Updates

In today's difficult economic environment, many companies—including those in the portfolios of private equity and venture capital funds—are struggling financially. For some, a transaction in which a private equity sponsor or a venture capital investor has a significant interest may provide a lifeline for the troubled company. Such transactions may present conflicts of interest and, even where the private equity or venture capital investor is not a controlling stockholder, will generally be subject to the rigorous entire fairness standard of review unless the transaction was either approved by an unconflicted, informed and fully authorized special committee of the board, or by the informed, uncoerced vote of the unconflicted stockholders.

In *Salladay v. Lev*, Vice Chancellor Sam Glasscock denied a motion to dismiss, finding that the plaintiff had adequately pled that a conflicted acquisition failed both potentially cleansing process steps. The case illustrates the need to rigorously follow case law guidance to achieve the benefits of conflict-cleansing procedures.

Private Equity and Other Stockholders Elect to Roll Over Their Shares in a Third-Party Merger

Private equity firm Loeb Holding Corporation was the co-founder and largest stockholder of Intersections, Inc. with 42.7% of its outstanding shares, and Loeb's managing director, Bruce Lev was a director. Michael Stanfield, a co-founder and the chairman of the board, owned 8.7% of the company's stock. In 2017, Intersections developed a new identity protection product utilizing artificial intelligence which it believed could radically increase its customer base.

Intersections struggled to bring its new product to market and in early 2018, the board formed a special committee of three independent directors to explore financing alternatives. At around this time, Loeb and another director, David McGough, who held 4.7% of the company's stock, loaned the company $3 million to pay down a portion of its existing third-party debt.

Later that year, Lev, Stanfield and Intersections' CFO met with a group of investors led by iSubscribed Inc. to begin discussions for a possible sale of the company through a going-private transaction. Stanfield, Lev, and McGough all indicated their desire to roll over their interests in the transaction. Without authority to do so, Stanfield informed iSubscribed that Intersections' board would be receptive to an offer of $3.50 to 4.00 per share. The board then reconstituted the special committee. In October, iSubscribed presented an offer to acquire Intersections at a price of $3.50 per share that contemplated the rollover of shares by the three largest stockholders and execution of a note purchase agreement to provide Intersections $30 million in debt financing convertible into Intersections stock on favorable terms. The proposal contemplated that the note purchase agreement would give the buyer the right to elect a majority of Intersections' board if the proposed acquisition transaction were terminated. The proposal also contemplated that Loeb and McGough would exchange their existing Intersections promissory notes into the same new convertible notes to be issued to iSubscribed under the note purchase agreement.

The special committee, which engaged its own legal counsel, later negotiated an increase in the price to $3.68 per share, a 112% premium over the trading price according to the defendants, and made slight improvements to other terms. Only then did the committee hire an investment banking firm. That firm terminated its engagement almost immediately, whereupon the committee hired a second firm and charged it with preparing a fairness opinion in eight days, while withholding from that firm favorable projections of Intersections' prospects. In the meantime, the special committee considered proposals from two other potential financing partners but did not pursue them aggressively, conducting only one phone call with each and making no counter-offers. The special committee then approved a merger agreement with iSubscribed and the note purchase agreement authorizing the issuance of secured notes to the buyer and to Loeb and McGough, convertible into Intersections common stock at $2.27 per share. At a special meeting of stockholders held to consider the transaction, a majority of the unconflicted Intersections stockholders approved the merger.

Three Conflicted Directors Are Sued

A former stockholder sued the three conflicted directors for breach of fiduciary duty, alleging that the directors' actions should be reviewed under the rigorous entire fairness standard. Vice Chancellor Glasscock agreed that entire fairness would normally be the standard where half or more of the directors are conflicted, but noted that the business judgement standard could apply if, as here, the transaction did not involve a controlling stockholder and if: (1) the decision were made by "a fully empowered, independent committee" as outlined in *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013), or (2) it was approved by "a fully informed, uncoerced vote of disinterested stockholders" under *Corwin v. K.K.R. Holdings LLC*, 125 A.3d 304 (Del. 2015).

Special Committee Fails the *MFW* "Ab Initio" Requirement

The court in *Trados* suggested that business judgment deference may apply to a conflicted transaction not involving a controlling stockholder if the transaction is approved by a "duly empowered and properly advised" special committee. Vice Chancellor Glasscock concluded that, to provide an effective surrogate for arm's-length negotiations, the Intersections special committee should have been empowered and active *ab initio*, a criterion established under *Kahn v. M&F Worldwide*, 88 A.3d 635 (Del. 2014). Under *MFW*, a special committee can serve as "a potent tool to extract good value for the minority" in a controller transaction only if the committee is empowered at the outset, that is, before any substantive economic negotiations commence. Vice Chancellor Glasscock found that the same rationale applies where "even in a non-control setting, commencing negotiations prior to the special committee's constitution may begin to shape the transaction in a way that even a fully-empowered committee will later struggle to overcome".

Here, the special committee was not constituted in a way that invoked the cleansing effect of *Trados*. In mid- to late September of 2018, Stanfield and Lev met with iSubscribed to explore a potential transaction, iSubscribed signed a non-disclosure agreement and initiated due diligence, and Stanfield, without authority, told the prospective buyer that the "Board would be receptive to an acquisition offer of $3.50 to $4.00 per share." By the time the special committee was reconstituted, the prior discussions had "formed a price collar" that "deprived the committee of full negotiating power sufficient to invoke the business judgement rule".

Stockholder Vote Failed to Cleanse the Conflict Due to Inadequate and Potentially Coercive Disclosure

The conflict in *Salladay* could also have been cleansed by a "fully informed, uncoerced vote of the disinterested stockholders" of Intersections under the *Corwin* rationale: that the court will not second guess the decision to accept a transaction, despite conflicts of interest, if it is approved by the majority vote of an "informed and empowered electorate". The plaintiff adequately alleged the stockholder vote failed to cleanse the conflicts because Intersections' disclosure to disinterested stockholders was either materially incomplete or materially misleading.

The vice chancellor focused on two areas of inadequate disclosure in the merger proxy statement. First, disclosure of the note purchase agreement that described the buyer's right to designate a majority of Intersections' directors if the merger agreement were to be terminated (other than due to buyer's breach or abandonment), which could have led stockholders to believe that there would have been a change of control of Intersections *whether or not the merger was approved*, posed a classically coercive Hobson's choice: approve the merger, or risk becoming minority stockholders in an entity controlled by the buyer without any prospect of obtaining a control premium.

Although the proxy statement disclosed that the buyer's right to appoint a majority of the board in the event the merger was terminated was subject to NASDAQ Listing Rule 5640, the problem, according to the vice chancellor, was that the proxy statement did not adequately disclose enough information for Intersections' stockholders to understand the effect of that rule. Rule 5640 provides that voting rights of existing holders of publicly traded common stock cannot be disparately reduced or restricted through any corporate action or issuance, which could have prevented iSubscribed from exercising its contractual right to appoint a majority of the directors unless it held a majority of Intersections' stock. Instead, iSubscribed would own at most one third of the outstanding shares on an as-converted basis. Invoking the Delaware "buried facts" doctrine, the court found that (although the application of Rule 5640 may have been in dispute) Intersections' stockholders would have had to engage in "a scavenger hunt" in order to put together the information that would allow them to understand that iSubscribed may not have been entitled to appoint a majority of Intersections' directors in the event that the merger were voted down.

The vice chancellor also faulted the failure to explain in the proxy statement the reason why the first financial advisor, hired by the special committee to provide a fairness opinion after the transaction had been "nearly fully formed", resigned shortly after it had been retained. The fairness opinion is central to a reasonable investor's decision whether to accept merger consideration, particularly in a conflict transaction. Vice Chancellor Glasscock noted that a board member (and the new financial advisor) would certainly want to know the reasons why the first advisor resigned; it followed, in his view, that a stockholder would too. Because of the materiality of this omission, and the coercive effect of the buried facts regarding the buyer's ability to control the board if the merger were not approved, the merger vote was not fully informed and did not serve to cleanse the conflicts in the merger transaction.

Lessons for Conflict Transactions Involving Less Than Controlling Stockholders

The good news for private equity sponsors and venture capital investors who may be interested stockholders is that, for potentially value-creating transactions involving conflicts, it is possible to cleanse the conflict either through use of a special committee or the vote of a majority of the disinterested stockholders. The key to the desired result is the careful adherence to the requirements of the specific cleansing mechanism.

Special Committee

- **Disinterested members.** In *Salladay*, plaintiff did not assert that the special committee members were interested in the merger transaction. Nevertheless, Delaware courts will carefully consider allegations of potential interest on the part of ostensibly independent directors—including any close personal and business relationships with interested stockholders, as the Delaware Supreme Court did in *Cty. Emps.' Ret. Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del 2015). Accordingly, in establishing a special committee, it is imperative that the board probe any potentially compromising relationships on the part of potential committee members.
- **Establishment Ab Initio.** Imposition of the *MFW ab initio* requirement is perhaps the most critical element of *Salladay* and may pose a significant practical hurdle for private equity or venture capital portfolio companies, especially those in financial distress. In seeking additional investors or potential acquirors for a portfolio company under time constraints, private equity and venture capital investors may find it difficult to avoid crossing the threshold of substantive economic negotiations, especially with respect to valuations, before a special committee can be formed and empowered. However, formation of a special committee must take place before such economic negotiations occur to obtain the full cleansing effect of the special committee's approval.
- **Full Empowerment.** A special committee must have full power to retain advisors, to negotiate with a buyer or investor, and to make the ultimate decision regarding the conflicted transaction. The committee in *Salladay* appeared to be appropriately empowered; however, the initial discussions of the conflicted parties with the buyer undercut and limited that authority by effectively setting a price collar on the transaction.
- **Capable Advisors.** The Intersections special committee retained their own counsel and financial advisor, but they lost the advantage of having an independent financial advisor by negotiating the key substantive terms of the transaction without the benefit of their advisor's input. The resignation of the first advisor they retained at least raised an inference that the advisor did not believe that they would be able to appropriately provide their professional judgment. Just as the special committee should be formed *ab initio*, the financial and other advisors should be retained by the committee at the outset when their input is most likely to add value.
- **Active Negotiations.** In *Salladay*, the court outlined allegations that showed a less than diligent special committee process: belatedly retaining the financial advisor, failing to vigorously pursue discussions with

other funding sources, and failing to share projections showing an upside case reflecting success of its new product with the second financial advisor, instead providing them with less optimistic base case projections on which the advisor based its fairness opinion. It is also unclear to what extent the special committee negotiated the terms of the note purchase agreement that set a conversion price well below the per share merger price. To effectively serve as a surrogate for the disinterested stockholders, a special committee must actively negotiate terms and effectively use its advisors.

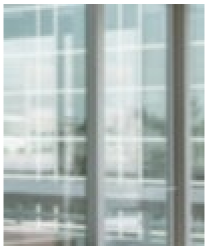
Stockholder Vote

- **Don't Hide the Ball.** The proxy statement in *Salladay*, in one place or another, disclosed all the information from which a determined stockholder could calculate the impact of the NASDAQ listing rule that would have prevented the buyer from obtaining control of the board if the merger were not approved by stockholders. But to gather and assess that information required that same stockholder to follow clues scattered throughout the document and make her own calculations to arrive at a conclusion. Absent that effort, she would be left with the impression that, even if she were opposed to the merger, a "no" vote meant that she would be in a worse position—as a minority stockholder in a controlled corporation. Vice Chancellor Glasscock agreed that the stockholder vote was not sufficiently informed to invoke the business judgment standard of review. The lesson is—when in doubt about the clarity of a fact that is material to a conflicted transaction, err on the side of clear and complete disclosure in a manner that is easily comprehensible to a reasonable stockholder attempting to decide whether to approve the matter.
- **Fairness Opinion Process is Material.** Inadequate disclosure is one of the primary reasons that a vote by disinterested stockholders can be found to be ineffective. The fairness opinion and the processes around its formulation are always of central concern. Accordingly, everything leading to the selection of the financial advisor who prepared the opinion, the information provided to that advisor for purposes of preparing the opinion and on which the advisor relied, and the procedures followed by the advisor in reaching its conclusion will be examined in detail. Events such as the resignation of the initial advisor in such short order beg an explanation and should have been candidly addressed in the proxy statement.
- **Belts and Suspenders.** In *Salladay*, the Intersections board sought to overcome the conflicts in the merger transaction by employing both conflict-cleansing mechanisms but were unsuccessful in each case. Nevertheless, if practical, and particularly where circumstances may call into question whether the special committee was really empowered before substantive economic discussions commenced, it may be prudent to seek protection of such a transaction through a fully-informed vote of the minority stockholders in addition to a *Trados* special committee process.

Authors

Evelyn Cruz Sroufe

Of Counsel
ESroufe@perkinscoie.com 206.359.8502



Eric A. DeJong

Partner
EDeJong@perkinscoie.com 206.359.3793

Andrew Bor

Partner
ABor@perkinscoie.com 206.359.8577

Raul Beke

Associate
RBeke@perkinscoie.com 206.359.8079

Explore more in

Public Companies Corporate Governance Mergers & Acquisitions

Related insights

Update

Wrapping Paper Series: Issues and Trends Facing the Retail Industry During the Holiday Season

Update

[DOJ’s Notice of Proposed Rulemaking on Sensitive Personal Data and Government-Related Data]