancery erred in granting the defendants' motion to dismiss the claim that Haley breached his fiduciary duty by failing to disclose material information to the board. The Supreme Court—with one dissenter—reversed the Court of Chancery's ruling and remanded the case for further proceedings.

This decision shows that Delaware courts seriously consider directors' duties, including the duty of candor, and will not apply the business judgment where a plaintiff is able to allege sufficient facts surrounding a director's undisclosed, material conflict of interest.

Case Background

In late 2014, after experiencing flat earnings following the 2008 economic downturn, Willis began exploring strategic alternatives at the suggestion of Jeffrey Ubben, co-founder and chief

investment officer of ValueAct Capital Management LP. ValueAct was Willis' second largest stockholder, owning more than 10.3% of Willis' outstanding shares since 2014 and more than 5% of its equity since 2010.

Willis' CEO met with Haley in early 2015 to discuss the possibility of a business combination and continued those discussions throughout the spring of that year. Haley, however, kept only one member of Towers' board of directors apprised of the merger discussions and allegedly unilaterally entered a nondisclosure agreement with Willis. In May 2015, Haley convened the Towers' board for the first time to discuss the potential merger with Willis. The board formed a special committee but disbanded it 10 days later, which, according to the plaintiffs, "left the task of negotiating the Merger to the now-conflicted Haley."

At that time, one of Towers' directors contacted Willis' chairman to propose that Haley serve as the CEO of the post-merger entity. Willis agreed to this proposal. The plaintiffs claimed that at this point Haley stopped advocating that Towers' stockholders should own a majority of the combined company. In early June, Haley and another Towers director proposed an exchange ratio to Willis that would result in Willis' stockholders owning approximately 51% of the combined company and Towers' stockholders owning the remaining 49% (and Willis would pay a \$500 million dividend to Towers' stockholders). ValueAct objected to this offer and, through Ubben, demanded that Willis press Towers harder. Willis subsequently proposed a revised structure that did not include any dividend to the Towers stockholders and would instead result in Willis' stockholders owning 50.1% and Towers' stockholders owning 49.9% of the combined entity. Haley countered with a \$337 million dividend (about \$4.87 per share) and the earlier agreed-upon exchange ratio.

Haley and Willis' CEO met on June 10 and agreed to merge Towers and Willis on those terms. According to the plaintiffs, Haley reached this agreement without the approval of the full Towers board, without input from Towers' financial advisor, without considering standard valuation materials, and without considering the value of any synergies. In late June, Towers' board met and Merrill Lynch advised that the merger was fair to Towers' stockholders even though the merger consideration valued Towers' stock at \$125.13 per share, a 9% discount to its unaffected trading price. Haley participated in the discussion and voted on the merger. The Towers board unanimously approved the merger, which was conditioned on stockholder approval. Haley also was slated to serve as the merged entity's CEO and as a director on its board.

When the merger was announced on June 30, 2015, the market reacted negatively. Towers' stock price dropped almost 9% to \$125.80 and multiple analysts proclaimed that the merger was a bad deal for Towers' stockholders.

In September 2015, ValueAct presented Haley with an executive compensation proposal that detailed the value of Haley's equity incentive compensation, which provided Haley an opportunity that was allegedly worth more than \$140 million. The proposal also reflected that ValueAct would provide Haley with a long-term equity incentive compensation amount greater than those of the CEOs at two peer companies, both of which had larger market capitalizations than the post-merger entity would have.

In addition to negative analyst reviews, a Towers stockholder commenced a public campaign against the merger, outlining the deal's negative aspects and advocating that stockholders vote against it. This stockholder also filed multiple opposition letters with the SEC regarding the merger.

In mid-October, Towers and Willis issued a proxy statement soliciting votes in favor of the merger and setting a date for their respective stockholder meetings. The proxy statement did not mention ValueAct's compensation proposal to Haley, any discussions about post-merger compensation, or the extent of ValueAct's role in the merger process. In early November,

Institutional Shareholder Services and Glass Lewis both recommended that stockholders vote against the merger.

Given the uncertainty of stockholder approval for the merger, ValueAct began attempting to generate positive sentiment for the merger, including through the issuance of a press release highlighting the merger's benefits to Towers' stockholders and by directly communicating with Towers' largest stockholder to encourage them to vote in favor of the merger. Haley and Ubben also agreed to increase the amount of the special dividend to \$10 per share.

The full Towers board met on November 17, the first time since June 29. Haley did not disclose to the board his post-closing compensation with ValueAct or the compensation proposal that ValueAct had presented to him. In late November, Towers filed a proxy update, but it also did not disclose Haley's proposed compensation package or ValueAct's role in the merger negotiations.

On December 11, 2015, 62% of Towers' stockholders and 95.5% of Willis' stockholders voted in favor of the merger.

The Chancery Litigation

The underlying litigation in the Court of Chancery arose from three separate stockholder actions filed in 2018, which were subsequently consolidated. The plaintiffs asserted three causes of action: (i) breach of fiduciary duty against Haley for failing to disclose the ValueAct compensation proposal to the Towers board, (ii) breach of fiduciary duty against Towers' directors for allowing Haley to negotiate the merger, and (iii) aiding and abetting breach of fiduciary duty against ValueAct and Ubben for participating in the director defendants' breach of fiduciary duty.

The defendants moved to dismiss the complaint, arguing that the business judgment rule applied to the merger and that the plaintiffs failed to plead facts sufficient to rebut the business judgment rule. The plaintiffs argued that Haley had a material conflict, which he failed to disclose to the Towers board and which a reasonable board member would have regarded as significant in evaluating the proposed transaction.

The Court of Chancery granted the motion to dismiss, concluding that the facts alleged did not support a finding of deceptive silence, fraud on the board, or a "conflicted negotiator gone rogue." The court explained that Haley's failure to disclose the compensation proposal did not rebut the business judgment rule because the Towers board already knew that Haley would become the CEO of the combined company following the merger and that the combined company would be much larger and the CEO would be entitled to increased compensation. The court also noted that the proposal was simply that, a proposal. Thus, the plaintiffs failed to demonstrate that a reasonable director would have found the proposal significant when evaluating the merger because it reflected "a theory of compensation and upside potential in the event of pie-in-the-sky outcomes unconnected to any business plan or forecast."

The Supreme Court Reverses the Court of Chancery's Ruling

Contrary to the Court of Chancery, the Delaware Supreme Court held that the plaintiffs' theory that Haley breached his fiduciary duty of loyalty by selling out Towers' stockholders in exchange for a lucrative compensation package was reasonably conceivable and the claim should survive a motion to dismiss.

The Supreme Court explained that the parties agreed that in order to rebut the business judgment rule, the plaintiffs were required to adequately allege that (i) Haley was materially self-interested in the transaction, (ii) Haley failed to disclose his interest in the transaction to the board, and (iii) a reasonable board member would have regarded Haley's material interest a significant factor when evaluating the proposed transaction.

First, the Supreme Court determined whether Haley's alleged omissions met the definition of materiality; that is, whether the information is "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking." The court held that the plaintiffs had adequately alleged that the compensation proposal altered the nature of Haley's potential conflict in a material way and that the board would have found it material that its own lead negotiator had been presented with a compensation proposal with a potential upside of almost five times his current compensation at Towers. This proposal came at a time of uncertainty surrounding the merger and before the board had authorized him to renegotiate the merger consideration.

The Supreme Court emphasized that the fact that the proposal was not binding did not relieve Haley of his duty of candor to disclose to the Towers board the progression of the potential conflict, particularly where there was uncertainty surrounding the deal. The court explained that the plaintiffs were entitled to an inference that the undisclosed compensation proposal was a motivating factor in Haley's conduct in the renegotiations of the merger to the detriment of Towers' stockholders.

The Supreme Court also concluded that the plaintiffs had adequately alleged that (i) Haley failed to inform the Towers board of his deepened interest in the transaction and (ii) a reasonable board member would have regarded Haley's material interest in the proposal as a significant fact in evaluating the merger. While Haley may have kept the board informed regarding the status of the merger negotiations, this was not sufficient to rebut the contention that Haley failed to properly disclose his self-interest to the board. The plaintiffs further alleged that one of Towers' directors, who was the chairman of Towers' Compensation Committee, testified in a related appraisal action that he would have wanted to know that Haley was discussing his compensation at the future company with Ubben and ValueAct. The Court of Chancery, however, "summarily discounted" that director's testimony as "insignificant."

Therefore, the Supreme Court held that the plaintiffs had adequately pleaded their claim for breach of fiduciary duty against Haley and, thus, that claim should have survived the motion to dismiss. Additionally, the Supreme Court directed the Court of Chancery to reconsider the claim for aiding and abetting breach of fiduciary duty against ValueAct and Ubben. The dissent, however, emphasizes that the Court of Chancery's opinion should be affirmed because the complaint did not adequately allege that the compensation proposal made Haley's conflict one that a reasonable board member would have regarded as a significant fact in the evaluation of the merger. The dissent notes that the complaint did not allege that Haley discussed his potential compensation with Ubben after ValueAct made the proposal or that Haley had any compensation negotiations with anyone from Willis until after shareholders approved the merger. The dissent also disagreed with giving weight to the board member's prior testimony, explaining that it is not clear what that director meant when he said he would have wanted to know that Haley was "discussing his compensation" and what that would include. The dissent did not find that the compensation proposal added anything material to Haley's already disclosed material self-interest and that the Towers board was already aware that Haley would receive a significant pay increase as CEO of the new company.