

Client Alert

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Court Refuses to Dismiss Loyalty Claims Against Outside Directors in a Third-Party Sale

A recent Delaware Court of Chancery decision refused to dismiss claims alleging that a board of directors breached its fiduciary duty of loyalty in authorizing a sale of a corporation to a third party. The stockholder plaintiff alleged that the sale was motivated by the corporation's former chairman and chief executive officer, who owned 37% of the corporation's common stock and needed liquidity. The decision is significant for refusing to dismiss allegations of disloyal conduct against outside directors who were disinterested in the transaction and otherwise unaffiliated with the former CEO.

Background

[*New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*](#) involved the 2010 sale of infoGROUP, Inc., to a private equity fund. The stockholder-plaintiff alleged that the sale was motivated by the corporation's former chairman and chief executive officer, who owned 37% of the company and "desperately needed liquidity" to fund a new venture and to satisfy \$12 million in settlement obligations stemming from a Securities and Exchange Commission action and a derivative suit brought against him. The plaintiff claimed that the board of directors breached its fiduciary duties by capitulating to the former CEO's pressure and approving a transaction that was not in the best interests of all shareholders.

In addressing the defendants' motion to dismiss, the court first held that the former CEO, who was still a director of the company, was "interested" in the transaction. Although all of the corporation's stockholders were to be cashed-out at the same price in the merger, the court reasoned that the former CEO had received a benefit not shared with other stockholders in the form of "liquidity."¹ The court further concluded that this benefit was "material" to him.

The court then turned to the remaining members of the board — all of whom, with the exception of the current CEO, were "outside" directors and none of whom were affiliated with the former CEO. The court found that those directors were not "independent" because they had been dominated by the former CEO through a pattern of threats and intimidation. Specifically, the complaint alleged that the former CEO:

- had threatened to sue the directors if they did not pursue a sale of the company;
- told the board that he had discovered potential evidence of financial fraud that could lead to personal liability for the directors;
- was "generally disruptive" at board meetings, led the chairman of the board to resign, and caused another director to threaten to resign;

¹ Delaware courts have previously found similar "benefits" to render a director or controlling stockholder "interested" in a transaction. See *Tooley v. AXA Financial, Inc.*, 2005 WL 1252378 (Del. Ch. May 13, 2005) (refusing, "albeit barely," to dismiss a claim where the plaintiff alleged that the board delayed the closing of a third-party's tender offer to accommodate the controlling stockholder's administrative needs); *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (refusing to dismiss claims that directors acted disloyally in approving a sale to a third party allegedly to satisfy the controlling stockholder's need for liquidity).

- had “denigrated” the company’s management and called for the firing of its current CEO, who also sat on the board;
- issued a press release without board approval that recommended a sale of the company; and
- tainted the sale process by speaking to potential bidders without board supervision and by leaking confidential information.

The court also focused on an email cited in the complaint between two directors in which they indicated that some directors might want to “dump the company and run” due to the “pain, trauma, time and everything else.”

Based on the foregoing and after drawing all reasonable inferences in favor of the plaintiff, the court held that the plaintiff had rebutted the business judgment rule and stated a claim that the directors were not independent and had breached their fiduciary duty of loyalty in approving the transaction.

Implications

Court rulings that refuse to dismiss loyalty claims against outside directors are unusual and deserve significant attention. This is particularly so in the context of a third-party transaction in which all stockholders received the same per share consideration. In addition, none of those outside directors was “interested” in the transaction or affiliated with the key insider who gave rise to the conflict of interest.

infoGROUP is particularly noteworthy for its conclusion that the directors were not “independent.” Under Delaware law, a director is independent when his or her decision is based on the merits of the corporate action and not by extraneous considerations. Here, the court concluded that the directors were not independent because they had been dominated by the former CEO. This domination, according to the court, was achieved through the former CEO’s “pattern of threats aimed at [the directors] and unpredictable, seemingly irrational actions that made managing the Company difficult and holding the position of director undesirable.” A finding that general “intimidation” of outside directors can strip them of their independence goes beyond traditional notions of “domination and control.”

infoGROUP is also reminiscent of the July 28, 2009, decision in [Louisiana Mun. Police Employees’ Ret. Sys. v. Fertitta](#). There, the Court of Chancery refused to dismiss loyalty claims brought against outside directors who allegedly failed to stop the company’s CEO/39% stockholder from engaging in open-market purchases to acquire a majority of the company’s voting stock. The *Fertitta* court held that “the board’s failure to employ a poison pill to prevent [the CEO] from obtaining control without paying a control premium” was sufficient “to infer fiduciary misconduct more serious than a breach of the duty of care.”

infoGROUP and *Fertitta*, therefore, are important reminders for outside directors when dealing with significant or influential insiders. Under Delaware law, outside directors generally have little reason to fear personal liability so long as they act in good faith. Actions taken at the bequest of a key insider or that favor one constituency over another, however, should be treated with caution. Such decisions should be considered carefully and reflected through a proper decision-making process. Here, the court inferred that “the sale of *infoGROUP* was the best option [for the former CEO] to fulfill his need for liquidity, *regardless of whether the timing, price, or process employed were in the best interests of the Company’s other shareholders.*” Thus, at trial, the court will look to whether the board conducted the sale process and reached a determination that the transaction was in the best interests of all shareholders, and not just to appease the former CEO. At the same time, many observers would argue that the board had to consider how the company’s prospects as a stand-alone entity could be adversely affected by the fact that its largest stockholder was advocating publicly for a sale of the company.

In any event, *infoGROUP* also shows that a court may find a conflict of interest even where a transaction facially treats all stockholders equally. In *infoGROUP*, specific factual allegations of the former CEO’s need for liquidity and personal financial situation were sufficient to deem him “interested” in the transaction. Although *infoGROUP* involved a unique set of facts, future plaintiffs can be expected to

challenge transactions involving large stockholders, including financial sponsors and founding families seeking an exit for their investment, by claiming that those stockholders had personal interests in addition to the consideration paid to stockholders and that such transactions were ill-timed and improperly motivated.

If you have any questions about this decision or other matters of corporate law, please contact Gary Thompson at (804) 788-8787 or gthompson@hunton.com, Steven Haas at (804) 788-7217 or shaas@hunton.com, or your Hunton & Williams LLP contact.

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