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Court Holds No Duty to Include a "Fiduciary Out" in Extra-ordinary Transaction Agreements

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On March 30, 2011, the California Court of Appeals affirmed a long standing principle of California law that boards of directors of California companies can lawfully bind themselves to complete an extra-ordinary corporate transaction such as a merger or recapitalization without the need for a "fiduciary out" and without an independent shareholder vote. *Monty* v. *Leis*, No. B225646 (Cal. Ct. App. March 30, 2011).

Pacific Capital Bancorp ("PCB"), parent of Pacific Capital Bank, suffered losses in the real estate loan market that resulted in a write-down of its assets and was met with a series of banking regulatory orders which required that PCB raise capital. After seeking additional capital from numerous sources, PCB entered into an exclusive investment agreement with the Ford Financial Fund, LP ("Ford") a fund affiliated with renowned bank investor Gerald Ford. Ford agreed pursuant to the investment agreement to inject $500 million of capital into the bank to allow it to meet regulatory requirements and grow its business. As a result, Ford would own over 80% of PCB's common stock. PCB relied on the "financial distress" exception to the NASDAQ shareholder vote requirements to issue common and convertible preferred shares to Ford. After issuance, Ford voted the common shares it held to amend the articles of incorporation to authorize additional shares to be used to satisfy the conversion feature in the preferred stock. Two shareholders filed suit seeking to enjoin the transaction on a number of grounds and the trial court denied the injunction.

After examining the issues raised, the appeals court determined that the investment agreement did not contain improper defensive mechanisms. Specifically, the appeals court rejected the argument that the PCB board breached its duties by failing to include a "fiduciary out" provision enabling PCB to back out of the transaction for a better deal. In doing so, the appeals court specifically declined to follow the Omnicare case, noting that that case had been criticized even

by the Delaware courts. Rather, the court opined that a board of directors may lawfully bind itself in a merger or investment agreement from negotiating or accepting competing offers. The Court specifically found that the board had “no duty” to include a “fiduciary out.”

The PCB case is an important recognition of the proper role of a board of directors in a regulated business. In the PCB case, the directors were faced with the immediate and pressing need to raise a significant amount of capital in a short period of time or risk further bank regulatory action. They made an informed and correct decision to commit themselves to a transaction with a sophisticated investor that could provide capital, prevent the company from more aggressive regulatory sanctions and preserve some value for shareholders.