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Activist Investing and Its Divided-Loyalty Implications

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The Delaware Court of Chancery recently upheld a claim that a director who voted to approve a merger had a conflict of interest based on his affiliation with a hedge fund that allegedly was focused on short-term gains. In refusing to dismiss the complaint, Vice Chancellor J. Travis Laster placed significant weight on the incumbent board's fight letters during a proxy contest, which argued that the hedge fund was pursuing a quick sale of the company to advance its own interests at the expense of other stockholders. The court's finding that pursuing short-term investment strategies — which are frequently associated with activist hedge funds — can give rise to a conflict of interest represents a significant development in the ongoing debate surrounding activist investing.

Activist investors often seek board representation in parallel with their aggressive advocacy of short-term gains. When these two elements converge, the court's ruling counsels incumbent boards and activist designees to carefully consider the takeaway lessons described below, especially in the context of a board's consideration of any significant transaction after the activist's representatives join the board.

Background

The decision in *In re PLX Technology Inc. Stockholders Litigation*, C.A. No. 9880-VCL, trans. ruling (Del. Ch. Sept. 3, 2015), arose from a post-closing challenge to the \$300 million sale of PLX Technology. Prior to the transaction, PLX had lost a proxy contest led by Potomac Capital, an activist hedge fund that advocated a sale of the company. In public letters to its stockholders during the proxy contest, PLX accused Potomac of being a self-interested activist investor that is focused on short-term gains at the expense of other stockholders. It also claimed that Potomac's primary goal is to force a quick sale of the Company in order to realize a short-term gain on its investment.

The proxy contest resulted in the election of three of Potomac's nominees, including one of its principals. Approximately six months after the proxy contest, PLX entered into a merger agreement with a third party. PLX stockholders challenged the merger claiming, among other things, that the board of directors did not obtain the best price reasonably available. The plaintiffs also alleged that certain directors, including Potomac's principal who represented the hedge fund on PLX's board, had a conflict of interest.

The Court's Ruling

In a bench ruling, the court held that the stockholder-plaintiffs had stated a claim for breach of fiduciary duty against most of PLX's directors. Of particular significance, the court held that Potomac's principal was a dual fiduciary by virtue of his status as both a PLX director and a principal of the hedge fund. The court acknowledged that large stockholders typically do not have a conflict of interest when they are

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treated equally in a sale of the company because their interest, like that of the rest of the stockholders, should be to maximize the value of their shares.¹ The court explained, however, that this presumption of aligned interests can be rebutted by specific facts.

In PLX, the court relied in large part on the incumbent directors' public fight letters in the proxy contest to conclude that Potomac's principal might have a conflict of interest. Both Delaware law and federal securities laws require accuracy in a company's public statements to stockholders. The court therefore took the board's prior statements at face value. In particular, the incumbent directors had repeatedly stated that Potomac was willing to sell PLX at an inopportune time to advance its own interests at the expense of long-term stockholder value. The court explained that, as specifically alleged in the complaint, "the board believed and represented that Potomac was a short-term investor that had a disparate investment horizon, was trying to get a short-term sale event from which it would benefit primarily because of its low basis, and that it had interests that were different from those of the stockholders as a whole" (emphasis added).² The court analogized the hedge fund principal's situation to a "golden leash" arrangement because he allegedly "was getting paid for a near-term event," which gave him an incentive that differed from those of the other directors.

The court also held that the plaintiffs stated a claim against the incumbent outside directors. The court said the complaint adequately alleged that they "did not engage in the sale process entirely because it was in the best interests of the stockholders but rather did so ... because of Potomac and [its principal's] badgering." The court cautioned that the ruling against the incumbent outside directors was a very close call. The most important allegation to the court was that, when previously confronted by a proxy contest from a different hedge fund, PLX's board had the same response: it initially resisted a sale of the company and then shifted to support one. The court granted the motion to dismiss with respect to the two independent directors who were nominated by Potomac. The court said they did not have divided loyalties and there were no allegations that they were badgered into the sale process.

Takeaways

PLX is a fact-dependent case that arose out of unusual circumstances and was issued on a plaintiff-friendly pleading standard. Other allegations not discussed above also factored into the court's decision, including claims that management's internal projections were manipulated to justify the sale process and that the board of directors did not appropriately address conflicts of interest of its financial adviser. Still, there are several important takeaways from this ruling with respect to activist hedge funds.

Activist Hedge Fund Strategies May Create Conflicts of Interest

PLX addressed a pressing corporate governance issue at the forefront of almost every fight between a company and an activist hedge fund — namely, whether the activist is pursuing short-term gains at the expense of long-term stockholder value. Activist hedge funds frequently push companies to implement strategies intended to generate near-term returns, such as a leveraged recapitalization or a sale of the company. The PLX court held that an activist's short-term investment strategy can, under certain circumstances, create a conflict of interest for a director. Although hedge funds (as stockholders) may not owe fiduciary duties, their board representatives, like all directors, owe fiduciary duties to the company and its stockholders. As a result, PLX is an important warning to hedge fund principals and other constituent directors sitting on boards of directors, particularly where the challenged board action is subject to enhanced judicial scrutiny such as in a change-of-control transaction.³

It is Still Difficult for Plaintiffs to Claim that a Desire to Sell is a Disabling Conflict of Interest

It bears noting that in several cases, including *Synthes* and *Mortons*, the Court of Chancery set a very high bar for stockholder-plaintiffs who claim that a sale process was improperly influenced by a large stockholder that received the same per-share consideration as all other stockholders.⁴ Generally, plaintiffs must sufficiently allege an urgent need for liquidity (i.e., a “fire sale”) in which a large stockholder needs to sell immediately, even if at a suboptimal price. PLX does not change this law, but it does show how plaintiffs might rebut that presumption in certain circumstances. At the same time, the specific arguments made by the PLX stockholders typically would not apply to private equity firms, founding families and other large investors that have held their shares much longer than Potomac did. Whether plaintiffs can successfully use these arguments at other companies responding to activist hedge funds remains to be seen.

Lessons for Directors in Dealing with Activist Hedge Funds

PLX holds several lessons for incumbent directors dealing with stockholder activists. First, PLX shows how statements made in the heat of a proxy fight might return to haunt an incumbent board. It should go without saying that just because the board opposed Potomac’s nominees and argued against Potomac’s proposals does not mean the ultimate sale of the company was a breach of fiduciary duty.⁵ PLX shows, however, how plaintiffs might use the board’s communications to stockholders against them in litigation, both to challenge a later decision and to argue that one or more directors have a conflict of interest. Moreover, it is a reminder that directors must not let their passion in a proxy contest affect the accuracy of their statements.

Second, following a proxy contest, the directors must be cognizant that an activist’s board representatives might have a conflict of interest that needs to be addressed. In some situations, forming a special committee of independent directors might be advisable to consider the activist’s proposal. In other situations, the activist’s representatives might need to recuse themselves from certain board deliberations.

Third, directors need to remain diligent when dealing with an activist’s representatives in the boardroom. Experience reveals that many activist representatives have strong personalities and, once in the boardroom, will forcefully advocate the hedge fund’s views. In PLX, the incumbent directors allegedly acquiesced after being badgered into a sale. This theory of liability against outside directors seems remote, and the court indicated its skepticism in allowing the claim to proceed. Nevertheless, similar allegations were upheld in the 2011 decision in *infoGROUP* based on very unusual allegations.⁶

Finally, the directors should be prepared to defend a change of course. In situations similar to PLX, directors will want to be able to articulate why they chartered a new corporate strategy or otherwise took a course of action that materially deviated from prior statements. Relying on outside advisers and documenting board decisions through proper meeting minutes will help build a demonstrable record to support such decisions.

Notes

¹ See, e.g., *Iroquois Master Fund Ltd. v. Answers Corp.*, 105 A.3d 989, n.1 (Del. 2014) (Order) (“When a large stockholder supports a sales process and receives the same per share consideration as every other stockholder, that is ordinarily evidence of fairness, not of the opposite, especially because the support of a large stockholder for the sale helps assure buyers that it can get the support needed to close the deal.”); *In re Synthes Inc. S’holder Litig.*, 50 A.3d 1022 (Del. Ch. 2012) (concluding that a controlling stockholder did not have a conflict of interest where all shares received the same consideration); *In re CompuCom Sys. Stockholders Litig.*, 2005 Del. Ch. LEXIS 145 (Sept. 29, 2005) (same); *In re Schawk Inc. S’holders Litig.*, Consol. C.A. No. 9510-VCL, trans. ruling (Del. Ch. Sept. 15, 2015) (granting a motion to dismiss where the founding family received the same consideration paid to minority stockholders); but see *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (denying a motion to dismiss where directors allegedly breached their duty of loyalty by approving a transaction negotiated by a controlling stockholder to satisfy its liquidity needs); *N.J. Carpenters Pension Fund v. infoGROUP Inc.*, 2011 Del. Ch. LEXIS 147 (Sept. 30, 2011) (denying a motion to dismiss where directors allegedly breached their duty of loyalty by acquiescing to a sale alleged to benefit a large stockholder in need of liquidity); *Tooley v. AXA Fin. Inc.*, 2005 Del. Ch. LEXIS 67 (May 13, 2005) (refusing, “albeit barely,” to dismiss a claim where the plaintiff alleged that the board delayed the closing of a third party’s tender offer to accommodate the controlling stockholder’s administrative needs).

² In its discussion, the court also referenced this law review article: William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PENN. L. REV. 653 (2010).

³ See also Allen C. Goolsby & Steven M. Haas, *Constituent Directors: Court Allows Company to Impose Confidentiality Restrictions on Stockholder’s Right to Designate a Director* (July 8, 2015).

⁴ See, e.g., *In re Morton’s Rest. Grp. Inc.*, 74 A.3d 656, 667 (Del. Ch. 2013) (“Thus, there are only ‘narrow circumstances’ where a controlling stockholder’s desire to sell in a transaction according equal treatment to all stockholders would create a disabling conflict of interest. Those unusual circumstances ‘involve a crisis, a fire sale’ in which the pressure on the controller to sell quickly is so high that the controller imposes pressure on the corporation to artificially truncate the market check and forgo the additional value that could be brought about by making ‘logical buyers aware’ that the company is for sale and giving them a reasonable time and fair opportunity to consider whether to make an offer.”).

⁵ Indeed, the court stated that “you should change your mind when you get new information Somebody who isn’t fanatically wed to a particular point of view should have the humility to think, ‘You know what? I may not have all the answers. I should listen to this person, and I might change my mind.’” *PLX* trans. ruling, at 48.

⁶ See *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 Del. Ch. LEXIS 147 (Sept. 30, 2011) (“[I]t is reasonable to infer that [the interested director] dominated the Board Defendants through a pattern of threats aimed at intimidating them, thus rendering them non-independent for purposes of voting on the Merger.”).