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Fiduciary Violations in Sale of Company

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Editor's Note: **Amy Simmerman** and **David Berger** are partners at Wilson Sonsini Goodrich & Rosati. This post is based on a WSGR memorandum by Ms. Simmerman, Mr. Berger, **Ryan Greecher**, **Brad Sorrels**, and **Nate Emeritz**. This post is part of the **Delaware law series**; links to other posts in the series are available **here**.

On June 21, 2019, Vice Chancellor Kathaleen S. McCormick of the Delaware Court of Chancery issued an opinion addressing a number of significant issues relating to the proper conduct of an M&A process. [1] In denying all defendants' motions to dismiss, the court first held that the selling company had failed to disclose certain material information to stockholders in seeking their approval of the deal, and as a result, the deferential standard of review set forth by the Delaware Supreme Court in *Corwin* did not apply to the transaction. As described in more detail below, the court further held, for purposes of a motion to dismiss, that the stockholder plaintiff adequately had alleged that the board breached its fiduciary duty of loyalty in managing various aspects of the sale process. The court also refused to dismiss the plaintiff's aiding and abetting and civil conspiracy claims against the selling company's longtime financial advisor that was also its largest stockholder, as well as against the acquiror of the company. The case provides a valuable reminder about potential pitfalls in M&A events and areas of potential risk in resulting stockholder litigation.

The Decision

The various claims in this case are based on a core set of allegations arising out of the plaintiff's second amended complaint. Those allegations included the following:

- the company's longtime financial advisor, who also owned 24 percent of the company's stock, engaged in discussions and negotiations with the buyer—with those discussions and negotiations including the financial advisor's CEO and personnel who continued advising the company on a potential restructuring of the company that would offer an alternative to a sale—for at least two months before the selling company's board was even aware of any sale discussions;
- during this two-month period and without informing the company, the financial advisor discussed price and shared confidential company information with the buyer—including as to a potential valuable divestiture that that the company could make (and ultimately did make after announcing the sale of the company) to increase the company's value;
- when the board eventually learned of the ongoing discussions, it did not properly manage the financial advisor's conduct (although it did ultimately hire another financial advisor to advise on the sale process);
- before supporting the deal, the selling company's CEO initially opposed the transaction as "too low" at an even higher price than the eventual sale price, while signaling that he might support a sale if adequate provision were made in the transaction for the company's management and employees;

- the board ultimately allowed the company's CEO to negotiate the compensation arrangements for management and employees at the same time he negotiated the sale price—and the total value of the compensation arrangements ($13 million) was nearly equal to a $13.5 million increase in consideration for stockholders that the target board asked for but the buyer rejected; and
- the board allowed a downward adjustment to the company's projections after the board approved the final deal price contingent on the new financial advisor issuing a fairness opinion on the transaction.

As an initial matter, the court concluded that because of various disclosure flaws relating to these issues, the selling company was not entitled to the benefit of Delaware's *Corwin* doctrine. [2] That doctrine provides that, so long as a controlling stockholder conflict does not exist, a fully informed vote of disinterested stockholders can eliminate most fiduciary duty claims—including claims relating to board conflicts or claims that a board failed to act appropriately under the *Revlon* case law to maximize the value of the selling company.

At this stage of the case, the court found three problems with defendants' disclosures. First, the court determined that the disclosures did not adequately describe the discussions between the company's longtime financial advisor and the buyer. The court criticized the company's "ambiguous statement" that the financial advisor had proposed "certain divestitures," which created "the misleading impression that the divestiture strategy was undeveloped." The court noted that, "[b]y contrast, the complaint portray[ed] a detailed [and] specific divestiture strategy informed by confidential financial information not previously disclosed to the stockholders." Second, the proxy statement was found to have failed to disclose the CEO's initial opposition to the deal and his alleged efforts to seek beneficial arrangements for management. Third, the court determined that the company should have disclosed the "more optimistic, earlier" projections and additional detail around the downward adjustment. The court therefore found that the plaintiff's claims were subject to the *Revlon* standard of review.

As for the underlying fiduciary duty claims against the board, the court concluded that, at least for purposes of a motion to dismiss, the plaintiff had adequately pleaded facts indicating that the board acted in bad faith in overseeing the sale process—such that the board potentially breached its duty of loyalty and could be subject to liability. Having to accept the plaintiff's well-pleaded allegations as true at this stage, the court concluded that the plaintiff had successfully alleged that "the director defendants knowingly placed [the CEO] in a position to extract compensation for management at the expense of the per share merger price received by the stockholders." Additionally, the plaintiff successfully alleged that the board "approved last-minute revisions to the company's projections that made the deal price more reasonable relative to the company's discounted cash flow valuation." In resting its conclusion on those grounds, the court declined to decide the plaintiff's additional argument that the board was on notice of the discussions between its longtime financial advisor and the buyer but did not properly manage that issue. On that point, the court noted that it was a "close call" whether the board's conduct amounted to a breach of the duty of care, for which the directors were exculpated from liability under the company's charter, or the duty of loyalty, for which the directors could not be exculpated.

For its part, the board maintained that it properly managed the process by, among other things, hiring a separate financial advisor once the board became suspicious of its longtime financial advisor's behavior and that the management compensation pool was aimed at retaining management in the event the transaction was not consummated. The court noted that the board could ultimately prevail on its arguments in a later stage of the case.

In addition to the claims against the board, the court refused to dismiss the plaintiff's claims of aiding and abetting and civil conspiracy against the company's longtime financial advisor and the buyer. As for the claims against that financial advisor, the court noted by conducting negotiations with the buyer for two months before the board was involved—and allegedly failing to inform the board in full about those discussions once the board demanded more information—the financial advisor created the type of "informational vacuum" for the board that can satisfy the "knowing participation" element of an aiding and abetting claim. As for the claims against the buyer, the court observed that the allegations were "less compelling" but emphasized the buyer's use of the financial advisor to pressure the board into accepting a merger, the buyer's acceptance of confidential company information, and the buyer's "exploitation" of the seller CEO's conflict in negotiations.

Finally, it is worthwhile to note that in a prior phase of the litigation, the plaintiff alleged that the discussions between the longtime financial advisor and the buyer ran afoul of Delaware's anti-takeover statute (Section 203 of the Delaware General Corporation Law). Although the selling company ultimately addressed those allegations by amending its disclosures and obtaining the high stockholder vote that can be triggered under Section 203, the plaintiff used documents obtained in discovery related to those allegations to amend its complaint and add the claims for breach of fiduciary duties, aiding and abetting, and civil conspiracy that were allowed to proceed in this opinion.

Takeaways

This new decision highlights several issues that are important to the Delaware courts and that, if not properly managed, can expose a board and other parties to risk, particularly at the pleading stage of the litigation. In the view of the Delaware case law, the board has a paramount role in the governance of a company and a sale process. Given that role, the board is expected to exert proper control over management and advisors in connection with a sale process and to address any conflicts that arise, whether on the part of management or advisors and whether the board anticipates the conflicts or learns of them after the fact. As part of this role, it is important that the board be involved at the beginning stage of any serious effort that could result in a sale of the company.

The case is also an important reminder that in a sale of control under *Revlon*, the board must remain focused on stockholder value, and any compensation arrangements entered into with management in connection with a sale of control must be viewed within the framework of how such arrangements benefit stockholders. Although boards generally have considerable flexibility in determining most management compensation issues, in the context of a change of control transaction, that flexibility may be limited and any such arrangements may be the subject of scrutiny.

Additionally, the case is yet another reminder about the importance of disclosing projections to stockholders. Projections have, for many years, been a lightning rod in Court of Chancery litigation and must be thoughtfully handled and appropriately disclosed along with other key facts about a transaction.

Finally, the case reflects the uptick in recent years of certain themes in stockholder litigation that occasionally gain traction: in particular, technical claims (such as the Section 203 claim in this case) and aiding and abetting claims against various parties—advisors, significant stockholders, and acquirors.

Endnotes

[1] *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, C.A. No. 2017-0421-KSJM (Del. Ch. June 21, 2019).
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[2] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015).
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