Cooley

Whataday for Special Committees: Salladay v. Lev Clarifies Committee Formation Requirements in Non-MFW Scenarios

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In late February as the COVID-19 pandemic was accelerating, the Delaware Chancery Court issued an important decision that is likely to impact transactions during the expected recession. In *Salladay v. Lev*, C.A. No. 2019-0048-SG (Del. Ch. Feb. 27, 2020) ("Salladay"), the court held that a conflicted transaction – not involving a controlling shareholder – could only be cleansed through the use of a special committee under *Trados II*[1] if the special committee was constituted *ab initio* (i.e., from the outset). *Salladay* is the first time that a Delaware court has held that the *ab initio* requirement established by *Kahn v. M&F Worldwide Corp*., 88 A.3d 635 (Del. 2014) ("MFW") and its progeny applies in a non-*MFW* scenario (i.e., in a transaction without a conflicted controlling shareholder). Accordingly, a conflicted transaction without a controlling stockholder, can be "cleansed" under *Trados II* and become eligible for review under the business judgment rule if an empowered special committee of independent directors is **constituted at the outset before any substantive economic discussions occur** and the other *MFW* standards relating to special committees are met.[2] However, if the special committee is not established *ab initio*, and there are disputed questions of fact about whether the conflicted transaction was properly cleansed under *Corwin*[3], then the director defendants will have the burden to prove that the transaction was entirely fair.

Background of the case

The challenged transaction in *Salladay* involved the going-private of Intersections, Inc., a data protection software company ("Intersections" or the "Company"). At the time of the transaction, Intersections' board of directors was comprised of six members, three of whom were deemed independent and disinterested for purposes of the going-private transaction, and three of whom were conflicted – including the Company's CEO who also served as chair of the board. In 2017, the Company began experiencing financial difficulty as it worked to update its flagship product, and in early 2018 it formed a special committee of its three independent directors to consider options for additional ways to raise capital. iSubscribed Investor Group ("iSubcribed" or the "Acquiror") entered the picture in September 2018 – after the special committee had already been disbanded – and had several conversations with the Company's management and conflicted directors regarding its interest in acquiring the Company before the special committee was reconstituted. Of particular importance was a meeting on September 27th, during which it was alleged that the Company's CEO informed iSubscribed that the Company's board would likely be receptive to an offer in the range of $3.50 to $4.00 per share. iSubscribed then submitted an initial offer of $3.50 per share. The special committee was reconstituted on October 5th and hired its own legal counsel and financial advisor shortly thereafter. Between October 5th and 11th, the special committee supervised a price negotiation with iSubscribed, which resulted in an increased offer of $3.68 per share. On October 11th, the special committee authorized its counsel to negotiate definitive documents and determined that any acquisition should be conditioned on approval of a majority of the disinterested stockholders. The Company and the Acquiror entered into a definitive merger agreement on October 31st. Each of the defendant directors (or their affiliates) agreed to rollover a substantial part of their equity as part of the transaction, and received certain other benefits not shared with the disinterested public stockholders. In conjunction with the definitive agreement, the Acquiror also extended a loan to the Company that was convertible into equity of the Company if the transaction was not closed. The transaction was ultimately approved by a majority of the Company's disinterested stockholders.

Key findings

In *Salladay,* the court found that a conflicted transaction not involving a controlling shareholder can only be cleansed under *Trados II* if the *ab initio* requirement from *MFW* jurisprudence has been satisfied – meaning that the special committee must be established prior to any substantive economic discussions taking place. Drawing from the Delaware Supreme Court's rationale in *MFW*, the court here explained that the "acquirer – as well as any interested directors – must know from the transaction's inception that they cannot bypass the special committee…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. In that scenario, a 'bare-knuckle contest over price' is unlikely, and the existence of the committee is insufficient to replicate an arms-length transaction." *Salladay* was decided in the motion to dismiss context, meaning that the court was required to accept any well-plead allegation as true. In reaching its decision, the court appeared to place substantial weight on the September 27th meeting during which it was

alleged that the Company's CEO suggested that an offer in the range of $3.50 to $4.00 per share would likely be acceptable to the Company's board. Noting iSubscribed's initial offer of $3.50 per share, and the eventual merger price of $3.68 per share, Vice Chancellor Glasscock found it reasonably conceivable that the prior discussions lead to a price collar, and set the stage for future price negotiations. Accordingly, the special committee did not have "the full negotiating power sufficient to invoke the business judgment rule." Because the challenged transaction in *Salladay* did not involve a conflicted controlling shareholder and was approved by a majority of the Company's disinterested stockholders, it also could have been cleansed under *Corwin*. However, for the reasons described below, the court found that the Company's disclosures regarding the transaction were misleading and lacked certain material information necessary to invoke a *Corwin* defense.

Process considerations

Timing is key

Given the court's decision in *Salladay*, companies seeking to utilize a special committee to cleanse a conflicted transaction would be well-advised to ensure that their management teams, directors and agents avoid any discussions about price with potential buyers or their agents (including thinking out loud or other musings without reaction from the other party or backroom conversations) before the special committee is formed. Furthermore, it's important to keep in mind that the *ab initio* requirement applies to all conflicted transactions where a special committee is utilized – not just transactions involving a change of control. There may be other types of transactions where it is prudent to utilize a special committee – such as a major financing or restructuring where a controlling shareholder is receiving disparate benefits – in which case the parties should make every effort to ensure that valuation or other financial terms are not discussed until the special committee has been formed and properly empowered to – and **in fact** does – direct the price discussions. We have seen situations where special committees were properly formed and empowered but then did not function in the role they were empowered to play. If a plaintiff is able to plead facts showing that discussions regarding price or valuation occurred prior to a special committee's formation or outside the committee process – particularly if the final transaction price/valuation is in the range discussed prior to the committee's formation – it will be increasingly difficult to invoke the business judgment rule. In that case, defendants will likely be forced to litigate the claims against them, and prove that either the transaction can be properly cleansed under the *Corwin* doctrine or that the transaction was entirely fair as to price and process under the entire fairness doctrine.

Cleansing under *Corwin*

As a result of misleading and omitted information from the Company's public disclosures, the court found that the transaction was not properly cleansed under *Corwin*.[4]

Buried facts doctrine and coercion

In concluding that the challenged transaction was not adequately cleansed under *Corwin* – despite approval by a majority of the Company's disinterested stockholders – the court focused first on the Company's disclosure regarding a potential change in control. The Company's proxy statement indicated that one of the factors the special committee considered in making its recommendation to approve the transaction was that if the transaction were not approved, the Acquiror would have a contractual right to designate a majority of the Company's board, subject to NASDAQ listing requirements. In reality, the Acquiror would not have a right to appoint a majority of the board because the Acquiror would not hold a majority of the Company's common stock upon conversion of the loan it granted to the Company at signing and the NASDAQ listing requirements would not permit exercise of this right. The court found that this disclosure was misleading under the "buried facts" doctrine, meaning that "isclosure is inadequate if the disclosed information is 'buried' in the proxy materials."[5] The proxy statement could have made that fact clear but instead included potentially coercive disclosure by suggesting that failure to approve the transaction would result in the Company becoming a controlled entity.

Financial Advisors

The court also found that the Company's proxy statement did not include sufficient information regarding the various financial advisors hired by the special committee. The special committee first hired a financial advisor to assist in the review of financing alternatives in early 2018. When the special committee was reconstituted for purposes of considering the challenged transaction, the committee hired a new financial advisor who resigned the very next day, after which the committee hired a third financial advisor who ultimately rendered a fairness opinion in connection with the transaction. The history with the two prior financial advisors, including the abrupt resignation of the second financial advisor, was not disclosed in the Company's proxy statement. Given the important role that a fairness opinion plays in the special committee process and recommendation to stockholders to approve a sale, the court found that a reasonable stockholder would want to know why a financial advisor terminated its engagement, particularly given the timing.

The *Salladay* case reiterates the need for full disclosure that is not misleading. Given the increased use of Section 220 book and records demands by plaintiffs, parties should assume that plaintiffs will obtain access to at least some of the company's records relating to the transaction – which may include text message and email communications, board minutes and board materials – and will look for ways to allege that disclosures did not meet the *Corwin* cleansing standards.

Board / committee minutes

Detailed board minutes will serve a critical role in the defense of any breach of fiduciary duty claims, particularly at the pleading stage. A company can form a special committee that complies with all of the requirements of *MFW* jurisprudence but its efforts will be largely meaningless without the special committee actually overseeing the process as supported in committee and board minutes. To effectively utilize a special committee to cleanse a conflicted transaction, the board minutes should reflect the timing of the committee's formation, the authority granted to it, and its ability to hire its own advisors. There should also be minutes of the special committee containing a detailed discussion of the committee's deliberations, along with a description of the materials it reviewed in reaching its recommendation. Having detailed committee and board minutes may also limit a plaintiff's ability to obtain access to a company's and its directors' email communications and text messages. In recent cases involving Section 220 demands[6], defendants were required to produce email communications and text messages when it was found that they did not maintain traditional board minutes documenting the issues in question.

Given the current economic environment, an increasing number of companies may consider consummating distressed sales which offer little or no consideration to their common stockholders – making process more important than ever. If those transactions are conflicted – whether due to a conflicted board or a conflicted controller – boards should strongly consider implementing a process that appropriately "cleanses" the transaction. *Corwin* is typically the easiest way to cleanse a conflicted transaction that does not involve a conflicted controller – particularly when a company does not have any independent directors to comprise a special committee or the independent directors do not feel comfortable taking on that role. If it's not realistic for a company to cleanse a transaction, the board can still take steps to help prove that the transaction was entirely fair – including by diligently documenting their decision-making process. Whether or not the company utilizes "cleansing" mechanisms, having detailed minutes – reflecting an understanding and proper exercise of the board's fiduciary duties – will be critical to any later defense of a challenged transaction.

Notes

1 *In re Trados Inc. S'holder Litig.*, 73 A.3 17, 65 n. 39 (Del. Ch. 2013) ("Trados II")

2 A conflicted transaction involving a controlling stockholder can be "cleansed" under *MFW* if the following requirements are met: (i) *ab initio* (i.e., at the outset and before any substantive economic discussions occur), the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the disinterested stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to select its own advisors and to say no definitively; (iv) the special committee meets its duty of care in negotiating a fair price and (v) the vote of the disinterested stockholders is informed and un-coerced.

3 A conflicted transaction not involving a conflicted controller can be "cleansed" under *Corwin v. KKR Financial Holdings LLC*, 125 A. 3d 304 (Del. 2015) ("Corwin") if the transaction is approved by a fully informed and un-coerced vote of a majority of the company's disinterested stockholders.

4 To show that a transaction was not adequately cleansed under *Corwin*, plaintiffs must plead facts regarding the materiality of missing information (or misinformation) from the Company's disclosures about the transaction. The court must then consider whether "t is reasonably conceivable that Plaintiff will be able to demonstrate a substantial likelihood that … reasonable … stockholders would have found this information to be important when deciding how to vote on the Merger". *Salladay* quoting *In re Saba Software, Inc. S'holder Litig.*, 2017 WL 1201108, at *13 (Del. Ch. Mar. 31, 2017).

5 *Salladay* quoting *Vento v. Curry*, 2017 WL 1076725, at *3 (Del. Ch. Mar. 22, 2017) (quoting *Weingarden v. Meenan Oil Co.*, 1985 WL 44705, at *3 (Del. Ch. Jan. 2, 1985)).

6 *See Schnatter v. Papa John's International, Inc.*, C.A. No. 2018-0542-AGB (Del. Ch. Jan. 15, 2019); see also *KT4 Partners LLC v. Palantir Technologies Inc.*, No. 281, 2018 (Del. January 29, 2019).

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