JONES DAY

COMMENTARY

OCTOBER 2018

IN SHORT

The Situation: A Delaware court recently found that a board breached its fiduciary duties by bowing to activist pressure and engaging in a sale rather than continuing the business as a going concern.

The Case: *In re PLX Technology Inc. Stockholders Litigation* involved a technology company that sold itself after incumbent directors lost three board seats in a proxy contest. After the proxy contest, the activist used his director position to steer the company toward a sale. The court held the directors breached their fiduciary duties by engaging in a sale when, but for the activist's pressure, they otherwise would not have sold the company.

Looking Ahead: The *PLX* decision will likely encourage plaintiffs to bring claims when a sale follows the installation of activist directors on the board, either by proxy contest or negotiated agreement. Directors must ensure that they act in the best interests of the company and the stockholders as a whole, rather than catering to the wants of a vocal minority with potentially divergent interests.

Directors approving a cash sale of a company must seek to obtain the highest value reasonably available, an obligation commonly referred to as the *Revlon* duty. Although *Revlon*-based claims typically involve allegations that the board mishandled the sale *process*, the recent *PLX* decision involved claims that the board violated its fiduciary duties by selling the company *at all*. According to the plaintiffs, the company was worth more as a stand-alone entity. *PLX* appears to be the first case finding a breach of fiduciary duties directly premised on such a theory (although the court ultimately awarded no damages for this breach).

Following a decline in PLX Technology Inc.'s share price, Potomac Capital Partners II, L.P. acquired a minority position in PLX's stock and launched an activist campaign demanding a sale. After discussions with its investment bank, PLX's board concluded that then-available sale prices were inadequate. Nevertheless, the board attempted to head off the proxy contest by creating a special committee that would consider a sale of the company.

Potomac won the proxy contest, and the board allowed the Potomac nominee to chair the special committee. A potential purchaser contacted PLX's investment bank. The potential purchaser expressed interest and signaled its price but noted that it needed time to close a different deal before engaging in a potential acquisition of PLX. PLX's investment bank shared that information with Potomac's nominee, but neither PLX's investment bank nor the activist-nominated director informed the rest of the board. Once the potential buyer reemerged, the activist-nominated director then pushed for PLX to engage as rapidly as possible, which PLX did, eventually striking a deal near the original price point. The transaction was approved via tender offer by 80.3% of PLX stockholders.

Plaintiffs brought post-closing claims alleging that the board had breached its duty by selling PLX rather than remaining an independent company and that Potomac and PLX's investment bank had aided and abetted the breach. The directors and the investment bank settled, but Potomac did not. Following trial, the court found that, notwithstanding the stockholder vote approving the merger, the vote did not act to "cleanse" the transaction or ratify the directors' conduct. Unlike in *Corwin v. KKR Financial Holdings LLC* (2015), a significant decision that effectively places some transactions outside of the scope of substantive judicial review, the court found that the stockholder vote offered no additional protection because the board failed to disclose material information to the stockholders. Among other shortcomings, the court faulted PLX's failure to disclose the initial expression of interest from the buyer because the "early communication undercuts the legitimacy of the eventual price negotiations."

PLX makes clear that capitulating to activist-nominated directors is not consistent with a director's fiduciary duties if the director believes that a different course is preferable for the company.

While *Revlon* requires boards to obtain the "best transaction"—ordinarily, get the highest price for stockholders—during a sale process, the *PLX* court held that the "best transaction reasonably available is not always a sale; it may mean remaining independent and not engaging in a transaction at all."

The court found a breach of fiduciary duty, described the board as "susceptible to activist pressure," and emphasized the wrongs of, among other things, the board agreeing to a sale when the directors thought it was a bad time to sell. *PLX* makes clear that capitulating to activist-nominated directors is not consistent with a director's fiduciary duties if the director believes that a different course is preferable for the company.

Crucial to the court's holding was the fact that the activist director had material information about the process that he concealed from the other directors in order to advance his and his fund's interests in a short-term sale. "Potomac and [its manager] undermined the Board's process and led the Board into a deal that it otherwise would not have approved." When the activist director withheld crucial information from the other board members, he "breached his fiduciary duty and induced the other directors to breach theirs." One disturbing aspect of the court's holding is that it implies that directors can breach their fiduciary duties as a result of the deception of other directors or third parties. While exculpatory charter provisions, which are commonplace, should protect innocent directors from monetary liability in such situations, the possibility of such an outcome remains concerning.

As is often the case where liability is found, the court also criticized the board's process, and especially its recordkeeping. The court described the minutes as reflecting "lawyers drafting minutes after the fact in an effort to paper a good process" rather than accurately documenting board and committee decisions. *PLX* is thus another reminder that boards should regularly draft and approve minutes within a reasonable time after a meeting as a reliable and contemporaneous record of the directors' actions.

Finally, although thoroughly discussing ways in which the board had breached its duties, the court ultimately found no damages because the plaintiffs had not proven that the company's independent value exceeded the merger price. In rejecting the plaintiffs' damages argument, the court reaffirmed the overwhelming weight recent Delaware Supreme Court decisions have given to the merger price in determining the fair value of a company.

FOUR KEY TAKEAWAYS

1. Boards that have recent activist-nominated members must be careful not to bow to activist pressure if they do not believe it is in the best interests of the company, as those directors may find themselves liable for approving the transaction.
2. Stockholders can prove a breach of fiduciary duty premised on a board improperly engaging in a sale, even if the sale process is not manipulated, meaning that any company considering strategic alternatives must actively consider *all* reasonable alternatives, including the value of staying the course and not selling.
3. The defendant-friendly protections offered by *Corwin* will be lost if a board fails to disclose all material facts, and those facts can include information uniquely within the possession of a single director.
4. Both in *PLX* and other recent decisions, some members of the Court of Chancery have been more willing to "look behind the curtain" at records, including minutes, where the court was concerned that the records may have been developed for litigation and were not an accurate, contemporaneous reflection of the actual process.

James P. Dougherty
Cleveland / New York

Robert S. Faxon
Cleveland

Benjamin L. Stulberg
Cleveland

Brandon G. Mordue
Cleveland

All Contacts >>>

YOU MIGHT BE INTERESTED IN: **Go To All Recommendations >>**

California Mandates Female Directors for Public Corporations

"Corporation" is Not a Four-Letter Word

What Should Boards *Really* Be Doing About ESG?

SUBSCRIBE SUBSCRIBE TO RSS

Jones Day is a global law firm with more than 2,500 lawyers on five continents. We are One Firm Worldwide℠.

Disclaimer: Jones Day's publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.

© 2018 Jones Day. All rights reserved. 51 Louisiana Avenue, N.W., Washington D.C. 20001-2113