FOLEY HOAG LLP

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Fiduciary Duties of Directors in Connection with An Acquisition: A Massachusetts Difference

By Peter M. Rosenblum

Customary analysis of the fiduciary duties of directors in connection with their consideration of an acquisition of the corporation focuses on the nature of that fiduciary duty: What is that duty? Under what circumstances is the standard of review of the directors' performance enhanced? Does the enhanced duty impose on the directors an obligation to take particular actions?[1] Can actions taken by the shareholders immunize the directors from liability for their actions and decisions?[2] Lawyers counseling boards of directors focus on these questions.

Yet, as important in practice may be the question: To whom do the directors owe that duty? Ordinarily, lawyers and directors speak of fiduciary duties owed to the shareholders. And they know that litigation in Delaware related to acquisitions of public corporations is regularly brought as a class action suit to enforce duties owed to shareholders.[3] However, that is not the universal rule, and a different answer to the question can be outcome determinative in litigation.

A recent case decided by the Massachusetts Supreme Judicial Court involving the high-profile acquisition of EMC Corporation ("EMC") demonstrates the importance of this question. In its decision and opinion, the Court follows traditional Massachusetts precedent that dictates a very different outcome from an outcome that would be the norm in Delaware. The Court held in no uncertain terms that, with two limited exceptions, directors of a Massachusetts corporation owe their fiduciary duties to the corporation and not directly to the shareholders and, therefore, a claim related to the merger must be brought derivatively.

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[1] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (when directors recognize that the corporation is to be broken up or control of the corporation is for sale, they have a duty to obtain the highest price reasonably available for the corporation).
[2] Corwin v. KKR Fin. Holdings LLC, 125 A. 3d 304 (Del. 2015) (fully informed, uncoerced vote of the disinterested stockholders invoked the business judgment rule standard of review); Singh v. Attenborough, 137 A. 3d 151 (Del. 2016).
[3] See, e.g., A. B. Badawi, Merger Class Actions in Delaware and the Symptoms of Multi-Jurisdictional Litigation, 90 Wash. U. Law Rev. 965, 967 (2013).

THE BACKGROUND

The facts of this case are familiar in outline: EMC, a large public corporation whose stock was traded on the NASDAQ stock exchange, entered into a merger agreement among EMC, Dell Inc. ("Dell") and a subsidiary of Dell. Under the terms of the merger agreement, upon the closing of the merger, EMC's shareholders would receive a cash payment for their shares. Following announcement of the proposed transaction, plaintiffs filed a putative class action on behalf of all shareholders of EMC directly against EMC's directors. They alleged that EMC's directors had violated their fiduciary duties by failing to take steps to maximize the value of EMC stock and by agreeing to "unreasonably preclusive deal protection provisions" that would hinder any potential superior bid for EMC.

At this point, the case took a turn that differed from the familiar. The defendants moved to dismiss the complaint for failure to state a claim. After a hearing, the trial judge allowed the motion and dismissed the complaint. He ruled that the directors owed no fiduciary duty directly to the shareholders in this case and that the action should have been brought derivatively. The plaintiffs appealed.

THE SUPREME JUDICIAL COURT'S DECISION

On appeal, the Supreme Judicial Court affirmed the trial judge's dismissal of the complaint. The Court held that a case alleging breach of fiduciary duties by directors in this situation must be brought derivatively, and not as a direct action by shareholders against the directors because the directors owe their fiduciary duties only to the corporation and not to the shareholders directly. The harm from breach of fiduciary duty, if suffered, would be a harm to the corporation, not to the shareholders directly.

The Court started its analysis with the Massachusetts statute that sets forth the standard of conduct for directors in a Massachusetts corporation.4 The Court noted that the plaintiffs recognized that the statute governs, "or at least has a direct bearing on," whether the directors owe a fiduciary duty to the corporation's shareholders directly. Following textual analysis of the statute, the Court concluded that the statute did not establish a duty owed directly to the shareholders. In doing so, it rejected broad language to a different effect in a relatively recent decision and distinguished the case.[5]

The Court then stated the general Massachusetts rule under its corporate statutes and common law principles: "[A] director of a Massachusetts corporation owes a fiduciary duty to the corporation itself, and not its shareholders." It cited longstanding Massachusetts precedent establishing this general rule. It noted two exceptions to the general rule, and those are described below. However, the exceptions did not apply to the EMC-Dell transaction.

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[4] G.L.c. 156D, §8.30.
[5] Chokel v. Genzyme Corp., 449 Mass. 272 (2007) (claim for breach of covenant of good faith and fair dealing; treated as a contractual matter as to which fiduciary principles are not in question).

In its decision, the Court also responded to the plaintiffs' argument that the Court should change the traditional Massachusetts approach and follow the approach taken in other jurisdictions, such as Delaware, which allow challenges to the fairness of merger transactions as direct claims. The Court declined to make this change.

EXCEPTIONS TO THE MASSACHUSETTS RULE

The Court found two exceptions to the general Massachusetts rule described above:

1. ***Close corporations****.* The Court noted that there is a "special rule" for close corporations. It identified the exception through a quotation from a prior opinion[6]: "'[i]n the case of a close corporation, which resembles a partnership, duties of loyalty extend to shareholders, who owe one another substantially the same duty of good faith and loyalty in the operation of the enterprise that partners owe to one another, a duty that is even stricter that that required of directors and shareholders in corporations generally.'" This is the learning of the Donahue[7] line of cases in Massachusetts that derives from the similarity in operation of closely held corporations, as defined in the line, and partnerships and of the similarity in approach of shareholders of closely held corporations and partners in partnerships. The Court indicates that the "direct cause of action against directors" will be available "in this context." It remains to be seen whether the Donahue logic would be applied to an independent director of a closely held corporation who was not also a shareholder.

2. ***Controlling shareholder transactions.*** The Court also recognized an exception for transactions in which a controlling shareholder who is also a director "implements a self-interested transaction that is to the detriment of minority shareholders." In that circumstance, the shareholders who are adversely affected would be able to bring a direct action, and would not have to proceed derivatively.

PRACTICAL CONCLUSIONS FROM THE CASE

The clearest effect of the case is to change the necessary litigation approach to challenges to most mergers involving Massachusetts public corporations. The typical class action against the directors will not be available to assert the challenge and seek relief. This may well make the challenges less attractive to some plaintiffs and discourage their challenges. The procedures required for derivative suits may also permit corporate actions to defend against the challenges, and may suggest different strategies at the board level for a target corporation.

Further, since a derivative plaintiff must be a shareholder of the corporation, the derivative plaintiff will lose the plaintiff's standing as a shareholder when the merger is consummated. In effect, this will mean that litigation challenging the performance by directors of a Massachusetts

[6] Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501, 528-529(1997)
[7] Donahue v. Rodd Electrotype Co. of New England, 367 Mass. 578 (1975)

target corporation of their fiduciary duties in connection with a merger must be initiated and concluded before the merger closes. Therefore, damage remedies for breach of the directors' fiduciary duties will become considerably less likely, and the focus of any litigation challenging the merger will likely be on equitable relief.

Importantly, though, the case does not alter the fiduciary duties of directors of Massachusetts corporations to their corporations. The customary counsel to directors about their fiduciary obligations and their duties of care and loyalty should continue to be given. The fact that procedurally a remedy for breach of duty must be sought in a different way or that challenging litigation may be less likely does not alter their fundamental fiduciary obligations.