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Chancery Court Refuses Pleading Stage Dismissal Under *Corwin* When Stockholders Not Fully Informed of Long-Overdue Financial Restatement

*Robert S. Reder**

*Amanda M. Mitchell***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

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Also determines plaintiff adequately pled target company directors breached their duty of loyalty by alleging items of material self-interest divergent from interests of stockholders

INTRODUCTION

Delaware courts continue to explore the contours of the Delaware Supreme Court's "seminal holding" in *Corwin v. KKR Financial Holdings LLC,* 125 A.3d 304 (Del. 2015) ("*Corwin*"). Application of Corwin in effect "cleanses" breaches of fiduciary duties committed by target company directors in approving a transaction *not* involving a controlling stockholder who "extracted personal benefits" therefrom, but only if the transaction "is approved by a fully informed, uncoerced vote of disinterested stockholders." In a recent *Delaware Corporate Law Bulletin,* see Robert S. Reder & Robert W. Dillard, *Chancery Court Declines to Apply Corwin at Pleading Stage to "Cleanse" Breach of Fiduciary Duty Claim Due to Material Non-Disclosures*, 72 VAND. L. REV. EN BANC 17 (2020), the authors discussed limits imposed on *Corwin's* reach in several post-*Corwin* decisions, including:

- "[T]he situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction . . . created a 'circumstance [that was] impermissibly coercive.' "

- The presence of "structural coercion": "a situation where a vote may be said to be in avoidance of a detriment created by the structure of the transaction the fiduciaries have created, rather than a free choice to accept or reject the proposition voted on."

- The allowance of books and records inspection under § 220 of the Delaware General Corporation Law ("*DGCL*").

- The failure by target company to disclose adequate information to stockholders regarding post-employment opportunities offered by the acquiring company to the two largest stockholders, who were also directors and officers.

- The insistence on a "far more proximate relationship than exists here between the transaction or issue for which stockholder approval is sought and the nature of the claims to be 'cleansed.' "

The process of defining *Corwin*'s boundaries continues. Vice Chancellor Joseph R. Slights III of the Delaware Court of Chancery (the "*Chancery Court*") explained in *In Re Tangoe, Inc. Stockholders Litigation*, C.A. No. 2017-0650-JRS, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018) ("*Tangoe*") that Directors "navigating a company through the storm" are entitled to the protection of the business judgment presumption when facing "stormy waters." To earn this protection, however, "directors must demonstrate that they carefully and thoroughly explained all material aspects of the storm to stockholders—how the company sailed into the storm, how the company has been affected by the storm, what alternative courses the company can take to sail out of the storm and the bases for the board's recommendation that a sale of the company is the best course."

Against this backdrop, in *Tangoe*, Vice Chancellor Slights found *Corwin* "cleansing" unavailable because "it [was] reasonably conceivable that the stockholders' approval of the transaction was uninformed," placing the stockholders in a veritable "information vacuum." While the target company directors "may ultimately demonstrate that they discharged their duty of loyalty in recommending the Transaction to Tangoe stockholders," they had yet to do so at the pleading stage and were not entitled to dismissal.

The factual bases underlying Vice Chancellor Slights's refusal to entertain a *Corwin* defense at the pleading stage in *Tangoe*—delayed Securities and Exchange Commission ("*SEC*") filings and inadequate financial statement disclosures to stockholders—are similar to the factual predicate underlying denial of *Corwin* "cleansing" in *In re Saba Software, Inc. Stockholder Litigation*, C.A. No. 10697–VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017) ("*Saba*"). In *Saba*, the Chancery Court found *Corwin* inapplicable because "the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction . . . created a 'circumstance [that was] impermissibly coercive.' " Because Vice Chancellor Slights relied on well-pled allegations "that the Tangoe stockholders were not fully informed when they approved the Transaction," he found it unnecessary to follow *Saba*'s lead in considering "whether their approval was also the product of coercion." (For a discussion of *Saba*, see Robert S. Reder, *Delaware Court Refuses to Invoke Corwin to "Cleanse" Alleged Director Misconduct Despite Stockholder Vote Approving Merger*, 70 VAND. L. REV. EN BANC 47 (2017).)

I. FACTUAL BACKGROUND

A former stockholder ("*plaintiff*") of Tangoe, Inc. ("*Tangoe*" or the "*Company*") alleged members of the Tangoe board of directors (the "*Board*") breached their fiduciary duties by "steering the Company into an ill-advised take-private acquisition by" a private equity group led by Marlin Equity Partners ("*Marlin*"). The transaction—structured as "a tender offer at $6.50 per share followed by a second-step merger" (the "*Transaction*")—was announced on April 28, 2017. Plaintiff was not pleased the $6.50 price represented "a 28% negative premium" to the market value of Tangoe shares, labelling it "inadequate." However, the underpinnings of the directors' alleged wrongdoing began much earlier.

A. Tangoe Restatement

Tangoe was a "global provider of connection lifestyle management software and services." In late 2015, both Vector Capital IV, L.P. ("*Vector*") and Clearlake Capital Partners IV GP, L.P. ("*Clearlake*") announced significant stockholdings in Tangoe and urged the Board to consider strategic alternatives. The Board declined this invitation.

On March 17, 2016, Tangoe announced it had erroneously recognized $17.1 million of non-recurring revenue, requiring a restatement of its financial results for 2013, 2014, and the first three quarters of 2015 (the "*Restatement*"). The Company also declared it did not expect to file its Annual Report on Form 10-K with the SEC when due but would try to complete the Restatement as soon as "reasonably practicable." One day later, Marlin acquired 3,001,426 shares of Tangoe common stock, bringing its beneficial ownership to approximately 7.6%. Then, on March 21st, the NASDAQ stock market ("*NASDAQ*") demanded Tangoe present a plan for coming into compliance with its SEC filing requirements by May 20th.

In April, the Board hired StoneTurn Group, a forensic accounting firm ("*StoneTurn*"), to assist Tangoe's independent accounting firm, BDO USA, LLP ("*BDO*"), in completing the Restatement. That same month, following several resignations, the Board appointed three of its members as interim officers (individually and collectively, "*Management Team*"), with a verbal commitment of "cash value" as compensation.

B. Sale Preparations

On May 16th, the Board retained Stifel, Nicolaus & Company, Inc. ("*Stifel*") as Tangoe's financial advisor to conduct a "strategic review process and then pursue a sale of the Company." On June 15th, Stifel delivered a presentation emphasizing that a sales process for Tangoe without current financials would increase "barrier to entry." It also informed the Board that Marlin, which had "an intent to force a sale of Tangoe to itself," had teamed with Tangoe's recently-departed CEO to assist in this effort. Following preliminary discussions with Tangoe, Marlin increased its ownership stake to 10.4%.

One month later, Vector and Clearlake each expressed interest in acquiring the Company. In the midst of the intensifying sale discussions, because SEC rules prohibited the Board from making equity incentive awards under existing plans with the Restatement pending, Tangoe entered into Equity Award Replacement Compensation Agreements ("*EARCAs*") granting each director 15,142 Measurement Shares which "would fully vest *only* upon a change in control."

Around this time, the Board directed Stifel to explore a sale of Tangoe with a group of acquirers, including Marlin, Vector, and Clearlake—all firms willing to "consider a transaction regardless of whether Tangoe completed its Restatement and remained listed." On August 15th, Tangoe entered into a confidentiality agreement with Marlin. On that same day, the Board also granted members of the Management Team additional Measurement Shares, 25% of which were conditioned "on achieving an undisclosed deal price."

C. Continued Restatement Delay

In late August, NASDAQ warned Tangoe stock would be delisted on September 22nd for failure to timely file several periodic SEC reports. After an appeal hearing, NASDAQ granted Tangoe a final extension to complete the Restatement while allowing Tangoe's stock to continue trading. With the Restatement further delayed, several of Tangoe's suitors expressed "concern with the lack of audited financial statements," causing "reluctance to pursue further discussions." By contrast, Marlin maintained its interest, proposing on November 4th a transaction at $9.00 per share, representing "a 9.3% premium to the current trading price."

Tangoe publicly informed stockholders on November 10th that while it would not timely file its 3rd Quarter Form 10-Q, the Board's "Audit Committee had 'substantially completed' its 'internal

investigation . . . of the financial statements for the periods being restated.' " Not disclosed, however, was the Company's discovery of $30.5 million in incorrectly recognized revenue that would require substantial adjustments to operating income. While most of the remaining potential buyers advised Stifel no "meaningful engagement" could take place while the Restatement remained outstanding, Marlin, Vector, and Clearlake continued to show interest. At this point, the Board apparently shifted its focus from the Restatement to (i) a sale transaction with "financial sponsors who were willing to look past the Restatement delays" and (ii) continued enhancement of Management Team compensation through additional EARCAs with accelerated vesting.

Following a December 27th Board meeting, Marlin indicated interest in acquiring Tangoe at a reduced price of $7.50 per share, conditioned on the receipt of "a quality of earnings report." This report was commissioned for Marlin's benefit, but never disclosed to the other stockholders.

D. Delisting

On January 3, 2017, Tangoe notified NASDAQ and the public of its likely non-compliance with the final deadline for completing the Restatement. To soften the blow of this announcement, Tangoe concurrently announced Marlin's proposed acquisition for $7.50 per share and the Clearlake and Vector offers for $7.00 per share. Nevertheless, between January 3rd and February 24th, Tangoe's stock price drifted from $8.32 per share to $6.01 per share.

Marlin's final February 27th acquisition proposal for $6.50 per share—"a 13% decline from Marlin's initial proposal"—was soon followed by news that Vector and Clearlake would not top Marlin's offer. Despite this news, Company management advised the Board they "unanimously believe[d] the Company ha[d] reasonable prospects to continue operations on a standalone basis."

On March 10th, Tangoe announced the expected delisting of its stock from NASDAQ. "[O]stensibly in response," Tangoe received letters from two separate groups of stockholders demanding a prompt transaction and the holding of its first annual stockholders meeting in nearly two years. Further, one of the groups threatened it was "more than willing to pursue any legal remedies necessary to force" Tangoe's compliance with its demands.

E. Approval of Marlin Transaction

On April 27th, "the Board approved the Transaction at $6.50 per share," triggering "nearly $5 million" in payments under the EARCAS. The following day, Tangoe signed a merger agreement with Marlin, triggering a 30-day "go-shop period." Despite Stifel contacting 36 potential bidders during this period, "not a single serious overture or alternative acquisition proposal was submitted."

As part of its review of the tender offer disclosure documents, the SEC staff advised the Company on June 5th of its concern "whether investors have access to financial information necessary to make a decision regarding the [Tender] Offer" given that no audited financial statements had been provided. "Undeterred," the Board allowed the tender offer to proceed. Tangoe stockholders, "[f]aced with the 'Hobson's Choice' of holding potentially illiquid stock or accepting an all-cash transaction" at a price representing "a negative premium against every conceivable benchmark prior to Tangoe's delisting," tendered 78.2% of Tangoe's outstanding shares into Marlin's offer. The Transaction closed soon thereafter.

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

Plaintiff claimed the Tangoe directors breached their fiduciary duties to stockholders by facilitating the Transaction during the series of aforementioned events: the failed Restatement, delayed SEC filings, NASDAQ delisting, near-deregistration of Tangoe common stock by the SEC, threatened proxy contest, and new equity awards vesting upon a change of control. In short, plaintiff alleged the Board, "[r]ather than navigate through or around the storm . . . sailed Tangoe directly 'into an iceberg and then faithlessly commandeered the lifeboats, leaving stockholders to drown.' "

In defense, the Tangoe directors argued (i) they were entitled to business judgement rule deference under *Corwin* "because a majority of disinterested, fully informed and uncoerced stockholders approved the Transaction" or, in the alternative, (ii) due to a DGCL § 102(b)(7) exculpatory provision in Tangoe's certificate of incorporation, plaintiff was obliged, but failed, to plead a non-exculpated claim for breach of the duty of loyalty. In denying the directors' motion to dismiss, Vice Chancellor Slights rejected both defenses.

A. Stockholder Vote Not Fully Informed

In response to a *Corwin* defense at the pleading stage, "the 'plaintiff challenging the decision to approve the transaction must first identify a deficiency in the operative disclosure document, at which point the burden would fall to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of th[e] vote.' " Vice Chancellor Slights found plaintiff properly pled two such deficiencies: (i) "failure to provide Tangoe stockholders with audited financial statements" and (ii) "failure to disclose whether (or when) the Restatement would be completed."

1. Lack of Reliable Financial Information

Although SEC rules do not require delivery of audited financials in connection with a tender offer, under the circumstances, the Vice Chancellor found it "reasonably conceivable that a reasonable stockholder would have deemed audited financials important when deciding whether to approve the Transaction." Given the uncertainty of the Restatement, the only financial information provided to stockholders was "sporadic and heavily qualified." The Vice Chancellor found that this "information vacuum, compounded by" the Company's failure "to file multiple 2016 quarterly reports" and to hold "an annual stockholders meeting for nearly three years," supported "a reasonable inference that stockholder approval of the Transaction was not fully informed in the absence of adequate financial information about the Company and its value."

2. Failure to Explain Restatement

In addition, the Board's failure to provide disclosures regarding the status of the Restatement "provides a basis to deny *Corwin* cleaning" because "[a]ll constituencies . . . knew well the Restatement stakes were high." Given the circumstances, the status of the Restatement "was *ne plus ultra* when considering whether to tender into the Transaction," yet stockholders had no means to know when, or even whether, the Restatement would be completed. This information was particularly important given Tangoe's public release in November that "[t]he internal investigation overseen by the Audit Committee in connection with the [R]estatement is substantially complete," followed by notification to the Board in December that StoneTurn had completed the forensic accounting and "only BDO's formal audit remained." However, the Board did not share the actual status of the Restatement

with stockholders, depriving "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."

B. Non-Exculpated Claim for Breach of Fiduciary Duty

Plaintiff alleged the Tangoe directors breached their fiduciary duties "by 'undermin[ing] the Restatement efforts [and] myopically focusing the Company's resources on securing a change-in-control transaction . . . which triggered significant payouts pursuant to their EARCAs, but severely undervalu[ing] Tangoe by forcing a sale at the nadir of its negotiating leverage.' " The directors disputed this was "a well-pled claim for breach of the duty of loyalty" sufficient to survive pleading stage dismissal. Vice Chancellor Slights disagreed, concluding plaintiff had satisfied its obligation to "plead sufficient facts to support a rational inference that the corporate fiduciary acted out of *material self-interest* that diverged from the interests of the shareholders."

1. EARCAs

First, plaintiff alleged the Board's approval of EARCAs vesting upon a change in control improperly "incentivized" Tangoe directors "to steer Tangoe into a sale of the company, not because a sale was in the best interests of stockholders, but because a sale was the most likely means by which the [d]irector[s] … would receive generous Measurement Shares …." The EARCAs' $5 million payout upon the Transaction's consummation "provided reasonably conceivable material benefits" to the directors. According to the Vice Chancellor, the "temporal connection" between the NASDAQ non-compliance letters, Board approval of the EARCAs, and the decision to move forward with a sale of the Company "bolsters Plaintiff's theory of [d]irector … self-interest."

2. Looming Proxy Contest

Second, plaintiff pointed out that stockholders with large stakes in Tangoe threatened the directors with a proxy contest to replace the Board "absent a prompt transaction." Although not sufficient on its own to demonstrate the requisite self-interest, "when coupled with the other pled facts," including the severely-delayed Restatement, the EARCAs, and Board recommendation of "steadily decreasing offers from Marlin," "the allegations regarding the looming proxy fight take on greater

measure of relevance" in considering whether to apply business judgment rule deference "at the pleading stage."

CONCLUSION

Tangoe highlights *Corwin's* outer limits in the context of pleading stage dismissal when a plaintiff alleges a stockholder vote was not "fully informed." Vice Chancellor Slights rejected a "shallow reading" of *Corwin* that "directors simply cannot achieve business judgment rule deference when they make difficult decisions amid a 'regulatory storm.'" On the other hand, the Vice Chancellor cautions directors that, to obtain pleading stage dismissal under *Corwin*, they must "demonstrate that they carefully and thoroughly explained all material aspects of the storm to stockholders" and remained "focused on the best interests of stockholders, not their own interests." This was a bar the Vice Chancellor found the Tangoe directors failed to clear. Full disclosure of all material facts remains a *sine qua non* for application of *Corwin* "cleansing."