

October 17, 2018

Activist Hedge Fund Overreach in Sale Process

Yesterday, the Delaware Court of Chancery issued a striking post-trial opinion addressing a company's sale following an activist hedge fund's campaign and proxy contest. The opinion by Vice Chancellor Laster in [*In re PLX Technology Inc. Stockholders Litigation*](#) found conflicted misconduct by the activist hedge fund and questioned whether the incumbent board of directors had improperly allowed the activist to take control of the sale process.

The Court found that the activist hedge fund and its principal "had a divergent interest in achieving quick profits by orchestrating a near-term sale" of the company, "knowingly participated" in breaches of fiduciary duty, "failed to disclose" and "withheld" information from fellow directors once appointed to the board, "breached his fiduciary duty and induced the other directors to breach theirs," "succeeded in influencing the directors to favor a sale when they otherwise would have decided to remain independent" and "lacked any ideas for generating value at [the targeted company] other than to sell it." The Court further found evidence that the incumbent directors improperly "deferred to [the activist] when he sought to position himself to best achieve a sale" and "permitted [the activist] to take control of the sale process when it mattered most."

In discussing activist hedge funds and scenarios in which Delaware law may recognize breaches of the duty of loyalty in the case of a stockholder director, the Court explained:

Delaware law recognizes that in some scenarios, circumstances may cause the interests of investors who hold common stock to diverge. For example, liquidity is one "benefit that may lead directors to breach their fiduciary duties," and stockholder directors may be found to have breached their duty of loyalty if a "desire to gain liquidity...caused them to manipulate the sales process" and subordinate the best interests of the corporation and the stockholders as a whole. For similar reasons, particular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those strategies, thereby creating a divergent interest in pursuing short-term performance at the expense of long-term wealth. In particular, "[a]ctivist hedge funds...are impatient shareholders, who look for value and want it realized in the near or intermediate term. They tell managers how to realize the value and challenge publicly those who resist the advice, using the proxy contest as a threat."

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1443.

The opinion underscores that activists who join boards must adhere to the same fiduciary duties as other directors and must place the interests of the company and all stockholders above any personal, fund-specific or short-sighted interests. It remains to be seen whether this clear judicial warning will encourage activists to exercise more self-restraint or refrain from seeking board seats for themselves and incurring potential liability from service as a director (in this case, the Court found that the deal price in the sale exceeded the standalone value of the company and accordingly did not award damages). It also remains to be seen whether the problematic conduct that occurred after stockholders had elected the activist principal to the board in a proxy contest will encourage stockholders to prefer truly independent directors unaffiliated with an activist fund and a company's own recommended nominees over activist fund employees.

In preparing for activism and considering negotiated resolutions or "settlements" with activist hedge funds, companies should ensure they implement board practices and negotiated arrangements that preserve the board's ability to discharge its fiduciary duties, consider potential conflicts of interest, feature appropriate guardrails against activist over-reaching and enable the board to resist improper influence and pressure.

Regardless of pressures from activist investors or other sources, boards of directors must remain well-advised and steadfast in exercising their own business judgment in charting the future course of the company.

Edward D. Herlihy
Sabastian V. Niles