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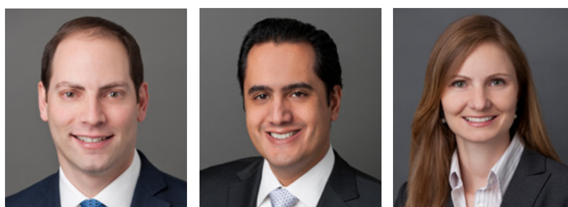
In re Novell: Directors' Bad Faith in a Sale Process



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On January 3, in *In re Novell Shareholder Litigation*, No. 6032-VCN 2013, 2013 Del. Ch. LEXIS 1 (Del. Ch. Jan. 3, 2013), Vice Chancellor John W. Noble of the Delaware Court of Chancery issued a memorandum opinion denying the defendants' motion to dismiss with respect to the plaintiffs' bad-faith claim in connection with Novell's sale transaction completed in April 2011. The court held that the plaintiffs had made a "reasonably conceivable" claim that Novell's board acted in bad faith and breached its fiduciary duties of care and loyalty by favoring one bidder over another comparable (and perhaps more favorable) bidder.

This case arose out of an auction process that was instituted by the Novell board following its receipt of an unsolicited $5.75-per-share acquisition proposal in March 2010 by a significant stockholder of Novell. During an auction process in which more than 50 parties were contacted, the board authorized Attachmate to partner with two of its private equity shareholders to submit a preliminary bid. Eight other parties also submitted bids, which were higher and lower in price than Attachmate's. The board continued with five parties, including Attachmate.

By June 2010, Attachmate indicated a need for additional financing sources and the board permitted Attachmate to approach Novell's significant stockholder who previously made the unsolicited proposal to serve as a financing source by rolling over its equity (this stockholder did in fact roll over its equity and received a 21.9 percent equity interest in the surviving company). In August, the board requested best and final bids from Attachmate and "Party C," at which time Attachmate and Party C bid $4.80 and $4.86 per share, respectively. Despite the higher offer by Party C, the board granted Attachmate exclusivity. At the end of October, Attachmate submitted a revised bid of $5.25 per share and Party C made an unsolicited $5.75-per-share bid. On the following day, Novell separately received a proposal from Microsoft to purchase its patent portfolio for $450 million. The board then took approximately a month to consider all of its options, and during this period the board informed Attachmate, but not Party C, of Microsoft's offer for its patent portfolio. Attachmate then increased its bid to $6.10 per share, conditioned on the portfolio sale being completed for no less than $450 million.

On November 21, 2010, the Novell board approved a merger agreement with Attachmate and agreed to sell its patent portfolio to an affiliate of Microsoft. The plaintiffs subsequently filed the complaint alleging the sales resulted from a tainted process and failed to maximize shareholder value, thus violating the board's *Revlon* duties. To support their claim, the plaintiffs cite the board: (1) allowing

Attachmate to partner with Novell's significant stockholder but not permitting Party C to do so; (2) having made no effort to negotiate with Party C even after Party C submitted a higher price than Attachmate; (3) failing to notify Party C that Microsoft was prepared to purchase the patent portfolio, which would have provided additional cash for the acquisition; and (4) agreeing to preclusive deal-protection measures (a no-shop, five-day matching right and a break-fee equal to 2.7 percent of the equity value).

In analyzing this case, it is important to keep in mind that the decision is a motion to dismiss. Accordingly, the evidentiary record is limited to the pleadings and the plaintiffs had the low burden of showing that there is a "reasonably conceivable" claim Attachmate was favored over Party C. Based on the complaint, the court found that it was in fact reasonably conceivable that the directors had treated Party C adversely and materially different from Attachmate, thereby potentially depriving the shareholders of the best value reasonably attainable. Noble made a point to clarify that "an independent and disinterested board ... is not absolutely required to treat all bidders equally," citing *In re Fort Howard Shareholders Litigation*, No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988). In fact, Noble offered several potential justifications for such disparate treatment and acknowledged that "it might not take much evidence ... to put that disparate treatment in a different context." However, because at this stage the defendants were not provided the opportunity to provide a reasonable explanation for the disparate treatment, the complaint stated a breach of fiduciary duty claim.

The court then turned to the question of whether the directors' conduct amounted to bad faith or simply a breach of a duty of care. Absent bad faith, the directors' conduct would have been exculpated under Novell's charter.

Under Delaware law, a plaintiff can plead a breach of duty of loyalty by alleging "a majority of the board lacked independence, was interested in the sales process, or acted in bad faith in conducting the sale process," as Noble noted. Because it is a well-settled presumption under Delaware law that fiduciaries act in good faith, a plaintiff must show more than a flawed or inadequate process; rather, there must be a "'conscious disregard for ... [fiduciary] duties,'" Noble said, quoting Lyondell *Chemical v. Ryan*, 970 A. 2d 235, 243 (Del. 2009). This standard can be met by showing the directors' actions were "'so far beyond ... reasonable judgment that it seem[s] essentially inexplicable on any grounds other than bad faith,'" Noble wrote, quoting *In re Alloy Shareholder Litigation*, No. 5626-VCP, 2011 Del. Ch. LEXIS 159 (Del. Ch. Oct. 13, 2011). Noble held that the board's failure to inform Party C of the patent sale, while keeping Attachmate fully informed, was sufficient, at this stage, to support an inference that the board acted in bad faith.

As Noble noted, the Novell directors may have had justified reasons for the disparate treatment of the bidders and, therefore, the case could ultimately be decided in the defendants' favor. Nonetheless, the opinion signals that directors may be held responsible for treating different bidders differently if there is not a clear record explaining the basis for such disparate treatment. As a result, it is important to create a thorough, contemporaneous record of why different treatment is being afforded various bidders in the M&A context.

The court also took the opportunity to reaffirm for practitioners that deal-protection provisions (i.e., non-solicitation, matching right and termination-fee provisions) are customary and the "mere inclusion of such routine terms does not ... amount to a breach of fiduciary duty." The court also once again solidified that the proper measure of a termination fee is based on a percentage of equity value.

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