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A Series Of Avoidable Missteps In PLX Sale

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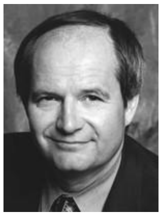

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After Avago Technologies Wireless (USA) Manufacturing Inc. acquired PLX Technologies Inc., certain former PLX stockholders sued for damages. They alleged that the PLX directors had breached their fiduciary duties, aided and abetted by both Potomac Capital Partners II LP (a hedge fund that is an activist stockholder and had three designees on the PLX board) and the PLX board's financial adviser/banker, Deutsche Bank. Before trial, the claims against the financial adviser were settled and those against the directors were dismissed or settled; the trial thus proceeded only against Potomac.

In the Oct. 16, 2018, post-trial decision, In re PLX Technology Inc. Stockholders Litigation, the Delaware Court of Chancery held that Potomac had aided and abetted a breach of fiduciary duties by the PLX directors that was predicated on the board having succumbed to Potomac's pressure to effect a quick sale of PLX. The court suggested in dicta that the financial adviser likely also had aided and abetted the breach. However, the court also held that the plaintiffs did not prove that damages had flowed from the breach; thus, judgment was entered in favor of Potomac.

Key Points

Notwithstanding the court's findings of fiduciary breaches and aiding and abetting, in our view the decision does not change the high unlikelihood of personal liability for directors, dominant stockholders or bankers in connection with a sale process.

Even putting aside the court's finding in this case that damages were not proven, duty of care breaches by directors are typically exculpated and duty of loyalty breaches are found only in the most egregious cases. Further, there is a very high bar to establishing an aiding and abetting claim (including a requirement of "knowing participation," which involves scienter). It takes an extraordinary series of missteps for a stockholder or a banker to be found to have aided and abetted a board's breaches — and generally these types of missteps can be readily avoided (see "practice points" below). We would suggest that PLX is most instructive as a guide to the errors by the board, the stockholder and the banker that led to the unusual findings in this case.

The decision underscores that only a most seriously flawed sale process will constitute a fiduciary breach.

The court stated that, notwithstanding all of the problematic factors relating to the sale process, the court still would have viewed the process as clearly "within the range of reasonableness" but for "one additional critical fact." That fact was that one of Potomac's director designees on the PLX board, Eric Singer (whom we'll refer to here as ES), who was also the co-managing partner of Potomac, and the banker withheld from the PLX board material information that the buyer had told them about its plans to make an acquisition proposal — which information (the Avago tip) included the buyer's intended timing and pricing. The court's discussion on this point reaffirms that, even in a flawed sale process, absent unusual and egregious factors, the potential of liability for director fiduciary breaches or for aiding and abetting is remote. The opinion also highlights the importance of the board's selection of the lead negotiator for the company and the need for the board to monitor and understand what the lead negotiator is doing (particularly if that person may have dual loyalties or be subject to actual or potential conflicts of interest). A board's identifying and addressing any conflicts of interest is critical.

Potomac's own statements and actions led the court to find that Potomac did not have an identity of interest with the other stockholders.

It appears that Potomac and the PLX board may not have realized that Potomac's agenda for a sale of PLX to Avago constituted a conflict of interest for Potomac. Potomac's sole investment thesis was to achieve a near-term sale of PLX to whomever the sole competing bidder was during the go-shop under a merger agreement between PLX and another company (IDT) that had recently been terminated due to antitrust issues. Presumably, in Potomac's view, such a sale would have benefited all of the stockholders (and, indeed, that might have been the case). However, Potomac's sole focus on pressing for the near-term sale (without having considered, or being open to consider, the possibility of any other route to enhancing PLX's value), and Potomac's emphasis on its achieving a short-term profit on the PLX shares that it had acquired at very depressed prices following termination of the PLX-IDT deal, led the court to conclude that Potomac had a "divergent interest" from the other stockholders. That conflict of interest, the court stated, triggered judicial skepticism regarding the sale process that was led by ES.

We note that, with only minor modification to any of a number of the steps that were taken by Potomac, the PLX board or the banker, the very same transaction could have been approved with essentially no vulnerability to successful challenge.

First, and most notably, if Potomac's conflict had been disclosed to the stockholders, then (so long as the other disclosure to the stockholders had been adequate), the Corwin business judgment standard of review (rather than the enhanced scrutiny of Revlon review) would have applied and the case would have been dismissed at the early pleading stage. Even under Revlon review, however, with any of the following changes, the court almost certainly would not have found a fiduciary breach because: (1) the sale process had been run by someone other than ES (or the board had provided consistent oversight of ES); (2) ES and the other Potomac director designees of the PLX board had evaluated what was in the interests of all of the stockholders (rather than only Potomac's interest); (3) the PLX board had more carefully considered what was in the interests of all of the stockholders (including by obtaining a stand-alone valuation for the company and an explanation of changes made in the company's projections); and/or (4) the PLX board had formed a substantive foundation for changing its view that it was the wrong time to sell the company (rather than framing its decision to sell the company in terms of a capitulation to Potomac due to its having gained the support of other stockholders and the proxy firm Institutional Shareholder Services).

The decision does not raise the bar for required disclosure — but highlights the importance of disclosure of the material facts.

The decision confirms that disclosure relating to a sale process does not have to include "every turn and bend" in the negotiations. However, the critical facts must be disclosed so that, for example, the stockholders can understand whether the negotiations were or were not at arm's length (including, as in PLX, whether a conflicted person was the lead negotiator, and whether he held critical "secret" meetings with the buyer or had other material information that was unknown to the board). As noted above, if the PLX board had made adequate disclosure (and thus Corwin had applied), the case would have been dismissed at the early pleading stage.

The court reviewed and criticized the financial adviser's actions (although the relevant claims had been settled before trial).

The court viewed the banker as conflicted due to its having a contingent fee arrangement and a "longstanding and thick relationship" with the buyer. The court viewed the banker's potential disloyalty to the target as confirmed by the banker's withholding the Avago tip from the board. The court also was critical of the facts that the board had not received a stand-alone valuation of the company nor an explanation of changes in projections relied on by the banker (as compared to the company's ordinary course projections).

The decision also serves as a reminder of the following:

- *Aiding-and-abetting liability without board liability.* It is possible for a third party (such as a banker or dominant stockholder) to have aiding-and-abetting liability for a breach by directors as to which the directors themselves have no liability because they were exculpated or the claims against them were settled.

- *Dual loyalties.* Directors with loyalties to both the company and a stockholder who appointed them must consider the interests of all of the stockholders, not just the appointing stockholder's interests.

- *Passive-only sale process.* A passive-only sale process (i.e., without any active solicitation of competing bids) can satisfy a board's Revlon duties.

- *Substantive foundation for board decisions.* With respect to any board decision, a board should establish and document a substantive foundation for the board's belief that the decision is in the best interest of all of the stockholders. If a board changes a previous position (such as a view that it is the wrong time to sell the company), the foundation for that change in view should be established and documented. Capitulation to a stockholder to "head off" a proxy contest, or because of support the stockholder has garnered, may not itself be sufficient as a basis for a board decision to support the stockholder's agenda.

- *Partial disclosure.* Partial disclosure relating to an otherwise immaterial matter may lead to an obligation for full disclosure with respect to that matter. (In this case, the court found it a "close call" whether projections that had been prepared in the ordinary course of business but were not relied on by the banker in rendering its fairness opinion should have been disclosed; however, the court ruled, the partial disclosure relating to the board having considered these projections led to an obligation to disclose that the values derived from those projections all were above the buyer's initial offer, the target board's counteroffer, and the ultimate sale price.)

Background

Potomac acquired PLX shares at very depressed prices following the termination (for antitrust reasons) of the PLX-IDT merger agreement, pursuant to which IDT was to acquire PLX for $7 per share. The proxy statement for that merger disclosed that, during the 30-day go-shop period, there had been one competing bid submitted. Potomac, wanting to achieve short-term profits on its PLX stake, conducted an activist campaign to press PLX to sell itself to whomever that competing bidder had been. As Potomac later learned, the competing bidder had been Avago and the bid had been for $5.75 per share (which was well above the prices at which Potomac had acquired its PLX shares). The PLX board had believed that it was the wrong time to sell the company after the recent termination of the IDT deal. Potomac won a proxy contest (which focused on the long tenure of the PLX directors), and ES and two other designees joined the PLX board.

After the Potomac designees joined the PLX board, Avago contacted the banker, who was also Avago's long-time banker and was then representing Avago in connection with another acquisition, and told the banker that it would be making a proposal to acquire PLX, for about $6.50 per share, as soon as the other acquisition it was working on closed (the Avago tip). The banker shared this tip with ES, but neither ES nor the banker shared it with anyone at PLX. When Avago's other acquisition closed, it made an acquisition proposal to PLX at $6.25 per share. Over just nine days, the PLX board, led by ES, countered at $6.75 and then agreed to $6.50.

Discussion

The court found that Potomac had a "divergent interest" from the other stockholders based on its single focus on achieving a quick sale of the company to Avago so that Potomac could obtain a short-term profit on its PLX shares. The court observed that ordinarily, ownership of a large block of stock "is helpful ... [in] undermin[ing] any concern about divergent interest — that is, the large stockholder's interest is aligned with the interest of the other stockholders in considering the trade-offs for the company between a sale and remaining independent and, if a decision is made to sell, in obtaining the best price reasonably available." However, there are times when a large stockholder's interest in liquidity or short-term profit can create a divergence of interest. This may occur in the case of "activist hedge funds [who] are impatient shareholders, who look for value and want it realized in the near or intermediate term."

The court acknowledged that it is not enough for a plaintiff merely to generally assert that a director has a conflict of interest "because she is affiliated with a particular type of institution that has particular incentives or pursues a particular strategy." The court acknowledged (in a footnote) a line of cases that has established that a general desire for liquidity does not represent a divergent interest from other stockholders unless it is based on a critical need for liquidity (such as to avoid imminent bankruptcy). In this case, however, there was a preponderance of evidence that "[ES] and Potomac had a divergent interest in achieving quick profits by orchestrating a near-term sale."

First, in their activist campaign and proxy contest, they argued vehemently that PLX should be sold quickly. Their only investment thesis was a quick sale to the other bidder who emerged during the go-shop for the IDT transaction. They "never prepared any valuation or other analysis of the fundamental value of PLX." They lacked "any ideas for generating value at PLX other than to sell it." Second, the PLX board made clear that it understood that ES and Potomac's intent was to effect a quick sale only for their own short-term profit motives. Third, once ES was on the PLX board, he "consistently acted with that intent" and "orchestrated" a process to "engineer" a deal on Avago's preferred terms.

The court viewed the banker as also having conflicts of interest, which led it to favor a sale of the company. First, the court cited the banker's contingent fee arrangement, which, the court stated (without further discussion), "gave [the banker] a powerful incentive to favor a sale over having PLX remain independent." (Contingent fee arrangements, of course, are quite customary with financial advisers.) Second, the court noted the banker's "longstanding and thick relationship" with Avago. The court acknowledged that the banker did not advise the buyer and seller simultaneously on the same deal, "but when dealing with an industry that values relationships, and recognizing that bankers frequently provide advisory services first and document the engagement later, a reviewing court cannot ignore the situation that [the banker] created." The court concluded: "As with [ES]'s conflict, [the banker]'s position on both sides of the deal necessarily colors the court's assessment of the decisions that the directors made."

In finding that the board breached its fiduciary duties, the court emphasized the "critical fact" that ES and the banker had withheld the Avago tip from the board. The court stated: "Taken as a whole, [the] evidence suggests that Potomac and [ES] undermined the Board's process and led the Board into a deal that it otherwise would not have approved .... Yet, in spite of this evidence, I could not conclude that the Board's decisions fell outside the range of reasonableness without one other critical fact:" the "secret" Avago tip. By withholding the Avago tip from the rest of the board, "[ES] breached his fiduciary duty and induced the other directors to breach theirs ..., fatally undermin[ing] the sale process." The court stated that, if the board had known the withheld information, it "might well have proceeded differently."

The court seemed to suggest that a board may have some affirmative obligation to seek to determine whether any director or the banker has material information that should be shared with the board. The court stated that the directors "breached their fiduciary duties by engaging in a sale process without knowing critical information about Avago's communications with [the banker]." The court wrote: "The directors other than [ES] should not be blamed for this oversight in any morally culpable sense; [ES] and [the banker] withheld the information from them. In terms of fulfilling their fiduciary duties to stockholders, however, the directors fell short." It is not clear whether the court was referring to the other ways in which the board fell short, or was suggesting that the directors should have done something to try to obtain information that was being withheld from them. We note that previous decisions have established that a board has an obligation to be proactive in determining whether directors or bankers have conflicts of interest. As we read the opinion, at least where the board knows that a director or banker may have a conflict, the board should consider seeking to determine whether the conflicted party has any information (such as past contacts with a potential buyer) that would be relevant to the sale process.

The court viewed the PLX board as having capitulated to Potomac without trying to obtain the best transaction for the stockholders (which could have been remaining independent). The board had held a firm view that it was the wrong time to sell the company immediately after termination of the PLX-IDT deal. The board formed a special committee to investigate a sale only after Potomac launched its proxy contest to obtain seats on the PLX board. A number of directors testified at trial that the committee was formed due to "Potomac's intervention," and that the situation with Potomac "caused [the directors] to view things a little differently." The court wrote: "This was a Board that was susceptible to activist pressure." The court observed that, after Potomac won the proxy contest and ES and the other Potomac designees joined the board, the other directors "found a new willingness to support a sale at prices below the values that they had previously rejected" — even though PLX's business had grown stronger. We note that there was apparently no evidence of any other foundation for the directors' change of view. The court also observed that the incumbent directors "deferred to [ES] when he sought to position himself to best achieve a sale," by agreeing to his request to become chairman of the special committee, and "permitted [ES] to take control of the sale process when it mattered most" (i.e., when Avago "resurfaced" after it had completed its LSI transaction).

Finally, and critically, the directors testified that, given the situation with Potomac, they were "engaging in the art of the possible" when they supported the Avago deal. "This testimony was direct evidence of breach," the court wrote. In the court's view, the "art of the possible" meant seeking the "next best deal" rather than, as required under Revlon, the best deal. The court did not address whether, in the face of strong stockholder and proxy firm support for an activist, a sale championed by an activist (what the court called a "next best deal") could be, in a board's reasonable judgment, the best deal reasonably available. We note that, in any event, in PLX, as the activist held a minority of the board seats, the board could have resisted the activist's agenda.

The court found that the activist stockholder "knowingly participated" in the directors' breach of duty as it had "created a critical informational gap" that "contributed" to the breach. The knowing participation by ES was based on the court's imputing ES' "knowledge and actions" to Potomac. Although the actions of the director representative of a stockholder cannot always be attributed to a stockholder, the court noted, in this case, "the combination of [ES'] position with, ties to, and actions on behalf of Potomac" (including "his role in directing and implementing Potomac's strategy" as the co-managing partner), according to the court, "support[ed] a different result."

The court found that the plaintiffs did not prove damages from the board's breach and emphasized the reliability of an arm's-length negotiated merger price in determining stand-alone value. Although the court viewed the sale process as flawed, the court stated that it was "sufficiently reliable to exclude the plaintiffs' damages contention" — given the pre-signing market checks and, in particular, that no topping bid had emerged post-signing. Moreover, the court stated, as the target and the buyer were in the same industry, the deal likely was synergistic and the deal price therefore likely exceeded the stand-alone value of the company. The court did not address to what extent a flawed sale process could have resulted in a depressed merger price that conceivably could be below a company's stand-alone value.

The court found that the PLX board breached its duty of disclosure. The court found that the board, in connection with the stockholder vote on the sale, (1) did not disclose to stockholders the Avago tip, (2) "downplayed" ES' role in the negotiations, and (3) misleadingly characterized the projections used by the banker to evaluate the fairness of the deal price as having been prepared in the ordinary course of business. In addition, the court stated that it was a "close call" whether an earlier set of projections (that were not relied on by the banker) would have had to be disclosed, but as there was "partial disclosure" that the board had reviewed them, the board also had to disclose that the values indicated all were above the price initially proposed by Avago, PLX's counteroffer and the ultimate deal price.

Practice Points

A board should proactively identify and address conflicts of interest.

A director should disclose to the board any actual or potential conflict that he or she has. These obligations apply throughout the sale process. The board may determine that there is not actually a conflict. If there is a conflict, the board should decide what role, if any, the conflicted person should play in the sale process. The board may decide to establish a special committee that excludes conflicted persons or to establish procedures for monitoring and oversight of conflicted persons.

Where a stockholder's agenda is based on a desire for liquidity, the board should determine whether that desire represents a conflict of interest.

The board should seek to distinguish between (a) a general desire for liquidity, which should not represent a divergent interest from the other stockholders, and (b) a desire that reflects a critical need for liquidity (such as to avoid imminent bankruptcy) or a single focus on achieving liquidity motivated by the particular stockholder's situation (such as in PLX, wanting to obtain a quick profit on shares recently bought at depressed prices, without regard to the interests of the other stockholders), which could represent a divergent interest.

A board should consider seeking to determine whether a director or banker (especially if conflicted) has material information relating to the sale process that has not been shared with the board.

In addition, a director or banker should disclose any such information to the board.

Given the very significant benefit that arises from review under Corwin rather than the heightened scrutiny of Revlon, in the case of "close calls," a company may wish to err on the side of more disclosure to stockholders rather than less.

"Every bend and turn" of negotiations does not have to be disclosed; however, a company should disclose the material elements so that stockholders can determine, for example, whether the negotiations were actually at arm's length or not. A board should not "downplay" the role of a possibly conflicted person who was a key negotiator, should accurately characterize projections as to whether they were prepared in the ordinary course, and should be mindful that partial disclosure of otherwise immaterial facts may create an obligation for full disclosure.

An activist or sponsor stockholder, when formulating a plan for the company that it intends to press, should consider the advantages and disadvantages of a single-focused approach.

The stockholder may well be advantaged if, although it has a preferred plan, it has considered or at least is open to considering alternative routes to enhancing the company's value.

A board, obviously, should have a rational basis for its decisions, including for supporting a stockholder's agenda.

If a majority of the board seats are not held by the stockholder, the board can and should resist the stockholder's plan unless it has determined that the plan is in the best interests of all of the stockholders — and, when Revlon applies, that the deal is the best deal reasonably obtainable. (When, as in PLX, a majority of the board has not been designated by the stockholder who is pressing an agenda, it is unlikely that the stockholder's plan could be the only deal reasonably obtainable.) Capitulation to a stockholder because it has gained significant support, or to avoid a proxy contest or public embarrassment, may not in and of itself provide a sufficient basis for a board decision. Also, if a board changes a previously held view (such as that it is not the right time to sell the company), the board should establish (and document) a substantive foundation for the change.

A board should not ignore the issues actually raised by a stockholder in a proxy contest — which may be different from the issues the stockholder had raised previously in discussions with the company.

In PLX, while Potomac had focused on pressing a sale of the company, in its proxy contest it focused on board tenure and stock ownership. PLX's proxy materials focused on its willingness to sell the company and its disagreement with Potomac just as to timing. ISS supported Potomac based on the board tenure issue. We note also that PLX could have considered eliminating the tenure issue by itself replacing or adding directors.

A board should ensure that it has all material information reasonably obtainable by it that it needs to evaluate the banker's financial analyses and advice.

Generally, a board should evaluate the alternative of the company remaining independent (including by obtaining from the banker a stand-alone valuation of the company). Generally, a board should obtain identification and explanation of any changes made to company projections that were prepared in the ordinary course of business. If the board is told that changes were made to "update" the projections for "new information," the board should seek to understand whether there actually was new information that was reflected. A board should obviously follow up to determine why it has not received information that it has requested. A banker engaged in negotiations with a potential buyer should keep the target apprised of all key developments in the negotiations and should not hold "secret" meetings.

Defendants in fiduciary breach cases should take the position that, even in the case of a flawed sale process, there are no damages in the context of an arm's-length negotiated merger price.

Where there is a reasonable period of time for, and no significant contractual impediments to, a topping bid emerging, and no topping bid emerges, the court is likely to view the merger price as the best evidence of the company's stand-alone value — particularly in the case of a strategic buyer or other indication of synergistic value being included in the merger price.

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