December 8, 2008

The Financial Crisis and the Business Judgment Rule

State Courts Reject Challenges to Bear Stearns and Wachovia Transactions

SUMMARY

Two judicial decisions issued late last week offer the first indication of how courts will evaluate board decisions made in response to the extraordinary conditions created by the ongoing financial crisis. Both opinions stand as strong endorsements of the protections offered by the business judgment rule for directors who act diligently and in good faith in making major corporate control decisions during this crisis.

In an opinion issued on December 4, 2008, Justice Herman Cahn of the New York Supreme Court, Commercial Part, granted defendants' motion for summary judgment and dismissed a consolidated class action challenging, among other things, the adequacy of the consideration paid by JPMorgan Chase in its acquisition of Bear Stearns. *In re Bear Stearns Litigation*, No. 600780/08. In an opinion issued on December 5, 2008, Judge Albert Diaz of the North Carolina Superior Court denied, in substantial part, a Wachovia Corporation shareholder's motion seeking to enjoin the merger between Wachovia and Wells Fargo. *Ehrenhaus* v. *Baker et al.*, No. 08 CVS 22632.

Both rulings recognize the financial, governmental, and time pressures faced by the Bear Stearns and Wachovia boards of directors due to the global financial crisis, and express great reluctance to second guess informed, good faith decisions made by boards of directors under these pressures. Sullivan & Cromwell LLP advised the boards of both Bear Stearns and Wachovia in these transactions.

BACKGROUND

The *Bear Stearns* case arose out of the March 16, 2008 agreement by Bear Stearns to be acquired by JPMorgan. In the face of a substantial likelihood that Bear Stearns would not be able to meet its financial obligations, and would be forced into bankruptcy on the morning of Monday, March 17, the transaction was rapidly negotiated during the immediately preceding weekend. In a series of emergency meetings, Bear Stearns' board of directors – assisted by financial and legal advisors – reviewed the firm's liquidity problems and evaluated its options. The Federal Reserve Bank of New York had informed Bear Stearns on March 14 that a Federal Reserve-backed loan facility announced earlier that day would no longer be available as of March 17, and the Department of the Treasury informed Bear Stearns that it needed to complete a stabilizing transaction by the end of the weekend.

Bear Stearns and its advisors reached out to numerous potential acquirers over the weekend before reaching a merger agreement with JPMorgan that incorporated several "deal protection" measures, including an option for JPMorgan to buy Bear Stearns' headquarters building. Over the course of the following weekend, certain transaction terms were renegotiated, including the price paid by JPMorgan, which was increased from $2 to $10 per share. At the same time – in an effort to halt the flight of Bear Stearns' customers and counterparties – additional "deal protection" provisions were added to increase the likelihood of the merger being consummated. Under one of these provisions, Bear Stearns agreed to sell JPMorgan 95 million shares of Bear Stearns common stock (39.5% of the company's voting power). The merger was approved by Bear Stearns' shareholders on May 29, 2008, and closed the next day.

The *Wachovia* case arose out of similar circumstances. On September 26, 2008 – one day after federal regulators seized the banking assets of Washington Mutual and Congress rejected the Treasury Department's initial bailout plan – Wachovia's board of directors was informed by management that, if it could not arrange a merger by September 29, the Federal Deposit Insurance Corporation would place Wachovia's bank subsidiaries under receivership. Faced with this prospect, Wachovia immediately entered into emergency negotiations with Citigroup and Wells Fargo. Following a determination by the Federal Deposit Insurance Corporation, early in the morning of September 29, that Wachovia should enter into a transaction with Citigroup, Wachovia and Citigroup signed a non-binding agreement-in-principle that contemplated the sale of Wachovia's bank subsidiaries to Citigroup. On October 2, Wells Fargo proposed a competing offer for a merger transaction involving the whole company. Wachovia's board – assisted by legal and financial advisors – approved the Wells Fargo merger on October 3.

As in *Bear Stearns*, the Wachovia-Wells Fargo transaction documentation contained several "deal protection" measures. One such measure involved the issuance to Wells Fargo of preferred stock (representing 39.9% of Wachovia's total voting power). In addition, the Wachovia board could not solicit alternative merger proposals, and was required to submit the Wells Fargo merger agreement for shareholder approval even if a superior offer were received. Wachovia's board could, however, submit

the Wells Fargo agreement to shareholders without recommendation, and communicate the reasons for its lack of recommendation.

In both cases, plaintiffs challenged both the process and the substantive fairness of the transactions in general, and the "deal protection" measures in particular. Plaintiffs also argued that the Bear and Wachovia boards potentially could have secured government aid as an alternative to a merger.

THE *BEAR STEARNS* DECISION

The New York Supreme Court rejected all the plaintiffs' challenges to the Bear Stearns-JPMorgan merger. Justice Cahn held that the business judgment rule applied, and refused to second guess the decisions of Bear Stearns' board of directors:

> In response to a sudden and rapidly-escalating liquidity crisis, Bear Stearns' directors acted expeditiously to consider the company's limited options. They attempted to salvage some $1.5 billion in shareholder value and averted a bankruptcy that may have returned nothing to the Bear Stearns' shareholders, while wreaking havoc on the financial markets. The Court should not, and will not, second guess their decision.

Justice Cahn then went further, invoking the extraordinary circumstances of the financial crisis in holding that even the enhanced standards of scrutiny sometimes employed by Delaware courts would still not invalidate the "deal protection" measures approved by the directors (as counseled by their financial and legal advisors):

> The financial catastrophe confronting Bear Stearns, and the economy generally, justified the inclusion of the various merger provisions intended to increase the certainty of the consummation of the transaction with JPMorgan.

Justice Cahn refused to engage in speculation as to whether Bear Stearns could have secured a better deal from federal regulators "by threatening a worldwide financial collapse."

THE *WACHOVIA* DECISION

The North Carolina Superior Court also rejected, with one exception, the plaintiff's challenges to the Wachovia-Wells Fargo merger. As in *Bear Stearns*, the court held that the business judgment rule applied, and that "the Board's decision-making process, although necessarily compressed given the extraordinary circumstances confronting it, was reasonable and fell within the standard of care demanded by law." The court identified several of these "extraordinary circumstances":

> The stark reality is that the Board (1) recognized that Wachovia was on the brink of failure because of an ***unprecedented*** financial tsunami, (2) understood the very real and immediate threat of a forced liquidation of the Company by government regulators in the absence of a completed merger transaction with someone, and (3) possessed little (if any) leverage in its negotiations with Wells Fargo because of the absence of any superior merger proposals.

The court noted that the only alternative acquisition offer available to Wachovia was the "markedly inferior Citigroup merger proposal." As in *Bear Stearns*, the court rejected the plaintiff's suggestion that Wachovia could have secured a better deal from the government:

> Pared to its essence, Plaintiff's argument is that he would have voted to reject the Merger Agreement and take his chances with the government had he been sitting on the Board on 2 October 2008. But it is precisely this sort of *post hoc* second-guessing that the business judgment rule prohibits, even where the transaction involves a merger or sale of control.

In this context, the court stressed that "so long as the decision to include the deal protection measures in the Merger Agreement was informed and in good faith, the Court will not intervene" absent clear proof that the provisions are coercive or threatened to force the directors to violate their fiduciary duties. The broad latitude given by the court, however, was not unlimited. The court enjoined enforcement of a provision of the transaction documentation providing that the preferred stock issued to Wells Fargo could not be redeemed by Wachovia for at least 18 months following the shareholder vote on the merger agreement, even if the merger were not approved by the shareholders. Although the court acknowledged that the board acted in good faith and on an informed basis, it held that "this particular provision serves no beneficial purpose in such an instance and, in fact, prevents the Board from fulfilling its fiduciary duties."

IMPLICATIONS

The *Bear Stearns* and *Wachovia* decisions offer an initial view of how courts are likely to treat the ongoing financial crisis in evaluating board decisions. Their holdings have several important implications:

- *First*, these cases suggest that courts are cognizant of the extreme conditions created by the financial crisis, and will take into account the overwhelming financial, governmental, and time pressures boards of directors are facing when evaluating whether board decisions are entitled to the protections of the business judgment rule.
- *Second*, these cases suggest that courts are aware of the uncertainties created by regulatory and legislative responses to the financial crisis, and that courts will not fault boards for failing accurately to predict these governmental responses. For example, the court in *Wachovia* brushed aside the

plaintiff's suggestion that Wachovia's board could have waited to see if Congress would pass a bailout package that would provide an alternative financing opportunity.

- *Third*, despite the broad deference these courts have given board decisions made in response to the financial crisis, the *Wachovia* decision suggests that courts still may be willing to invalidate or enjoin provisions – such as the 18-month bar on redeeming Wells Fargo's preferred shares – that the court believes will prevent boards from fulfilling their fiduciary duties.

For so long as the current financial crisis continues, boards of directors of financial institutions are likely to face major decisions, whether in the context of sale transactions or otherwise, under unprecedented circumstances. Both the *Bear Stearns* and *Wachovia* holdings confirm that directors who properly inform themselves (with the assistance of financial and legal advisors, where appropriate) and act in good faith will not face legal exposure for their decisions, even where those decisions might have been considered extraordinary under more "normal" circumstances.

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