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Why Chancery Rejected Corwin Cleansing In Tangoe

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Last November, in the Tangoe Stockholders Litigation, the Delaware Court of Chancery ruled at the pleading stage that, in connection with the sale of a company (Tangoe Inc.) to a private equity firm (Marlin Partners), the facts alleged by the plaintiff supported a reasonable inference that the company directors had breached their duty of loyalty to the stockholders. The gravamen of the complaint was that, in connection with considering and recommending a sale of the company, the directors had focused on their own compensation in the event of a sale, and had not considered whether the alternative of the company remaining independent would — as appeared to be the case — create more value for the stockholders than the sale would.

The court further ruled that Corwin “cleansing” was not available, due to inadequate disclosure to the stockholders in connection with their approval of the challenged transaction. Therefore, the court rejected dismissal of the plaintiff’s claims, and the suit will proceed to trial.

Key Points

Inapplicability of Corwin Cleansing Due to Flawed Disclosure

Tangoe is one of the rare — but apparently increasingly frequent — cases in which the court has ruled that Corwin cleansing of a challenged transaction is not available because the stockholder approval of the transaction was not “fully informed and uncoerced.”

While it remains to be seen whether these cases may indicate some retreat by the court from its approach of very broad applicability and interpretation of Corwin, as discussed below, we think it more likely that these recent decisions reflect that, in the post-Corwin world, fewer cases are being brought where the fiduciary and disclosure claims are not especially strong.

Fiduciary Breach Based on Directors’ Focus on Their Compensation Upon Sale of Company

Tangoe underscores that, when a board considers a sale of the company, the focus should be on the best interests of the stockholders, and not on maximizing the directors' compensation in the event of the sale.

In this case, the directors apparently had not considered a standalone alternative for the company, but had focused extensively on finding a way to circumvent restrictions to their ability to award themselves compensation upon a sale of the company, and then made numerous such awards — while the stockholders received a negative 28 percent premium on their shares, in the context of likely imminent deregistration of the company's stock due to the board's own failures to complete required restatements of financials.

Need to Consider Standalone Alternative When Recommending Sale and Facing Possible Deregistration

Like the court's 2017 decision in Saba Software, Tangoe highlights that, when a company faces deregistration of its stock due to an ongoing failure by the board to produce a required restatement of financials, a sale of the company to preserve what value remains is not necessarily a clear path for the board out of the difficulties.

Both Tangoe and Saba Software indicate that, in this situation, at a minimum, a board should ensure that it discloses to the stockholders the likely timing for completion of the required restatement, and/or the reasons why it has not been completed — so that the stockholders, when considering whether to approve the sale, can evaluate whether the company's continuing as a standalone entity is a feasible alternative.

Discussion

Corwin Still Broadly Applicable

Corwin provides for business judgment review (and, so, dismissal at the early pleading stage of litigation) of challenged transactions that were approved by stockholders in a vote that was "fully informed" and not "coerced." Tangoe is one of just a small number of cases in which the court has held Corwin to be inapplicable based on the stockholder vote not meeting these criteria.

The factual situation in this case was very similar to that in Saba Software, which was the first case in which the court ever found Corwin to be inapplicable on this basis. Notably, the court recently also found, in PLX Technology (Oct. 16, 2019) and Xura (Dec. 10, 2019), that Corwin was not applicable to the challenged transactions because the stockholder approval was not "fully informed."

Importantly, however, Tangoe, Saba Software, PLX Technology and Xura all involved a very negative overall factual context, and disclosure claims that had a direct relation to the core of the fiduciary claims being asserted. Thus, in our view, while it remains to be seen whether these cases may indicate some retreat by the court from its approach of very broad applicability and interpretation of Corwin, we think it more likely that these recent decisions reflect that fewer cases are being brought in which the fiduciary and disclosure claims are not especially strong.

Importance of Considering the Standalone Alternative

In both Tangoe and Saba Software, the company being sold was in the midst of potential delisting and deregistration due to a years-long unexplained failure of the board to complete a required restatement of financials.

In Tangoe, the company did not disclose to the stockholders why the restatement had not been completed — or when it would be, if ever. In Saba Software, the board stated that the restatement would be completed in the near future, but, in the court's view, given the board's history of having failed to complete the restatement for a long time without explanation, the stockholders could not evaluate the likelihood that the restatement would now be completed unless the board disclosed why the restatement had not been completed for so long.

In both cases, the court concluded that the stockholders, faced with a "Hobson's choice" of retaining potentially illiquid stock or approving an all-cash deal (albeit at a depressed price), chose the all-cash deal while not having the information necessary to evaluate whether the company had a realistic alternative of remaining as a standalone company. Notably, in both cases, if the disclosure to stockholders had been viewed by the court as adequate (and thus Corwin had applied), the cases would have been dismissed at the pleading stage of litigation — even though the court viewed the plaintiffs' claims as establishing a reasonable inference of a breach of fiduciary duties by the target directors.

Court's Finding That Disclosure Was Inadequate

The court found that the Tangoe stockholder vote was not "fully informed" because (1) the stockholders had not been provided audited financial statements and (2) the board had not explained whether the required restatement ever would be completed, and, if so, when. Audited financial statements were material, the court stated, because, throughout the uncertainties relating to the restatement, the financial information the board provided to stockholders was "sporadic and heavily qualified."

The "information vacuum" under which the stockholders were operating was highlighted by the board: (1) having cautioned the stockholders that the unaudited financials were preliminary, not in accordance with GAAP, and likely to be adjusted in the future; (2) having chosen not to disclose an outside firm's "quality of earnings" report that the board obtained to address some of the uncertainties relating to the company's financial situation; (3) having recently failed to file multiple quarterly reports; and (4) not having held an annual stockholder's meeting for three years.

The court stated that information about whether and when the restatement would be completed was critical to the stockholders' evaluation of the proposed sale. The court emphasized that the board knew, but chose not to share with the stockholders, that the restatement was close to being completed (i.e., the forensic work was completed and only the "formal audit" remained).

By not disclosing this to the stockholders, the board "deprived them of the opportunity to consider whether to stay the course and allow the Restatement to proceed or whether to sell as the consequences of the unfinished Restatement were still unfolding." The information about the restatement process was material, the court wrote, because "the delisting depressed the amount potential acquirers were willing to pay for Tangoe and stockholders needed to understand whether the delisting was likely to continue or whether the Company had a legitimate prospect of completing the Restatement and regaining its listed status with NASDAQ."

Court's Suggestion That Stockholder Vote Likely Had Been Coerced

The court stated that, having determined that the vote was not fully informed, there was no need for the court to determine whether the vote had also been "coerced." However, the court wrote: "Saba likely foretells where that analysis would lead me."

In Saba Software, Vice Chancellor Joseph Slights decided that the "Hobson's choice of either retaining stock that was likely to become illiquid or taking an all-cash deal" was "situationally coercive."

Directors' Improper Focus on Their Compensation

The court found that the directors had breached the duty of loyalty, as their motivation to approve the sale was based on their own self-interest in enhancing their compensation rather than the interests of the stockholders. The court also ruled that, even while the stock declined as the company faced the prospect, and then the reality, of delisting, "the Board's focus was on Board and executive compensation" rather than enhancing value for the stockholders.

After the board's financial advisor told the board that no strategic buyers were interested in considering an acquisition of the company unless the board completed the required restatement, "the Board was not moved" to complete it. Rather, the board "diverted focus and resources from the Restatement process and fixed its sights on Board compensation and a quick deal with any of the financial sponsors who were willing to look past the Restatement delays."

The board adopted a new compensation scheme to get around the prohibition on awards being made under the existing compensation plan, pending completion of the restatement — and then made numerous awards to themselves under the new plan, which would be payable on a sale of the company.

Still a High Bar for Duty of Loyalty Claims

It is well-established that the Court of Chancery will find claims of duty of loyalty violations to have been adequately pled only in unusual cases involving truly egregious conduct by directors. We observe that the directors' conduct in Tangoe apparently was egregious.

The directors made misstatements to the U.S. Securities and Exchange Commission, which created a need for restated financial statements; failed, over a years-long period, to produce the restated financial statements; provided no explanation or information to the stockholders about the failure to produce the restatement; when considering whether to sell the company rather than complete the restatement and remain independent, did not evaluate the stand-alone option, even though it appeared to be the option with the potential for greater value for the stockholders; and, when deciding to sell the company (at a negative 28 percent premium), significantly increased the compensation that would be payable to them when the company was sold.

Conclusion

Tangoe is one of four Delaware decisions issued since October 2018 (the others being PLX, Xura and Riche v. Pappas) in which the Court of Chancery has held that Corwin was inapplicable — in each case, due to inadequate disclosure to stockholders in connection with the approval of the challenged transaction. While it remains to be seen whether these cases may indicate some retreat by the court from its approach of very broad applicability and interpretation of Corwin, we think it more likely that these recent decisions reflect that, in the post-Corwin world, fewer cases are being brought where the fiduciary and disclosure claims are not especially strong.

In each of these cases, there was an especially negative factual context, and the disclosure issues went to the core of the fiduciary claims being made. These decisions highlight that Corwin is case-dispositive — that is, if Corwin applies, fiduciary claims will be dismissed at the early pleading stage of litigation. If the disclosure had been sufficient in these cases, then Corwin would have applied and the cases would have been dismissed — even though the court found in each that there were well-pled allegations, indicating a likelihood of serious fiduciary breaches by the directors.

Stated differently, Corwin has changed the risk-benefit analysis on disclosure, and thus requires a new mindset relating to disclosure. While the disclosure of conflicts and flaws in a sale process may be embarrassing, the disclosure is unlikely to change the result of a stockholder vote approving the transaction at issue and, critically, it will help to ensure the applicability of Corwin and thus the dismissal of litigation challenging the transaction post-closing.

Of course, another reason for erring on the side of more rather than less disclosure is that insufficient disclosure creates a risk of preclosing injunction of a transaction (a stage of litigation at which Corwin is always inapplicable).

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