Navigating a Forced Sale

When selling under pressure, boards must be able to justify their reasoning and explain why their decisions are best for stockholders.

BY DOUG RAYMOND

Boards sometimes find themselves under severe pressure to sell the company. Sometimes, it's due to market dynamics or an aggressive suitor. Sometimes, it's a significant stockholder looking for liquidity. And sometimes it's because the company has run out of cash and the board is worried about making payroll. Two recent Delaware Court of Chancery decisions, *In re Dura Medic Holdings Inc. Consolidated Litigation* and *Manti Holdings LLC v. The Carlyle Group Inc.*, offer valuable guidance for boards in two of these situations and illustrate the need for boards to be able to articulate exactly why a sale is happening and demonstrate why their process was reasonable under such circumstances.

When a company runs out of cash, the board may have no alternative other than trying to sell its assets for whatever it can get. In these situations, there's usually no time for a slow and deliberative process. This is what happened in *Dura Medic Holdings*. Dura Medic was acquired by a private equity (PE) firm, but encountered severe liquidity challenges in 2018 arising from regulatory compliance problems. The PE firm provided interim financing, but by late 2020, the company was on the verge of collapse. At that point, the board and management rushed to find a buyer. The company ultimately sold its assets to another company in what was described in the ensuing litigation as a "fire sale," but which avoided the alternative of liquidation.

When the minority stockholder sued, he alleged the board had breached its fiduciary duties by rushing to a sale. The court considered various alternative standards by which to judge the board's action, ranging from the wide deference of "business judgement" to the exacting and most rigorous "entire fairness" review, which applies when fiduciaries have conflicts of interest and requires them to prove both fair process and fair price. The court settled on "enhanced scrutiny," an intermediate standard requiring the board to show it acted reasonably in both process and outcome. This is the standard that applies in scenarios similar to *Revlon*, where a company is in its "end stage" and the board must prioritize maximizing stockholder value. Recognizing this was a final-stage transaction that would end the stockholders' investment in the company, the court found the sale process and price were reasonable under the dire circumstances. Dura Medic's financial distress was well-documented, the company lacked other viable options and the only competing offer was materially worse. The board's decision to sell rather than liquidate therefore satisfied its fiduciary duties under the enhanced scrutiny standard.

When a company has no choice but to sell, boards should aim to demonstrate that the sale was the best available option under the circumstances and other options were, to the extent possible, explored in good faith. A full auction process may not always be feasible, but directors should make a reasonable effort to test the market, negotiate fair terms and avoid conflicts of interest.

Boards can face similar challenges when a controlling stockholder wants to exit, even if there is no compelling internal need for a sale. In the *Manti Holdings* case, a different PE firm acquired Authentix but then decided it wanted to exit its investment because it reached the end of its PE fund's 10-year life cycle term. When the PE firm went to sell, the minority stockholders sued the PE firm and its designated directors, alleging they were forcing a sale at a bad time for the company, and only to get liquidity for the fund and an exit at their expense. The minority stockholders argued the sale gave the PE fund a unique benefit that was fundamentally unfair to the minority stockholders, which should have triggered the exacting scrutiny of entire fairness. The court rejected this argument after a trial, finding that, while the PE fund owned preferred stock with a $70 million liquidation preference, it also owned the majority of common stock and, in turn, had the greatest incentive to maximize the sale price. The court also found the PE fund was not under liquidity pressure because it was not driven by fund expiration, investor demands or a clawback mechanism that could have required it to pay back its investors if the fund failed to meet certain returns. Although the fund desired to exit, the court found the plaintiffs had not shown whether it needed to sell or if it faced other pressures that would have caused it to accept less than fair value. The court concluded the fund's interests were aligned — not conflicting — with the minority stockholders and decided the entire fairness analysis therefore did not apply. The bad news for the fund was the court reached this conclusion only after a trial, including full — and expensive — development of the background facts.

In each case, the boards were found to have satisfied their fiduciary obligations. Despite their significant differences, these cases illustrate a common theme: When a company is sold under pressure, whether due to financial distress or a controlling stockholder's decision, boards should be prepared to explain why the sale happened and how it was conducted.

Directors need to be able to articulate exactly why they are trying to sell and be prepared to defend the timing and process of a sale, even in exigent circumstances. Transparency is also critical. Directors should document every step of the decision-making process to show why a sale is necessary and why the transaction chosen is the best option available. If a controller wants to sell, directors should ensure the rationale is sound, all stockholders are treated fairly and, if there are unequal benefits, then the board should consider how to address that in the context of applicable legal standards to avoid application of the entire fairness standard, if possible.

Ultimately, whether a sale is driven by necessity or strategy, boards should be able to justify why they are selling, follow a defensible process and ensure their decisions align with the best interests of all stockholders. ■

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