

# Client Alert

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## Court Rejects Challenge to M&A Transaction Despite Activist Pressure

In *Rudd v. Brown*, the Delaware Court of Chancery dismissed a stockholder's claim that directors had breached their fiduciary duties by pursuing a sale of the company to avoid a proxy contest threatened by an activist hedge fund.<sup>1</sup> The court held that the plaintiff had not successfully challenged the directors' independence with conclusory allegations that the directors approved a sale at an allegedly inadequate price to avoid a potentially embarrassing proxy contest in which they might lose their board positions.

### Background

The litigation arose from the 2015 sale of Outerwall, Inc., the operator of Redbox kiosks, to a private equity firm. Prior to the sale, an activist hedge fund, Engaged Capital, acquired 14.1% of the company's stock, called for the company to explore strategic alternatives, and threatened a proxy contest to remove the incumbent directors. Shortly after the sale process commenced, the company entered into a "cooperation agreement" with the activist, which allowed the activist to appoint a director to the company's board. The agreement further provided that the activist could appoint another two directors in the future, which, according to the court, "essentially provided a deadline for the Board to negotiate a sale or be swamped by [the activist's] appointees."<sup>2</sup>

Following the sale process in which 53 potential bidders were contacted, the company entered into merger agreement in July 2015. The merger was completed approximately two months later, with 69.3% of the shares being tendered in the first-step tender offer.

### Court of Chancery's Opinion

In pursuing post-closing breach of fiduciary duty claims, the plaintiff alleged that the board of directors had acted disloyally by pursuing the sale of the company because of "their desire to avoid ouster at the hands of [the activist] and the reputation harm that would come with it."<sup>3</sup> The plaintiff argued that the directors' desire to avoid the proxy contest constituted self-interest and that the sale price was inadequate.

The court held that these allegations were insufficient to plead a breach of loyalty claim. In reviewing prior cases, the court explained that "[t]he threat of a looming proxy contest might inform the inference of conflict at the pleading stage 'when coupled with other pled facts.'"<sup>4</sup> It noted, for example, prior cases where a threatened proxy contest was coupled with "other indicia of gross negligence or disloyalty,"<sup>5</sup> such as an asset sale to insiders<sup>6</sup> or where a board had "double flip-flopped" by initially opposing a sale and

<sup>1</sup> *Rudd v. Brown*, C.A. No. 2019-0775-MTZ (Del. Ch. Sept. 11, 2020).

<sup>2</sup> *Id.* at 8.

<sup>3</sup> *Id.* at 19.

<sup>4</sup> *Id.* at 20 (emphasis added).

<sup>5</sup> *Id.* at 25.

<sup>6</sup> See *Kosseff v. Ciocia*, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006); see also *In re Tangoe, Inc. S'holders Litig.*, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018).

then selling the company at a price less than the board's initial stance on the company's value.<sup>7</sup> In the absence of any such allegations, the court dismissed the complaint based on its "bare-bones conflict theory."<sup>8</sup>

The court also rejected allegations that the activist's board nominee had a conflict of interest. Importantly, the nominee appears to have been nominally independent of the activist hedge fund, meaning he was not a principal or employee of the fund. The plaintiff alleged that the nominee had a history of working with the activist where he joined the boards of other companies and pushed for M&A transactions. Based on the pleadings, however, the court said the directors alleged "track record" did not give rise to a conflict of interest.

This holding can be contrasted with the Court of Chancery's ruling in *PLX*, where an activist appointed one of its principals to the board of a company being pressured to sell itself.<sup>9</sup> The *PLX* court found that the activist and its designee "had a divergent interest in achieving quick profits by orchestrating a near-term sale," and that the activist aided and abetted the board's breach of fiduciary duty by concealing material information from the board relating to the sale process.

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<sup>7</sup> *In re PLX Techn. Inc. S'holders Litig.*, C.A. NO. 9880-VCL, trans. ruling (Del. Ch. Sept. 3, 2015).

<sup>8</sup> *Rudd*, mem. op. at 26.

<sup>9</sup> *In re PLX Tech. Inc. S'holders Litig.*, 2018 WL 5018535 (Del. Ch. Oct. 15, 2018).