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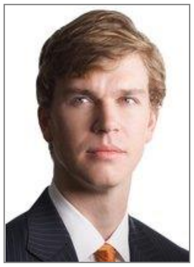
Chancery Ruling Offers Takeaways On Conflicts In M&A Sales

By **Sawyer Duncan** (September 18, 2020, 5:53 PM EDT)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A recent decision in the Delaware Court of Chancery dismissed claims for breach of fiduciary duty against the board of directors and management of Outerwall Inc. in its $1.6 billion sale to private equity fund Apollo Global Management LLC that was precipitated by an activist investor's threat of a proxy contest against the Outerwall board unless a sale process was conducted.

A class of Outerwall stockholders alleged that the Outerwall board was conflicted in its 2016 decision to sell the company and that the $52 per share consideration in the tender offer transaction was grossly inadequate. After oral argument and additional briefing, Vice Chancellor Morgan T. Zurn ruled that because the plaintiff-stockholder class could not establish that the board or management executives were conflicted or disloyal, its claims against the board were exculpated by Outerwall's charter and must be dismissed.

The class action's allegation of disloyalty against the lone nondirector defendant, Outerwall's ex-chief financial officer whom Apollo later retained as the CEO of a key division of the post-closing business, was also dismissed as insufficiently credible.

The opinion in Rudd v. Brown provides valuable insight in the context of conflicts of interest and fiduciary duties of boards and management executives during M&A sales processes completed amid threats of activist-driven proxy contests. This article discusses the decision and offers some practice points for boards and executives in light of the Chancery's analysis of the case.

Background

Outerwall was a Nasdaq-listed company that operated across three distinct segments: (1) Redbox Automated Retail LLC, where consumers could rent or purchase movies and video games from self-service kiosks; (2) Coinstar LLC, where consumers could convert their coins to cash and convert coins and cash to stored value products at self-service kiosks; and (3) ecoATM, where consumers could sell certain electronic devices for cash at self-service kiosks.

Outerwall's corporate certificate of incorporation contained a provision adopted pursuant to Title 8 of the Delaware Code, Section 102(b)(7), exculpating its directors from personal liability to the company to the fullest extent permitted by Delaware law.

In the months and years leading up to the Apollo sale transaction, Outerwall continually assured investors that it was poised for substantial long-term growth. But the business became troubled at the end of 2015.

On Dec. 7, 2015, Outerwall provided an update on its financial expectations for the full year 2015. The revised outlook reflected lower Redbox segment revenue than expected for the fourth quarter of 2015 based on preliminary results through the end of November and expectations for December 2015, as well as the expected write-off of certain capitalized assets associated with one of its potential new business concepts, which the company decided to discontinue. Outerwall's stock price dropped precipitously following this news.

In early February 2016, Engaged Capital LLC, an activist investor, disclosed that it had accumulated a 14.1% position in Outerwall's common stock. Apart from Outerwall, Engaged was known to be in the business of launching aggressive campaigns pressuring directors and executives of numerous companies to force change — such as M&A sale processes — or face ouster from their boards.

Shortly thereafter, Engaged disclosed that it had increased its position to 14.6% of Outerwall's stock with a copy of a letter and slide deck presentation Engaged sent to the board the same day. Engaged's letter stated that Outerwall's then-chairman had refused to meet with Engaged, and that other Outerwall directors also refused to participate in dialogue.

Engaged also assailed Outerwall's board and management, claiming that Outerwall was "significantly (and persistently) undervalued by the market" and that "[u]pside is material and can be achieved quickly."

Engaged then delivered an ultimatum that the Outerwall board should immediately retain financial advisers and begin a sales process with the goal of taking the company private. After referencing "credible suspicions regarding the Board's past refusals to engage with interested parties," Engaged threatened: "If the Board continues to fail to act in the best interests of shareholders, we will give shareholders the opportunity to hold the Board accountable at the upcoming annual meeting by seeking to replace multiple directors."

Morgan Stanley assisted Outerwall in conducting a full auction process, that resulted in an active bidding war for the company. As the auction process progressed, Outerwall entered into a cooperation agreement with Engaged in April 2016, whereby Engaged agreed not to launch a proxy fight and to support Outerwall's director nominees at the upcoming stockholder meeting in exchange for the ability to appoint one board member effective immediately.

Engaged then appointed a director to the Outerwall board. Outerwall further agreed to expand the board from seven to nine seats, and to allow Engaged to appoint directors to those two vacant seats on or before Aug. 1, 2016. According to the complaint, this date essentially provided a deadline for the board to negotiate a sale or be swamped by Engaged appointees.

Apollo ended up submitting the highest bid of $52 per share. Apollo's bid represented a 92% premium over the closing price of Outerwall's stock on the last trading day before Engaged filed its Schedule 13D, and a 51% premium over Outerwall's closing price on the last trading day before the company announced it was exploring strategic alternatives. The sale closed in September 2016.

The plaintiff-stockholders filed suit in the Chancery Court in September 2019, alleging that the transaction consideration was inadequate and that Outerwall's directors and ex-chief financial officer, who was heavily involved in the sale process and deal negotiations, breached their fiduciary duties in connection with the deal.

The Outerwall defendants moved to dismiss on grounds that the claims were (1) time-barred, (2) subject to dismissal under Corwin since the tender to Apollo by nearly 70% of Outerwall stockholders represented "a fully informed, uncoerced majority of the disinterested stockholders," and (3) exculpated under the company's charter. Ultimately, the court concluded that the plaintiffs failed to plead that the director-defendants breached their duties of loyalty and failed to state a claim against the officer-defendant.

Discussion

An exculpatory provision in a Delaware target's corporate charter provides a meaningful shield against Revlon claims arising from an otherwise unconflicted, good faith M&A sale process conducted with due care.

Even under enhanced Revlon scrutiny, an exculpatory charter provision shields defendant directors from monetary liability where the underlying claims for a breach of fiduciary duties in conducting the sale are based only on duty of care violations, without facts sufficient to plead that a majority of the board was not disinterested or independent or that the board was otherwise disloyal because it failed to act in good faith in approving the transaction.

Thus, stockholder claims against directors who are exculpated under their company's charter must marshal additional evidence that those directors' conduct exceeded mere careless or negligence. In Rudd, there was no other indicia of the Outerwall directors' lack of disinterestedness or independence. As further discussed below, Delaware courts will not presume disloyalty via circumstantial inference alone.

A board that explores or completes a sale process in response to a threat posed by an activist investor does not necessarily give rise to a conflict of interest without other indicia of disloyalty.

In attempt to circumvent the exculpatory provision in Outerwall's charter, the plaintiffs alleged that the threat of a proxy contest by Engaged against the incumbent directors constituted a nonexculpated conflict of interest on the theory that the deal allowed the board to avoid the negative public scrutiny and loss of board seats that they anticipated by virtue of the actions taken by Engaged.

Although plaintiffs advanced three previous Delaware decisions[1] where an activist conflict of interest was found to have arisen in the shadow of a proxy contest, but those cases were quickly distinguished. Vice Chancellor Zurn noted that Delaware courts have expressed reluctance to find that directors are conflicted simply because they operate under the threat of a proxy contest.

The threat of a looming proxy contest might inform the inference of conflict at the pleading stage only when coupled with other pled facts. Where none exist to be pled, dismissal at the pleading stage may be appropriate.

A CEO-director that stands to benefit from sale of her company by way of accelerated stock vesting and change-in-control payments will not be presumed to have violated the duty of loyalty in

approving and working to complete a sale process without specific evidence of bad faith or self-interest.

Outerwall's CEO-director stood to earn over $13 million from the vesting and acceleration of his equity awards as well as from other golden parachute-related payments in connection with the sale. Since a substantial equity ownership interest in the company aligns an executive's interest with those of the company's stockholders, Delaware courts have thus "routinely held that an interest in options vesting does not violate the duty of loyalty."

More generally, "[t]he possibility of receiving change-in-control benefits pursuant to pre-existing employment agreements does not create a disqualifying interest as a matter of law." In fact, the defendants explained that the compensation due to the CEO-director, overwhelmingly consisting of equity, evidenced his strong motivation to maximize the deal price in a Revlon-compliant manner.

The independence of a director that was appointed by an activist stockholder agitating for the target's exploration of strategic alternatives is not necessarily compromised by voting in favor of a change of control transaction, absent more specific factual development supporting her disloyalty.

The lawsuit asserted that the director appointed by Engaged was conflicted by way of such appointment and "put forth Engaged's objective of exiting its investment in Outerwall" ahead of the interests of Outerwall stockholders. In defense, defendants' reply brief countered that plaintiffs were unable to explain why Engaged would not have the same interest as every other Outerwall stockholder — to obtain the highest possible price for its shares.

The Rudd opinion noted that Delaware law is clear that a director's independence is not necessarily compromised by virtue of his status as a stockholder appointee.[2] Just because an activist-appointed director ultimately votes to approve a sale transaction does not necessarily impugn his independence without more concrete evidence of a conflict.

An executive that is later retained for employment by the buyer following a takeover will not be presumed to have been conflicted where there are insufficient facts to infer that such executive's involvement in the sale process was disloyal or inappropriate.

As an officer of the company, but not a director, Outerwall's ex-CFO Galen Smith was not protected by the exculpatory charter provision. The plaintiffs alleged that Smith was conflicted due to his purported interest in securing post-close employment upon completion of the deal. In support of this inference, plaintiffs alleged only that, during the deal negotiations, Apollo conveyed that it intended to retain the then-current CFO of Outerwall and the rest of his management team to carry out its post-closing strategic plan.

No other facts were presented in support of the alleged conflict. And Outerwall's proxy disclosure, the veracity of which was not challenged in the suit, was clear that "[n]either [Apollo] nor any other potential bidder engaged in any discussions regarding the retention of the Company's executive officers and/or directors during the negotiation and bid submission process."

The opinion observed that allegations of management involvement in the sale process, without more, do not provide sufficient evidence of a credible basis to infer that the sale process was corrupted by management's self-interest in the pursuit of post-closing employment terms. The court accordingly dismissed the claim against Smith as well.

Practice Points

Boards should feel free to explore strategic alternatives at the behest of activists, so long as they conduct such activities with due care and use sound process.

An activist threat alone will not jeopardize the directors' independence so long as transaction process is structured in a way that maximizes stockholder value and avoids bad faith omissions of material information to stockholders considering whether to vote in favor the deal.

Where the board's execution of a transaction process remains otherwise above reproach — by working with top-flight advisers and creating a careful record of propriety in their negotiations — a proxy contest or other activist agitation will not serve to create a presumption of a conflict, and the mere decision to announce publicly that a company was exploring strategic options is not itself a breach of the duty of loyalty.

There is no single blueprint to fulfilling fiduciary duties under Revlon.

Courts continue to give boards wide latitude to select a reasonable best path to value maximization. Although the Revlon doctrine imposes enhanced judicial scrutiny of certain transactions involving a sale of control, it does not eliminate the basic requirement that plaintiffs plead sufficient facts to support the underlying claims for a breach of fiduciary duties in conducting the sale.

Corwin deference may be available in a tender offer transaction where no facts exist that deal disclosure was materially misleading.

The Rudd opinion did not address defendants' argument that the sale transaction's tender offer structure, which garnered support from nearly 70% of Outerwall stockholders, deserved Corwin deference because it was thusly the product of an uncoerced, informed stockholder vote.

The plaintiffs did not allege that the deal constituted waste or that the tendering stockholders were coerced. In such situations, and where plaintiffs are unable to allege false disclosures or bad faith omissions, the cleansing effect of the Corwin doctrine may well serve as a continued shield against fiduciary liability.

Clear proxy disclosure and sound process mitigates risk of fiduciary duty litigation.

Outerwall's proxy disclosure that the executives did not discuss their post-closing arrangements with the acquiror prevented the plaintiffs from advancing their conflict claims against the executives.

Of course, in order to viably make such a disclosure, the facts and transaction record must support it. Appointing a special committee when appropriate and ensuring potentially interested management executives to refrain from negotiations about post-closing matters remains best practice to avoiding the kind of liability sought in Rudd.

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This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] In re: Tangoe Inc. Stockholders Litig., No. CV 2017-0650-JRS, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018); Kosseff v. Ciocia, No. CIV.A. 188-N, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006); and In re PLX Technology Inc. Stockholders Litigation, C.A. No. 9880-VCL (Del. Ch. Sept. 3, 2015).

[2] See, e.g.,KKR Fin. Hldgs. LLC S'holder Litig., 101 A.3d 980, 996 (Del. Ch. 2014); and Sheldon v. Pinto Tech. Ventures, L.P., 2019 WL 4892348, at *5 & n.38 (Del. Oct. 4, 2019)(collecting cases).