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Decision Highlights the Limits of Corwin *(and the Benefits of a Good Process) in the Sale of a Company to a PE Buyer*–Mindbody

In *In re MINDBODY, Inc. Stockholders Litigation*, the plaintiffs challenged the merger (the "Merger") pursuant to which private equity firm Vista Equity Partners acquired MINDBODY, Inc. (the "Company"). The key allegations were that the Company's CEO-founder-director ("RS"), due to his self-interest in obtaining liquidity and lucrative post-sale employment, "tilted" the sale process in favor of Vista rather than seeking to maximize the price on behalf of all the stockholders. The transaction was approved by a majority-independent board and the stockholders. However, the court ruled, at the pleading stage of litigation, that it was reasonably conceivable that RS may have breached his fiduciary duties to the stockholders; and, because his potential conflicts of interest were not disclosed, the alleged breaches were not "cleansed" under *Corwin*. The court also found it reasonably conceivable that the Company's CFO (who was not a director) ("BW") breached his fiduciary duties by following RS's lead in the process.

We would observe that it is relatively common, especially when a sale process involves private equity bidders, for a CEO engaged in a sale process to want to obtain liquidity and post-closing employment. *Mindbody* underscores that the particular facts and circumstances will be critical to the court's determination whether those desires constitute a disabling conflict of interest.

Key Points

- **The decision underscores the need for careful planning and execution in a sale process–including, specifically, with respect to officers' and/or directors' desire for liquidity or post-closing employment.** The decision highlights that, at the pleading stage, the court may delve in depth into the possible personal motivations of management and/or directors in a sale process to determine if they had potential conflicts of interest.

- **The decision highlights the effect that a *combination* of negative factors can have on the court's result.** The court found that the CEO-director's strong focus on obtaining liquidity may have constituted a conflict even though he did not have an "exigent need" for liquidity. Also, the court found that his strong focus on obtaining lucrative post-closing employment (including an equity interest in the acquiring company) may have constituted a conflict even though discussions had not taken place as to the specific terms of such employment. In our view, the court's approach does not reflect a change in the standards being applied but, rather, the effect of the *combination* of serious negative alleged facts: namely, the CEO's apparently "strained" personal finances; *plus* his apparent single-mindedness on obtaining lucrative post-closing employment; *plus* a sale process that strongly favored the bidder he expected would provide such employment; *plus* his apparent manipulation of the company's earnings guidance; *plus* his not disclosing material information to the board; *plus* a go-shop provision that was too limited to be an effective check on the sale process.

- **The decision also illustrates the potential limits of *Corwin* when there are serious alleged conflicts of interest.** We have observed in previous memoranda that there appears to be a retrenchment to some extent by the court in applying *Corwin* in cases with a strongly negative factual context. In our view, *Mindbody* raises the further question whether, in the case of serious allegations of severe director conflicts or misconduct, there would ever be sufficient disclosure such that *Corwin* would apply. (If directors actually acted in their self-interest rather than the stockholders' interest, would the disclosure have to specifically state as much for *Corwin* to be applicable?) A good sale process, therefore, should remain the objective–to avoid the risk of personal liability, reputational damage, and an injunction against the deal before it closes.

Background. Mindbody (a cloud-based payments company for the wellness industry) was founded by RS in 2001 and went public in 2015. In early 2018, it made two major strategic acquisitions, following which its stock price was $37.50. In the week after its September 2018 earnings call, during which it emphasized the progress being made with integration, the stock price increased to $43.85 and analysts set target prices upwards of $45 per share. In early 2019, Vista acquired the Company in the Merger, for $36.25 per share in cash. At that time, the board was comprised of RS, "EL" (a designee of venture capital firm Institutional Venture Partners ("IVP")), and six independent directors. Before the Merger, RS controlled 19.8%, and IVP controlled 24.6%, of the Company's voting power.

RS had discussed a possible buyout with Vista in 2017 but Vista (a PE firm known for providing highly lucrative compensation to its portfolio company CEO-founders) had chosen not to engage because Mindbody's stock was at an all-time high. In August 2018, RS met with an investment banker at Qatalyst Partners and related that he was "frustrated with running a public company" and with having his personal wealth "tied up" in the Company. Qatalyst put RS in touch with Vista. RS did not inform the board about his discussions with Qatalyst or Vista. In October, at Vista's invitation, RS attended Vista's annual conference (the "CXO Summit") for its portfolio company CEO-founders ("CXOs"), at which Vista touts the great wealth it creates for the CXOs. Soon thereafter, Vista told RS that it would like to acquire the Company "at a substantial premium to its recent trading range." At the time, the 30-day average stock price was $38.46 and the stock had traded over $41.00 in October. RS instructed management not to discuss Vista's expression of interest with the board because he wanted to be the one to do so first. He then raised with the board the idea of taking the Company private, but did not mention Vista's expression of interest. He postponed the Company's October 2018 earnings call to November. On the November call, he lowered the Company's Q4 guidance, citing difficulties in the integration process (although management viewed the Company as on track with the process and on track to meet its forecasts). The following day, the stock price dropped to $25.00.

The board formed a "Transaction Committee" comprised of RS, EL and two other directors. At RS's urging, the Committee retained Qatalyst to act as the Company's financial advisor in connection with the possible sale of the Company. RS and Qatalyst then selected the potential bidders to be contacted. On December 18, while other parties were beginning or midway through their due diligence processes, Vista submitted an offer to buy the Company at $35 per share. The offer emphasized Vista's admiration for the Company's management and its desire to partner with them going forward. Qatalyst informed RS that management could expect to receive a 10% equity stake in the post-merger entity (which would double their pre-deal stake). Qatalyst then instructed two of the three remaining potential bidders to submit offers within the next 24-48 hours. Both indicated they could not submit a bid on that timeline and withdrew.

On December 20, 2018, the board met and instructed Qatalyst to seek a $40 per share price from Vista. The next day, Vista made a "final and best" offer of $36.50. The board met again on December 23. On that date, Qatalyst advised the directors that the other potential bidders needed more time to complete due diligence before they could submit bids; Qatalyst delivered a fairness opinion for Vista's bid; the board unanimously approved Vista's offer; and the Company entered into the Merger Agreement with Vista. RS and IVP executed irrevocable proxies to vote their shares for the Merger. On February 14, 2019, the stockholders approved the Merger and it closed the next day. The plaintiffs brought suit against RS, EL, and BW, alleging fiduciary breaches. Vice Chancellor Kathaleen McCormick granted the defendants' motion to dismiss with respect to EL, but denied it for RS and BW.

Discussion

RS's desire to obtain liquidity constituted a potential conflict of interest. Under Delaware precedent, it has been well established that a director who holds stock has an *identity* (and *not* a conflict) of interest with the other stockholders in maximizing the sale price when the company is sold. The Vice Chancellor noted that, in *Synthes* (2012), the court established that "liquidity needs can give rise to a conflict only where there is a 'crisis,' 'fire sale,' or 'exigent need' for 'immediate cash.'" The Vice Chancellor stated, however, that the *Synthes* standard should be interpreted in the context of the factual situation in that case–which, she wrote, unlike *Mindbody*, involved a complaint "strikingly devoid of pled facts to support the alleged liquidity-driven conflict." The Vice Chancellor noted that, based on the *Mindbody* plaintiffs' allegations, RS's personal finances were "seemingly stretched"–given his numerous financial commitments (*e.g.*, millions of dollars invested in relatives' businesses, a sizable home mortgage, a million-dollar home renovation, and a multi-million dollar commitment to a local college); his having begun to start trying to obtain liquidity (by setting up a "10b5-1 plan" to sell his stock on a monthly basis); his having complained about his personal wealth being "tied up" in the Company; and his having told his personal financial advisor that he would be "digging into" his line of credit to fund his high expenses.

Of course, many CEOs selling their companies have been in similar situations–with "stretched" finances, their personal wealth "locked in" the company, and a general desire for liquidity–and they have not been found to have a conflict unless they had an "exigent need for immediate cash." In this case, it appears that the Vice Chancellor was responding to the combination of numerous, serious negative factors that, taken together, led almost inescapably to a conclusion that it was reasonably conceivable at the pleading stage that RS may have been acting based on his own rather than the stockholders' interests. These factors included not only his often-repeated focus on obtaining liquidity *but also* a blatant focus on post-closing employment, manipulation of the Company's guidance, failure to disclose material information to the board, and sale process decisions that definitively advantaged the bidder that he believed would most benefit him personally. *In combination, these factors strongly supported an inference that RS was acting based on his personal interests.*

IVP's desire to obtain liquidity due to the impending expiration of its fund did *not* constitute a conflict of interest for its representative on the board. The plaintiffs argued that EL was conflicted by virtue of IVP's fixed-life investment fund that was facing an expiring investment horizon. The court reaffirmed that a fund's desire for liquidity based on its investment horizon does not itself create a conflict for the fund's designated directors. Moreover, in this case, the court stated, even assuming that EL was conflicted based on IVP's investment horizon, no facts were alleged that supported a reasonable inference that EL (who was not involved in the lowered guidance, the due diligence process, or the go-shop process) actually took any action to tilt the process toward Vista.

RS's desire for lucrative post-closing employment constituted a potential conflict of interest. Under Delaware precedent, an officer's or director's desire to obtain post-closing employment with the acquiring company does not, in and of itself, constitute a conflict of interest–although it becomes a conflict if, absent instruction and oversight by the board, the officer or director engages in discussions about the specific terms of such employment before the material sale terms have been agreed. The court noted that, in this case: Vista was known for being a buyer that always retained the management teams of its acquired companies and offered them lucrative compensation; Vista had expressed in its offer letter that it wanted the management team to continue post-closing; and RS had learned from Qatalyst that management would be granted a 10% equity stake in the post-merger entity (doubling their pre-deal stake). Of course, none of these factors is necessarily uncommon in the course of a sale process involving private equity firm bidders. Again, however, it was the combination of factors that indicated that RS may have differentiated his personal interests from those of the other stockholders. Notably, the sale process began with RS's reaching out to Qatalyst about his desire to sell the Company to a private equity fund that would agree to employ the management team post-closing; he rejected contacting certain "logical" buyers on the basis that he did not want to work for them or they were known generally to not retain management; and he gushed that the CXO Summit was "mind-blowing" and that Vista "loved" him and he loved Vista. Moreover, he and Vista had numerous "private conversations" throughout the sale process. Finally, and critically, he did not disclose most of the foregoing to the board.

Vista was strongly favored in the sale process. The court observed that:

- RS lowered guidance, apparently (according to the court) to depress the stock and make the Company a less expensive target for Vista (which had previously rejected acquiring the Company because of its high stock price);
- RS was in contact with Vista (but not the other bidders) before and throughout the sale process;
- Vista received access to about 1,000 documents for due diligence. while the other bidders received about 35 documents and the provision of information to them was delayed;
- RS provided "real-time input" to Vista on its valuation model (but not to the other bidders);
- After Vista submitted its offer, the board accelerated the process, as a result of which the remaining bidders withdrew because they needed more time to complete their due diligence;
- The board sought only once to have Vista increase its price (to $40) and then readily accepted Vista's "final and best offer" of $36.50; and
- The post-signing go-shop was ineffective–because it required that any superior offer be both made *and accepted* during a 30-day period (which spanned the Christmas holidays and during which RS took vacation), and the board did not include in the go-shop due diligence data room all of the materials to which Vista had been provided access.

***Corwin* did not apply because the stockholder vote was not "fully informed."** Under *Corwin*, stockholder approval of a transaction "cleanses" potential fiduciary breaches if the vote was fully informed and uncoerced. The court wrote: "Generally, where facts alleged make the paradigmatic *Revlon* claim reasonably conceivable, it will be difficult to show on a motion to dismiss that the stockholder vote was fully informed." While the court noted the following specific deficiencies in the disclosure, we question (as noted above) whether, in light of the combination of seriously negative factors, any disclosure short of, in effect, a declaration that fiduciary duties were breached would have been deemed adequate–and, even if such disclosure were made, whether the court would find *Corwin* cleansing available.

- ***RS's post-sale employment.*** The Company stated that the terms of post-closing employment for management had not been discussed with Vista. The court found this disclosure "true in the literal sense," but "materially misleading" given the absence of disclosure as to (i) RS's many private interactions with Vista (and Vista CXOs) before and throughout the sale process and (ii) the advantages provided to Vista in the sale process. The court (citing its 2018 *Morrison v. Berry* and *Xura* decisions) stated that a reasonable stockholder would want to know about the level of a director's commitment to a potential purchaser, as well as the extent to which a CEO influenced the negotiations and ultimate terms of a transaction, and any possible self-interested motivation for "pushing" for an allegedly undervalued transaction.

- ***Vista's willingness to pay a premium.*** The court found that the proxy statement should have disclosed that Vista stated in its initial expression of interest that it was willing to pay "a substantial premium to [the] recent trading range." This statement "signaled Vista's willingness to pay a price per share much higher than the ultimate Merger price," a fact that would be material to a reasonable stockholder. The court acknowledged that "preliminary discussions" need not be disclosed, but observed that here the statement was made by the ultimate acquiror after weeks of discussions with the CEO, in a direct expression of interest, and at a time when the target's stock was trading at a price higher than the ultimate merger price.

- ***Sale process.*** The proxy statement did not disclose the sale process deficiencies discussed above. The court stated that a reasonable stockholder would want to know whether a serious bidder was treated in a materially different way from others because it would help with assessing "the probative value of the sale process."

- ***Q4 guidance and results.*** The proxy statement disclosed that the merger price represented a premium of 68% to the then-current trading price. The court reasoned that gauging value against the then-current trading price was materially misleading "because Defendants drove down that price" by lowering Q4 guidance and then not disclosing that Q4 actual results substantially beat both the original and the lowered guidance. Stockholders were left with the impression that the merger price offered a substantial premium, "when it is reasonably conceivable that the premium resulted from the Q4 'guide down' that depressed the Company's stock."

A director's failure to disclose material information to the board (a "fraud-on-the-board") can have serious consequences. First, generally, when there has been a "fraud-on-the-board" (*i.e.*, one or more directors did not disclose material information to the board, such as relating to a conflict of interest or the sale process), the applicable standard of review is the stringent "entire fairness" standard (which requires that both the price and the process are fair to the stockholders). In this case, the parties had agreed that, if *Corwin* were not applicable, *Revlon* (which requires that directors seek to maximize the sale price) would apply. The court stated that it remained an open issue whether, given RS's non-disclosures to the board, entire fairness, rather than *Revlon*, would be the standard of review applied at trial. Second, while "as a general rule, a plaintiff can only sustain a claim for breach of the duty of loyalty by pleading facts showing that it is reasonably conceivable that each of *a majority of the board* is conflicted," the *Mindbody* plainitffs argued that there should be an exception to this rule where there has been a fraud-on-the-board.

The court found that the plaintiffs alleged sufficient facts to support this "theory." The court reasoned that the existence of the Committee "evidences some level of board involvement and oversight that cuts against the notion that the Board was the passive victim of a rogue fiduciary," but that its "mere existence" did not suggest sufficient involvement and oversight, particularly in light of the following allegations: the timing of the Committee's formation was unclear; its mandate initially was limited (and, by the time it was expanded, the Company had already retained Qatalyst and RS and Qatalyst had already selected the potential bidders to be contacted); it relied entirely on Qatalyst and never hired its own counsel or financial advisor; and it "took a back seat" while RS vetoed outreach to certain potential bidders, controlled the level of diligence provided to potential bidders, and continued to meet privately with Vista. The Vice Chancellor wrote: "For these reasons, it is reasonably conceivable that the Board lacked material information and failed to adequately oversee [RS]. Therefore, at the pleading stage, the presence of a disinterested and independent majority of the Board does not defeat a claim for liability."

BW may have breached his fiduciary duties by following RS's sale process directions. The court found it reasonably conceivable that BW acted with "gross negligence" throughout the sale process by being "at least recklessly indifferent to the steps RS took to tilt the sale process in Vista's favor." The court noted that BW followed RS's instructions not to disclose immediately to the board Vista's expression of interest; followed RS's lead in trying to "be creative" to guide expectations for 2019 downward; delivered the lowered Q4 guidance on the earnings call (even though RS's communications with him suggested RS's manipulative purpose and other management members stated that the lower guidance was inaccurate); and worked with RS to delay and limit other bidders' access to due diligence materials. The court noted that BW, as an officer (and not a director), would not be exculpated under the Company's charter for a breach of the duty of care. The court therefore found it unnecessary to address at the pleading stage whether BW also may have breached the duty of loyalty based on his personal motivations for post-closing employment.

Practice Points

- **Officers and directors must be careful about what they say or write (including in emails or other informal communications) during a sale process.** They should be highly sensitive to the possibility that their statements (for example, relating to a desire for liquidity and/or post-closing employment) could be interpreted as reflecting that they may view themselves as having interests different from the other stockholders and possibly are motivated by their self-interest.

- **In a sale process:** a board must carefully seek to identify actual and potential conflicts of interest of officers and directors (and, particularly, of the lead negotiator), and then must appropriately deal with them; a director generally should not meet privately with a bidder unless instructed and supervised by the board–and, if private discussions do take place, they should be promptly disclosed to the board; an officer's or director's discussions with a potential buyer about post-closing employment should not constitute a disabling conflict if the discussions occur after the material terms for the sale of the company have been agreed and/or if the discussions are appropriately overseen by the board (or other appropriate body or person); expressions of interest should be promptly reported to the board; and, if an advantage is to be accorded to a particular bidder over others, the board (or committee) should be informed and should approve the course of action only if it believes that it will be beneficial to the stockholders.

- **A board should be *proactive* in identifying conflicts.** The Mindbody board allowed RS to run the sale process notwithstanding strong clues that made it reasonably conceivable that he may have been strongly motivated by his own personal interests. The board could have become aware of RS's potential conflicts (and questionable sale process decisions) if it had, for example, spoken with the financial advisor about how the list of potential bidders to be contacted was developed; asked the financial advisor if it had previously had discussions with Vista or other potential bidders about the Company; spoken with RS to become informed about his personal objectives; spoken with other management members about how the process was unfolding; and/or in general provided more oversight of the sale process. Importantly, whenever just before or during a sale process there is a change in the company's projections or guidance, or a significant drop in the stock price, the board should carefully investigate the reasons therefor.

- **An officer should not simply follow the sale process directions of a potentially conflicted CEO that appear to undermine the sale process.** For example, an officer should not limit or delay the provision of due diligence materials or change the company's guidance or projections without a legitimate basis for doing so.

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