Insights: The Delaware Edition

Skadden

December 2023

Contents

1 / Court of Chancery Finds Officer Liable for Competing With Corporation and Misappropriating Trade Secrets

4 / 'Busted Deals' and Damages: Court of Chancery Clarifies Who Can Recover 'Lost-Premium' Damages

7 / Books and Records Demands 2023 Recap: Courts Continue To Develop the Law Regarding the Scope of Inspection

11 / Real World Examples Where Conflicts Tainted a Deal Process, and Other Deals That Were Insulated From Conflicts

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

A recent Court of Chancery ruling underscores that corporate directors and officers who are planning to provide services to a second entity must understand the interplay between the new roles and duties that they wish to undertake and their current obligations and fiduciary duties to their existing employer or affiliates. The court has also clarified who can recover "lost-premium" damages, established a new process for books and records demands, and provided guidance on ways boards can protect the integrity of a deal where a key figure has a conflict.

Court of Chancery Finds Officer Liable for Competing With Corporation and Misappropriating Trade Secrets

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> See page 3 for key points

On September 1, 2023, Vice Chancellor Paul A. Fioravanti, Jr. of the Court of Chancery delivered a decision finding that the president of a plaintiff company and a second business the president had formed and served simultaneously were liable for his misappropriation of trade secrets, breach of contract and breaches of his fiduciary duty of loyalty to the plaintiff.

In *Sorrento Therapeutics, Inc. et al. v. Anthony Mack et al.*, C.A. No. 2021-0210-PAF (Del. Ch.) (Sept. 1, 2023), the court rejected former Scilex Pharmaceuticals Inc. President Anthony Mack's defenses that his work for his other company that also operated in the pain-management space, Virpax Pharmaceuticals Inc. (Virpax), did not breach both a non-compete clause in a Restrictive Covenants Agreement (RCA) and his duty of loyalty to Scilex as an officer of the company.

The court also held that documents Mack downloaded from Scilex servers for use by Virpax constituted misappropriation of trade secrets. Additionally, the court found Virpax liable for interfering with the RCA, aiding and abetting Mack's breaches of his fiduciary duties and misappropriation of trade secrets.

Background

Defendant Mack founded and served as president of Scilex. Following its November 2016 acquisition, Scilex became a subsidiary of Sorrento Therapeutics, Inc. Mack agreed to stay on as president of Scilex, and entered into the RCA with Sorrento. The RCA restricted Mack from "directly or indirectly" engaging in activities that competed with Scilex in developing pain-management products for a two-year period.

On the same day that Mack signed his offer letter to remain as president of Scilex, he formed Virpax Pharmaceuticals, LLC (Virpax LLC). Several months later, he formed Virpax, the defendant in this case. Virpax LLC owns a 20% interest in Virpax, which went public in 2021.

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As president of Scilex, Mack was tasked with identifying products for licensing and commercialization. In November 2016, Scilex was working on approvals for a pain-management product called ZTlido.

After trial, the court found that, through Virpax, Mack pursued development and obtained licenses for three different pain-management products that had first been offered to Scilex. The evidence also showed that Mack pursued these opportunities while simultaneously excluding Scilex from discussions, yet he used Scilex assets to benefit Virpax in its efforts. Mack also downloaded and kept for Virpax more than 1,000 Scilex documents prior to resigning from Scilex.

Following Mack's resignation from Scilex, the plaintiffs brought suit arguing, among other things, that Mack had breached both the RCA and his fiduciary duty of loyalty, and misappropriated trade secrets when he pursued the development of pain-management products on behalf of Virpax instead of Scilex. The plaintiffs also sued Virpax alleging tortious interference with the RCA, and aiding and abetting Mack's breaches of fiduciary duty and misappropriation of trade secrets.

Claims Against Mack

Breach of Contract

Applying California law, the court found that Mack breached the non-compete provisions in the RCA. While California law broadly prohibits non-compete agreements, there is an exception for agreements executed in connection with the sale of a business. The court found that the sale of Scilex to Sorrento fell squarely within this exception, and that Mack's efforts to license pain-management products for Virpax violated the RCA.

Breaches of the Fiduciary Duty of Loyalty

The court also addressed the plaintiffs' claims that Mack violated his fiduciary duty of loyalty by usurping Scilex's development opportunities and by misappropriating Scilex's corporate assets for the benefit of Virpax.

The court rejected Mack's argument that the fiduciary duty claims were simply duplicative of the breach of RCA claims, finding that the fiduciary duty claims depended on additional facts, were broader in scope and involved different considerations in terms of a potential remedy.

The court also rejected Mack's argument that he did not usurp a corporate opportunity because Scilex and Sorrento would not have been able to commit resources to new development projects. The court explained that, while it may have been unlikely that Scilex would pursue new projects, the issue here was the company's ability to pursue the opportunity, not the board's likelihood of actually deciding to do so.

Regarding Mack's misappropriation of Scilex's assets to benefit Virpax, the court characterized Mack's conduct as "inapposite to the standard of conduct for a corporate fiduciary."

Claims Against Virpax

Virpax was found liable for both tortiously interfering with Mack's RCA with Sorrento, as well as aiding and abetting Mack's breaches of fiduciary duty.

Applying Delaware law, the court imputed Mack's knowledge of the RCA and the development of Scilex's products to Virpax. The court rejected Virpax's argument that it possessed an "interference privilege" because its business interests were aligned with Mack's. Virpax was not a "stranger" to the RCA or the business relationship between Mack and Scilex as a result of being imputed with Mack's knowledge, the court said. Thus, Virpax's "general business interest in competing in the pain management marketplace," was outweighed by Mack's contractual obligations to Scilex.

For the same reasons, the court also held Virpax liable for aiding and abetting Mack's breaches of fiduciary duty to Scilex. Because Mack's knowledge could be imputed to Virpax, the company was deemed to have "knowingly participated" in the breaches of duty.

Misappropriation of Trade Secrets

Both Mack and Virpax were also found liable for misappropriation of Scilex's trade secrets. While the plaintiffs originally sought to establish that each of the more than 1,000 Scilex documents downloaded by Mack were

protected trade secrets, they presented only a handful of those documents at trial, and the court ultimately found that only five fit the criteria.

The court rejected the defendants' argument that Scilex's knowledge of the existence of the defendants' competitive activities meant it acquiesced in Virpax's use of Scilex's trade secrets because the plaintiffs lacked full knowledge as a result of Mack's active concealment of his ventures with Virpax from key Scilex and Sorrento personnel.

The court reserved ruling on an appropriate remedy pending additional submissions from the parties.

Key Points

- Corporate directors and officers who are planning to provide assistance or services to a second entity should consult with an attorney to understand the interplay between the new roles and duties that they wish to undertake and their current contractual obligations and fiduciary duties to their existing employer or affiliates.
- It is vital that companies be aware of and understand the outside business pursuits of their corporate officers. Companies should consult with counsel to ensure officers maintain appropriate focus on, and loyalty to, the company, and to implement disclosure requirements in the event of potential competing interests.

'Busted Deals' and Damages: Court of Chancery Clarifies Who Can Recover 'Lost-Premium' Damages

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> See page 6 for key points

In October 2023, Chancellor Kathaleen St. J. McCormick of the Court of Chancery addressed an issue of first impression in *Crispo v. Musk*, C.A. No 2022-0666-KSJM, holding that "a provision purporting to define a target company's damages to include lost-premium damages [in a busted deal] cannot be enforced by the target company" and if "a damages-definition provision purports to define lost-premium damages as exclusive to the target … it is unenforceable."

The court's ruling arose in a "curious procedural context": the plaintiff's petition for a $3 million mootness fee. The plaintiff contended that his stockholder class action played a causal role in forcing Elon Musk's buyout of Twitter to close.

Amid the Twitter/Musk litigation, the plaintiff had filed suit seeking to specifically enforce the merger agreement as a third-party beneficiary and alleging that Musk breached his duties as a *de facto* controller of Twitter. Before the deal closed, the court dismissed nearly all of the plaintiff's claims, but left open the theoretical question of whether the merger agreement permitted stockholders to seek "lost stockholder premium" damages under the merger agreement (the Lost-Premium Provision) as third-party beneficiaries.

When the deal closed, concerns regarding lost-premium damages were eliminated. Accordingly, the court rejected the plaintiff's fee petition, stating the claim was not "meritorious when filed because plaintiff either did not have third-party beneficiary status or his third-party beneficiary status had not yet vested."

However, in rejecting the fee petition, the court provided a lengthy analysis that served as the framework for its novel holding on Lost-Premium Provisions. The court's analysis included:

- Delaware law considerations unique to stockholders claiming third-party beneficiary status.
- An overview of provisions that developed in the wake of the Second Circuit's *Con Ed* decision.
- An analysis of the enforceability of the Lost-Premium Provision.

Third-Party Beneficiary Status

"Delaware courts are reticent to confer third-party beneficiary status to stockholders under corporate contracts for a mix of doctrinal, practical, and policy reasons," the court explained. "One reason for this reticence [is that it] runs counter to Delaware's board-centric model." Granting stockholders "the concurrent right[] to enforce [a] contract alongside the company, risks unsettling the board-centric model by encroaching on the board's authority over litigation assets … [and] risks creating a path by which stockholders could readily circumvent the demand requirement, which has been carefully developed and fine-tuned over decades of jurisprudence," the court said.

It also noted that the practical considerations included "a proliferation of stockholder suits in a variety of commonplace scenarios."

"Merger agreements might be viewed as unique among corporate contracts because stockholders are, undeniably, the intended economic beneficiaries of those agreements," the court said. However, the "unique aspects of merger agreements" enhance the "need to recognize the contractual primacy of the board of directors in the sale context" because a board exercising its fiduciary duties "should not be constrained by the possibility that a multitude of individual stockholders might seek to sue a buyer directly under the merger agreement."

Thus, the court concluded that "no-third-party-beneficiaries provisions are arguably entitled to greater weight in the context of merger agreements."

Con Ed Provisions

The court then turned to *Consolidated Edison v. Northeast Utilities* (2d Cir. 2005), in which the Second Circuit held that stockholders lacked standing to sue the acquirer for breach of the merger agreement.

The Court of Chancery noted that the *Con Ed* decision "came as a surprise to M&A practitioners 'who believed that a merger premium (or some amount of shareholders damages) would be recoverable against a buyer such as *Con Ed* who wrongly terminates or breaches a merger agreement.'" The court identified three primary approaches that creative deal lawyers used to deal with Con Ed's fallout:

1. Expressly provide shareholders with third-party beneficiary status. But the court noted that "practitioners were wary of this approach for the same reasons that Delaware law is reticent to grant stockholder[s] third-party beneficiary status."
2. Make the target the agent for recovering damages on behalf of its stockholders. But the court noted "this approach rested on shaky ground … because there is no legal basis for allowing one contracting party to unilaterally and irrevocably appoint itself as an agent for a non-party for the purpose of controlling that party's rights."
3. Define damages that result from a breach to include the lost premium, which commentators have coined the "damages-definition" approach. This was the provision at issue in Twitter.

Enforceability of Lost-Premium Provisions

Addressing the "damages-definition" approach, the Court of Chancery stated that "[a] target company has no right or expectation to receive merger consideration, including the premium, under agreements that operate like the Merger Agreement," where "no stock or cash passes to or through the target" and "merger consideration is paid directly to the stockholders."

Accordingly, the court held that "a provision purporting to define a target company's damages to include lost-premium damages cannot be enforced by the target company." And to the extent a provision "purports to define lost-premium damages as exclusive to the target [] it is unenforceable." Thus, the court concluded that the Lost-Premium Provision at issue was "unenforceable unless the Merger Agreement conveys third-party beneficiary status to stockholders."

The court noted that it was possible "the parties took the risk that the provision would be unenforceable" because the parties chose language to exclude stockholders as third-party beneficiaries. However, the court noted that, despite being "facially reasonable," the interpretation failed to "satisfy the cardinal rule of contract construction that" a court should give effect to all provisions, if possible.

The court went on to state that another construction of the provision would "grant stockholders third-party beneficiary status that vest[s] in exceptionally narrow circumstances and for the limited purpose of seeking lost-premium damages" when specific performance is no longer available. But the court ultimately determined that it need not identify "which of these interpretations is most faithful to the parties' expectations" because, even if the plaintiff had third-party rights under the Lost-Premium Provision, they would not have vested.

Key Points

- Despite the odd procedural posture, this was an important, novel ruling on an issue of significance for corporate practitioners.
- Although the court's ruling on lost-premium damages is arguably *dicta* given that the issue of whether the merger agreement permitted stockholders to pursue lost-premium damages never ripened, it is still something that corporate practitioners should be considering. The court's stated view, were the issue to ripen in a future matter, is clearly that a target company is not able to seek such lost-premium damages, and that stockholders could have third-party standing to pursue such relief directly.
- Practitioners have expressed concern about the prospect of stockholders being deemed third-party beneficiaries to a merger agreement, including for lost-premium damages provisions. To date, practitioners have generally relied upon Delaware's board-centric model and jurisprudence that suggests stockholders would not be considered third-party beneficiaries to a merger agreement unless there is a clearly specified intent.
- The ruling arguably exposes a legal tension that may be explored in the future. Specifically, the court noted that, when a target corporation seeks lost-premium damages, it is considered an unenforceable "penalty" if only stockholders are entitled to receive a premium under a merger agreement. However, when discussing Delaware's board-centric model, the court noted that a board "manages the business and affairs of the corporation, which extends to litigation assets" and that "[d]eeming stockholders third-party beneficiaries of corporate contracts … risks unsettling the board-centric model by encroaching on the board's authority over litigation assets." Additional case law may develop about lost premium being treated as a litigation asset of the company.
- In all likelihood, we should expect corporate practitioners to make adjustments in the future to address the court's views and concerns.
  - The court offered at least one potential solution regarding the agency approach: "Perhaps corporate law could supply a solution here" by having the company adopt a "charter provision designating the company as the stockholder's agent for purpose of recovering lost-premium."
  - Along these lines, another option is a statutory fix. The Delaware Legislature could amend the Delaware General Corporation Law to expressly allow target corporations entering into a merger agreement to designate themselves as the stockholders' agent for purposes of obtaining lost premium. This would be consistent with Delaware's board-centric model and with merger practice over the past several decades.

Books and Records Demands 2023 Recap: Courts Continue To Develop the Law Regarding the Scope of Inspection

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> See page 10 for key points

As discussed in prior articles, stockholder plaintiffs have increasingly sought to obtain companies' books and records under 8 *Del. C.* § 220 (Section 220) and the Delaware Limited Liability Company Act's analogous provision, Section 18-305(a), which has led the Court of Chancery to face a record number of books and records actions. In response, over the past year, Chancellor Kathaleen St. J. McCormick has begun assigning books and records actions to magistrates in Chancery in an attempt to reduce the court's ballooning docket.

While magistrates are now also contributing to books and records case law, existing trends for books and records actions appear, at the moment, to remain roughly the same. The court has reiterated that a stockholder's burden to establish a proper purpose for inspection is low but not inconsequential. Moreover, a stockholder can only obtain those documents that are necessary and essential to the stockholder's purpose, and formal board-level materials are typically the starting point and ending point for inspection.

The court also continues to shift fees when defendant companies engage in extreme and vexatious litigation conduct. Finally, this past year saw an order from the Delaware Supreme Court that clarified the standard for the confidential treatment of documents provided in response to a books and records demand.

A New Process Is Adopted for Recently Filed Actions

Accompanying the increase in books and records actions assigned to magistrates, the court has in recent months set forth a new process that is intended to clearly identify and potentially narrow the disputes at issue between the parties.

The new procedure works as follows:

- After a books and records action is filed, the court issues a letter directing the parties to promptly meet and confer regarding any defenses the defendant company intends to assert and instructing the defendant company to identify the location of documents sought.
- If documents pertaining to certain categories do not exist, the defendant must indicate as much.

The court has also reminded parties that books and records actions are summary in nature and should be resolved within 90 days. Accordingly, the court expects that proceedings in front of a magistrate reach final resolution within 60 days so that the exceptions process permitted by Court of Chancery Rule 144 can be timely completed.

The court encourages parties to submit the action to the magistrate for a final decision, not subject to further judicial review, if they prefer a more leisurely schedule.

The Court Largely Continues To Focus Its Analysis on the Scope of Inspection

Despite shifts in process and assignment, the substantive trends in books and records actions remain largely the same, with the focus being on whether the requested documents are necessary and essential to the plaintiff's purpose. However, one notable exception to the trend of Delaware courts finding a proper purpose is *Simeone v. Walt Disney Company*, 302 A.3d 956 (Del. Ch. 2023).

In *Disney*, the stockholder sought books and records to investigate alleged wrongdoing and potential breaches of fiduciary duty in connection with Disney's opposition to Florida House Bill 1557, also known as the "Don't Say Gay" bill. In response to the demand, Disney voluntarily produced 73 pages of board minutes and corporate policies related

to the company's opposition, but the stockholder continued to seek the production of electronic communications.

Vice Chancellor Lori W. Will held that the stockholder's disagreement with Disney's business decision to publicly oppose a bill did not provide a credible basis to suspect wrongdoing. The court also determined that the demand's stated purposes belonged to the stockholder's counsel, not the stockholder, given the stockholder's limited and non-substantive involvement in the demand and litigation.

Finally, Vice Chancellor Will held that, even if the stockholder had stated a proper purpose, he was not entitled to additional documents because the produced formal materials contained all the necessary and essential information.

Following *Disney*, two decisions from Magistrate Bonnie W. David reiterated that, generally, the production of formal, board-level materials is all that is necessary and essential.

Pompano Beach General Employees' Retirement System v. Wells Fargo & Co. involved an ESG-related matter like that at issue in Disney. C.A. No. 2023-0656-BWD (Del. Ch. Sept. 14, 2023) (TRANSCRIPT). Specifically, a stockholder served a Section 220 demand related to the Wells Fargo board's handling of allegations related to diversity hiring practices. After Wells Fargo voluntarily produced formal board- and officer-level documents, the stockholder demanded email communications.

At a one-day paper trial, the parties limited their arguments to the scope of the demand. Magistrate David held that, in the aggregate, the formal materials already provided were sufficient to understand what information the board received about the allegations, when it received that information and the board's response. No evidence suggested that the board acted outside formal channels, and the stockholder was not entitled to fish for potentially relevant emails without such evidence.

Likewise, *in In re Zendesk, Inc. Section 220 Litigation*, Zendesk voluntarily produced board-level documents in response to demands seeking to investigate potential wrongdoing in connection with an all-stock merger. 2023 WL 5496485 (Del. Ch. Aug. 25, 2023). Unsatisfied, the plaintiffs claimed there were "gaps" and "inconsistencies" in the formal board materials.

Magistrate David held that the stockholders failed to establish that electronic communications were essential to accomplish their purpose, where the board honored corporate formalities during the deal process and the produced formal materials answered "the who, what, where, when, and why of the possible wrongdoing." The court noted that the stockholders were not entitled to "discovery-style email production" in order to "flesh out [their] theories" with incremental details.

Fee-Shifting in Extreme Circumstances

Over the past year, the court continued to shift fees against defendant companies where the conduct was extreme and vexatious. In *Myers v. Academy Securities, Inc*., Magistrate David partially shifted fees when the company took frivolous positions in response to the demand and adopted continually shifting defense theories. 2023 WL 6380449, at *2 (Del. Ch. Oct. 2, 2023), *report and recommendation adopted* (Del. Ch. 2023).

The court stated that the company raised "baseless factual assertions and legal red herrings" during the litigation, including by "focus[ing] significant time on an irrelevant argument that Plaintiff technically violated regulatory requirements …, which seemed intended more to harass or embarrass than to undermine Plaintiff's entitlement to books and records."

The court noted that, although "[i]ndividually, these arguments would not justify fee-shifting, … in the aggregate, they reflect an unfortunate pattern of unreasonable positions designed to unnecessarily complicate the proceedings."

Similarly, in *Seidman v. Blue Foundry Bancorp*, Vice Chancellor Morgan T. Zurn shifted fees where the defendant company "took a series of litigation positions that, when viewed collectively, were glaringly egregious." 2023 WL 4503948, at *6 (Del. Ch. July 7, 2023).

Among other things, the court determined that the defendant company:

- Made frivolous arguments, including that the plaintiff was required to demonstrate an actionable claim, even though Delaware law is clear that a Section 220 action "is not the time for a merits assessment of [a plaintiff's] potential claims."
- Refused to permit inspection of any documents, even formal board materials that, under prevailing law, "should nearly always be produced."
- Insisted that the plaintiff, a resident of Florida, appear in person for a half-day deposition in Delaware, forcing the plaintiff to engage in needless motion practice.
- Sandbagged the plaintiff with an improper purpose defense after the close of discovery, despite asserting in an earlier interrogatory that it would not raise that defense.

Moreover, in *Bruckel v. TAUC Holdings, LLC*, Vice Chancellor Zurn again shifted fees in an action by a manager of an LLC to inspect books and records related to his status as a manager. 2023 WL 4583575, at *1 (Del. Ch. July 17, 2023).

The court found that the defendant company engaged in bad faith conduct by, among other things:

- Arguing that the plaintiff lacked a proper purpose, even though it is clearly established under Delaware law that managers need not have a proper purpose to inspect books and records.
- Failing to identify whether formal board materials existed.
- Holding more than 60 manager meetings without the plaintiff (and without one additional manager on a rotating basis) "in order to represent to Plaintiff that no Board meetings were held or no Board materials existed."

To be sure, fees are not shifted as a matter of course. The court continues to deny fee requests where extreme circumstances are not present.[1]

Delaware Supreme Court Further Clarifies Standard for Confidentiality

In *Rivest v. Hauppauge Digital, Inc*., the Court of Chancery adopted a magistrate's recommendation that the defendant company produce annual and quarterly financial statements, but rejected the magistrate's recommendation that the documents be subject to a confidentiality restriction. 2022 WL 3973101 (Del. Ch. Sept. 1, 2022).

Vice Chancellor J. Travis Laster stated that there is no "presumption of confidentiality" for documents produced in response to a books and records demand and that the defendant company bore the burden of establishing a need for a confidentiality restriction. Vice Chancellor Laster held that the company failed to meet its burden because its concerns regarding competitor use of information were not credible. The court also stated that even if the company's concerns were credible, they were outweighed by the stockholder's countervailing interest in determining the value of his stock.

On appeal, the Delaware Supreme Court upheld the Court of Chancery's decision, stating that in the absence of compelling evidence showing the need for confidentiality, the lower court's rejection of such a provision was not an abuse of its discretion. *Hauppauge Digital, Inc. v. Rivest*, 300 A.3d 1270 (Del. 2023). The Supreme Court held that the Court of Chancery properly weighed the parties' legitimate interests consistent with Delaware precedent when it had concluded that placing confidentiality restrictions on financial statements for closed periods did not outweigh the stockholder's interest in free communication when attempting to value its stock.

[1] *See, e.g., Meehan v. Tiger Analytics, Inc.*, 2023 WL 6053017, at *3 (Del. Ch. Sept. 18, 2023), *report and recommendation adopted* (Del. Ch. 2023) (holding that, although nine-month delay in producing documents was dilatory, such delay was not in bad faith where the company did not follow corporate formalities, and good faith efforts were made to finalize and produce documents).

Key Points

- While the new process for books and records actions appears to place a larger burden on defendant companies at an earlier stage of the proceedings, it is intended to minimize the scope of the disputes at issue. It is likely that this process will be further developed and refined as it is utilized more.
- Given that Delaware courts generally hold that a stockholder has established a proper purpose, most corporate defendants are well advised to consider producing board-level documents in response to a demand. However, if a stockholder insists on documents that go beyond formal, board-level materials, there is a significant amount of Delaware precedent holding that such materials need not be produced.
- If defendant companies engage in extreme or vexatious litigation conduct, including taking meritless defense positions, forcing needless motion practice and refusing to produce any board-level documents in the face of an established right, the Court of Chancery may shift fees.
- There is no *per se* rule that the documents provided in response to a books and records demand are confidential. To receive confidential treatment of its documents, a company must identify specific reasons why the documents should be subject to confidentiality restrictions.

Real World Examples Where Conflicts Tainted a Deal Process, and Other Deals That Were Insulated From Conflicts

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Sometimes when a board is considering a strategic transaction, it may find that a key figure who can influence the deal process — for example, a founder, controller or CEO-negotiator — has a potential conflict of interest. They may be on both sides of the deal, or they may simply have personal motivations and interests that are not shared by all stockholders. Such conflicts can arise on either the buy- or sell-side.

In this situation, it will fall to the board or a special committee to find the best way to address any conflict. Each situation comes with its own set of facts, so there are no all-purpose rules that apply in every case. But four recent Delaware decisions scrutinized deal processes that were challenged by stockholders because influential figures, negotiators or other fiduciaries involved in the process had conflicts. These rulings offer examples both of behavior that could be cast in an unfavorable light if a deal is challenged, and approaches boards have taken that courts found were helpful to insulate the conflicted person and preserve the integrity of the deal process.

A deal process need not be "pitch perfect," the Delaware Supreme Court stressed in one of the cases. Examining the facts of the four cases suggests what actions courts may find in-tune or off-key.

Factors the Courts Viewed Disfavorably

CEO Directing the Sale Process Was Set on One Buyer

- When the take-private of Mindbody was challenged by stockholders, the court described how a private equity firm groomed the seller's CEO to favor a deal with it. For example, the buyer invited the CEO to a conference it sponsored to prospect for acquisition targets where it emphasized how officers of companies it acquired could become very wealthy post-acquisition. Enamored with the prospective buyer, the CEO told it that he was looking for a "good home" for his company and its management team.
- The court highlighted that the CEO rejected bidders that he disliked for personal reasons and signaled a lack of interest in competing offers by going on vacation during the go-shop process, telling management to decline presentations in his absence unless they were "urgent." He also adjusted his company's revenue guidance downward to depress the stock price and make a deal more attractive for his preferred buyer.
- The court took issue with the CEO's outsized role throughout the deal process and noted that the seller should have taken time to develop alternatives to promote competition and ensure a value-maximizing process.

Negotiator's Experience Level and Personality

- When TransCanada purchased Columbia Pipeline and the target's stockholders challenged the deal, the court noted that both Columbia's CEO and CFO hoped to retire early and, from the outset, sought to arrange a sale that would trigger change-of-control benefits for themselves.
- The court also detailed the missteps of the CFO, who was appointed to lead the sale process despite the fact that he had never had a major role in an M&A negotiation. During one early meeting with the eventual buyer, the CFO handed over his talking points about the deal price and timing. He also arranged one-on-one meetings with Columbia directors, which he used to manipulate the flow of information and steer the directors individually toward his desired result.
- The court said that qualities that may be laudable in other contexts can be undesirable during the deal process. For example, in Columbia Pipeline's case, the "trusting, team-oriented, and transparent" CFO who lacked "guile" and a "poker face" created vulnerabilities and undercut his company's negotiating leverage.

- By contrast, in the Tesla-Solar City decision discussed below, the court praised the board for vesting negotiating power in an indisputably independent director who exercised mastery over the negotiations.

Interactions With Counterparties

- In both the Mindbody and Columbia Pipeline cases, the court reprimanded the negotiators for ignoring communication guidelines set by their boards. For example, the negotiators privately tipped their preferred counterparties (directly and through their bankers) about their companies' target price and their personal motivations for a sale.
- The Mindbody court also criticized the CEO for permitting the company's banker to facilitate a connection for him with the potential private equity buyer before the formal sale process had begun and without board authorization.

Counterparty's Role Aiding and Abetting Conflicts

While the conflicts in the Mindbody and Columbia deals arose on the target side, in both cases the courts found the buyers — the counterparties — liable for damages as well because they took advantage of those conflicts.

- The Columbia Pipeline and Mindbody decisions chastised the buyers for inducing the sellers' conflicted negotiators to act against the interests of their stockholders by, for example, revealing inside information, including before due diligence, so that the buyers could move more quickly than other potential bidders.
- The Columbia court further admonished the executive who led negotiations for TransCanada for persistently violating Columbia's process boundaries, including standstill agreements, no-teaming agreements and prohibitions on unsupervised contacts with management.
- The court also criticized him for exploiting the conflicts of interest on the seller's side by reneging on an agreement in principle and then "ambushing" the seller with a lower bid, coupled with a coercive and false threat to publicly disclose that negotiations had ended, knowing the seller was by then wedded to making a deal happen.
- The court also held that TransCanada's lead negotiator manipulated his relationship with Columbia's lead negotiator by drawing on their past professional friendship and creating the impression that they were working together as partners behind the scenes.
- In the Mindbody and Columbia Pipeline cases, the courts also faulted the buyers for failing to correct misstatements or omissions in the sellers' proxy statements. In both cases, the buyers were contractually obligated to do so.

Factors the Courts Viewed Favorably

An Independent Board or Special Committee Making Its Own Decisions in the Best Interests of the Company

- When Tesla considered buying Solar City, Tesla's founder, who was presumed to control the company, also held a stake in Solar City and was therefore on both sides of the transaction. The court questioned the founder's involvement, which included making overtures to Tesla's board about the transaction, directing management to prepare presentations about the transaction, and participating in board meetings about the transaction.
- Notwithstanding those facts, the court found that the Tesla board was not coerced on the timing or terms of an offer, or how long to spend on due diligence. The board proved itself willing to vigorously debate assumptions and oppose the conflicted director's wishes.
- Similarly, when Oracle purchased a company co-founded by Oracle's founder, former CEO and largest shareholder, and on whose board he served, the court rejected a challenge to the deal. There the special committee implemented "rules of recusal" that prohibited the founder from discussing the transaction with anyone but the special committee, required employees who were involved in assessing the transaction to be informed of the recusal, and forbade officers and other employees from participating in the negotiation process absent the special committee's direction.[1]

[1] Skadden advised Oracle's special committee.

- In contrast to the Mindbody situation, the court in Oracle praised the special committee's willingness to let the deal die if it was not in the company's best interests.

Helpful Independent Financial Advisors

- The courts in the Tesla, Oracle and Columbia Pipeline cases praised the boards or special committees for selecting top-tier financial advisors without longstanding relationships or conflicts with their companies or counterparties.

- In the Tesla case, the court positively noted that, during due diligence, the company's banker investigated the seller's financial state, had discussions with the seller's financial advisor, adjusted the focus of its work as concerns arose, reran analyses as needed, and kept the board apprised of new developments. The court also noted that, in response to information discovered during due diligence, the board lowered the offer price.

- In the Mindbody decision, the court applauded the company's banker for sharing its knowledge about the buyer, including its modus operandi and associated risks, but said that the company's CEO ignored that information.

In Sum

In sum, Delaware courts have long held that a deal process does not have to be perfect and there is no one-size-fits-all blueprint. The facts and circumstances of each deal process will be considered and any one of the potentially problematic issues described above alone may not be enough to doom the process. But these cases should help directors understand what circumstances may taint a deal process and, on the other hand, what guardrails they may want to consider to protect the integrity of a deal process.

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Special thanks to **Stephen F. Arcano**.

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