Significant Delaware Decisions in 2013

BY EDWARD B. MICHELETTI AND SARAH RUNNELLS MARTIN

Edward B. Micheletti is a partner and Sarah T. Runnells Martin is an associate in Skadden, Arps, Slate, Meagher & Flom's Wilmington office. Mr. Micheletti is a co-author and Ms. Martin is on the board of editors of the leading deal litigation treatise, "Mergers and Acquisitions Deal Litigation Under Delaware Corporation Law." Contact: edward.micheletti@skadden.com or sarah.martin@skadden.com.

In 2013, the Delaware Supreme Court and Delaware Court of Chancery issued a number of noteworthy opinions. The opinions discussed below address, among other things, issues related to derivative standing, forum selection bylaws and the standard of review to be applied in transactions involving controlling stockholders.

Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp., 75 A.3d 888 (Del. 2013)

The Delaware Supreme Court issued an opinion addressing the continuous ownership requirement for stockholders in derivative lawsuits, derivative standing and the fraud exception to the continuous ownership requirement. In connection with an appeal of dismissed derivative claims filed against directors and officers following a merger, the Ninth Circuit Court of Appeals certified the following question to the Court:

> **Whether, under the "fraud exception" to Delaware's continuous ownership rule, shareholder plaintiffs may maintain a derivative suit after a merger that divests them of their ownership interest in the corporation on whose behalf they sue by alleging that the merger at issue was necessitated by, and is inseparable from, the alleged fraud that is the subject of their derivative claims.[1]**

The Delaware Supreme Court answered the certified question in the negative, and in doing so ratified and reaffirmed the continuous ownership rule and the fraud exception recognized in *Lewis v. Anderson*.[2] The Court explained that the "fraud" exception to the continuous ownership rule only applies in the "limited circumstance[s]" where the "'merger itself is being perpetrated merely to deprive shareholders of their standing to bring the derivative action.'"[3] The Court further explained that its *dicta* in an earlier opinion, *Arkansas Teacher Retirement Systems v. Caiafa,*[4] which upheld the approval of a settlement of a related litigation, did not "change the scope of the fraud exception," or "'clarify,' 'expand,' or constitute 'a new material change' in *Lewis v. Anderson*'s continuous ownership rule or the fraud exception."[5] Thus, the Court held that stockholder plaintiffs may not maintain a derivative suit after a merger that divests them of their ownership interest in the corporation on whose behalf they sue by alleging that the merger at issue was necessitated by, and is inseparable from, the alleged fraud that is the subject of their derivative claims.[6]

In re BioClinica, Inc. S'holder Litig., No. 8272-VCG, 2013 WL 5631233 (Del. Ch. Oct. 16, 2013)

Vice Chancellor Sam Glasscock III dismissed breach of fiduciary duty and aiding and abetting claims brought by stockholders in connection with the acquisition of BioClinica, Inc. by JLL Partners, Inc., BioCore Holdings, Inc. and BC Acquisition Corp. In evaluating defendants' mo-

 © 2014 THOMSON REUTERS

tion to dismiss, the Court explained that, in light of an exculpatory provision protecting directors from liability for breaches of the duty of care, plaintiffs must plead a violation of the duty of loyalty or good faith. The Court found that plaintiffs failed to state a claim for breach of the duty of loyalty, and found that "Plaintiff's contention that the vesting of stock options in a change of control transaction implicates the duty of loyalty is frivolous. Delaware courts recognize that stock ownership by decision-makers aligns those decision-makers' interests with stockholder interests; maximizing price. Our Courts have therefore routinely held that an interest in options vesting does not violate the duty of loyalty."[7]

The Court found that "because the Plaintiffs fail to adequate[ly] allege any director interest in the transaction, the Plaintiffs' remaining claims against the directors must be based on a breach of the duty of good faith to survive."[8] The Court rejected the stockholder plaintiffs' allegations that the BioClinica board acted in bad faith by "'inflating' the capital expenditure estimates provided by management and used in [its investment banker's] fairness opinion in order to knowingly depress the implied values in those valuations,"[9] explaining that "without a story of *why* the directors would artificially inflate the capital expenditures, there is no basis to conclude that they acted in bad faith."[10]

With respect to plaintiff's *Revlon* claims, the Court noted that plaintiffs "ask that I infer some sinister motive from the Board's initial decision not to solicit strategic bidders." The Court held that

> **There are, however, no well-pled facts suggesting bad intentions on behalf of the Board. On the contrary, approaching private equity bidders seems like an entirely reasonable way to protect BioClinica's confidential information during a first market test. Furthermore, even if the directors did initially favor private equity bidders, the directors later authorized Excel to solicit strategic bidders. That those strategic bidders were unwilling to make a binding offer to acquire BioClinica does not imply any bad faith on the part of the directors.[11]**

The Court therefore granted defendants' motion to dismiss.

Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013)

Chancellor Leo E. Strine Jr. held that director-enacted bylaws containing an exclusive forum provision are valid and enforceable as a matter of Delaware law.[12] The forum selection bylaws at issue specified the Delaware courts as the exclusive forum in which stockholder derivative suits, fiduciary duty claims and other intra-corporate actions must be brought, unless otherwise consented to by the company. Chancellor Strine held:

> **[T]he court finds that the bylaws are valid under our statutory law. 8 *Del. C.* § 109(b) provides that the bylaws of a corporation "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." The forum selection bylaws, which govern disputes related to the "internal affairs" of the corporations, easily meet these requirements. The bylaws regulate the forum in which stockholders may bring suit . . . to obtain redress for breaches of fiduciary duty by the board of directors and officers. The bylaws also regulate the forum in which stockholders may bring claims arising under the DGCL or other internal affairs claim. In other words, the bylaws only regulate suits brought by stockholders as stockholders in cases governed by the internal affairs doctrine. . . . Because Delaware law, like federal law, respects and enforces forum selection clauses, the forum selection bylaws are also not inconsistent with the law.[13]**

The Court further explained that the Delaware General Corporation Law:

> **"allows the corporation, through the certificate of incorporation, to grant the directors the power to adopt and amend the bylaws unilaterally. The certificates of incorporation of [the defendant corporations] authorize their boards to amend the bylaws. . . .In other words, an essential part of the contract stockholders assent to when they**

buy stock in [the defendant corporations] is one that presupposes the board's authority to adopt binding bylaws consistent with 8 *Del. C.* § 109. . . .Therefore, this court will enforce the forum selection bylaws in the same way it enforces any other forum selection clause ... ."[14] The court noted, however, that "as-applied challenges to the reasonableness of a forum selection clause should be made by a real plaintiff whose real case is affected by the operation of the forum selection clause."[15]

Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP, 80 A.3d 155 (Del. Ch. 2013)

The Delaware Court of Chancery held that, pursuant to Section 259 of the DGCL, the buyer of a Delaware corporation owned and controlled pre-merger privileged communications between the selling corporation's outside counsel and its stockholders and representatives, regarding the negotiation of the transaction, which were contained in the corporation's computer systems. The opinion arose from an ongoing dispute wherein the buyer claimed that it was fraudulently induced to acquire the Delaware company.

Chancellor Strine noted that this case presented an issue of statutory interpretation in the first instance.[16] Under Section 259 of the DGCL, following a merger, "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation . . . ."[17] Chancellor Strine reasoned that if the Delaware legislature had intended to exempt attorney-client privileged communications from the property and rights to be transferred under Section 259, it would have so provided.[18] He also distinguished a decision of the New York Court of Appeals, *Tekni-Plex, Inc. v. Meyner & Landis*,[19] relied on by the seller, which concluded (without citation to Section 259) that pre-merger attorney-client communications regarding the merger negotiations did not pass to the surviving corporation for policy reasons under New York attorney-client privilege law.[20]

Chancellor Strine further explained that:

"the answer to any parties worried about facing this predicament in the future is to use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own. . . . Absent such an express carve out, the privilege over all pre-merger communications—including those relating to the negotiation of the merger itself—passed to the surviving corporation in the merger, by plain operation of clear Delaware statutory law under § 259 of the DGCL."[21]

Kallick v. SandRidge Energy, Inc., 68 A.3d 242 (Del. Ch. 2013)

Chancellor Strine enjoined the incumbent board of SandRidge Energy, from, among other things, soliciting against or otherwise impeding a consent solicitation until the board approved the rival slate for purposes of a "Proxy Put" provision in SandRidge's credit agreements.

Large stockholder TPG-Axon launched a consent solicitation to seat a new board committed to changing the company's management and exploring strategic alternatives for the company.[22] The incumbent's board resisted the consent solicitation, contending that TPG's slate was less qualified than the incumbents to run the company due to its lack of expertise, and warned that the election of TPG's proposed slate would trigger SandRidge's lenders' right to put back $4.3 billion worth of notes (the Proxy Put).[23] Applying intermediate scrutiny under *Unocal*, the court determined that the board's duty of loyalty required it to approve the opposing slate, unless it posed a material threat of harm to the company. The court stated that "[i]n keeping with this state's public policy of stringent policing of the fairness of corporate elections, this court's decision in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals* made clear that a board deciding whether to approve directors for the purposes of a Proxy Put could not act consistently with its fiduciary duties by simply failing to approve any director candidates who ran against the incumbent slate."[24]

© 2014 THOMSON REUTERS

Rather, the incumbent board must respect its primary duty of loyalty to the corporation and its stockholders and may refuse to grant approval only if it determines that the director candidates running against them posed such a material threat of harm to the corporation that it would constitute a "breach of the directors' duty of loyalty to the corporation and its stockholders" to "pass[ ] control" to them. In other words, unless the incumbent board determined, by way of example, that the rival candidates lacked ethical integrity, fell within the category of known looters, or made a specific determination that the rival candidates proposed a program that would have demonstrably material adverse effects for the corporation's ability to meet its legal obligations to its creditors, the incumbent board should approve the rival slate and allow the stockholders to choose the corporation's directors without fear of adverse financial consequences, and also eliminate the threat to the corporation of a forced refinancing. Notably, absent any determination by the incumbents that the rival slate has suspect integrity or specific plans that would endanger the corporation's ability to repay its creditors, there is no harm threatened to the creditors by the election of the slate. Rather, the only "harm" threatened is that the stockholders will choose to seat a new board of directors. The incumbents' expected view that they are better suited to run the company effectively is, without substantially more, not a sufficient fiduciary basis to deny approval to their opponents.[25]

The Court found that "[g]iven that the incumbent board has admitted that it has no basis to doubt the integrity of the TPG slate or the basic qualifications of that slate to serve with competence as the directors of a public company, the incumbent board is merely basing its refusal to make a decision on its contention that the incumbents are the better choice at the ballot box."[26] Because the incumbent slate could not identify any material threat of harm, the court enjoined the board from (i) soliciting any further consent revocations, (ii) relying upon or otherwise giving effect to any consent revocations received to date and (iii) impeding TPG's consent solicitation process in any way until the incumbent board approved the TPG slate.[27]

In re MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013)

In this opinion, Chancellor Strine granted summary judgment in favor of the defendants in litigation following a controlling stockholder going-private transaction, and in doing so, held that, with certain procedural protections, controlling stockholder transactions can be evaluated under the business judgment standard of review. MacAndrews & Forbes, a holding company solely owned by Ronald Perelman, owned 43% of M&F Worldwide ("MFW"). MacAndrews & Forbes offered to purchase the remainder of MFW's equity in a going private merger. Up front, MacAndrews & Forbes said it would not proceed unless the transaction was approved by (i) an independent special committee and (ii) a vote of a majority of the stockholders unaffiliated with MacAndrews & Forbes.[28]

In reviewing the motion for summary judgment, the court noted that "[t]he question of what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by *both* a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote has been a subject of debate for decades now."[29] Answering that question, the court held that the business judgment rule will apply to a merger proposed by a controlling stockholder where, from the outset, the offer is conditioned upon the "(i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors."[30] The Court emphasized that for the business judgment rule to apply, it must "be clear that the procedural protections employed qualify to be given cleansing credit. . . ."[31] For example, the business judgment rule would not apply if the special committee were not comprised of independent directors, or the majority-of-the-minority vote were tainted by a disclosure violation or coercion.[32] Here, the Court found that there was "no triable issue of fact regarding (i) the indepen-

dence of the special committee, (ii) its ability to employ financial and legal advisors and its exercise of that ability, and (iii) its empowerment to negotiate the merger and definitively to say no to the transaction."[33] With respect to the majority-of-the-minority vote, "the plaintiffs admit that it was a fully informed vote, as they fail to point to any failure of disclosure. Nor is there any evidence of coercion of the electorate."[34] Thus, the Court applied the business judgment rule to the decision to approve the merger, and granted summary judgment in defendants' favor. The plaintiffs have appealed the decision.

Pyott v. La. Mun. Police Emps.' Ret. Sys., 74 A.3d 612 (Del. 2013)

The Delaware Supreme Court, *en banc*, reversed the Court of Chancery's 2012 denial of a motion to dismiss a derivative action. In 2010, derivative actions were commenced on behalf of Allergan, Inc. in both the Delaware Court of Chancery and the U.S. District Court for the Central District of California. Shortly before Vice Chancellor J. Travis Laster of the Court of Chancery held argument on a motion to dismiss, the California court dismissed with prejudice the action before it pursuant to Rule 23.1. Nevertheless, the Court of Chancery denied the defendants' motion to dismiss the Delaware complaint. In so doing, the court refused to give collateral estoppel effect to the California court's dismissal.[35]

The Delaware Supreme Court held that the Court of Chancery erred in refusing to give preclusive effect to the California court's dismissal.[36] First, the Delaware Supreme Court explained that the trial court's holding as a matter of Delaware law that the stockholder plaintiffs in the two jurisdictions were not in privity was erroneous because California law controlled the issue. Under California law, "derivative stockholders are in privity with each other because they act on behalf of the defendant corporation."[37] The Delaware Supreme Court explained that the U.S. Supreme Court has held "that a state court is required to give a federal judgment the same force and effect as it would be given under the preclusion rules of the state in which the federal court is sitting."[38] Although the Court of Chancery recognized this settled law, it failed to apply it because it "conflated collateral estoppel with demand futility."[39] The Delaware Supreme Court explained that "[o]nce a court of competent jurisdiction has issued a final judgment . . . a successive case is governed by the principles of collateral estoppel, under the full faith and credit doctrine, and not by demand futility law, under the internal affairs doctrine."[40]

Second, the Delaware Supreme Court explained that the trial court's adoption of a "fast filer" presumption in analyzing the adequacy of the California plaintiffs' representation was erroneous.[41] The Court found that, without the erroneous presumption that a fast-filing stockholder with a nominal stake is an adequate representative, there was "no basis on which to conclude that the California plaintiffs were inadequate."[42]

Se. Pa. Transp. Auth. v. Volgenau, No. 6354-VCN, 2013 WL 4009193 (Del. Ch. Aug. 5, 2013)

Vice Chancellor John W. Noble granted the defendants' motion for summary judgment and applied the business judgment rule to a leveraged buyout involving a controlling stockholder and a third party. In the transaction, the controlling stockholder was able to roll over a portion of his equity while minority stockholders were cashed out. A plaintiff stockholder brought a class action suit alleging that the directors, and the controlling stockholder, breached their fiduciary duties in approving the sale of the corporation to a private equity firm.

The Court distinguished its decision in *In re MFW Shareholders Litigation*[43], , which applied the business judgment rule to a going-private transaction initiated by a controlling stockholder, because "[u]nlike *MFW*, which involved a controlling stockholder on both sides of the transaction, this case involves a merger between a third-party and a company with a controlling stockholder."[44] Relying on *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,[45] the Court held that such a third-party transaction involving a controlling stockholder will be reviewed under the business judgment rule where "(1) the transaction [is] recommended by a disinterested and independent special committee, (2) which has 'sufficient authority and opportunity to bargain on behalf of minority stockholders,' including the 'ability to hire independent legal and financial

© 2014 THOMSON REUTERS

advisors[;]' (3) the transaction [is] approved by stockholders in a non-waivable majority of the minority vote; and (4) the stockholders [are] fully informed and free of any coercion."[46]

NOTES

1. 75 A.3d at 897.
2. 477 A.2d 1040 (Del. 1984).
3. 75 A.3d at 897 (quoting *Lambrecht v. O'Neal*, 3 A.3d 277, 284 n.20 (Del. 2010)).
4. 996 A.2d 321 (Del. 2010).
5. 75 A.3d at 897.
6. 75 A.3d at 897.
7. 2013 WL 5631223, at *5.
8. 2013 WL 5631223, at *5.
9. 2013 WL 5631223, at *6.
10. 2013 WL 5631223, at *6.
11. 2013 WL 5631223, at *6.
12. 73 A.3d 934, 963.
13. 73 A.2d at 939.
14. 73 A.3d at 939-40.
15. 73 A.3d at 941.
16. 80 A.3d at 156.
17. 80 A.3d at 156 (quoting 8 *Del. C.* § 259).
18. 80 A.3d at 157-58.
19. 674 N.E.2d 663 (N.Y. Ct. App. 1996).
20. 80 A.3d at 158-59.
21. 80 A.3d at 161-62.
22. 68 A.3d at 244.
23. 68 A.3d at 244-45.
24. 68 A.3d at 246.
25. 68 A.3d at 246.
26. 68 A.3d at 246.
27. 68 A.3d at 264.
28. 67 A.3d at 499.
29. 67 A.3d at 500.
30. 67 A.3d at 502.
31. 67 A.3d at 501.
32. 67 A.3d at 501.
33. 67 A.3d at 501.
34. 67 A.3d at 501-02.
35. *La. Mun. Police Emps.' Ret. Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012).
36. *Pyott*, 74 A.3d at 616.
37. *Id.* at 614.
38. *Id.* at 615-16.
39. *Id.* at 616.
40. *Id.*
41. *Id.* at 618.
42. *Id.*
43. 67 A.3d 496 (Del. Ch. 2013).
44. 2013 WL 4009193, at *10-11.
45. No. 758-CC (Del. Ch. Oct. 2, 2009).
46. *Id.* at *11 (quoting *In re John Q. Hammons Hotels Inc. S'holders Litig.*, 2009 WL 3165613, at *12 (Del. Ch. Oct. 2, 2009).

© 2014 THOMSON REUTERS