Special Commentary

In re Mindbody, Inc. Stockholders Litigation: Delaware Court of Chancery Rules "Paradigmatic *Revlon* Claim" Not Cleansed by *Corwin* Doctrine

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In *Corwin v. KKR Financial Holdings LLC*,[2] decided in October 2015, the Delaware Supreme Court held that "the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders."[3] Subsequent decisions by the Supreme Court and Court of Chancery have made clear that "*Corwin* cleansing" can be a powerful pleading-stage argument for defendants faced with post-closing stockholder litigation challenging a merger not involving a conflicted controlling stockholder,[4] because "[w]hen the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result."[5]

Five years to the day after the Supreme Court issued its decision in Corwin, the Court of Chancery issued a decision in *In re Mindbody, Inc. Stockholders Litigation*,[6] finding that Corwin cleansing did not apply to a stockholder challenge of a private equity buyout and largely denying the defendants' motions to dismiss. As illustrated in the Mindbody decision, the efficacy of a *Corwin*-cleansing argument can be diminished where a complaint pleads a "paradigmatic claim" under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*.[7] of undisclosed, unmanaged conflicts of interest on the part of a CEO who allegedly tilts the target's sale process toward a favored bidder for personal gain rather than seek to maximize stockholder value—in such circumstances, disclosure deficiencies relating to the purportedly flawed process may well arise precluding a Court from finding that a stockholder vote was fully informed.[8]

Mindbody

Mindbody involved a challenge by stockholders to the sale of Mindbody, Inc. ("Mindbody" or the "Company") to a private equity firm ("PE Buyer"). The plaintiffs alleged that Mindbody's CEO-founder, the CFO, and a director appointed by a significant, but non-majority, venture capital investor ("VC Firm") "tilted the sale process" in PE Buyer's favor due to purported conflicts of interest in the form of the CEO's needed liquidity, both the CEO's and CFO's prospect of future employment with the PE Buyer, and the VC Firm's desire to exit its investment.[9] Ultimately, the Court found that the well-pled undisclosed transactional conflicts on the part of the CEO were enough to taint the process and the corresponding stockholder vote.

According to the complaint, the Company made two strategic acquisitions in 2018 that the Company touted would yield significant growth in 2019.[10] But despite the Company's self-proclaimed bright outlook, the CEO was allegedly motivated to force a sale of the Company due to his personal wealth being "'locked inside' Mindbody" and a number of recent events that overextended the CEO's personal finances.[11] The complaint also alleged that the VC Firm was motivated to force a sale because the investment fund was nearing its investment horizon, the firm had previously sought to exit its investment without success, its

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[2] 125 A.3d 304 (Del. 2015).

[3] *Id.* at 305-06.

[4] *Larkin v. Shah*, 2016 WL 4485447, at *13 (Del. Ch. Aug. 25, 2016).

[5] *Singh v. Attenborough*, 137 A.3d 151, 152 (Del. 2016).

[6] 2020 WL 5870084 (Del. Ch. Oct. 2, 2020).

[7] 506 A.2d 173 (Del. 1986).

[8] *Mindbody*, 5870084, at *26.

[9] *Id.* at *1.

[10] *Id.* at *2.

[11] *Id* at *3.

board designee planned to soon resign from the board, and the VC Firm could not easily sell its large block of stock without accepting a discount.[12]

The plaintiffs alleged that prior to the PE Buyer making an offer to acquire Mindbody, Mindbody's investment banker connected the CEO with the PE Buyer's principals as well as additional private equity firms.[13] The CEO immediately met with the PE Buyer, a firm allegedly with "a history of retaining management in take-private transactions and offering them compensation packages with significant upside."[14] The plaintiffs asserted that the CEO also attended a summit held by the PE Buyer for the CEOs of its portfolio companies.[15] All of these events allegedly occurred before the PE Buyer made an indication of interest to purchase Mindbody and before the CEO met with the other private equity firms identified by Mindbody's banker.[16] Two weeks after the summit, the PE Buyer made a direct expression of interest to acquire Mindbody at a premium to its then-trading price, which had a thirty-day weighted volume average of $38.46.[17] The CEO allegedly informed some members of senior management about the expression of interest, but instructed them not to discuss it with the Mindbody board.[18]

The CEO and CFO thereafter conducted an earnings call during which they lowered Mindbody's guidance, which purportedly was inconsistent with management's actual expectations.[19] And while that earnings call had previously been scheduled for the month prior, it was rescheduled, with Mindbody's management using the resulting delay to allegedly look for "'a creative way'" to lower Mindbody's guidance.[20] Mindbody's stock price dropped over 20% the day after the call.[21]

Around that time, the board formed a transaction committee, chaired by the VC Firm's board designee, "for the limited purpose of reviewing the potential engagement of a financial advisor to assist Mindbody with evaluating potential strategic alternatives and evaluating candidates for this role."[22] The CEO was also a member of the committee.[23] Two financial advisors pitched the committee, and the committee allegedly went with the CEO's direction to retain the bank that had connected him with the PE Buyer.[24] The board then expanded the committee's mandate, which initiated a sale process.[25]

Together, the CEO and banker allegedly selected potential bidders to contact.[26] Meanwhile, the CEO had allegedly been in touch with the PE Buyer and its principals throughout this time and immediately provided due diligence to the PE Buyer and gave "real-time input on [its] valuation model."[27] Other bidders received significantly less information in due diligence than the PE Buyer (for example, allegedly receiving only 36 documents while the PE Buyer received over 1,000).[28] The CEO also allegedly declined to include certain potential bidders in the sale process because he did not want to work for the specific company post-acquisition.[29]

Thereafter, the PE Buyer submitted an offer to purchase Mindbody for $35/share, lower than its prior indication of interest.[30] In response, Mindbody's committee instructed the banker to accelerate any further bidding process.[31] In response to that surprising acceleration, all other potential bidders withdrew.[32] After

[12] *Id.*
[13] *Id* at *4.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id* at *5.
[19] *Id.*
[20] *Id.*
[21] *Id* at *7.
[22] *Id.*
[23] *Id.*
[24] *Id.* at *7-8.
[25] *Id.* at *8.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id* at *9.

the board made a counteroffer of $40/share, the PE Buyer countered at $36.50/share, which the board approved.[33]

The merger agreement provided for a thirty-day go-shop period, beginning on Christmas eve.[34] The CEO and CFO were on vacation during the go-shop, and the Company allegedly delayed entering into NDAs and providing diligence to prospective bidders contacted during the go-shop period.[35] During the go-shop, the CEO accepted an invitation from the PE Buyer to attend another conference hosted by the PE Buyer and the Super Bowl in the PE Buyer's suite.[36] Mindbody also allegedly failed to disclose to the public and other potential bidders its massive beat in its 2018 Q4 financial results, though it provided that information to the PE Buyer.[37]

Subsequently, with the CEO and VC Firm's irrevocable proxies in favor of the merger, which accounted for approximately 40% of the Company's voting power, a majority of stockholders approved the merger, which closed the next day.[38]

Following the filing of stockholder suits challenging the merger, the cases were consolidated and defendants moved to dismiss, arguing that *Corwin* cleansing applied due to the fully informed stockholder approval of the transaction.[39] The Court largely denied the motions.

The Court found that the plaintiffs adequately pled a "paradigmatic claim" under *Revlon* due to their allegations of "a supine board under the sway of an overweening CEO bent on a certain direction[ ] [who] tilts the sales process for reasons inimical to the stockholders' desire for the best price."[40] In particular, the Court explained that the plaintiffs sufficiently pled that the CEO may have breached his fiduciary duties because he allegedly: (i) "was conflicted because he had an interest in near-term liquidity and an expectation that he would receive post-Merger employment accompanied by significant equity-based incentives" with the PE Buyer; (ii) skewed the process in the PE Buyer's favor "by strategically driving down Mindbody's stock price [through lowered earnings guidance] and providing [the PE Buyer] with informational and timing advantages during the due-diligence and go-shop periods"; and (3) "withheld material information from the Board"[41] by allegedly not disclosing numerous conflicts suggesting that the CEO "affirmatively courted [the PE Buyer]" in pursuit of material personal benefits.[42]

The Court next found that the plaintiffs sufficiently pled that the stockholder vote was not fully informed, and thus the *Corwin* defense did not apply.[43] The Court noted that "[g]enerally, where facts alleged make the paradigmatic *Revlon* claim reasonably conceivable, it will be difficult to show on a motion to dismiss that the stockholder vote was fully informed."[44] Based on the plaintiffs' allegations, the Court found disclosure deficiencies in the form of the allegations regarding the CEO's conflicts of interest and his putative efforts to tilt the sale process in the PE Buyer's favor, including regarding post-closing employment, the initial expression of interest, and the PE Buyer's timing and information advantages vis-à-vis other potential bidders.[45] The Court also found disclosure deficiencies in the proxy's description of the merger price as a premium, explaining in pertinent part that the plaintiffs had asserted well-pled allegations that the CEO "drove down the stock price by lowering Q4 guidance, rendering it reasonably conceivable that the Q4 actuals would correct the misleading impression created by the deflated stock price."[46]

After finding the *Corwin* defense did not apply, the Court held that the plaintiffs had stated a claim for breach of the duty of care against Mindbody's CFO as well. The Court found that the plaintiffs had

[33] *Id.*
[34] *Id.*
[35] *Id* at *9-10.
[36] *Id* at *10.
[37] *Id.*
[38] *Id.*
[39] *Id* at *10-12.
[40] *Id* at *14.
[41] *Id.*
[42] *Id.* at *23-25.
[43] *Id.* at *26.
[44] *Id.*
[45] *Id* at *27-28.
[46] *Id* at *31.

sufficiently pled that the CFO may have acted with gross negligence because he was alleged to have been aware of the CEO's actions in tipping the sale process in favor of the PE Buyer and acted with "reckless[] indifference" to such conduct.[47] In particular, the Court noted that the CFO was alleged to have "himself delivered the lowered guidance on the Q3 earnings call," and purportedly "was also involved in providing timing and informational advantages to [the PE Buyer] throughout the sale process."[48]

Finally, the Court dismissed the plaintiffs' claim against the director-designee of the VC Firm, rejecting the plaintiffs' liquidity-driven conflict theory.[49] The Court noted that, as a general matter, liquidity-driven conflicts are "difficult to plead" and "routinely reject[ed]" where they are based on allegations of an investment fund nearing its investment horizon.[50] The Court found that the plaintiffs' allegations did not comprise the "rare fact pattern" where a liquidity-driven conflict will be well-pled,[51] and explained that, even assuming a conflict, there were no allegations that the director-designee "took any action to tilt the process toward his personal interest."[52]

Takeaways

Corwin cleansing can be a powerful tool for defendants facing a complaint challenging a merger that has been approved by the target's stockholders,[53] giving rise to an irrebuttable business judgment presumption if invoked.[54] However, while *Corwin* and other decisions have successfully reduced the prevalence of frivolous stockholder litigation in the Delaware state courts, the doctrine will likely not defeat the rare "paradigmatic *Revlon* claim."[55]

Moreover, the use of pre-suit books and records demands has become a more utilized means for stockholders to test the adequacy of a company's disclosures against the processes that led to the transaction.[56] The potential utility of such a demand in attempting to defeat a *Corwin* defense has perhaps increased by recent precedent permitting stockholders, in limited circumstances, to inspect "informal" books and records, such as emails and text messages.[57] Indeed, in *Mindbody*, the plaintiffs referenced the text messages of the CEO in their operative complaint, and those text messages formed the foundation of well-pled allegations of undisclosed conflicts of interest.[58] Deal participants should be mindful that text messages and emails potentially could someday be scrutinized by plaintiffs' counsel, either through a pre-suit books and records demand or discovery in plenary litigation.

In light of the above, *Mindbody* offers key practice pointers. *First*, a board or transaction committee should play an active and direct role in the sale process.[59] Part of those duties include being proactive about identifying and managing actual or potential conflicts of interest of directors, officers, or advisors arising from the transaction. While management may often be involved in sale processes, a board cannot completely cede its oversight responsibility to officers; relying entirely on management potentially could "taint the design and execution of the transaction."[60]

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[47] *Id.* at *33.
[48] *Id.*
[49] *Id.* at *33-34.
[50] *Id* at *33.
[51] *Id.* at *33-34.
[52] *Id.* at *34.
[53] *See, e.g., In re Merge Healthcare Inc. S'holders Litig.*, 2017 WL 395981, at *1 (Del. Ch. Jan. 30, 2017) (dismissing complaint alleging "a less-than-rigorous sales process" under *Corwin*).
[54] *Larkin*, 2016 WL 4485447, at *1 ("In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebut[t]able business judgment rule ....").
[55] *Mindbody*, 2020 WL 5870084, at *26 ("Generally, where facts alleged make the paradigmatic Revlon claim reasonably conceivable, it will be difficult to show on a motion to dismiss that the stockholder vote was fully informed."); *see also Sciabacucchi v. Liberty Broadband Corp.*, 2017 WL 2352152, at *20 (Del. Ch. May 31, 2017) (observing that "Corwin 'was never intended to serve as a massive eraser, exonerating corporate fiduciaries for any and all of their action or inactions preceding their decision to undertake a transaction for which stockholder approval is obtained'") (quoting *In re Massey Energy Co. Deriv. Litig.*, 2017 WL 1739201, at * 19 (Del. Ch. May 4, 2017)).
[56] *See Lavin v. West Corporation*, 2017 WL 6728702, at *9 (Del. Ch. Dec. 29, 2017) ("[T]his court should encourage stockholders, if feasible, to demand books and records before filing their complaints when they have a credible basis to suspect wrongdoing in connection with a stockholder-approved transaction and good reason to predict that a *Corwin* defense is forthcoming.").
[57] *See KT4 Partners, LLC v. Palantir Techs. Inc.*, 203 A.3d 738 (Del. 2019).
[58] *See, e.g., Mindbody*, 2020 WL 5870084, at *4.
[59] As the Delaware Supreme Court has noted, a board of directors "may not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control." *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989).
[60] *Id.*

Second, if management is involved in the process, the board should consider any potential conflicts of interest, such as officers' desire for liquidity and/or post-merger employment. "There is nothing inherently wrong with an interested chief executive officer negotiating a merger transaction. In most instances, the chief executive officer is the person most knowledgeable about the company, its value, and the industry in which it operates."[61] However, generally speaking, merger communications should be overseen by and/or reported to the board, and discussions regarding post-merger employment details should be reserved until an agreement on the key sale terms has been reached.[62] Officers should understand they owe fiduciary duties to the company and its stockholders and, unlike directors, do not enjoy the benefit of a Section 102(b)(7) exculpatory charter provision.

Third, before appointing a director designee of a large stockholder to a transaction committee, the board should evaluate whether the stockholder may have interests that potentially conflict with those of the company's other stockholders. While a large stockholder's interests in maximizing the sale price are typically aligned with other stockholders, director designees remain a target of plaintiffs claiming a purported conflict as a result of ties to the large stockholder.

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[61] *In re Ply Gem Indus., Inc. S'holders Litig.*, 2001 WL 755133, at *10 (Del. Ch. June 26, 2001).

[62] *Forgo v. Health Grades, Inc., et al.*, C.A. No. 5716-VCS (Del. Ch. Sept. 10, 2010) (TRANSCRIPT) at 20-22 (plaintiffs demonstrated a reasonable probability of success on the merits of their *Revlon* claim where buyer's assurances to management regarding post-closing employment meant management had "a totally different incentive system than everybody else. And the Board didn't supervise it."); *In re Zenith Nat'l Ins. Corp. S'holders Litig.*, C.A. No. 5296-VCL (Del. Ch. Mar. 19, 2010) (TRANSCRIPT), at 13 ("There are allegations that during the initial meetings the CEO bargained for price, bargained for his own position in the follow-on entity, and also bargained for the ability to compensate and determine the compensation of senior management. That raises a colorable claim as to whether the CEO, in fact, was engaged in steering; in other words, steering for this bidder as opposed to other bidders who might not give him the same freedom, and whether the bidder -- whether the CEO was potentially diverting merger consideration in the form of value to himself and his team rather than value for the stockholders.").