Chancery Reaffirms Very High Bar For Board Liability On Deal

By **Gail Weinstein, Steven Epstein and Philip Richter** (June 22, 2023)



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The Delaware Court of Chancery, at the pleading stage of litigation, recently dismissed a lawsuit against the directors of Block Inc. — a tech company originally called Square Inc., led by former Twitter CEO Jack Dorsey.

The suit — City of Coral Springs Police Officers' Pension Plan v. Jack Dorsey, Block Inc. — challenged Block's $237.3 million acquisition in 2021 of an 86.23% stake in Tidal, a music streaming company 27% owned by Shawn Carter, who is professionally known as Jay-Z.

The court found that the plaintiffs did not establish that the directors of Block, who were independent and disinterested in the transaction, acted with bad faith.

Key Points

Minimal Requirements for Good Faith

An independent and disinterested board will not have liability unless it did not act in good faith — even in the context of a decision to approve what the court called "by all accounts, a terrible business decision" following an apparently minimal and flawed process.

The court emphasized that the defendant directors asked questions about the transaction before approving it, and held that this was sufficient to suggest good faith even though all of the answers to the questions they asked seemed to indicate that the deal should not be done.

The decision thus serves as a reminder of the very high bar for a finding that an independent board acted in bad faith.

Judicial Criticism of the Process, Although No Liability

While the court held that the director defendants had no liability, the court's recitation of the background facts and other commentary made clear the court's view that Dorsey may have been motivated by his friendship with Carter and that the directors had not done a good job and had made a "terrible business decision."

The opinion thus reflects the court's trend in recent years of detailing and strongly criticizing flawed processes in which defendant directors engage, even when holding for the defendants.

Background

Before the acquisition of Tidal, Block was a fintech company that processed mobile payments. It had never been involved in the music streaming business nor had any plans to do so. Jack Dorsey — Block's founder, CEO, chairman and, at the relevant times, owner of

between 48% and 51% of the company's voting power — developed the idea for the acquisition of Tidal while he and Carter were spending the summer in the Hamptons.

On Aug. 25, 2020, Dorsey proposed the acquisition, via videoconference from the Hamptons into a regular Block board meeting. The board was composed of 11 members, all of whom — other than, allegedly, Dorsey, based on his friendship with Carter — were independent and disinterested in the transaction.

The board formed a transaction committee composed of four of the independent directors to consider and negotiate the proposal. Over the following months, despite receiving significant negative information about Tidal and the transaction, the committee approved the transaction. On announcement, Block's stock price declined 7%. The acquisition closed in April 2021.

Following a Section 220 books and records investigation, a Block stockholder brought suit against Dorsey and Block's other directors, claiming that they had breached their fiduciary duties in approving the acquisition. Chancellor Kathaleen St. J. McCormick found that the directors did not face a substantial likelihood of liability for approving the transaction.

As the plaintiffs therefore had not established demand futility, the court granted the defendants' motion to dismiss the case.

The Problems Facing Tidal and the Transaction

In their consideration of the proposed acquisition, the transaction committee learned that:

- By mid-2020, Tidal had amassed only 2.1 million paying subscribers (while Spotify had 138 million, Apple Music had 60 million, and Amazon Music had 55 million); had "logged multimillion-dollar losses for each of the preceding ten quarters"; and had accrued $127 million in liabilities, mostly from unpaid royalties to record labels.

- In 2020, Carter had personally loaned Tidal $50 million to help it through its difficulties.

- Between 2015 and 2020, Tidal had "churned through five different CEOs."

- Tidal's contracts with musicians were only "semi-formal at best," Tidal was losing the major contracts it had, and Tidal had suffered a public falling-out with Kanye West, who was an initial Tidal stockholder with an exclusive streaming contract and cut ties with company.

- None of the artists signed with Tidal would have any legal obligation to stay with the platform after a merger.

- Tidal was the subject of an ongoing criminal fraud investigation by the government of Norway, where the company initially was created, for artificially inflating its streaming numbers.

- Dorsey was the sole Block management member in favor of the acquisition.

The Court's Negative View of the Process

The court's recitation of the background facts indicated its negative view of the process.

The court noted that the committee had only three formal meetings — one lasting 35 minutes; and the other two each lasting one hour. It was only just before the first meeting that the committee received management's valuation of the transaction; and was informed that Dorsey, before the committee was formed and without board authorization, had submitted a letter of intent to Tidal a month earlier, with a proposed price of almost $555 million. It was only a day before the second meeting that management told the committee about Tidal's significant financial and other problems.

It was only at the second meeting, and only in response to questions from the committee, that management told the committee that Dorsey was the only senior manager in favor of the deal; that Tidal artists had no legal commitment to maintain their relationship with the platform following a merger; and that management did not have a detailed plan for assimilating and building the business.

When the committee updated the full board at the board's regular meeting, the update was one of 14 items of business discussed. Shortly thereafter, following the parties' agreement on a term sheet, Dorsey and Carter "were spotted vacationing together in Hawaii."

At the third meeting, the committee received further negative information about Tidal, including management's predictions that the acquisition would generate increasing negative earnings before interest, taxes, depreciation and amortization for Block over the next three years. In response to new questions from the committee, management explained that, if Tidal's signed artists stayed with the company post-merger, it would be based only on the influence of Carter and Dorsey.

Management's presentation at this third meeting "set forth the acquisition as more of an assumption than an open question," stating that the committee would be updated once management had "finalized terms we are comfortable with." The committee then "went dark" for three months while Dorsey negotiated the purchase price; and it then approved the acquisition by unanimous written consent, "without any further meetings."

Business Judgment Review

The court emphasized that the decisions of independent directors are entitled to deferential business judgment review — meaning that they face no liability, even for bad business decisions, unless they had acted in bad faith.

What Constitutes Bad Faith

The Delaware Supreme Court has described a "non-exhaustive set of circumstances" that constitute a failure to act in good faith: "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

The Supreme Court has stated that there may be other examples of bad faith yet to be proven or alleged, but that these three are the most "salient." Pleading a failure to act in good faith requires the plaintiff to plead particularized facts that demonstrate that directors

acted with scienter — i.e., that they had actual or constructive knowledge that their conduct was legally improper and that they were acting inconsistent with their fiduciary duties.

The Court's Examples of Bad Faith and Good Faith

The court cited In re: Walt Disney Co. Derivative Litigation, affirmed by the Delaware Supreme Court in 2006, as an example — where the stockholder-plaintiff sued Disney's departing CEO, Michael Eisner, and the Disney board for breach of fiduciary duties in connection with their stark lack of involvement in the hiring, and the terms of the firing, of Eisner's longtime friend, Michael Ovitz, as president.

The court found it reasonably conceivable, at the pleading stage of litigation, that the Disney directors had "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care'…attitude concerning a material corporate decision" — and "ostrich-like approach" that fell outside the protection of the business judgment rule.

The court also noted the recent Harris v. Junger transcript decision from April, where the court found that an independent board may have acted in bad faith based on the inability of defendant directors to articulate to the court a business rationale for the challenged transaction, which had the effect of perpetuating the controller's control.

By contrast, the court stated, in McElrath v. Kalanick — affirmed by the Delaware Supreme Court in 2020 — although the board of Uber had approved an apparently flawed transaction that had the effect of providing the company's controller with perpetual control, the board had acted in good faith. The board had not simply rubber-stamped the deal but had met to consider it, enlisted the assistance of outside counsel, "heard a presentation summarizing the transaction …, discussed due diligence, and asked questions."

The Transaction Committee's Good Faith

The Block board had identified a business rationale for the acquisition of Tidal — namely, the company's expansion into the music industry, which it believed would be a benefit to Block. The Block plaintiff, while acknowledging that the committee had asked "many questions throughout the process," argued that the problem was that "the answers did not seem to matter."

When asked if senior management supported the deal, the answer was that only Dorsey supported it; when asked whether artists would be bound post-merger, the answer was that they would not; when asked for near- and long-term plans for integrating Tidal, the answer was that there were none, and that this presented a big risk. However, the court viewed the plaintiff's argument as effectively asking the court "to presume bad faith based on the merits of the deal alone."

The court emphasized that there were no allegations that any of the committee members were beholden to Dorsey in any way; and that the committee "did not sit idly by" but asked "many appropriate questions," including follow-up questions, and received more than 20 single-spaced slides providing management's detailed answers. The court also noted that, over the course of the negotiations, the purchase price dropped considerably.

The court concluded that, on these facts, the committee's actions more closely resembled those in McElrath than in Disney or Harris.

Observations

The case reflects the inherent difficulties with judicial determination of the subjective intentions of directors, for example to determine bad faith. As the court cannot read minds, it can only draw reasonable inferences from the facts. Some business decisions may be so blatantly against the company's interests that the court may infer that the directors, even though independent and disinterested, must have been motivated by something other than the company's best interests.

In Block, the court emphasized that the transaction committee met, heard a presentation, and asked questions — from which the court inferred a lack of bad faith notwithstanding the "terrible business decision."

We would note, in addition — although not addressed by the court — that Dorsey, who currently owns about 10% of Block, likely had a very significant personal financial stake in the acquisition, which would seem to suggest that, although he may have been motivated in part by his friendship with Carter, he likely believed that the acquisition was in the best interests of Block and its stockholders.

Also, as the court briefly mentioned, the purchase price dropped considerably over the course of the negotiations — from management's initial expected purchase price of $550 million to $750 million to the ultimate purchase price that implied an enterprise value of about $275 million.

It would seem that the significant price decreases may suggest that Tidal's problems and the deal risks were being taken into account by the board.

Practice Points

Boards and Special Committees

Block serves as a reminder that a board or special committee cannot do nothing (i.e., cannot adopt an "ostrich-like" approach).

Rather, it should:

- Carefully evaluate a transaction — as well as alternatives, including no transaction — before approving it;
- Meet an appropriate number of times for an appropriate length of time;
- Receive one or more presentations from management — and, if appropriate, others — that summarizes all material aspects of the transaction;
- Ask questions of management — and, if appropriate, others — including follow-up questions;
- Consider the responses it receives to its questions; and
- Understand the business rationale for the transaction.

Further, a board should establish a careful record — for example, in minutes of meetings — reflecting its consideration of the transaction. We note that additional protection for a board or committee is afforded by obtaining a fairness opinion.

Management

The decision serves as a reminder that management should:

- Not engage in discussions with a target except as authorized by the board;
- Report to the board material contacts with the target and other material developments in the process;
- Provide appropriate information to the board about the target and the transaction;
- Respond in reasonable detail to the board's questions; and
- Not consider a transaction as a fait accompli while the process is ongoing.

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