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■ DIRECTOR LIABILITY

In re PLX: Delaware Court Provides Guidance on Potential Conflicts Involving Activist Directors

A Delaware Chancery Court decision highlights potential liability for directors in activist situations, as well as the critical role disclosure plays in defending against price and process claims.

By John Mark Zeberkiewicz

In *In re PLX Technology Inc. Stockholders Litigation*,[1] the Delaware Court of Chancery found that the directors of PLX Technology, Inc. (PLX), in approving the company's sale to Avago Technologies (Avago), breached their duty of disclosure as well as their so-called *Revlon* duties to establish a process designed to seek the best transaction reasonably available. Interestingly, the breach associated with the sales process stemmed not from specific misconduct on the part of a majority of the directors but from the fact that the board's approval was provided in the absence of a material fact that one of the directors, Eric Singer, a principal and designee of the activist hedge fund Potomac Capital Partners, neglected to disclose to his fellow directors. That predicate breach, together with Singer's position with Potomac, led to the finding that Potomac aided and abetted the directors' breach of fiduciary duties.

In spite of the foregoing, the Court held that Potomac was not liable to the plaintiffs for monetary damages. The Court observed that PLX's sales process, albeit flawed, was sufficient to provide evidence of the value of PLX's stock. In reaching its conclusions, the Court provided significant guidance around the types of issues that may result in potential conflicts of interest in the M&A context, particularly with respect to directors representing activist hedge funds.

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Background

In April 2012, after becoming the target of an activist stockholder campaign, PLX's board agreed to a deal in which PLX would be acquired by Integrated Device Technology, Inc. (IDT) for a mix of cash and stock valued at $7.00 per share.[2] During an ensuing go-shop period, Avago submitted an all-cash bid of $5.50 per share. The board did not pursue the competing bid, and the IDT-PLX transaction ultimately was abandoned after the Federal Trade Commission announced it would move to block it on antitrust grounds.[3] The transaction's collapse precipitated a significant decline in the price of PLX's stock, leading the board to conclude that it would need time to stabilize the company before restarting any sales process.[4]

While the stock was trading at depressed prices, Potomac amassed a significant position in PLX, adopting as its investment thesis the notion that, since a competing bidder had emerged during the IDT sales process, the board should attempt to sell the company to that bidder in the near term.[5] In November 2013, Potomac launched a proxy contest, seeking to replace three directors. Potomac publicly criticized PLX's board, expressing its view that the Board should commence a strategic alternative review process. While the board did not foreclose the possibility of a sale, it criticized Potomac for having a short-term outlook and pushing solely for a sale.[6] In late 2013, while the proxy contest was underway, PLX's management began preparing an update to its business plan, generating a five-year plan that the board endorsed at a meeting in December 2013 (December 2013 projections).

Later in December of 2013, PLX held its annual stockholders' meeting, at which Potomac's three nominees, including Singer, were elected. Shortly after the stockholders' meeting, Avago's Vice President for Corporate Development contacted PLX's financial advisor and indicated that, although Avago would not be moving forward presently due to its recent acquisition of one of PLX's competitors, it anticipated reemerging in the relative near term with an offer to buy PLX at a price of $300 million (which equated to roughly $6.50 per share).[7] In a conversation later that day, PLX's financial advisor "'gave [Singer]'"—but not the full board—"'the color'" on his conversation with the Avago officer.[8]

In January 2014, at its first meeting following the election of the new directors, PLX's board reconstituted its committees, naming Singer, who continued to agitate for a sale, as chairman of the Strategic Alternatives Special Committee (Special Committee).[9] In May 2014, Avago reemerged as a potential bidder, submitting an indication of interest at $6.25 per share. In advising the Special Committee, PLX's financial advisor, using the December 2013 projections, presented a discounted cash flow model showing a range of $6.90 to $9.78 per share, with the upshot that the low end still exceeded Avago's indication of interest. The minutes of that meeting, however, included references to events that called into question the reliability of the projections,[10] and the financial advisor's presentation included a second discounted cash flow model—one based on the "Preliminary Management sensitivity case" that was '"intended to reflect events and trends" since the preparation of the December 2013 projections.[11] The Court, however, expressed considerable skepticism around the "sensitivity case" and the sudden appearance of references to the apparent "aggressive" nature of the December 2013 projections.[12]

The Special Committee eventually recommended submitting a counterproposal of $6.75 per share, which the full board subsequently approved. PLX and Avago later agreed on that price and entered into a 21-day exclusivity period (which had followed a narrow pre-signing market check)-, after which management began preparing a new set of projections that reflected a decrease in revenues (June 2014 projections). Based on the June 2014 projections, the financial advisor's discounted cash flow model yielded a range of $4.81 to $6.79.[13]

Claims for aiding and abetting breach of fiduciary duty involve four elements.

PLX's board met to consider the approval of the final deal terms on June 22, 2014. The merger agreement would be effected as a tender offer followed by a back-end merger without a vote of stockholders under Section 251(h) of the Delaware General Corporation Law and would have a customary no-shop provision with a fiduciary out and a termination fee representing 3.5 percent of PLX's equity value. [14] The minutes of that meeting stated that the board had received materials describing the basis for the changes to the assumptions in the June 2014 projections, but the Court found that the statement "appear[ed] to be wishful minute drafting."[15] Based on the June 2014 projections, the financial advisor rendered its fairness opinion.

Directors were under a duty to disclose all facts material to the stockholders' decision whether to tender their shares.

Avago launched the tender offer on July 8, 2014. The tender offer closed on August 11, 2014, having obtained support from more than 80 percent of PLX's outstanding common stock. The merger was consummated the following day. The plaintiffs filed suit shortly after the announcement of the transaction. Claims against three of the directors were dismissed on the basis of the holding in *In re Cornerstone Therapeutics, Inc. Stockholders Litigation*,[16] and all of the defendants other than Potomac later entered into a settlement with the plaintiffs that the Court approved. The plaintiffs continued to pursue their claim against Potomac for aiding and abetting breach of fiduciary duty.

Legal Analysis

Claims for aiding and abetting breach of fiduciary duty involve four elements:

(1) the existence of a fiduciary relationship; (2) a breach of duty; (3) the defendant's knowing participation in that breach; and (4) damages proximately caused by the breach. The Court analyzed each in turn, finding that the plaintiffs had carried their burden on all but the last.

The Fiduciary Relationship

According to the Court, the plaintiffs "easily established" the first element of their aiding and abetting claim, as PLX's directors, in approving the merger agreement, were obligated to "'seek the transaction offering the best value reasonably available to stockholders.'"[17] The Court observed that the best transaction would not necessarily mean approving a sale, but "may mean remaining independent and not engaging in a transaction at all."[18] The Court also noted that the directors were under a duty to disclose all facts material to the stockholders' decision whether to tender their shares.[19]

The Predicate Breach of Fiduciary Duty

In assessing the predicate breach of fiduciary duty underlying the plaintiffs' aiding and abetting claims, the Court first addressed the standard of review that would apply to the directors' decision to approve the merger. Under traditional Delaware jurisprudence, a sale of the company for cash to a third party would ordinarily be subject to enhanced scrutiny.[20] The Delaware Supreme Court's opinion in *Corwin v. KKR Financial Holdings, LLC*, however, held that the business judgment rule applies when a transaction not subject to entire fairness *ab initio* is approved by a fully informed, uncoerced vote (or tender) by the disinterested stockholders.[21] Although more than 80 percent of PLX's outstanding stock was tendered into the merger—which would have resulted in the reinstatement of the presumption of the business judgment rule—the Court found that, due to deficiencies in the disclosure, the stockholders' tender was not fully informed, thereby precluding *Corwin*'s reinstatement of the business judgment rule and leaving enhanced scrutiny as the operative standard of review.[22]

Disclosure Claims

The Court found that the plaintiffs had proved that the directors breached their duty of disclosure in several respects. First, the Court found that the Company's recommendation statement failed to mention that representatives of Avago, in December 2013, advised PLX's financial advisor that Avago was considering making a bid and the price they were considering, and the financial advisor conveyed that information to Singer. The omission of any reference to these facts from the recommendation statement, according to the Court, was material to the stockholders' decision whether to tender, as the "early communication undercut[] the legitimacy of the eventual price negotiations with Avago that Singer led."[23] Second, the Court found that the recommendation statement failed to adequately disclose pricing discussions that Singer held with representatives of Avago during the negotiations, concluding that stockholders would want to know the information for purposes of evaluating whether the parties' in fact bargained at arms' length, or whether Singer was steering the full board toward the price Avago had previously signaled it would be willing to pay.

Next, the Court noted that some of the plaintiffs' alleged disclosure deficiencies—such as whether a meeting of the Special Committee occurred on a particular date and whether Singer had engaged in undisclosed conversations with Avago regarding tender and support agreements—might not, standing alone, be material. But the Court observed that, when viewed with the other elements of the record, the facts took on greater materiality, particularly in light of the fact that the recommendation statement appeared to attempt to minimize Singer's role in the approval of the transaction. Finally, the Court found that the recommendation statement was materially misleading in its description of the revised 2014 projections, including its creation of a misleading impression that the June 2014 projections were prepared in the ordinary course of business for operating purposes when they were in fact prepared after Avago made its bid and used for the fairness opinion.

Sales Process Claims

The Court next evaluated the plaintiffs' claims challenging the sales process. The Court noted that, due to the breaches of the duty of disclosure, the PLX board's approval of the merger agreement was subject to enhanced scrutiny, meaning the plaintiffs, in asserting their claim against Potomac for aiding and abetting breach of fiduciary duty, would be required to prove that the directors' conduct fell outside the range of reasonableness. In assessing the reasonableness of the directors' conduct, the Court noted it would not second-guess "'reasonable, but debatable, tactical choices'" but rather would focus on "'evidence of self-interest, undue favoritism or disdain toward a particular bidder, or a similar non-stockholder-motivated conflict" that would compromise the integrity of the process.[24]

In this case, the Court found that Singer's interest in seeking a sale in the near-term supplied the divergent interest that served as the predicate for the breach of fiduciary duty.[25] The Court found that Singer, as an agent of Potomac and a director of PLX, faced a classic dual fiduciary problem.[26] While Potomac's ownership of a significant block of common stock might ordinarily be viewed as a mitigating factor on an analysis of potential conflicts (as stock ownership tends to align the holder's interests with those of the stockholders generally in an all-cash sale to a third-party), in this case the Court was persuaded that Singer and Potomac had a divergent interest in securing profits from a sale in the near term.[27] In finding these divergent interests, the Court pointed to the statements that Potomac had made during its proxy contest in support of a sale as well as Singer's initial investment thesis in PLX, which was premised on a presumption of a sale in the near term. The Court also found that Singer's actions as a director of PLX were geared primarily toward a sale.[28]

The directors' decision-making process … had been compromised, causing their process to fall outside the range of reasonableness.

The Court found that the board's sales process, absent the divergent interests, would have fallen within the range of reasonableness, noting that the board's narrow pre-signing market check, coupled with a passive post-signing market check period, represented a reasonable approach.[29] The Court found, however, that "Potomac and Singer succeeded in influencing the directors to favor a sale when they otherwise would have decided to remain independent."[30] Although it found that the Potomac and Singer "undermined the Board's process," it stated that it would not have concluded that the board's actions were outside the range of reasonableness but for the fact that Singer, having received information regarding Avago's intention to make a bid (and the price it was willing to pay), withheld the information from the rest of the board.[31] Had the board been apprised of that fact, the Court noted, it may have constructed a different process, including conducting a more vigorous market check or taking more time to consider alternatives. Thus, the Court concluded that the directors' decision-making process, including the informational basis on which their decision was made, had been compromised, causing their process to fall outside the range of reasonableness and sustaining the finding that the plaintiffs had proved a breach of duty in connection with the sales process.

Knowing Participation in the Underlying Breach

Next, the Court found that Potomac knowingly participated in the breach. In this regard, the Court looked to the factors on the Restatement (Second) of Torts, including whether a party committed a tortious act in concert with the other or pursuant to a common design, or knew the other's conduct constituted a breach and provided assistance or encouragement. In this case, the Court found that the fact of Singer's relationship with Potomac, which involved Singer directing Potomac's strategy, was sufficient to impute Singer's actions and knowledge to Potomac. Although the Court was careful to avoid the implication that the actions of a director representing a particular stockholder or group of stockholders would always be attributed to the stockholder or group, it did find that the combination of factors unique to Singer's and Potomac's relationship were sufficient to support the finding of knowing participation.[32]

Causation of Damages

As to the causation of damages element, the Court found that the plaintiffs failed to carry their burden of proof. The Court noted that, when seeking compensatory damages for post-closing disclosure claims, the appropriate measure of damages is based on the out-of-pocket loss equal to the "fair value" of their stock, as the award is premised on the notion that, in the absence of the false or misleading disclosure, the stockholders could have rejected the transaction and retained their proportionate interest of the corporation's equity—a measure of damages known as "quasi-appraisal."[33] In the case of damages for breach of fiduciary duty, the measure of damages is based on what the plaintiffs claim would have occurred in the absence of the breach. As the plaintiffs alleged in this case that PLX would not have been sold absent the breach, the Court found that quasi-appraisal—the same measure of damages for disclosure claims—represented the logical measure of damages.[34]

Although the plaintiffs argued that the standalone value of the Company was worth nearly $10 per share (more than 50 percent higher than the actual deal price of $6.50 per share) based on its expert's analysis, the Court found that the projections on which that model was based—the Company's December 2013 projections—were not sufficiently reliable to support the requested award.[35] The Court noted, among other things, PLX's track record of missing its projections as well as the fact that potential bidders apparently did not, in submitting their bids, give full credit to the figures in the December 2013 projections. Given these issues, the Court, with a nod to *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, where the Delaware Supreme Court, in the context of a statutory appraisal claim, found deal price to have heavy probative value,[36] held that, despite the flaws in the process introduced by Singer and Potomac, the PLX board's sales process was sufficiently reliable to allow for reliance on the real-world market evidence it generated for purposes of assessing damages.[37] The Court observed, among other things, that the post-signing market check would have allowed the emergence of a topping bid, but no such bid emerged.[38] The Court also noted that the merger involved a combination of businesses in the same industry and that the record supported the inference that Avago's price included the embedded synergies—and thus likely exceeded PLX's value as an independent company.[39]

Key Takeaways

The *PLX* opinion highlights that the Delaware courts will focus not just on direct economic conflicts of interest, but also on more subtle conflicts, including potential liquidity conflicts and other factors that may cause a director's interests to diverge from the interests of stockholders generally. This is particularly salient in the activist context, where funds frequently seek representation on the board in the service of a particular agenda, one that is often alleged (fairly or unfairly) to be designed to promote short-term profits at the expense of the stockholders long-term best interests. The actions of directors who act in service of these potential divergent interests may be subject to attack for breach of fiduciary duty. Where these directors are also principals or managers of the funds that designated them to the board, they run the risk of implicating their designating funds as aiders and abettors of breach of fiduciary duty.

The *PLX* opinion also illustrates the critical role that disclosure plays in defending against price and process claims. The Court observed that, absent the finding that PLX's recommendation statement included material omissions, the plaintiffs' process-based claims would have been subject to the favorable presumption of the business judgment rule. Instead, the claims were evaluated under the enhanced scrutiny test, in which the Court focused heavily on the activist-fund designated director's divergent interests to assess whether the board's process fell within the range of reasonableness. The *PLX* Court was troubled by alleged omissions relating to the background of the transaction, including omissions regarding the nature of communications between an individual director and the potential buyer. The *PLX* opinion thus highlights the significant premium on ensuring that the defendant corporation's disclosure document adequately captures facts throughout any sales process, including discussions, arrangements or negotiations between directors and other parties, that, in light of potential conflicts of interest, would be material to the stockholders' decision whether to approve the transaction.

In addition, the *PLX* opinion highlights the importance of the directors' duty of candor to their fellow directors. In concluding that the plaintiffs had met their burden of proof on their process-based claims, the Court focused on the fact that, due to Singer's failure to disclose the "tip" he received regarding Avago's intention to submit a bid, the board was operating without full information when it approved the sale to Avago. While the Court observed that such fact did not render the directors other than Singer culpable in a moral sense, it did cause the full board to breach its situational duties. *PLX* serves as an important reminder that it is critical that directors advise their fellow board members of facts that may be material to the board decision-making process generally.

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Interestingly, the *PLX* opinion represents an extension of the Delaware courts' recent focus on deal price when assessing damages. In this case, as the plaintiffs were claiming that, in the absence of the directors' breach, the stockholders would have retained their proportionate share of PLX as a going concern, the Court was willing to use the deal price as a measure of damages. It is important to recognize, however, that the Court's willingness to adopt the deal price was based on its conclusion that the process, albeit flawed, was not so unreasonable to preclude the use of deal price as a metric of damages. In this case, the fact that PLX had conducted a narrow pre-signing market check, along with the passive post-signing market check and the customary break-up fee, rendered the process sufficiently reliable for purposes of measuring damages.

Notes

1. 2018 WL 5018535 (Del. Ch. Oct. 18, 2018).
2. *Id.* at *3 - 4.
3. *Id.* at *4.
4. *Id.*
5. *Id.*
6. *Id.* at *12.
7. *Id.* at *15.
8. *Id.*
9. *Id.* at *16.
10. *Id.*
11. *Id.* at *22.
12. *Id.* The Court stated: "In reality," the sensitivity case merely "decreased all of the revenue projections in the December 2013 projections by 10% and cut the annual increase in operating expenses by half," which had the effect of generating "a valuation result that perfectly framed the anticipated transaction value of $300 million."
13. *Id.* at *26.
14. *Id.*
15. *Id.* at *26.
16. 115 A.3d 1173 (Del. 2015). In *Cornerstone*, the Delaware Supreme Court held that, in cases where a plaintiff is seeking only monetary relief against an independent director of a corporation that has adopted a provision of its certificate of incorporation under Section 102(b)(7) of the Delaware General Corporation Law eliminating the directors' liability for monetary damages to the corporation or its stockholders for breach of fiduciary duty of care, the plaintiff must plead non-exculpable claims (e.g., breach of duty of loyalty or bad faith) against that director to overcome a motion to dismiss, even if the entire fairness or enhanced scrutiny standards of review are otherwise applicable. *Id.*
17. *In re PLX*, 2018 WL 5018535, at *29 (citations omitted).
18. *Id.*
19. *Id.*
20. *Id.* at *32.
21. 125 A.3d 304, 309 (Del. 2015).
22. *In re PLX*, 2018 WL 5018535, at *38.
23. *Id.* at 33.
24. *Id.* at *40.
25. *Id.*
26. *Id.*
27. *Id.* at *41.
28. *Id.* at *41 – 43.
29. *Id.* at *44. The *PLX* Court pointed to the Delaware Supreme Court's opinion in *C & J Energy Servs., Inc. v. City of Miami Gen. Empls.' and Sanitation Empls.' Ret. Tr.*, 107 A.3d 1049 (Del. 2014). In C & J Energy, the Supreme Court stated that a board would be entitled to "pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so." *Id.*
30. *In re PLX*, 2018 WL 5018535, at *45.
31. *Id.* at *47.
32. *Id.* at 50.
33. *Id.*
34. *Id.*
35. *Id.* at *51 - 54.
36. 177 A.3d 1, at 30 (Del. 2017).
37. *In re PLX*, 2018 WL 5018535, at *55 - 56.
38. *Id.*
39. *Id.*