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Corporate Governance Group Client Alert

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DELAWARE COURT FINDS THAT INTIMIDATION CAN STRIP OTHERWISE DISINTERESTED BOARD MEMBERS OF THEIR STATUS AS INDEPENDENT DIRECTORS

Also concludes that one director's "desperate need of liquidity" constitutes a "disabling interest" in terms of his independence

When contesting a decision of a corporate board of directors, one way for plaintiffs to overcome the presumption of the business judgment rule is to establish that a majority of the board members lacked "independence." In *New Jersey Carpenters Pension Fund v InfoGROUP, Inc.*,¹ the Delaware Court of Chancery recently found that otherwise disinterested board members may lose their status as independent directors by allowing a conflicted director to intimidate them into a particular course of action. As a result, the Court refused to dismiss duty of loyalty claims brought against the directors stemming from a change of control transaction.

Background

Vinod Gupta founded and was the owner of 37% of the stock of *infoGroup, Inc.*, an international marketing solutions provider. The remainder of the shares were dispersed among public stockholders. Although Gupta remained a member of the board of directors at the time of the approval of the transaction at issue, he was previously forced to resign as Chairman and CEO in 2007 as part of a settlement of a stockholder derivative suit which, together with a related SEC investigation, saddled him with over \$12 million in litigation-related debts. Gupta owed an additional \$13 million in loans incurred to purchase *infoGroup* stock.

Squeezed by his debts and the funding requirements of a new business venture, Gupta recognized that his only potential source of "meaningful" cash flow was his significant ownership interest in *infoGroup*. However, due to the size of his ownership position, which made the stake unmarketable, coupled with his immediate need for cash, Gupta faced a liquidity crisis. In late 2008,

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¹ C.A. No. 5334-VCN (Del. Ch. September 30, 2011).

Gupta concluded that “the sale of *infoGroup* was the best option to fulfill his need for liquidity, regardless of whether the timing, price, or process employed were in the best interests of the Company’s other shareholders.”

In December 2008, Gupta issued a press release, unauthorized by the board, that lobbied for a sale of *infoGroup*. The board countered with its own press release, “stating that market conditions would make it difficult to obtain a good price for the Company, and that the Board was confident in the Company’s current plan.” Evercore Partners, which was retained by the board “to help the Company explore strategic alternatives,” agreed that “it’s highly credible at this point not to pursue a sales transaction in [this] environment.” Undaunted, Gupta intensified his efforts to bring about a sale, employing, in the words of the Court, “rather indelicate methods of persuasion.” In addition to “repeatedly” threatening individual board members with lawsuits if they failed to act to sell the company, Gupta was “generally disruptive” at board meetings and waged a campaign against management, advocating the firing of the then current CEO (also a member of the board) and allegedly causing the resignation of the Chairman.

Despite their misgivings regarding a sale, the other board members apparently were eventually “overwhelmed” by Gupta, as evidenced by an email from one director to another expressing his concern that a majority of the directors would “just want to ‘dump the company and run ... based on the pain, trauma, time, and everything else” Even after the board initiated a sale process in September 2009, Gupta allegedly “disrupted the sales process by influencing the list of potential bidders, conducting unsupervised negotiations, and leaking confidential information about the sale to various parties.” In March 2010, the board accepted an offer of \$8.00 per share – below the then current market price of \$8.16 per share – that was approved by a stockholder vote on June 29, 2010. Gupta entered into an agreement with the acquirer that required him to vote his shares in favor of the transaction.

Soon after the closing of the transaction, the New Jersey Carpenters Pension Fund, an *infoGroup* stockholder, filed suit in the Court of Chancery alleging, among other things, that by succumbing to Gupta’s intimidation, the board permitted “several deficiencies in the sales process” as a result of which “*infoGroup*’s shareholders ultimately received an unfair price.” According to the complaint, this conduct resulted in a breach of the duty of loyalty on the part of the directors. The directors, including Gupta, moved to dismiss.

The Court’s Analysis

The Court began its analysis by explaining that one way for a plaintiff to satisfy its initial burden of presenting sufficient facts to rebut the presumption of the business judgment rule – and thereby to survive a motion to dismiss – “is to allege facts which, if accepted as true, establish that a majority of the individual board members had a ‘financial interest in the transaction or were dominated or controlled by a materially interested director.’” In such case, “the business judgment rule is rebutted and entire fairness standard of review is applicable.”²

Based on the facts before it, the Court concluded that plaintiff had made sufficient allegations as to the board’s lack of independence to enable it to survive the defendants’ motion to dismiss.

² When the entire fairness standard is invoked, “the initial burden of proving the entire fairness of the transaction is borne by the defendants.”

Gupta's Independence

The Court recognized that “[a] director is considered interested in a transaction if he receives ‘a personal financial benefit from a transaction that is not equally shared by the stockholders.’” Given Gupta’s “purportedly ... desperate need of liquidity” and an ownership stake that rendered a sale of his entire *infoGroup* stake impractical, the Court concluded that Gupta’s interests differed materially from those of any other *infoGroup* stockholder. Thus, although Gupta received the same per share consideration in the merger as each other stockholder, the liquidity afforded him by the sale of *infoGroup* “was a benefit unique to Gupta” not shared by the other *infoGroup* stockholders. In the Court’s view, this unique benefit, and his particular need for such a benefit, made it “reasonable to infer that Gupta suffered a disabling interest when considering how to cast his vote [as a director] in connection with the Merger,” rendering him an interested director.

Independence of the Other Directors

Quoting from the Delaware Supreme Court’s oft-cited opinion in *Aronson v Lewis*,³ the Court explained that “independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. These extraneous considerations and influences may exist when the challenged director is controlled by another.” According to the Court, such “[c]ontrol may ... occur where a director is in fact dominated by another party, and domination can occur through force of will.”

Therefore, while none of the other board members was alleged to have “financial dependence” upon, or “close familial or business relationships” with, Gupta – the traditional indicia of a control relationship – the Court found that “one may reasonably infer from ... [plaintiff’s] allegations that Gupta sought to intimidate the Board Defendants, and in so doing, dominate them, so that they would capitulate to his demands to sell the Company.” On this basis, at least for purposes of defendants’ motion to dismiss, the Court ruled that “it is reasonable to infer that Gupta 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.”⁴

Conclusion

In the lead-up to a change of control transaction, it is often necessary for a board of directors to negotiate with significant or influential stockholders. Such dealings may become intense when the interests of the large stockholder differ from those of other stockholders, and the line between communication and intimidation can become blurred. The Court of Chancery’s ruling in *infoGroup* that intimidation by a large stockholder who serves on the board can compromise the independence of otherwise unaffiliated and disinterested directors presents boards of directors and corporate insiders, as well as their legal advisors, with a clear warning that any such dealings must be approached with caution. While large stockholders certainly are permitted to express their views and vote in accordance with their own interests, overreaching can have negative consequences for the transaction once challenged.

³ 473 A.2d 805 (Del. 1984).

⁴ Boards of directors often empower independent committees of directors to consider potentially conflicted change of control transactions in an effort to shift to plaintiffs the burden of establishing the “entire fairness” of the transaction in case the presumption of the business judgment is found not to be applicable. Because the members of an “M&A Committee” established by the *infoGroup* Board “to review proposals to acquire the Company ... were subjected to the threats and intimidating behavior described above,” the Court explained that it need not “consider the effect the approval by an independent committee would have on this transaction.”

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