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Chancery Court Grants Pleading Stage Dismissal of *Revlon* Claims Against Target Company Directors Despite Looming Proxy Contest

*Robert S. Reder**

*Victoria D. Selover***

**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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Finds threat of proxy contest, standing alone, did not support assertion of a non-exculpated breach of fiduciary duty on the part of target company directors protected by an exculpatory charter provision

INTRODUCTION

When disappointed stockholders claim that company directors violated their fiduciary obligations under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) ("*Revlon*") in selling the company, the directors may assert, in the alternative, two principal defenses. *First*, the directors may claim that a fully informed, noncoerced approval of the transaction by stockholders effectively cleansed any directorial breaches of fiduciary duty under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"). *Second*, if *Corwin* cleansing is not available, the directors may argue that plaintiffs failed to adequately plead facts establishing a directorial breach of fiduciary duty. Moreover, if the directors are protected by an exculpatory provision in the company's certificate of incorporation, as authorized by Section 102(b)(7) of the Delaware General Corporation Law ("*DGCL*"), effectively barring any claims "for monetary damages" against the directors for duty of care violations ("*Exculpatory Provision*"), the alleged fiduciary breach must be of the *non-exculpated* variety. In such case, to survive a pleading stage motion to dismiss, a plaintiff must adequately plead a breach of the directors' duty of loyalty; that is, in approving the transaction, the directors were not disinterested or independent, or the directors failed to act in good faith.

It is by now well-established that the Delaware Court of Chancery ("*Chancery Court*") does not reflexively grant motions to dismiss *Revlon* damages claims when target company directors assert a *Corwin* defense or challenge the adequacy of the plaintiffs' allegations. For instance, in *In Re Tangoe, Inc. Stockholders Litig.*, C.A. No. 2017-0650-JRS, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018) ("*Tangoe*"), the Chancery Court refused to dismiss a *Revlon*-based damages claim on two alternative grounds. *First*, inadequate disclosures to stockholders regarding a necessary, but long-delayed, financial restatement precluded *Corwin* cleansing. *Second*, plaintiffs adequately pled facts supporting the reasonable inference of a *non-exculpated* breach of fiduciary duty. Included among the *Tangoe* plaintiffs' pleadings was an allegation that target company directors were not disinterested in light of a threatened proxy contest to replace the board "absent a prompt transaction." For a discussion of *Tangoe*, *see* Robert S. Reder & Amanda M. Mitchell, *Chancery Court Refuses Pleading Stage Dismissal Under* Corwin *When Stockholders Not Fully Informed of Long-Overdue Financial Restatement*, 73 VAND. L. REV. EN BANC 35 (2020).

By contrast, despite plaintiff's reliance on *Tangoe,* defendant directors were able to achieve a pleading stage dismissal in *Rudd v.*

Brown, C.A. No. 2019-0775-MTZ, 2020 WL 5494526 (Del. Ch. Sept. 11, 2020) ("*Rudd*"). In *Rudd*, a disgruntled target company stockholder alleged that the board of directors' approval of a sale transaction was tainted by a significant stockholder's threatened proxy contest to replace the board if the company failed to pursue a sale. Vice Chancellor Morgan T. Zurn distinguished *Tangoe*, pointing out that the *Tangoe* plaintiffs did not rely solely on a threatened proxy contest in pleading a breach of the duty of loyalty. While Delaware jurisprudence recognizes such a threat "might inform the inference of conflict at the pleading stage 'when coupled with other pled facts,' " the "barebones conflict theory" based exclusively on a threatened proxy contest has "no logical force." On this basis, the Vice Chancellor dismissed the *Rudd* plaintiff's claims.

I. FACTUAL BACKGROUND

A. Engaged Amasses Outerwall Shares

Outerwall, Inc. ("*Outerwall*" or the "*Company*") "operates and maintains fully automated self-service kiosks in leading grocery stores and other retailers nationwide." Outerwall operates through three business segments: Redbox, Coinstar, and ecoATM. After boasting of its strong financial performance through much of 2015, in October, the Company experienced an unexpected decline in Redbox revenue. Then, in December, the Company "updated its financial expectations for [the] year to reflect lower expected Redbox segment revenue for the fourth quarter." As a result, "Outerwall's stock price briefly dropped." Nevertheless, CEO Erik Prusch continued to assure the public of Outerwall's "ability to drive the bottom-line." Despite these assurances, on February 4, 2016, Outerwall reported its fourth quarter and year end results that showed "further decline in Redbox revenue," only partially offset by "an increase in Coinstar and ecoATM revenue."

Beginning in early 2016, Engaged Capital, LLC ("*Engaged*"), "an activist investor known for launching 'aggressive campaigns with respect to numerous companies to force change' and for securing appointees on the boards of the companies in which it invests," announced purchases of significant stockholdings in Outerwall. Ultimately, Engaged amassed a 14.6% stake. In Securities and Exchange Commission ("*SEC*") filings, Engaged opined that "the market was undervaluing Outerwall" and "criticized 'persistent failures by the Board and management team.' " Engaged therefore urged Outerwall's board of directors (the "*Board*") to consider strategic alternatives. If not, Engaged threatened that they "will give shareholders the opportunity to hold the Board accountable at the upcoming annual meeting by seeking to replace multiple directors."

B. Cooperation Agreement with Engaged

In response to Engaged's threat, the Board retained Morgan Stanley & Co. LLC ("*Morgan Stanley*") as its financial advisor. On March 14, Outerwall announced the Board "had initiated a process 'to explore strategic and financial alternatives to maximize shareholder value.' " As part of this effort, Morgan Stanley "contacted fifty-three potential bidders, including both financial and strategic buyers." A number of these parties signed confidentiality agreements with Outerwall to "facilitate due diligence" and explore the purchase of Outerwall.

Seemingly, Engaged was placated by the Board's actions because, on April 12, Outerwall announced a Cooperation Agreement with Engaged. Under this agreement, Engaged pledged to vote in favor of Outerwall's Board nominees and not to engage in a proxy contest at the upcoming annual stockholders meeting. In exchange, Outerwall granted Engaged the right to appoint one Board member "effective immediately," agreed to expand the Board from seven to nine not later than August 1 and agreed to allow Engaged to fill the resulting two vacancies.

C. Board Resolves To Sell Outerwall to Apollo

Meanwhile, although "Outerwall received numerous acquisition proposals," the bidding came down to three interested parties offering cash in exchange for the Company's outstanding shares: giant private equity firm Apollo Global Management ("*Apollo*") submitted an indication of interest with a range of $50 to $55 per share, Company A submitted an indication of interest at $48 per share, and Company B submitted an indication of interest with a range of $55 to $57 per share. In a second round of bidding, Apollo offered $50 per share (at the bottom of its range), Company A held at $48 per share, and Company B lowered its range to between $43 and $45 per share. At this point, the Board terminated discussions with Company B and gave the remaining two bidders a July deadline.

After Apollo and Company made various counteroffers, on July 25, Outerwall announced "it had entered into an agreement with Apollo . . . to . . . acquire all of the outstanding shares of Outerwall common stock for $52 per share" (the "*Acquisition*"). The Acquisition was of the two-step variety: a tender offer followed by an intermediateform merger under the DGCL. In related SEC filings, Outerwall disclosed three sets of financial projections and related assumptions. The parties completed the Acquisition on September 27.

D. Litigation Ensues

Just before the closing, an Outerwall stockholder ("*Plaintiff*") brought a class action lawsuit in Chancery Court seeking damages from members of the Board and certain Company officers. Rather than claiming generally that "the sale process was defective," Plaintiff asserted more "narrow grounds": the Board "pursued and disclosed" the Acquisition "disloyally, to avoid a looming proxy contest and in pursuit of other personal interests." Specifically, Plaintiff challenged the $52 per share Acquisition price as "grossly inadequate" and claimed that the financial projections in the Company's SEC filings "contained material misrepresentations or omissions," thereby "rendering the Company's stockholders unable to make an informed decision whether to tender their shares and whether to seek appraisal."

The defendant directors moved to dismiss, asserting what has become the usual two alternative defenses: (i) "because a 'fully informed, uncoerced majority of the disinterested stockholders' " approved the Acquisition, "dismissal is warranted under *Corwin*" or, alternatively, (ii) Plaintiff failed to plead a non-exculpated fiduciary breach. Vice Chancellor Zurn granted defendant directors' motion to dismiss.

II. VICE CHANCELLOR ZURN'S ANALYSIS

Vice Chancellor Zurn assumed, for purposes of defendant directors' motion to dismiss, "that Outerwall stockholders were not fully informed." This assumption precluded their *Corwin* defense. Accordingly, the Vice Chancellor focused on whether Plaintiff adequately pled a non-exculpated fiduciary breach.

A. Pleading Requirements in Light of Exculpatory Provision

The Vice Chancellor, invoking *Revlon*'s familiar mantra, explained that scrutiny of the directors' conduct must focus on "whether the directors . . . have performed their fiduciary duties 'in the service of a specific objective[, specifically] maximizing the sale price of the enterprise,' " in approving the Acquisition. Rather than "creat[ing] a new type of fiduciary duty in the sale-of-control context" or "alter[ing] the nature of the fiduciary duties that generally apply," the Vice

Chancellor explained that *Revlon* "is 'a context-specific articulation of the directors' duties,' " requiring "that plaintiffs plead sufficient facts to support the underlying claims for a breach of fiduciary duties in conducting the sale."

Because the Outerwall directors benefitted from the protection of an Exculpatory Provision, the Vice Chancellor observed that Plaintiff was required to allege "well-pled facts that, if true, implicate breaches of loyalty or good faith" in order to defeat defendant directors' preliminary motion to dismiss "even under *Revlon* scrutiny." In other words, Plaintiff must plead "a non-exculpated fiduciary duty claim."

As for the types of allegations required to establish a *non-exculpated* claim for breach of fiduciary duty, whether in the *Revlon* context or in relation to the alleged SEC filing deficiencies, the Vice Chancellor explained that Plaintiff must "plead facts . . . 'supporting a rational inference that the director harbored self-interest adverse to the stockholder's interest, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith.' " Rather than assert bad faith on the part of the Board, Plaintiff argued that each defendant director "was conflicted because he or she lacked disinterestedness or independence" due to Engaged's threatened proxy contest.

B. Proxy Fight Allegation Insufficient

Specifically, Plaintiff claimed that the Outerwall directors were conflicted by "their 'desire to avoid ouster at the hands of Engaged' and the reputational harm that would come with it." To support his claim, Plaintiff pointed to, among other precedent, *Tangoe* for the proposition that threat of a proxy contest can provide evidence of a director's disloyalty in the context of a sale transaction. As noted above, the *Tangoe* plaintiffs cited several factors as contributing to the directors' disloyalty in pursuing the sale transaction. Primarily, plaintiffs claimed that the directors forced an undervalued sale for self-interested reasons—under new equity award replacement compensation agreements, the directors would receive generous compensation awards upon a sale of the company. According to the *Tangoe* court, these agreements "'provided reasonably conceivable material benefits' to the directors, thereby rendering them conflicted." Further, before the sale was announced, a group of stockholders with sizeable holdings delivered letters to the Tangoe board threatening "to replace the Board with 'new directors.' " The *Tangoe* court found the threat of the proxy contest, *in light of the compensation-related conflicts*, "t[ook] on a greater measure of relevance at the motion to dismiss stage."

Vice Chancellor Zurn rejected Plaintiff's reliance on *Tangoe*, observing that "Delaware courts 'have expressed reluctance to find' that directors are conflicted 'simply because they operate under the threat of a proxy contest.' " At most, "[t]he threat of a looming proxy contest might inform the inference of conflict at the pleading stage 'when coupled with other pled facts.' " The Vice Chancellor noted that in *Tangoe* the Chancery Court "found conflict in board decisions made in the shadow of a proxy contest, but only where those decisions bore other indicia of . . . disloyalty. Plaintiff's allegations offer no such meat on the bone." In short, Plaintiff alleged "no facts beyond the threat of a looming proxy contest that would make it reasonably conceivable that the Director Defendants were conflicted."

On this basis, Vice Chancellor Zurn granted defendant directors' motion to dismiss. "Plaintiff's allegation that the Director Defendants were conflicted solely because they initiated the sale process after Engaged threatened a proxy contest," the Vice Chancellor opined, "is insufficient as a matter of law to plead a non-exculpated breach of fiduciary duty" for either the Acquisition or the related SEC disclosures.

CONCLUSION

In *Rudd*, Vice Chancellor Zurn rejected Plaintiff's attempted reliance on *Tangoe* for the proposition that threat of a proxy contest, in and of itself, disabled otherwise independent and disinterested target company directors from making an unconflicted decision to sell the Company. Even absent the potent *Corwin* defense, because the Outerwall directors were protected by the Exculpatory Provision, Plaintiff's failure to plead a *non-exculpated* breach of fiduciary duty resulted in a pleading stage dismissal of his *Revlon*-based damages action. More was required in the pleadings than naked reliance on Engaged's threat to replace the Board. While the Chancery Court does not reflexively dismiss *Revlon*-based claims, the bar for achieving a damages award against target company directors remains a high one indeed.