When Activists Are At The Gate: Lessons From Chancery

By **Edward Micheletti, Jessica Kunz and Chad Davis**

Edward Micheletti

Several recent decisions applying Delaware law offer helpful insight about the impact that activist investor involvement has on board decision-making leading to a transaction, and how those decisions will be reviewed by the courts in any subsequent litigation. These cases demonstrate the importance of careful responses by boards of directors to satisfy their fiduciary duties in the face of activist pressure. Discussed below is a case addressing the implications of activism in the context of the Corwin doctrine[1] and three cases addressing the potential effect activist involvement can have on the judicial standard of review of a transaction.

Corwin and Activism

Jessica Kunz

In Morrison v. Berry,[2] Vice Chancellor Sam Glasscock III dismissed an action challenging the sale of The Fresh Market to the private equity fund Apollo Management LP. The court observed the facts presented a fairly straightforward and "exemplary case" of the "utility" of the ratification doctrine set out in Corwin.[3] One aspect of the decision warrants particular focus: The court provides an example of a disclosure concerning activist pressure faced by Fresh Market that passed muster for Corwin purposes.

Fresh Market's founder, a then-board member and 10 percent stockholder, allegedly sought out a private equity buyer without the knowledge of the other members of the board and reached a preliminary agreement with Apollo to roll over his shares. After the agreement, Apollo made an unsolicited offer to acquire Fresh Market. The board formed a special committee, which recommended stockholders accept the offer, and a majority of the disinterested shares tendered. Among other challenges raised in the deal litigation that followed, the plaintiff alleged that an activist stockholder pressured the board to sell Fresh Market.

On a motion to dismiss, the defendants argued that the Corwin ratification doctrine applied and required dismissal. For Corwin to apply, the stockholder vote approving the challenged transaction must be "fully informed,"[4] and in Morrison, one of the disclosure challenges asserted by the plaintiff targeted the activist issue. In particular, the plaintiff alleged "that the Schedule 14D-9 conceal[ed] the pressure on the Board from activist stockholders to sell the Company by failing to specifically mention a letter from Neuberger Berman, one of the Company's significant stockholders, expressing its view that the Board should consider selling the Company."[5] Even though the specifics of the letter were not disclosed, the court rejected the disclosure challenge. The court observed the board had disclosed "that the Company 'could become the subject of shareholder pressure and communications' if it didn't 'enhance efficiency,' and in fact already 'initiate[d] a comprehensive strategic review' and 'hir[ed] outside financial advisers' as recommended by Neuberger Berman."[6] The court found that this level of disclosure was adequate, which formed part of the court's ultimate decision to dismiss the case under Corwin.

Activist Pressure and the Judicial Standard of Review

Three recent cases involving allegations concerning activist stockholder pressure resulted in three different standards of review: business judgment, enhanced scrutiny and entire fairness. These cases, discussed below, demonstrate that there is no "one size fits all" approach to how a court will review board conduct and decision-making in response to activist involvement and that careful attention to facts, and reliance on advisers before making decisions, is crucial in these circumstances.

In August 2017, Chancellor Andre G. Bouchard applied the business judgment rule to dismiss a post-closing damages action that challenged a strategic stock-for-stock merger of equals in In re MeadWestvaco Stockholders Litigation.[7] In finding that the stockholder plaintiffs failed to plead a nonexculpated breach of fiduciary duty, the court observed that "[t]he thesis of the complaint is that the directors entered into the merger in bad faith in reaction to a threatened proxy contest by an activist investor."[8]

Shortly after the publication of an analyst note proposing a merger between MeadWestvaco Corp. and Rock-Tenn Co., "well-known activist firm" Starboard Value LP began purchasing MeadWestvaco stock.[9] Over the next few months, Starboard pressed for changes that it claimed would "enhance[e] the company's value," including a possible merger with Rock-Tenn.[10] Shortly before MeadWestvaco broke off merger negotiations, its board met with Starboard. In the following weeks, Starboard increased its ownership stake in the company and, signaling a proxy fight, announced it had signed an advisory agreement with a high-level industry player. MeadWestvaco resumed merger negotiations with Rock-Tenn, which ultimately resulted in the board's unanimous approval of the merger, which represented a 9.1 percent premium for MeadWestvaco shares. The transaction was approved by MeadWestvaco stockholders, with 98 percent of voting shares cast in favor of the transaction.

Stockholders sued post-closing for money damages, alleging breaches of fiduciary duty by the board in connection with the transaction. In light of MeadWestvaco's Section 102(b)(7) charter provision exculpating its directors from personal liability for any breach of the duty of care, the court found that the board's decision to approve the merger was presumptively governed by the business judgment rule, and thus a post-closing damages claim could survive a motion to dismiss only if the complaint alleged facts from which it could reasonably be inferred that either (1) a majority of the board was not both disinterested and independent, or (2) the board acted in bad faith.

Among other things, the plaintiffs argued that Starboard's presence was the "impetus" for the board's decision to engage in the negotiations with Rock-Tenn that led to the merger.[11] However, the court found the complaint "devoid of any allegations calling into question the disinterestedness or independence" of a majority of the MeadWestvaco board.[12] The court likewise found that the plaintiffs had failed to meet the "difficult standard" required to state a claim for bad faith.[13] To wit, the court observed that the plaintiffs' pleadings demonstrated the board's active engagement in the process and that there was no basis to infer the directors disregarded their duties or took any inexplicable actions based on Starboard's involvement. Rejecting the plaintiffs' theory that the merger price was "essentially inexplicable on any ground other than bad faith," the court observed that nowhere did the complaint suggest that "Starboard expressed any opposition to the merger price or believed that the MeadWestvaco directors left any additional value behind."[14]

A July 2017 decision by the Maryland Circuit Court applying Delaware law, In re American Capital Ltd. Shareholder Litigation,[15] stands in contrast to In re MeadWestvaco and highlights facts that could lead a court to apply the entire fairness standard of review in cases involving activist pressure. Interestingly, this matter is one where the activist itself got swept into the deal litigation arising from the transaction that it had allegedly pressured the board to approve.

American Capital Ltd. announced a plan to split up and spin off a majority of the company's assets into two public entities, each of which would be managed by the company. Shortly after the company filed a preliminary proxy statement in favor of the spinoff, activist investor Elliott Management Corp. announced that it had acquired an 8.4 percent economic interest in the company. Elliott launched a proxy solicitation against the spinoff, urged the board to undertake a strategic review process, and threatened to seek to replace the board. The board undertook a strategic review, during which Elliott's stake increased incrementally to 15.9 percent as a result of share buybacks. Following the strategic review, the board executed a merger agreement with Ares Capital Corp., pursuant to which Ares would acquire the company for a mix of cash and stock. The board also signed a settlement agreement with Elliott, providing Elliott several concessions, including certain board seats if the merger did not close and reimbursement of up to $3 million of fees and expenses.

Stockholders filed suit challenging the transaction and later amended their complaint to add Elliott and certain of its affiliates as named defendants. Although the suit was filed prior to the transaction closing, the plaintiffs abandoned their efforts for injunctive relief. Post-closing, all defendants moved to dismiss the operative complaint, but claims against the board of directors for breach of fiduciary duty were settled shortly before the hearing on the motion. Elliott proceeded to a hearing on its motion to dismiss, which was denied.

The court held the transaction was subject to entire fairness review because the plaintiffs had stated a claim that Elliott, despite owning only a 15.9 percent economic interest, controlled and/or dominated the board with respect to the Ares merger.[16] According to the court, the complaint alleged that "Elliott not only triggered the ultimate sale to Ares, but also had regular, detailed, and intimate knowledge of nearly every facet of the board's decision-making process."[17] The court further found that "[i]f the facts pleaded [we]re true, Elliott had access to the board, its advisors, and all deal information to an exquisite degree" and supported the inference that Elliott "acted as a de facto member" of the board.[18] The court also took issue with the board's reimbursement of Elliott's expenses as part of its settlement agreement, noting that there was no legitimate explanation given for the company compensating Elliott for "advising" it when it was already advised by two reputable investment banks.[19]

Finally, in March 2017, in venBio Select Advisor LLC v. Goldenberg,[20] Vice Chancellor J. Travis Laster applied enhanced scrutiny[21] and issued a temporary restraining order (TRO) blocking a "transformational transaction" entered in the midst of a proxy contest.[22] This time, the plaintiff was the activist stockholder itself. The nominal defendant, Immunomedics Inc., a pharmaceutical company with a promising new cancer drug, was in a long-running process of identifying a partner for the licensing and distribution of its new drug. The company's largest stockholder, venBio, contended that the licensing process for the promising drug was taking too long and launched a proxy contest to replace the board in the upcoming annual meeting. VenBio announced in November 2016 its intent to nominate four directors for the company's board, which at the time had five seats. On Feb. 9, 2017, a preliminary count of proxies submitted indicated that the venBio slate would likely defeat the incumbents.

On Feb. 10, 2017, the board responded by, among other things, allegedly cutting short the ongoing process of finding a licensing and distribution partner, and announced the execution of a licensing agreement with one of the remaining bidders. venBio moved for a TRO to block the closing of the licensing transaction. According to venBio, the signing of the licensing agreement was an attempt by the incumbents to weaken venBio's proxy challenge. The court noted that Delaware case law teaches "that when incumbent directors act to affect the outcome of a proxy contest, they act against a specter of self-interest."[23] The court described the standard of review of such actions as falling between entire fairness and business judgment. The court granted the TRO, finding that the plaintiffs stated a colorable claim that the directors' self-interest in prevailing in the proxy contest tainted the licensing agreement decision. Thereafter, a settlement was reached between certain parties, and the matter is currently stayed.

Key Takeaways

- Board members faced with activist pressure need to be mindful at all pertinent times of their duties of care and loyalty owed to stockholders when taking steps to address or consider such pressure. There is no specific "road map" to be followed by a board when faced with a stockholder request to pursue a particular course of action. The board should be guided by its fiduciary duties.

- A board's decision as to whether to undertake any particular action should be based on the totality of information available and not solely in response to the demands of a particular stockholder. In other words, directors should inform themselves about requests received from activists but are not required to implement them.

- If, after receiving pressure from activist stockholders, a board determines to pursue a particular strategy or to enter into a transaction to sell the company, careful consideration of the company's disclosure obligations is appropriate, especially when the transaction structure permits the potential application of the Corwin defense to dismiss any post-closing litigation.

- Different standards of review can apply to board decisions that are made in the face of activist involvement. The facts and circumstances of each situation or transaction will dictate what standard of review will apply and how much leeway the court will have to "second guess" the board's process and decision-making. This underscores the importance for boards to retain and rely on knowledgeable and experienced legal and financial advisers during any process where activist involvement or pressure is occurring.

- The recent decisions discussed in this article underscore the importance of running a careful process when responding to proposals by activists. They demonstrate the need for boards to reach an independent determination regarding the merits of an activist's proposal for a company, recognizing that an activist stockholder is but one stockholder and the board's fiduciary duties run to all stockholders.

Edward B. Micheletti is a partner at Skadden Arps Slate Meagher & Flom LLP and heads the firm's Wilmington, Delaware, litigation practice. Jessica R. Kunz is an associate and Chad Davis is a law clerk in Skadden's Wilmington office.

taken as legal advice.

[1] See Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304 (Del. 2015).

[2] Morrison v. Berry, C.A. No. 12808-VCG, 2017 WL 4317252 (Del. Ch. Sept. 28, 2017).

[3] Id. at *1.

[4] The court observed the applicability of Corwin to tender offers. Id. at *1 n.13.

[5] Id. at *3 (internal quotations omitted).

[6] Id. (alterations in original) (internal footnotes omitted) (quoting the company's 14D-9 and plaintiff's complaint).

[7] In re MeadWestvaco Stockholders Litig., C.A. No. 10617-CB, 2017 WL 3526326 (Del. Ch. Aug. 17, 2017).

[8] Id. at *1.

[9] Id. at *2.

[10] Id. at *3.

[11] Id. at *6.

[12] Id.

[13] Id. at *6-7.

[14] Id. at *9.

[15] Case No. 422598-V (Md. Cir. Ct. July 12, 2017).

[16] See id. at *29-31. In making this finding, the Maryland court distinguished a prior Delaware Court of Chancery decision in In re Novell Inc. S'holder Litig., C.A. No. 6032-VCN, 2013 WL 322560, at *12 (Del. Ch. Jan. 3, 2013) (finding that, standing alone, the "possible initiation of a proxy contest is not sufficient to establish domination and control, or to create a disqualifying interest" in a case where Elliott was agitating for a sale of a different company but only owned 7.1 percent of the company and had no representation on the board noting that inducing the board to consider the advisability of a sale, and "obtaining the desired response" is not sufficient to demonstrate control). The Maryland court found "the facts alleged are quite different than those outlined in Novell," including that Novell lacked allegations of actual undue influence on the board. See In re American Capital, Case No. 422598-V, at *31.

[17] In re American Capital, Case No. 422598-V, at *18.

[18] Id. at *32.

[19] Id. at *32-33.

[20] C.A. No. 2017-0108-JTL (Mar. 9, 2017) (TRANSCRIPT).

[21] The decision did not explicitly indicate what specific line of enhanced scrutiny it was adopting; however, it appears that Vice Chancellor Laster applied Unocal, as the transcript decision does not expressly discuss the "compelling justification" standard of Blasius. See

id. at 70-72 (citing Mercier v. Inter-Tel (Delaware) Inc., 929 A.2d 786 (Del. Ch. 2007) (discussing overlap of Blasius and Unocal)).

[22] Id. at 60.

[23] Id. at 71.
