

Fraud on the Board II: Conflicted CEO Tilts Company Sale in PE Firm's Favor

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In *In re Mindbody, Inc. Stockholders Litigation*, the Delaware Court of Chancery declined to dismiss breach of fiduciary duty claims against the chief executive officer of MINDBODY, Inc. (the Company) arising out of the Company's 2019 sale to private equity firm Vista Equity Partners. In what is becoming an increasingly common claim in M&A litigation, the court found it reasonably conceivable that the CEO, unbeknownst to the Company's board of directors, favored Vista in the sale process due to his desire for short-term liquidity and the prospect of post-closing employment and buy-side equity.

Background

Richard Stollmeyer founded the Company in 2001 to operate cloud-based business management and payments software for the wellness services industry, serving as chairman of the board of directors and as CEO. Despite the Company's growth as a public entity, Stollmeyer's personal wealth was concentrated in the Company's stock, which he was unable to sell except under a 10b5-1 plan that Stollmeyer analogized to "sucking through a very small straw."

In August 2018, Stollmeyer met with an investment banker from Qatalyst Partners and shared his desire to sell the Company to a private equity firm that would agree to employ him post-closing. Qatalyst connected Stollmeyer with Vista and two other private equity firms. Stollmeyer immediately met with Vista — which had a history of retaining management in take-private transactions and offering rollover equity — and attended a summit, where Vista touted its history of generating wealth for the CEOs of its portfolio companies.

In October 2018, Vista expressed interest to Stollmeyer in acquiring the Company at "a substantial premium to its recent trading range." At the time, the Company's 30-day volume weighted average price was \$38.46, and its stock traded at a high point of \$41.25. Stollmeyer informed members of management of Vista's indication but instructed them not to disclose the indication to the board. A month later, Stollmeyer led an earnings call during which he lowered the Company's guidance, resulting in its stock closing at \$32.63 on the same day and opening at \$25.00 the following day. According to the court, as he prepared for the earnings call, Stollmeyer told other members of management that "a few hundred thousand of Q4 revenue" would make a "huge difference" come the day of the earnings call, which the court characterized as Stollmeyer looking for a way to negatively affect the Company's stock price.

Sometime after Vista expressed interest, the board formed a transaction committee that included Stollmeyer. At Stollmeyer's insistence, the committee hired Qatalyst to serve as the Company's financial advisor. Stollmeyer

and Qatalyst reached out to a list of potential bidders, including Vista. Vista sent due diligence requests to the Company, which Stollmeyer used to populate a data room containing over 1,000 documents. Other potential acquirors received less information and in a less timely fashion. Thereafter, Vista submitted an offer to buy the Company for \$35 per share and informed Stollmeyer that management would receive a 10% equity stake in the post-closing entity, effectively doubling management's pre-deal stake in the Company. All other potential acquirors withdrew shortly thereafter due to their inability to meet the committee's accelerated timeline. After negotiating a price increase from Vista, on December 23, 2018, the board approved the sale of the Company to Vista at \$36.50 per share.

The merger agreement contained a go-shop provision, allowing the Company to solicit and negotiate alternative acquisition proposals from December 24, 2018 through January 22, 2019. The Company populated the go-shop data room with only some of the diligence materials that Vista had received. Potential acquirors communicated that they could not compete for the Company because of the compressed timeframe of the go-shop. In early January, the Company received its Q4 results, reflecting 37% growth year-over-year. The Company provided the Q4 results to Vista, before the go-shop ended, but not to other potential bidders. The Company did not disclose the Q4 results to stockholders before the stockholder vote on the merger. On February 14, 2019, the Company's stockholders approved the merger and it closed the next day. Afterwards, certain Company stockholders filed suit, alleging, among other things, that Stollmeyer had breached his fiduciary duties as an officer by initiating, timing, and tilting the sale process in favor of Vista in his own self-interest. Stollmeyer moved to dismiss the plaintiffs' complaint.

Court's Analysis

The court began its analysis by observing that *Revlon* enhanced scrutiny applied to the plaintiffs' claims unless *Corwin* ratification applied otherwise.^[1] Under *Revlon*, fiduciaries must perform their duties in the service of maximizing the sale price of the corporation. A plaintiff can state a *Revlon* claim by pleading that just one conflicted fiduciary failed to provide material information to the board, which is otherwise known as "fraud on the board."

Addressing the plaintiffs' claims, the court held that it was reasonably conceivable that Stollmeyer was conflicted in the sale process due to his own self-professed need for liquidity and desire for post-closing employment with Vista. According to the court, Stollmeyer's need for liquidity stemmed from his inability to sell his public shares in substantial quantities in the face of a personal financial need. The court also found that Stollmeyer himself admitted that he desired post-closing employment with a buyer that would retain the management team, citing Stollmeyer's initial encounter with Qatalyst that led him to Vista.

Next, the court held that it was reasonably conceivable that Stollmeyer tilted the sale process in favor of Vista (i) by lowering the Company's guidance on the November 2018 earnings call to depress its stock to make it a more attractive target for Vista and (ii) by providing Vista with timing and informational advantages in diligence and in the go-shop process. The court also found that the go-shop was ineffective from a process standpoint because it spanned Christmas and New Year's Eve and required a competing bidder to make a bid, and the Company to accept that bid, within a mere 30 days. Finally, the court held that it was reasonably conceivable that Stollmeyer failed to disclose his material conflicts to the board, including (i) his initial outreach to Qatalyst in August 2018, (ii) his desire to find a private equity buyer that would retain the management team, (iii) his failure to immediately

disclose Vista's initial indication of interest to the board, (iv) his failure to inform the board of his dealings with Qatalyst before the committee retained Qatalyst, and (v) his elimination of bidders with whom he did not wish to work from the sale and go-shop process, while providing Vista with timing and informational advantages.

The court also held that the stockholder vote on the merger was not fully informed so as to invoke the business judgment rule under *Corwin*. In this regard, the court found that Stollmeyer's conflicts of interests with Vista and his efforts to tilt the sale process in Vista's favor had not been disclosed in the merger proxy, nor had the Company's Q4 results which potentially rendered materially misleading the proxy's description of the merger consideration as a 68% premium to the then-current trading price of the Company's shares.

Takeaways

As discussed in a [prior analysis](#), "fraud on the board" theories demonstrate the need for all directors and officers actively involved in negotiating a sale transaction to fully, accurately, and immediately disclose all actual and potential conflicts of interests to the board of directors to preserve the presumption of the business judgment rule. With the increasing frequency and success of such theories, boards of directors should closely monitor the transaction process and strive to uncover undisclosed conflicts of interests by asking questions of its primary negotiators. Members of management involved in the negotiation of a sale transaction are also well-advised to keep discussions surrounding the terms and possibility of post-closing employment until after the execution of definitive transaction documents.

[1] The court acknowledged that its precedent focusing on "fraud on the board" theories had traditionally elevated the standard of review from *Revlon* or business judgment rule to entire fairness but that the parties had agreed that *Revlon* was the appropriate standard of review. According to the court, it is an open issue whether entire fairness would ultimately apply.

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