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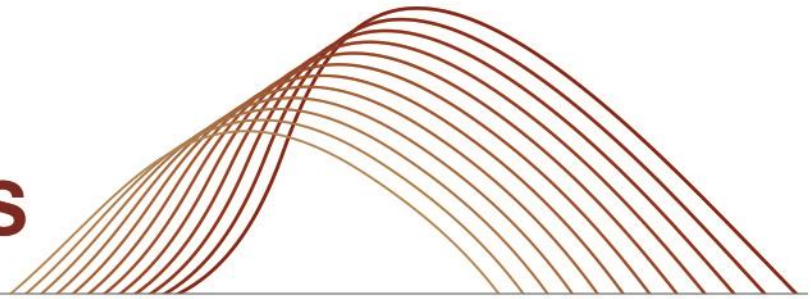

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PLX Likely Stands On Its Own, But Has Room to Grow

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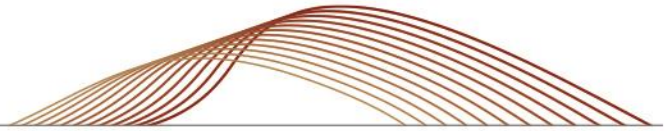
PLX: A Uniquely Egregious Set of Facts Led to a Breach

Given a recent court ruling in Delaware, activist investors should be mindful to ensure that pursuit of their investment agendas do not cause boards, obviously including activist investors themselves, to breach fiduciary duties to shareholders. Often, activist investors push incumbent boards and management towards the boundaries of their fiduciary duties. In its October 2018 ruling in *In re PLX Technology Inc. Shareholders Litigation*, the Delaware Chancery Court ruled that actions taken by a director affiliated with Potomac Capital Partners II, L.P., an activist investor, in connection with a sale of PLX Technology to Avago Technologies Wireless (U.S.A.) Manufacturing Inc., caused not only a breach of the board's fiduciary duties, but also constituted aiding and abetting on the part of the activist investor. Potomac and its affiliated director's singular focus on a short-term profit through a sale of PLX Technology motivated the court's decision. The case serves as a useful reminder of the perils of aggressive activist behavior throughout a sale process. Yet, the actions of the director at fault in *PLX* were so uniquely egregious, that the limits on activist behavior remain in question.

Antitrust concerns thwarted a possible merger between PLX Technology and a third party, allowing Potomac to purchase the company's shares at a hefty discount. Potomac, looking to turn a quick profit, took an activist approach and pushed for PLX Technology to quickly sell itself. With a depressed share price after the failed merger, the PLX Technology board did not feel that the timing was right to sell the company. In order to pressure the sale of the company, Potomac launched a proxy contest and replaced three of the eight directors on the PLX Technology board with Potomac-affiliated directors. One of these new directors was a co-managing member of Potomac.

While serving on the board, the Potomac-affiliated director was tipped off by Avago's banker of an incoming proposal by Avago to acquire PLX Technology for $6.50 per share, less than the $7.00 per share agreed to in the failed merger. The director did not share this tip with anyone else on the board. He then played a central role in arranging the eventual sale to Avago, which acquired PLX Technology at the secretly discussed $6.50 per share. This illustrated to the court that the director had a conflict of interest between his roles as Potomac's co-manager and as a PLX Technology board member, and that the director impaired the sale process through his direct participation. Interestingly, Vice Chancellor Laster hinted that the sale appeared to be reasonable. The sale included transaction safeguards which are meant to ensure that a company will be sold through a competitive process. However, when accounting for the Potomac-affiliated director's undisclosed conflict and involvement in



the sale process, the effectiveness of the transaction safeguards became suspect and the court found such safeguards, and the process as a whole, to be inadequate.

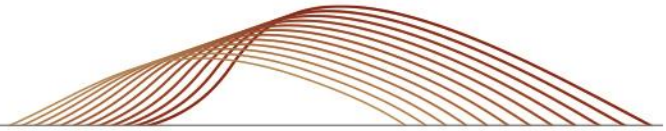
Finding a Conflict of Interest Embedded in Activist Strategy

PLX may serve as a warning for boards to disclose any possible conflict of interest when an activist investor holds a director position during a sale. However, the facts of *PLX* illustrate particularly egregious activist behavior, which probably indicates that the case stands on its own. The court did not find a conflict of interest solely because Potomac and its affiliated director put pressure on the board to sell, rather, the director's actions throughout the sale process illustrated a clear and single-minded focus on turning a short-term profit at the expense of PLX Technology's shareholders. Further, the sale might have survived the court's scrutiny, despite the conflict of interest, had that director not driven the sale.

Delaware law presumes that investors want to maximize the value of their investments, but, as Vice Chancellor Laster noted, sometimes the interests of certain shareholders diverge. This may occur when certain shareholders are focused on efficient liquidation while others may want the highest possible sale price in order to maximize returns. This contrast between shareholder interests materialized in *PLX*, as Potomac put more value into following a short-term investment strategy than in getting the best price for all shareholders. Notably, the Vice Chancellor hinted that activist investors focused on short-term profits may be especially susceptible to harboring this investment strategy conflict.

This ruling does not necessarily mean that a director affiliated with an activist investor is presumed to have such a conflict. Delaware courts have held that a director's affiliation with an institution, alone, is not enough to prove that the director is conflicted—plaintiffs must prove that the director actually holds the divergent interest. It was apparent in *PLX* that the Potomac-affiliated director's interests aligned with Potomac's short-term investment agenda, and not with the interests of PLX Technology's shareholders. Potomac and its affiliated director exclusively sought a quick sale of PLX Technology. The PLX Technology board offered alternative strategies which did not involve a sale of the company, but Potomac and its affiliated director rejected them without consideration. In response to the other directors' hesitation to initiate a sale, the Potomac-affiliated director threatened to contact prospective acquirers himself unless the board decided to sell the company. However, he did not himself pursue any alternative deals and withheld the Avago tip from the other directors, likely because, as the court surmised, those actions may have threatened the Avago deal. By disclosing the tip or actually contacting other potential buyers, the other board members may have more heavily evaluated different offers and negotiated more aggressively with Avago, which could have created obstacles in the way of Potomac's desire for a quick sale.

Had Potomac and its affiliated director been amenable to alternative strategies to a sale, the court may not have found a conflict. In *Chen v. Howard-Anderson*, a director of an acquired company was affiliated with an investment fund that owned a large share of the acquired company and also had an alleged urgency to obtain liquidity. The shareholder-plaintiffs claimed that the director steered the sale of the company in a way to address this alleged liquidity need, and not in a way to get the best share price for the company's shareholders. However, the court did not find the director conflicted because he had also supported alternative acquisition strategies for the acquired company.



Further, it is possible that the court's ruling in *PLX* may have been different had the board not allowed the Potomac-affiliated director to take a central role in the sale. In *English v. Narang*, shareholder-plaintiffs sued a retiring CEO-director after he tendered his controlling shares in an acquisition of his company. The shareholder-plaintiffs claimed that the CEO-director urgently needed liquidity because he was retiring and his controlling shares accounted for nearly all of his net-worth. However, the court did not find a conflict, in part, because the CEO-director did not solicit offers or direct negotiations and key decisions were made by a number of non-conflicted directors and advisors. In *PLX*, the non-Potomac directors deferred to the Potomac-affiliated director on key aspects of the sale, often conceding to the Potomac-affiliated director's judgment when they may have otherwise acted differently or independently. The Potomac-affiliated director was the chair of the special committee tasked with selling the company. He held private discussions with both the investment bankers and Avago. Lastly, he persuaded the board to sell at the secretly discussed $6.50 per share. By doing so, the Potomac-affiliated director forced the committee to engage in what the court labeled as the "art of the possible." That is, the board members found themselves agreeing to a price that was most likely to result in a sale, and not a price that was in the best interest of the shareholders.

Looking Forward

The true extent of *PLX* is still to be determined, but it will not likely spawn similar decisions. Regardless, we advise directors to continue to observe similar cases coming out of the Delaware courts, mainly those involving comparable investment strategy conflicts and situations. Boards should keep in mind that before a sale, *PLX* may impose heightened disclosure requirements on boards of directors, especially where a director is affiliated with a shareholder which may be employing the same investment strategy as seen in *PLX*. If such shareholder is an activist investor, the board should be particularly cautious.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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