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Flawed sale process places directors, executives and acquirers in harm's way

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The recent *Mindbody* decision provides a useful refresher on the pitfalls to avoid when selling or buying a Delaware publicly traded company.

The recent Delaware Chancery Court decision in *In re Mindbody, Inc. Stockholder Litigation* is noteworthy as one of the few instances in recent years of plaintiff stockholders prevailing on a *Revlon* claim (and being awarded damages of $1 per share or approximately $44 million against the target's CEO, for the *Revlon* claim and disclosure claims, and against the acquirer (a private equity sponsor), for aiding and abetting the disclosure claims). However, given the alleged conduct of the parties, the decision is unsurprising both as a ruling for the plaintiff stockholders on a "paradigmatic *Revlon* claim" and on disclosure claims.

Revlon

When a Delaware corporation is in *Revlon* mode (as the target in *Mindbody* was, because it was selling itself for all cash), the directors must act reasonably to obtain the highest price reasonably available to the stockholders under the circumstances. As the *Revlon* line of cases have held, there is "no single blueprint" for maximizing stockholder value, so long as the directors chose a reasonable route to arrive at that outcome. As a result, the Delaware courts have traditionally been focused on board process and take a dim view of actions by directors or officers that fail to satisfy their *Revlon* duties.

The various *Mindbody* missteps that ran afoul of Delaware law

The *Mindbody* decision reads like a catalogue of actions that are antithetical to obtaining the highest price reasonably available to the stockholders. Set out below is a summary of those actions that the Delaware Chancery Court found were proven at trial and that the court relied on to rule in favor of the plaintiff stockholders on the *Revlon* claim and the disclosure claims:

- **Failing to keep the board informed:** The target's CEO was alleged to have had initial discussions with the acquirer that he did not report to the board for over a week. In addition, it was alleged that the target CEO never informed the board that, among other things, both he and the target's largest stockholder (who also had board representation) had a strong desire for short term liquidity, the acquirer was interested in acquiring the target and he had tipped the acquirer as to the anticipated sale process and (through an intermediary) the CEO's minimum desired price. As the court noted, the target board was in the dark on all of this. The target board should have been fully informed so that they could better manage the sale process.
- **Failing to be attuned to potential conflicts:** There were numerous alleged conflicts which the target board should have been made aware of, including among others, the target CEO's need for short term liquidity and his desire to sell quickly, his positioning the sale process in favor of the acquirer, the target CEO's "love" of the acquirer and his

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expectation of post-closing employment, and the target CEO's and the target's largest stockholder's motivation to sell in light of the upcoming expiration of the super-voting rights of their shares. It is also advisable for target boards and their advisers to consider what potential conflicts might be present in any deal, regardless of whether or not they are informed of them and to act in order to manage or mitigate them. Particularly where, as was the case here, the acquirer is a private equity sponsor, the court will scrutinize whether management skewed the process to the private equity sponsor, given the potential conflict of future leadership, equity and liquidity event opportunities. To the extent directors become aware of any potential conflicts, additional care should be utilized in designing a sale process and effectively implementing such process. In this instance, for example, the transaction committee formed by the board was effectively chaired by the designee of the largest stockholder and the allegation was that it did not impose effective constraints on the CEO.

- **Don't play favorites:** The court concluded that there were multiple instances of the target's CEO giving the inside track to the acquirer, providing information to the acquirer earlier than to other potential bidders, and generally tilting the playing field toward the acquirer. Based on the information provided by the target's CEO, it was alleged that the acquirer had an outside consultant complete an important market study of the target before the sale process even began. The record as determined by the court also reflects that the target's CEO excluded one potential bidder from participating in the sale process because he did not want to work for that particular company post-closing. Finally, the timing of the sale process and provision of information to the bidders also favored the acquirer to the detriment of all other bidders, and allowed the acquirer to submit an offer within three days of receiving data room access.
- **Failing to seek to use every ability to maximize price and terms:** The *Mindbody* decision detailed numerous missed opportunities to seek to maximize price and terms. By allegedly tipping the acquirer as to the formal sales process and giving the acquirer the inside track such that it could sprint to the finish line before any of the other bidders even had a reasonable chance to get up to speed, the target's CEO set up a situation where it was highly unlikely there would be any realistic chance of competition among bidders on price and terms. Further, the court found that the target's CEO and advisers telegraphed what price he was looking for, rather than keeping the acquirer in the dark so that the acquirer would have to bid against itself. In addition, there were allegations that the target's CEO continued to seek to spend more time with the acquirer, at one point in violation of board guidelines on process, despite astute advice from the target's financial advisor that the more the acquirer believed the target's CEO was "in their camp", the less per share merger consideration the acquirer would pay. This proved prescient—when the acquirer submitted its best and final offer, there was no competitive pressure, and the target had no leverage to extract a higher price.
- **Communications play an important role in litigation:** Text messages and other communications played a central role in the court's examination of the factual background. The court found that the target's CEO had texted messages regarding his and the acquirer's "love" for one another, his intent to engage with the acquirer in violation of the board's guidelines, and various other communications that were damaging to the target in the trial. In addition, early versions of the acquirer's investment committee materials described in detail contacts between the CEO and the acquirer that were never disclosed in the proxy statement (or to the target's board). Finally, employees of the acquirer communicated internally with each other as to what they expected the final per share merger consideration would be, with one screenshot photo showing that the mid-point of "over/under" among the acquirer's employees was a price which was $1 higher than the deal price. As we frequently advise deal participants, emails, texts and social media messages between deal participants and among the directors, as well as internal investment materials, are not privileged and are discoverable, and contemporaneous communications consistently play an important role in how courts assess the credibility of after-the-fact explanations of those contemporaneous writings and related conduct.
- **Failing to utilize bargained for rights:** The court noted that while the merger agreement contained a bargained for 30 day "go shop" provision, the target did not use its right to shop the company post-signing to the fullest. For example, the target's CEO allegedly went on vacation halfway through the go shop period, and instructed management to decline go shop presentations unless urgent, thereby signaling a lack of interest to the go shop bidders. The court found that target's CEO also provided the acquirer information about go shop bidders before the end of the go shop process, thereby further reducing any chance of extracting an improved bid from the acquirer.
- **Don't mislead stockholders as to the favorability of the deal:** The Delaware Chancery Court found that the target's CEO had unduly talked down the target's quarterly guidance, so as to make the acquirer's offer look more appealing. Neither the target nor its officers or directors should be engaging in behavior that is intended to give a misleading impression to target stockholders as to current or projected performance of the target or the favorability of a transaction.
- **Always aim for fair disclosure:** Finally, the Delaware Chancery Court concluded that the "background of the merger" section in the proxy statement intentionally omitted several meetings between the target's CEO and the acquirer that occurred before the formal sale process, as well as the differing interests and conflicts of the target's CEO. While both the target's CEO and the acquirer were allegedly aware of these omissions, they nevertheless signed off on the disclosure. Further, due to the material omissions in the disclosure, there was no fully informed target stockholder vote that would have "cleansed" any deficiencies in the sale process under *Corwin v. KKR Financial*

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Guidance for both targets and acquirers

The foregoing is by no means an exhaustive list of actions or behavior that should be avoided when selling a publicly traded company. It should also be noted that the cumulative weight of these actions presented a very difficult path for the CEO and acquirer in court in trying to defend any particular action. Each public company sale transaction is different, and directors of other targets will be confronted with unique courses of action that they will need to weigh in light of discharging their *Revlon* duties.

As they consider those situations, target directors should be guided by the touchstone of *Revlon*—namely that while there is “no single blueprint”, their actions (as well as the actions of target officers) should be aimed at the objective of maximizing value to the stockholders. While often there is a *bona fide* question as to whether or not an action is appropriate to pursue, there are times the answer is self-evident when considered in light of the objective of *Revlon*.

In addition, both target and acquirer should pay close attention to the background of the merger section in the disclosure documents. Often there is independent information (e.g., phone records, texts, emails, DGCL § 220 requests, etc.) that can reveal discussions or events that were omitted from that section that a court may find to be material. In this case, the failure was particularly acute as the target had essentially two bites at the apple to rectify the disclosure issues—first when the proxy was originally filed and second when the target issued supplemental disclosures in an effort to moot customary disclosure claims from other plaintiffs. The court found that the target’s supplemental disclosures still failed to disclose key facts, and indeed, mischaracterized events.

Finally, acquirers should be aware of the risk that may come from a target CEO providing the acquirer with the “inside track” in a public company sale process. While we understand that some acquirers may be willing to “run the risk” in exchange for an improved chance to become the winning bidder, acquirers should be aware that they may ultimately have to pay for that risk in a settlement or judgment arising out of stockholder litigation brought against the deal. Indeed, while the acquirer was found liable for aiding and abetting disclosure violations only, if it were not for a “procedural foot fault” by the plaintiffs’ lawyers, the court implied that it is likely the acquirer would have also been found liable for aiding and abetting the *Revlon* violations.

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