

Locke Lord QuickStudy: Delaware Court of Chancery Applies *Revlon*, Not Business Judgment Rule, Despite ?Stockholder Approval in *In re Mindbody, Inc.* ?

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Despite having stockholder approval of the \$1.9 billion take-private sale of the wellness technology company Mindbody, Inc. to Vista Equity Partners Management LLC, the Delaware Court of Chancery at the motion to dismiss stage declined to apply the business judgment rule in claims against the former CEO and COO of Mindbody. *In re Mindbody, Inc.*, No. 2019-CV-0442-KSJM, 2020 WL 5870084 (Ch. Oct. 2, 2020). Applying Delaware’s intermediate-review *Revlon* standard, the Court found the plaintiffs’ allegations that the CEO and COO tilted the sale process in favor of Vista based on a desire for liquidity and the prospect of future employment with Vista stated a claim for relief. Rather than applying the business judgment rule under the *Corwin* standard, the Court found that the plaintiffs’ allegations made it reasonably conceivable that the stockholder vote, which was not challenged as coerced, was not “informed” and thus the actions were subject to a stricter standard of review than business judgment.

Allegations Against the Former Officers

The plaintiffs alleged that Mindbody’s co-founder and former CEO and director “tilted” the sale process because he was “motivated by a need for liquidity and the prospect of future employment with Vista,” based on his personal finances being tied up in the company. The plaintiffs further alleged that both the former CFO and COO were similarly “motivated by the prospect of future employment.” Pursuant to these motives, the officers allegedly manipulated the sales process by (1) lowering Mindbody’s earning guidance to depress the company’s stock price in order to make it a more attractive target at the time Vista was looking to acquire Mindbody, and (2) providing Vista with timing and information advantages over other bidders during the due-diligence and go-shop periods. Specifically, Mindbody’s CEO allegedly eliminated one potential bidder and declined to share diligence with another bidder after Vista made its initial bid, admitting in both instances that he did not want to work for those potential acquirers. Plaintiffs further alleged the officers did not meaningfully seek out competing bids, that its former CEO withheld material information from the Board, and that the Board failed to adequately oversee the CEO.

The Court Applied the *Revlon* rather than the *Corwin* Standard

Ordinarily, when there is a change of control transaction, a challenge to compliance with fiduciary duties is reviewed by the Delaware courts under the stricter standard created by the Delaware Supreme Court’s landmark

decision *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In *Revlon*, the Delaware Supreme Court created an intermediate standard between the business judgment rule and the entire fairness rule (a stringent standard of review requiring that directors' prove that a transaction was entirely fair). The *Revlon* standard requires Courts to use "enhanced scrutiny" when evaluating board action such that the board must take efforts to achieve the highest value reasonably attainable for its stockholders. Reviewing board action under *Revlon* shifts the burden from the plaintiff to the board. This is in contrast to review under the more deferential business judgment rule. Under the business judgment rule, director decisions are upheld so long as they were (1) made in good faith, (2) with the care that a reasonably prudent person would use, and (3) with the reasonable belief that the director was acting in the best interests of the corporation. To rebut the business judgment rule, plaintiffs generally must allege either that a majority of the directors that approved the transaction were interested, lacked independence from an interested party, or acted in bad faith. Absent that showing, the business judgment rule usually governs.

The *Mindbody* defendants argued that the business judgment rule should apply under the standard established in *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304 (Del. 2015). In *Corwin*, the Delaware Supreme Court held that an "uncoerced, informed stockholder vote is outcome-determinative, even if *Revlon* applied to the merger." The *Mindbody* defendants argued that dismissal was warranted under *Corwin* because a majority of the board approving the merger was disinterested and independent and the transaction was approved by a fully informed, uncoerced vote of the disinterested stockholders. The Chancery Court rejected this argument, finding that a "fraud on the board" exception to the shift to business judgment review under *Corwin* was warranted. The Court reasoned that "the mere existence of the Transaction Committee does not give rise to the countervailing inference Defendants seek." The Court then noted that "Plaintiffs do not argue that the stockholder vote was coerced" but rather, "[t]hey contend that *Corwin* does not apply because the vote was uninformed." Thus, the Court held that: "[o]ne sufficiently alleged disclosure deficiency will defeat a motion to dismiss under *Corwin*. ... [and] 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."

The *Mindbody* Court thus found that the *Revlon* standard applied on the basis that "the paradigmatic *Revlon* claim involves a conflicted fiduciary who is insufficiently checked by the board and who tilts the sale process toward his own personal interests in ways inconsistent with maximizing stockholder value." The Court also found that the CEO's alleged conflicts of interests with Vista and his alleged efforts to tilt the sale process in Vista's favor had not been disclosed in the merger proxy statement, which warranted denial of the motion to dismiss.

Conclusion

The *Mindbody* decision follows an increasing reluctance in Delaware to afford directors the benefit of the business judgment rule when a plaintiff alleges plausible facts suggesting a "fraud on the board" occurred and that resulted in the stockholders' vote not having been "fully informed."

In light of this decision and similar ones coming out of the Delaware Court of Chancery in recent years, boards of directors can expect plaintiffs to continue to pursue fiduciary duty claims that employ theories of "fraud on the board" and "uninformed stockholders' vote" in an effort to avoid dismissal at the pleadings stage. Directors evaluating the merits of a proposed transaction would be well advised, having this decision in mind, to be actively involved in the transaction process and to carefully scrutinize management representations regarding the

transaction. Similarly, managements should have in mind the need to fully inform the board of all material information and to consider carefully the information necessary to disclose to stockholders so that their approval is fully informed.

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