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Chancery Court Ruling Confirms High Bar to Pleading a Nonexculpated 'Revlon' Claim

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Vice Chancellor Morgan T. Zurn's recent decision in *Rudd v. Brown* reaffirms longstanding Delaware law protecting director decision-making in M&A transactions, even where *Revlon* duties apply and an activist has threatened the board members with a proxy campaign. The decision offers useful guidance to directors and senior officers and their advisors in a sales process precipitated by activist interest, and reassurance that complaints based on unsubstantiated allegations of director or officer conflicts will not get past the pleadings phase.

Background

The litigation involved a company called Outerwall, which operates Redbox, Coinstar and ecoATM self-service kiosks. In early 2015, the company touted its strong existing and anticipated future financial performance, but the tides began to shift toward the end of 2015 and into 2016, with the company reporting declining revenue and challenging headwinds in the business. In early 2016, an activist investor acquired a 14+% stake in Outerwall and launched a public campaign to push Outerwall's board to pursue a sale of the company. If the board declined to do so, the activist threatened to launch a proxy campaign to replace "multiple directors."

Brian Lutz, left, and Colin Davis, right, of Gibson, Dunn & Crutcher. Courtesy photos

Outerwall's board hired a banker, launched a sales process, and reached an agreement with the activist through which the activist agreed to stand down from its threatened proxy contest for the upcoming stockholder meeting in exchange for the ability to appoint one member of the board immediately, and two more directors later in the year.

Following an extensive sales process—including outreach to 53 potential bidders—and a competitive bidding process for the company, the board agreed to sell the company to Apollo through an all-cash tender offer and subsequent short-form merger. Nearly 70% of Outerwall's stockholders agreed to tender their shares, and Apollo completed the second step of the merger to close the acquisition.

An Outerwall stockholder filed a Section 220 action shortly before the transaction closed, seeking documents to investigate potential breaches of fiduciary duties in connection with the transaction. Following a paper trial, Chancellor Andre Bouchard entered judgment against the plaintiff, holding that the stockholder failed to establish a credible basis to suspect wrongdoing.

The Decision

Undeterred by the ruling in the books and records action, another stockholder filed a putative class action complaint asserting that the members of the Outerwall board of directors and the company's chief financial officer breached their fiduciary duties by agreeing to sell the company out of self-interest and at an inadequate price.

Zurn dismissed the complaint, finding that the stockholder failed to plead a viable breach of fiduciary duty claim against any defendant, even with the enhanced judicial scrutiny that applies under *Revlon*. The court rejected the stockholder's claim that it had adequately pled a nonexculpated claim against the directors on the ground that they were conflicted because of their desire to avoid a proxy fight, finding that the threat

of a proxy contest—without more—is insufficient to create a disabling conflict. And the court rejected purported conflicts as a result of the CEO's acceleration of stock options and change in control payments, the CFO's prospect of future employment, and a purported "objective" of selling the company by the director appointed by the activist. Zurn concluded that the plaintiff failed to plead facts sufficient to support a non-exculpated breach of fiduciary duty claim under *Revlon* as to the directors or a duty of loyalty claim against the CFO.

Takeaways

• **Activist pressure, standing alone, does not create a director conflict**. Activist investors are now a well-established feature of the board room and the broader M&A landscape, so there should be no surprise that many boards elect to commence an M&A process or pursue other alternatives as a result of the input and influence of investors agitating for change. Zurn followed established Delaware when rejecting the stockholder plaintiff's principal "conflict" theory, that the mere presence of a threatened proxy contest is sufficient to create a disabling director "interest." *Rudd v. Brown* reaffirms that only where a complaint contains specific facts reflecting other indicia of gross negligence and disloyalty by directors—such as directors revising their own compensation structure, thoughtlessly approving a self-dealing transaction, or taking inconsistent positions in response to a proxy threat—can the looming threat of a proxy contest support a director conflict. Here, the stockholder offered no such "meat on the bone" allegations, so the bare allegations of a threatened proxy contest standing alone failed to create a director conflict sufficient to support a non-exculpated breach of fiduciary duty claim. Directors should take comfort that a well-informed and unbiased decision to pursue an M&A transaction will be protected, even if it comes in the context of a threatened activist proxy campaign.

• **Directors or officers are not conflicted in M&A transactions simply because of their compensation arrangements, interest in future employment, or track record of selling companies.** Typical features of M&A transactions—like cashing out a director's equity, or an officer's interest in staying in retaining his or her job after the sale—do not, standing alone, create a conflict. And even a director's track record as an activist investor appointee does not create a conflict. Zurn noted that while one director was alleged to have "a long history of being appointed to companies' boards to push a merger or acquisition for short-term profit, including other companies that [the activist] had targeted for a sale in the past," this assertion failed to give rise to a conflict, as the court was aware of "no support for the proposition that a director is conflicted purely by virtue of his track record." Directors should be reassured that issues extraneous to their decision to purse or approve a sale of the company—including a possible cash out of their equity or the circumstances of their appointment to the board—should not, without more, create a disabling conflict.

• **When a stockholder loses a books-and-records action, there probably isn't a viable breach of fiduciary duty claim**. One of the head-scratching elements of the *Rudd* litigation is why the case was filed in the first place. A different stockholder of Outerwall litigated a separate books and records action through trial, and was unable to meet the low "credible basis to suspect wrongdoing" standard that applies under Section 220. Thus, it is perplexing why any stockholder (or their counsel) would think they could meet the higher burden of pleading facts giving rise to a nonexculpated breach of fiduciary duty claim in a plenary breach of fiduciary duty action. Given the procedural history, it was hardly surprising that Zurn concluded that in a deal with a robust sales process, competitive bids from multiple interested parties, robust disclosures (including three sets of projections), and no unusual compensation or employment discussions or terms, there was no viable breach of fiduciary duty claim.

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