Life After Healthco

by Mark N. Parry and Robert B. Stobaugh

In March 1991, the directors of Healthco International, Inc., the world's largest dental supply company, voted to sell the company in a leveraged buyout. In so doing the directors took actions generally considered to give a board the protection of the "business judgment rule," which protects directors from personal liability even if their decisions turn out later to injure the corporation or its shareholders.

The board received advice from management and outside experts, and it took adequate time to consider the matter. Once the board decided to sell the company, it attempted to obtain the best price. Furthermore, many of these directors owned substantial amounts of Healthco stock, a practice recommended by the NACD's Blue Ribbon Commission on Director Compensation.

Unfortunately, the buyout was unsuccessful, and Healthco filed for bankruptcy. The Bankruptcy Trustee sued the directors who had to endure a seven-week jury trial before being vindicated in *In Re Healthco International, Inc.* (1997).

The Actions of Directors

The story begins in June 1990, when a minority shareholder of Healthco acting on a belief that Healthco's stock was undervalued-began a proxy contest to remove the incumbent board. The proxy contest was resolved only after Hicks Muse, a major leveraged buyout firm, entered the picture as a "white knight" and the incumbent board agreed with the minority shareholder to replace three of the seven incumbent directors.

On March 26, 1991, the new Healthco board voted to sell the company to a subsidiary of Hicks Muse. As part of the process of determining to sell to Hicks Muse, the new board engaged in considerable activity of the kind that gives boards the protection of the business judgment rule.

The board took ample time to consider the matter and made extensive use of officers and expert consultants as sources of information and advice, receiving both oral and written reports. The new board met eleven times during its five and one-half months of existence prior to the vote to sell the company, with the meetings often lasting a number of hours and involving considerable discussion.

At nine of these meetings, an officer of the company gave a report to the board. Furthermore, the board received countless reports and advice from outside experts. Its law firm (Wachtell, Lipton, Rosen & Katz) attended nine of the eleven meetings and its investment banker (Lazard, Freres & Co.) attended eight.

In addition, the board heard from Bankers Trust Company and received a presentation from Hicks Muse in the presence of Hicks Muses' law firm (Weil, Gotshal & Manges) and a bank that was to be a major source of financing (Manufacturers Hanover Trust Company). The board, of course, had access to its outside accountants (Coopers & Lybrand) and the closing of the transaction was conditioned on receipt of a solvency opinion acceptable to counsel from a liquidity valuation firm (Valuation Research).

A report to the board by a Wachtell lawyer is particularly illuminating, as the following excerpt shows:

> [Counsel] said that in determining whether to proceed with the merger, the board ought to be guided by the business judgment rule, the elements of which he reviewed. He said that directors were not required to insure the success of the transaction; rather, they were required to exercise reasonable care in determining to move forward. In making this determination, he said that the board was entitled to rely on the opinions of experts such as Lazard Freres and Valuation Research, the firm which would provide the solvency opinion. Provided the board acted in accordance with the business judgment rule, it ought not to have any liability in the event the company were subsequently to become bankrupt and a fraudulent conveyance claim were made.

The board also took actions consistent with the special obligations required when a transaction involves the sale of a company. The directors attempted to maximize the corporation's value at a sale for the stockholders' benefit.

The new board engaged in extended negotiations with Hicks Muse, which was the most likely potential buyer identified by Lazard Freres after contacts with 47 firms.

The Bankruptcy

After the leveraged buyout, Healthco operated for some time. On July 2, 1992, more than one year after the date of the leveraged buyout transaction, new accountants hired by the company issued an audit report that contained an unqualified opinion. (That is, an opinion that the firm's financial statements were in accordance with generally accepted accounting practices and that did not question the firm's ability to continue as an on-going business).

But the company had operating problems, including a computer system that caused problems with inventory control and product deliveries. On June 9, 1993, more than two years after the consummation of the leveraged buyout, Healthco filed for relief under the Chapter 11 of Bankruptcy Code in the hope of reorganizing and continuing operations. On September 1, 1993, however, after the flight of its salespeople to competitors, the case was converted to Chapter 7 and the company was liquidated. Later, the Trustee in bankruptcy would claim that the proceeds of liquidation were $250 million less than the price paid for Healthco in the LBO.

The Bankruptcy Court

On June 7, 1995, the Bankruptcy Trustee began legal action in a United States Bankruptcy Court against 65 defendants—virtually all of the participants and their advisors in the transaction. With regard to the Healthco directors who had voted in favor of the sale, the Bankruptcy Trustee alleged that they had breached their fiduciary duty to Healthco and were personally liable for the failure of the leveraged buyout. (One should note that the trustee in a bankruptcy case often receives a percentage of any funds recovered from defendants.)

The defendant directors asked the Bankruptcy Court to dismiss the complaint. The defendant directors argued that their decision was protected by the business judgment rule. They said that they had met the duty of loyalty because they had no business dealings that would represent a disloyal act to the corporation or its shareholders, and stock ownership did not constitute an "interest" in the transaction that would be in conflict with the duty of loyalty.

They also argued that they had met the duty of care because they had acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company, consistent with *Smith v. Van Gorkom* (1985). Furthermore, they had attempted to maximize shareholder values, thus satisfying their duties under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (1986). The decisions in these two cases have provided strong precedents in the corporate governance field.

The Bankruptcy Court rejected the directors' arguments and refused to dismiss the case. On the contrary, the bankruptcy judge held that stock ownership by a director could render a director "interested" in the transaction, and, if the ownership interest was material, that interest would deprive the director of the protection of the business judgment rule. The bankruptcy judge reached this conclusion despite the Delaware Supreme Court's categorical rejection of that argument in a prior case. In *Unocal Corp. v. Mesa Petroleum Co.* (1985), the Delaware Supreme Court stated that a transaction does not become an "interested director transaction" merely because a director or directors are large shareholders.

The published decision of the bankruptcy judge, although purporting to apply Delaware law, seemed to represent a radical departure from previously established legal principles and accepted norms of conduct by directors under Delaware law. Fortunately for the directors (and for the cause of good corporate governance), the District Court declined to adopt the Bankruptcy Court's rulings that had dismissed the directors' "business judgment rule" defense and that had held that directors with a large shareholding interest were "interested parties" as a matter of law. Unfortunately, the District Court did not publish this decision and declined to review the Bankruptcy Court's refusal to grant the directors summary judgment. The District Court instead ordered that the issues be decided by a jury trial.

The Trial by Jury

The case was ultimately tried before a jury in the United States District Court in Worcester, Massachusetts in spring of 1997, with one of the authors (Parry) representing a defendant director. In order to meet the challenge

posed by the District Court's ruling, which required all corporate governance issues to be resolved by jury, the defendant directors relied on the testimony of the other author (Stobaugh) as an expert on corporate governance issues.

In his testimony, Professor Stobaugh explained to the jurors the generally accepted practices of directors. Although case law defines the duties of loyalty and care, the manner in which those duties are actually satisfied by directors is a question of "generally accepted practice." Stobaugh explained what is "generally accepted practice" based upon his years of study, teaching, and actual experience, and then compared the actions of the Healthco board with these practices.

As a matter of practice, it is unacceptable for a director to be financially interested in the subject of his or her business judgment in a way that is in conflict with the interests of the corporation and its shareholders. Indeed, such a conflict deprives a director of the protection of the business judgment rule. Stobaugh explained that this does not mean that a director should not own stock in the corporation. On the contrary, it is considered highly desirable for directors to own stock because this aligns their financial interests with the financial interests of the corporation and its shareholders. Thus, the stock ownership by Healthco directors was consistent with "generally accepted practice" (as well as being consistent with the recommendations of the NACD's Blue Ribbon Commission on Director Compensation). Stobaugh concluded that based upon generally accepted practice "no one could question the loyalty of directors to the corporation in deciding to approve the March 26th Agreement merely because they owned stock."

The Duty of Care

This duty requires that a director carry out his or her responsibilities in good faith, in a manner the director reasonably believes to be in the best interests of the corporation and its shareholders, and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. Stobaugh described the "generally accepted practices" used by directors in meeting this duty and concluded that the Healthco directors had acted in accordance with these practices. First, the board asked for and received advice from management and outside advisors Wachtell Lipton as legal advisors and Lazard Freres as investment bankers. Second, the board took adequate time to consider the matter, meeting many times and having extensive discussions. Third, once the board decided to sell the company, they attempted to obtain the best price for the company.

Following a seven-week trial, the jury returned a verdict in favor of all of the defendants on all of the claims.

Lessons from the Case

The *Healthco* case is not completely over—the plaintiff has appealed to the United States Court of Appeals for the First Circuit but its lessons are already clear. This landmark case illustrates the evolving and complex nature of directors' fiduciary duties in highly leveraged transactions. Even in areas of the law that were thought to be settled, like a director's ability to rely on the business judgment rule and the desirability of stock ownership, the *Healthco* case demonstrates that creative plaintiffs and the vagaries of the court system may force directors to defend their actions at trial.

The directors must retain advisers experienced in both consummating and defending highly leveraged transactions who will be familiar with the practicality of satisfying the duties of loyalty and care and who can design the deliberative process to ensure that the directors follow the "generally accepted practices" outlined above getting good professional advice and taking adequate time to consider it.

In many court venues, these actions will provide the directors with the protection of the business judgment rule so that the judge will grant summary judgment against the plaintiff. But if the judge does require a trial, persuasive evidence that the directors followed "generally accepted practices" will help convince a jury that the directors did not breach their fiduciary duties.

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