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Client Alert

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DELAWARE COURT CONFRONTS ALLEGED BREACH OF FIDUCIARY DUTY BY MAJORITY STOCKHOLDERS OF PRIVATELY-HELD COMPANY

Examines propriety of common takeover defenses adopted by craigslist following dispute with minority stockholder eBay

The dispute heard recently by the Court of Chancery in *eBay Domestic Holdings, Inc. v. Newmark*[1] pitted two well-known internet companies, eBay and craigslist, against each other. At issue were three fairly typical takeover defenses adopted by the majority stockholders of craigslist in response to competitive activities undertaken by eBay, its minority stockholder. What was not typical, however, was that these takeover defenses were adopted by majority stockholders firmly in control of a privately-owned company. Chancellor Chandler upheld one of the takeover defenses, but struck down the others on the basis that the majority stockholders breached their fiduciary duties to eBay. While this decision may be of limited precedential value in light of the unique circumstances, it is both interesting and instructive to see how the Chancellor applied traditional standards of review and analysis of takeover defenses in the private company setting.

Background

In 2002, privately-owned craigslist, Inc., "the most widely used online classifieds site in the United States," was in the midst of an internal crisis. One of its three owners, Phillip Knowlton, had grown frustrated with craigslist's "community-service approach to doing business," pursuant to which it offered the public free classified ads and relied for its revenues on fees for online job postings in certain cities and New York City apartment listings. Knowlton demanded that the other two owners, Craig Newmark and James Buckmaster, take steps to "monetize" the craigslist website to generate revenue

[1] C.A. No. 3705-CC (Del. Ch. September 9, 2010).

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and increase profits. Otherwise, Knowlton threatened use of "[n]on-[f]riendly-[p]ersuasion," a thinly-veiled euphemism for selling his interest to a craigslist competitor. Newmark and Buckmaster were unmoved and, by late 2003, Knowlton began to offer his shares to third parties.

In response, Newmark and Buckmaster met with potential suitors, making it clear that while they were willing to accommodate Knowlton's sale of his shares, their majority stake was not for sale. In August 2004, after three months of negotiations, eBay purchased Knowlton's 28.4% stake. Newmark and Buckmaster, who retained ownership of 42.6% and 29%, respectively, signed a voting agreement to assure control of the craigslist board.

In connection with its investment, eBay was able to negotiate several minority protections. Craigslist's corporate charter was amended to provide for a three-member board elected through cumulative voting, thereby assuring eBay the right to elect one board member. In addition, a stockholders' agreement with the other stockholders gave eBay (i) a veto over certain corporate transactions, (ii) preemptive rights in the case of new share issuances and (iii) a right of first refusal over any shares offered by either of the other two stockholders. The stockholders' agreement also gave Newmark and Buckmaster a right of first refusal over eBay's shares.

The stockholders' agreement also addressed what would happen if eBay sought to compete with craigslist. Specifically, if eBay were to launch an online job posting site in the United States and thereafter fail to abandon the site within 90 days following receipt of a "Notice of Competitive Activity" from craigslist, eBay would lose its veto and preemptive rights and right of first refusal. However, in that event, the right of first refusal granted to Newmark and Buckmaster with respect to eBay's shares also would terminate, and eBay's shares would become freely transferable.

Unfortunately, the relationship between these two very different internet companies was "marred by inconsistent expectations from the beginning." As Chancellor Chandler succinctly put it, "'eBay' is a moniker for monetization, and [] 'craigslist' is anything but." For instance, during the first year of the relationship, eBay "proposed at least three international joint ventures to craigslist, none of which materialized" because Newmark and Buckmaster generally showed little interest in eBay's suggestions.

Concurrent with its efforts to launch an international joint venture with craigslist, eBay began work on its own international classifieds site, to be known as "Kijiji." Then, on June 19, 2007, eBay informed craigslist that it would soon launch Kijiji in the United States. Recognizing that this would constitute a "Competitive Activity" under the stockholders' agreement, eBay sent a term sheet to craigslist's outside counsel three days later proposing amendments to certain provisions of the stockholders' agreement. Rather than negotiate on this basis, craigslist sent a Notice of Competitive Activity, thereby giving eBay 90 days either to cure or suffer the loss of its rights under the stockholders' agreement, but also terminate the transfer restrictions on its shares. eBay decided to go forward with Kijiji, despite the loss of its minority protections, and its craigslist shares became fully transferable.

On July 12, 2007, Buckmaster contacted Meg Whitman, the CEO of eBay, expressing a desire to "gracefully unwind the relationship" through a repurchase of eBay's shares or a sale of eBay's shares to a third party.

When Whitman responded with an email that Newmark and Buckmaster interpreted as telling them "to go 'pound sand,'" they spent the next six months strategizing with outside counsel to develop the following measures to solidify their long-term control and deprive eBay of its board seat (collectively, the "Board Actions"):

- an amendment of craigslist's charter establishing a staggered three-person board under which the directors would no longer be elected each year, but rather would be divided into three one-director classes to stand for election every three years (the "Staggered Board Amendment");

- adoption of a stockholder rights plan to be triggered if any current stockholder acquires any additional shares or any new stockholder becomes the owner of 15% or more of the outstanding shares (the "Rights Plan"); and

- an offer to "issue one new share of craigslist stock in exchange for every five shares on which a craigslist stockholder granted a right of first refusal in favor of craigslist" (the "ROFR/Dilutive Issuance"), an offer that eBay rejected, thereby diluting its ownership interest from 28.4% to 24.9%.[2]

eBay responded to the Board Actions by filing suit against Newmark and Buckmaster, alleging that they had breached their fiduciary duties to the minority stockholder (*i.e.,* eBay) by using their positions as directors and controlling stockholders "to secure rights and benefits for themselves that they were not able to secure when they negotiated … [their agreements] with eBay in 2004."

The Court's Analysis

Chancellor Chandler acknowledged that the defendants owed fiduciary duties to eBay in their capacities both as directors and, by virtue of the voting agreement between them, as controlling stockholders of craigslist. The Chancellor then evaluated the Board Actions not as an "'inextricably related' set of responses to a takeover threat," but rather on their individual merits, applying a different standard of review to each:

- in the case of the Rights Plan, the "enhanced scrutiny" standard developed in *Unocal Corp. v. Mesa Petroleum Corp.*;[3]

- in the case of the Staggered Board Amendment, the business judgment rule; and

- in the case of the ROFR/Dilutive Issuance, the entire fairness test.

Although, after applying these standards, the Chancellor rescinded both the Rights Plan and the ROFR/Dilutive Issuance, he allowed the Staggered Board Amendment to stand. Because, as discussed below, the Staggered Board Amendment is effective to neutralize eBay's ability to cumulate its votes to assure itself of one director seat, this ruling probably will be viewed by the majority stockholders as a victory and, it would seem, encourage a settlement of the issues between the two companies.

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[2] Because "the laws of mathematics require a minority stockholder to own at least 25% of the company for the minority stockholder's cumulated votes to be sufficient to elect one of the three directors," the ROFR/Dilutive Issuance would have eliminated eBay's ability to cumulate votes to elect one director.

[3] 493 A.2d 946 (Del. 1985).

The Rights Plan

As is typical in cases considering the implementation of rights plans and other defensive measures, the Court reviewed the Rights Plan under *Unocal's* enhanced scrutiny test. At the outset, Chancellor Chandler observed that "[t]o my knowledge, no decision under Delaware law has addressed a challenge to a rights plan adopted by a privately held company with so few stockholders." Unlike the typical fact pattern, Newmark and Buckmaster are not "widely dispersed, potentially disempowered, and arguably vulnerable stockholder[s]," but rather are majority stockholders with the power to "consider and opt-for a value-maximizing transaction whenever they want." Nor did they need the Rights Plan to protect their board seats; their voting agreement "ensures that each votes the other onto the board." Yet Chancellor Chandler found that "[t]hese unique factors do not, however, eliminate *Unocal*'s usefulness," stating that "[t]he intermediate standard of review is not limited to the historic and now classic paradigm." In fact, because "the board of a closely held company such as craigslist could deploy a rights plan improperly … [the] *Unocal* standard of review is best equipped to address this concern."

Under enhanced scrutiny, directors have the burden of establishing that (1) they "properly and reasonably perceive a threat to … corporate policy and effectiveness" and (2) their actions represent "a proportional response to that threat." With respect to the first prong, the defendants argued that eBay would pose a threat to "craigslist's values, culture and business model, including departing from [craigslist's] public-service mission in favor of increased monetization of craigslist" by seeking to acquire Newmark's and/or Buckmaster's shares from their heirs after they died. Thus, they "adopted the Rights Plan *now*... to bind *future* fiduciaries and stockholders from beyond the grave."

While conceding that, in *Paramount Communications, Inc. v. Time Inc.,*[4] the Delaware Supreme Court "accepted defensive action by the directors of a Delaware corporation as a good faith effort to protect a specific corporate culture," Chancellor Chandler also pointed out that "[p]romoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders." In the Chancellor's opinion, the "defendants failed to prove that craigslist possesses a palpable, distinctive, and advantageous culture that sufficiently promotes stockholder value to support the indefinite implementation of a poison pill." The fact that craigslist gives away services to attract business is "a sales tactic, … not a corporate culture" unique to craigslist. Rather, "[i]t is a fiction, invoked almost talismanically for purposes of this trial in order to find deference under *Time's* dicta."

The Chancellor also found that the defendants did not satisfy the second prong of *Unocal* because they "failed to prove at trial that when adopting the Rights Plan, they concluded in good faith that there was a sufficient connection between the craigslist 'culture' … and the promotion of stockholder value." In this regard, the Chancellor emphasized that "[d]irectors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization."

The Staggered Board Amendment

The goal of the Staggered Board Amendment was to deprive eBay of representation on the craigslist board. As a minority stockholder, eBay's ability to assure itself of one seat on the craigslist board depended on its continued ownership of at least 25% of the outstanding shares and the cumulative voting provision of craigslist's charter. However, at least two board seats must be up for election at a stockholders meeting to allow eBay to

[4] 571 A.2d 1140 (Del.1990).

effectively cumulate its votes. Thus, although the Staggered Board Amendment does not eliminate cumulative voting from the charter, as a practical matter, the Staggered Board Amendment renders the cumulative voting provision moot because, going forward, only one director position will be up for election each year.

In selecting the appropriate standard to review the Staggered Board Amendment, the Chancellor reviewed each of the available alternatives. First, the Chancellor noted that the Staggered Board Amendment does "not function as a defensive device under the unique facts of this case … [because] [e]ven if craigslist did not have a staggered board, Jim and Craig would control a majority of the board." Consequently, the Chancellor ruled that the Staggered Board Amendment was (unlike the Rights Plan) "not subject to *Unocal* review."

Next, the Chancellor determined that review under the deferential business judgment rule, rather than the intrusive entire fairness standard, was appropriate, despite eBay's contention that the defendants either "had a personal interest in the subject matter of the action" or "did not act in good faith in approving the action."

- With respect to eBay's first argument, the Chancellor noted that "[e]ntire fairness review ordinarily applies in cases where a fiduciary either literally stands on both sides of the challenged transaction or where the fiduciary 'expects to derive personal financial benefit from the [challenged] transaction in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.'" Even though the purpose of the Staggered Board Amendment was to neutralize eBay's power to elect a director via cumulative voting, the Chancellor observed that "Delaware law does not require that minority stockholders such as eBay have board representation … . If a corporation implements a staggered board, and this renders the corporation's cumulative voting system ineffective, minority stockholders have not been deprived of anything they are entitled to under common law or the DGCL ... ."

- As for eBay's assertion that the defendants acted in bad faith, Chancellor Chandler found that because eBay had voluntarily forfeited its veto right over charter amendments by engaging in a Competitive Activity, "the Staggered Board Amendments cannot be inequitable because they were exactly the sort of consequence eBay accepted would occur if eBay decided to compete with craigslist."

Accordingly, Chancellor Chandler involved the business judgment rule, under which a "board's business decisions 'will not be disturbed if they can be attributed to any rational business purpose.'" As far as the Chancellor was concerned, "[p]reventing a competitor that is also a minority stockholder from unilaterally placing a director on the board so that confidential corporate information will not be freely shared with that competitor is a legitimate and rational business purpose." On this basis, the Staggered Board Amendment was allowed to stand.

The ROFR/Dilutive Issuance

In contrast to his conclusion with respect to the Staggered Board Amendment, Chancellor Chandler viewed the defendants as standing "on both sides" of the ROFR/Dilutive Issuance because Newmark and Buckmaster approved the ROFR/Dilutive Issuance in their capacities as directors, and then elected to accept the company's offer in their capacities as stockholders. This in turn led the Chancellor to note that "[i]n transactions such as this, where fiduciaries deal directly with the corporation, entire fairness is ordinarily the applicable standard of review."

Next, the Chancellor instructed that to establish the entire fairness of a transaction, directors have the burden of proving "that the transaction was (1) effectuated at a fair price and (2) the product of fair dealing." Although these two elements are "not bifurcated," price is "the paramount consideration."

While the "price" to be paid in the ROFR/Dilutive Issuance seemingly was the same for all stockholders, the Chancellor determined that "[d]eeper reflection ... reveals that it actually costs eBay more ... than it costs Jim or Craig ... ." The Chancellor came to this conclusion because the defendants' shares were already encumbered (each had a right of first refusal over the other's shares), whereas eBay would be encumbering freely transferable shares if it opted for the ROFR/Dilutive Issuance. As such, the price of the ROFR/Dilutive Issuance "is not fair because it requires eBay, the minority stockholder, to give up more value per share than either Jim or Craig, the majority stockholders and directors. This disproportionate 'price' is sufficient, standing alone, to render the ROFR/Dilutive Issuance void." With the important element of fair price lacking, the Chancellor determined that the defendants had breached their fiduciary duty of loyalty and ordered rescission.

Conclusion

Even though, as noted above and by Chancellor Chandler himself, the corporate battle between craigslist and eBay presents unique issues not often found in the public company setting, there are several aspects of the Chancellor's ruling that public company boards and their advisors should consider:

- Even though eBay has no opportunity to gain control of craigslist as long as the two majority stockholders retain their shares, the Chancellor reviewed the Rights Plan using a *Unocal* enhanced scrutiny analysis, indicating that a defensive measure adopted to combat a threat to corporate culture warrants the same level of scrutiny as when employed in a takeover battle.

- On the other hand, corporations cannot simply recite they are protecting a corporate culture in order to win over judicial support for defensive measures. The Chancellor refused to credit craigslist's desire to preserve its business strategy – particularly one not aimed at "stockholder wealth maximization" – as being sufficient to justify adoption of the Rights Plan.

- Although the Staggered Board Amendment was effective to deny eBay its right to elect one director, the Chancellor's decision to treat its adoption as a matter subject to the business judgment rule made all the difference in terms of his final judgment. If the Staggered Board Amendment had to pass muster under either an entire fairness or enhanced scrutiny analysis, the outcome might have been different.

- Because the ROFR/Dilutive Issuance, on the other hand, was subjected to an entire fairness analysis, the Chancellor looked behind its apparent equal treatment of all stockholders to determine that the offer actually had the effect of benefitting the majority stockholders to the detriment of eBay. While the board's decision to deploy the ROFR/Dilutive Issuance might have survived as a rational measure if accorded the favorable presumption of the business judgment rule, rationality was not sufficient to withstand an entire fairness review.

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