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California Court of Appeal Refuses to Permit an Action for Rescission of a Strategic Transaction, Holding That a Board Has No Duty Under California Law to Include a "Fiduciary Out"

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In *Monty v. Leis*, 193 Cal. App. 4th 1367, 123 Cal. Rptr. 3d 641 (2011), the California Court of Appeal, Second District, affirmed the order of the California Superior Court, Santa Barbara County, denying a motion by shareholders of Pacific Capital Bancorp ("PCB"), a California corporation, for a preliminary injunction to enjoin or rescind a transaction by which Ford Financial Fund, L.P. ("Ford") would acquire between 80 and 91 percent of PCB's stock. The Court held that because the transaction closed while the motion was pending, the appeal of the preliminary injunction motion was moot, and that California law would not permit the shareholder plaintiffs to seek rescission of the transaction after it had been completed. The Court also rejected plaintiffs' argument that the investment agreement constituted an improper defensive mechanism because it did not include a provision that allowed PCB to back out of the deal if a better offer was received. Instead, the Court held, there is no requirement under California law that the board of directors negotiate a "fiduciary out" before binding the company to particular strategic transaction. This decision, in which the Court declined to follow Delaware law, underscores the latitude given to a board of directors of a California corporation to cause the company to enter into a strategic transaction.

In the wake of the recent economic recession, PCB suffered losses in the real estate loan market that resulted in significant write-downs in the value of its assets. If the bank failed to improve its capital position by September 8, 2010, it risked being seized by federal regulators and liquidated. On April 29, 2010, PCB entered into an investment

agreement (“Agreement”) with Ford pursuant to which Ford would provide $500 million in new capital to PCB and receive 225 million shares of common stock and 445,000 shares of convertible preferred stock. The Agreement allowed Ford to convert the preferred stock to 2.275 billion shares of common stock, leaving Ford with between 80 to 91 percent of PCB’s stock. The issuance of 2.275 billion shares of common stock would require an amendment of the articles of incorporation. PCB issued 225 million shares to Ford on the closing date, and such number of shares permitted Ford alone to approve the amendment to the articles of incorporation allowing issuance of the remaining common shares. NASDAQ rules required approval of shareholders without giving effect to the 225 million shares issued to Ford at the closing. However, because PCB was facing liquidation on September 8, 2010, the bank obtained a “financial viability” exemption from NASDAQ permitting it to proceed without such a vote.

Plaintiffs, shareholders of PCB, brought an action against PCB and its board of directors alleging both direct and derivative causes of action alleging breaches of fiduciary duty and interference with PCB's shareholders right to vote.

On June 10, 2010, plaintiffs filed a motion for a preliminary injunction seeking to enjoin the proposed investment transaction or to unwind the transaction if it closed. The trial court denied plaintiffs’ motion, holding that plaintiffs failed to demonstrate that the balance of harms was in their favor or that they were likely to succeed on the merits of their claims. The transaction closed on August 31, 2010. Plaintiffs appealed.

Plaintiffs began by arguing that the appeal was not moot because, in addition to seeking to enjoin the transaction, they also brought a claim for rescission. The Court rejected plaintiffs’ claim of rescission, observing that “where a merger or acquisition takes place after the trial court has refused to issue a preliminary injunction, courts have refused to set aside the transaction.” The Court also noted that setting aside the transaction would “require at a minimum the return to Ford of $500 million plus interest” and the loss of so much capital would necessarily cause regulators to seize PCB and liquidate its assets.

The Court also rejected plaintiffs’ argument that the Agreement contained an improper defensive mechanism because it did not allow PCB to back out of the transaction if it received a superior offer. In reaching its decision, the Court of Appeal expressly declined to follow the Delaware Supreme Court’s decision in *Omnicare, Inc. v. NCS Healthcare,*

Inc., 818 A.2d 914 (Del. 2003), and instead relied upon the reasoning of the United States Court of Appeals for the Ninth Circuit in *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.*, 741 F.2d 1555 (9th Cir. 1984). The Court cited to *Jewel* and noted that:

> An exclusive board-negotiated merger agreement may confer considerable benefits upon the shareholders of a firm. A potential merger partner may be reluctant to agree to a merger unless it is confident that its offer will not be used by the board simply to trigger an auction for the firm's assets. Therefore, an exclusive merger agreement may be necessary to secure the best offer for the shareholders of a firm . . . .

The Court concluded that “a board of directors [of a California corporation] may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers.” The board had no duty to include a “fiduciary out” in the agreement.
This decision by the California Court of Appeal confirms that courts are reluctant to “unscramble the eggs” after a strategic transaction closes, especially where the consequences of returning the target company to the *status quo ante* threatens the very survival of the target company. It also reflects the California courts’ reluctance to apply the reasoning of *Omnicare*, a controversial decision from the Delaware Supreme Court, in imposing a duty to include a “fiduciary out” in merger or other similar strategic transactions.

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