Insights:
The Delaware Edition

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This issue focuses on important, developing areas of Delaware corporation law and deal litigation, including the Court of Chancery's clarification of its evolving views about disclosure-based deal litigation settlements; developments in books-and-records demands; increased protections afforded to controlling stockholders seeking to buy out the minority; a much-anticipated Supreme Court opinion addressing advisor aiding-and-abetting liability; and three notable opinions involving stockholder derivative actions brought on behalf of corporations.

Court of Chancery Continues to Clarify Views of Disclosure-Based Deal Litigation Settlements

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As previously discussed in *Insights: The Delaware Edition*, throughout the second half of 2015, the Delaware Court of Chancery began to question its long-standing practice of approving deal litigation settlements involving broad releases for defendants in exchange for therapeutic benefits, and it analyzed such proposed settlements with increased scrutiny. During that time, members of the court issued varying decisions in this area and had not yet landed on a uniform view.

In January 2016, Chancellor Andre G. Bouchard issued his widely anticipated decision on a proposed disclosure-based settlement in *In re Trulia, Inc. Stockholder Litigation*. The chancellor denied the settlement, finding that the supplemental disclosures forming the basis of the settlement consideration did not meet the new "plainly material" standard he set forth in the opinion. He urged that instead of disclosure-based settlements, disclosure claims in deal litigation be adjudicated in an "adversarial process." Since *Trulia*, the court has issued additional decisions, all following the *Trulia* "plainly material" standard, but still with varied views.

Chancellor Bouchard's Views

On September 16, 2015, Chancellor Bouchard reserved decision on approval of a disclosure-based settlement of litigation arising from a stock-for-stock merger transaction between online real estate companies Trulia and Zillow. *In re Trulia, Inc. Stockholder Litig.*, C.A. No. 10020-CB (Del. Ch. Sept. 16, 2015) (TRANSCRIPT). At the time, the chancellor noted that the parties had presented the "underbelly of settlements" but nevertheless requested supplemental briefing, including to address whether disclosures must be material to support a disclosure-based settlement.

In January 2016, Chancellor Bouchard declined to approve the settlement. *In re Trulia, Inc. Stockholder Litig.*, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016). Regarding disclosure-based settlements in general, the chancellor reiterated many of the concerns expressed in cases such as *Acevedo v. Aeroflex Holding Corp.*, C.A. No. 9730-VCL (Del. Ch. July 8, 2015) (TRANSCRIPT); *In re Intermune Inc. Stockholders Litig.*, Consol. C.A. No. 10086-VCN (Del.

Ch. July 8, 2015) (TRANSCRIPT); and *In re Riverbed Technology, Inc.*, C.A. No. 10484-VCG (Del. Ch. Sept. 17, 2015).

Among other things, Chancellor Bouchard noted that the court may have an insufficient basis to evaluate a settlement when "no motion practice has occurred and the discovery record is sparse, as is typically the case in an expedited deal litigation leading to an equally expedited resolution based on supplemental disclosures before the transaction closes." Chancellor Bouchard also reflected on "the rapid proliferation and current ubiquity of deal litigation, the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders, [and] the risk of stockholders losing potentially valuable claims that have not been investigated with rigor." He concluded that "the Court's historical predisposition toward approving disclosure settlements needs to be reexamined."

With that backdrop, Chancellor Bouchard advised that "the optimal means by which disclosure claims in deal litigation should be adjudicated is outside the context of a proposed settlement so that the Court's consideration of the merits of the disclosure claims can occur in an adversarial process where the defendants' desire to obtain a release does not hang in the balance." The chancellor explained that such "adversarial process" can occur in two different contexts: i) during a preliminary injunction motion, "in which case the adversarial process would remain intact and plaintiffs would have the burden to demonstrate on the merits a reasonable likelihood of providing that 'the alleged omission or misrepresentation is material,'" or ii) in a mootness scenario, where "plaintiffs' counsel apply to the Court for an award of attorneys' fees after defendants voluntarily decide to supplement their proxy materials by making one or more of the disclosures sought by plaintiffs, thereby mooting some or all of their claims," in which case "defendants are incentivized to oppose fee requests they view as excessive."

In the settlement context, Chancellor Bouchard indicated that going forward, the court would be "increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the 'give' and 'get' of such settlements," and that "practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a ***plainly material*** misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently." The "plainly material" standard, the court clarified, requires "that it should not be a close call that the supplemental information is material as that term is defined under Delaware law."

Finding that the supplemental disclosures issued in connection with the Trulia settlement — which focused on additional details in the fairness opinion section of the proxy — were not "plainly material," Chancellor Bouchard declined to approve that proposed settlement.

Vice Chancellor Laster Identifies Certain Disclosures as 'Plainly Material' in Settlement Context

In February 2016, two weeks after the *Trulia* decision was issued, Vice Chancellor Laster declined to approve a partial class settlement, determining that, although the "plainly material" standard articulated in *Trulia* was satisfied, the settlement should nevertheless be rejected because "too many questions" had been raised to conduct an appropriate "give-get balancing." *Haverhill Retirement System v. Kerley*, C.A. No. 11149-VCL (Del. Ch. Feb. 9, 2016) (TRANSCRIPT).

In August 2015, plaintiff stockholders of Providence Service Corporation sought to preliminarily enjoin a preferred stock issuance on the basis of allegedly inadequate disclosures and inequitable coercion. After discovery and briefing, in lieu of proceeding to a preliminary injunction hearing, the parties settled those claims for additional disclosures involving alleged conflicts of interest and other therapeutic benefits, while other fiduciary duty claims remained.

Vice Chancellor Laster ultimately found that the "plainly material" standard articulated in *Trulia* was satisfied, as "the original disclosures that were put out in connection with [the] transaction were painfully inadequate." The disclosures included, among other things, the existence of two serious conflicts.

Nevertheless, Vice Chancellor Laster denied approval of the settlement because he was "not comfortable … carving off a portion of the case as if it [could] be excised and amputated in a neat little surgical bucket and then have the rest of the case proceed." He concluded that there was "too much evidence that raises too many questions about too many dimensions of the decision-makers and their advisors to attempt right now a give-get balancing that would give [him] any type of comfort that what [he] was doing [by approving the settlement] was appropriate." Vice Chancellor Laster noted that he would consider a mootness fee application should plaintiffs decide to pursue one.

Vice Chancellor Noble Approves Disclosure-Based Settlement Under 'Plainly Material' Standard

A few weeks later, on February 18, 2016, Vice Chancellor John W. Noble (in one of his last decisions before leaving the bench) approved a settlement (entered into pre-*Trulia*) involving "plainly material" supplemental disclosures. *In re NPS Pharmaceuticals Stockholders Litig.*, C.A. No. 10553-VCN (Del. Ch. Feb. 18, 2016) (TRANSCRIPT). "Recogniz[ing] the difficulty when the rules of the game change while you're playing the game," Vice Chancellor Noble indicated that had the settlement hearing occurred prior to the court's decision in *Trulia*, he "probably would have taken the *Carefusion* or *Riverbed* approach" and relied on the parties' reasonable expectations in approving the settlement. However, Vice Chancellor Noble indicated that "the world ha[d] finally changed" and he could not "forget about *Trulia*."

Applying *Trulia*'s "plainly material" standard, Vice Chancellor Noble found the additional disclosures provided in the settlement "sufficient," as they involved "information that clearly was important to the DCF analysis," including risk-adjusted and product-level projections, in addition to other information, such as additional details about the financial advisors' analysis, details about the board's consideration of strategic alternatives and information about the process leading up to the merger, that "help[ed] the shareholders understand a little bit better what was going on." Moreover, the parties had negotiated a less broad release, ultimately agreeing to release state law claims, as well as federal securities law claims concerning disclosure, that arose from the transaction. The court was comfortable that this release fit within the *Trulia* standard, in that it was "narrowly circumscribed" to encompass "disclosure claims," both state and federal, as well as "fiduciary duty claims which are essentially the price and process claims." Vice Chancellor Noble concluded that "plaintiffs' counsel did investigate the price and process claims and that the decision not to pursue them in this action was reasonable." He also approved a negotiated fee award of $370,000.

Chancellor Bouchard Approves Therapeutic Settlement but Confirms Views Expressed in *Trulia*

The same day Vice Chancellor Noble approved the NPS settlement, Chancellor Bouchard — in what appears to be his first opportunity applying the "plainly material" standard to a disclosure-based settlement since authoring *Trulia* — approved a settlement involving "plainly material" supplemental disclosures and a clarification that six nondisclosure agreements (NDAs) used as part of the process leading up to the merger did not prevent the parties to those NDAs from privately asking for a waiver of the standstill provisions in order to make a topping bid. *In re BTU International, Inc.*, C.A. No. 10310-CB (Del. Ch. Feb. 18, 2016) (TRANSCRIPT).

As Vice Chancellor Noble did in *NPS*, Chancellor Bouchard recognized that the settlement predated the *Trulia* decision but nevertheless applied "the kind of heightened scrutiny that Trulia contemplates." Chancellor Bouchard found that the disclosures at issue, which included cash flow projections used in the financial advisors' analyses, satisfied the "plainly material" standard.

Turning to the scope of the release, Chancellor Bouchard explained that "[t]he release … [was] consistent … with the scope of a release that would pass muster under *Trulia* because it [was] limited to the release of disclosure claims and fiduciary duty claims relating to the decision to enter the merger." Chancellor Bouchard also approved the negotiated fee award of $325,000.

However, during the hearing, Chancellor Bouchard emphasized again that the court prefers "that disclosure issues in deal litigation be resolved in an adversarial process, either through actual litigation or in connection with a mootness fee application," and reiterated that "counsel on both sides of the caption … would be wise to pursue the options enumerated in *Trulia* in the future, for the reasons that are explained in that decision.

Key Takeaways

The Court of Chancery's approach to disclosure-based settlements continues to develop and evolve. The recent decisions described above provide greater clarity for how the court expects or prefers parties to resolve disclosure claims in deal litigation. The key takeaways from these recent cases are:

- Disclosure-based settlements with narrowly tailored releases are still available in the appropriate circumstances but will receive greater judicial scrutiny as to whether disclosures satisfy the "plainly material" standard, and the release relates only to disclosure claims and process claims arising from the underlying transaction that have been "investigated sufficiently."
  - The courts continue to send the message that such settlements should be presented less frequently than in the past. The court's preferred approach for resolving disclosure claims is through an "adversarial process."
  - In light of the heightened "plainly material" standard for disclosure settlements, it could mean that more injunction hearings addressing disclosure claims may occur. However, this will likely be tempered by the Delaware Supreme Court's recent decision in *C&J Energy* where the court stressed that where no competing bid emerges after a deal is announced, demonstrating reasonable success on the merits will be difficult.
  - In addition, deal litigation involving disclosure claims may be resolved more frequently by mootness dismissals. As the court in *Trulia* noted, for the vast majority of such cases, a mootness dismissal based on supplemental disclosures effectively ends the litigation.
- Defendants faced with multiforum deal litigation involving a Delaware corporation will not be able to control that tactic as easily through a settlement with a broad release in the Delaware Court of Chancery.
  - This may prompt Delaware corporations to adopt forum-selection provisions that require deal litigation (and other claims involving the internal affairs of the corporation) to be filed exclusively in Delaware. In this regard, the *Trulia* court emphasized a company's ability to enact a forum-selection bylaw as an effective way to manage multiforum deal litigation.
  - The plaintiffs' bar may begin to file more deal litigation actions outside of Delaware, whether or not a company has an exclusive forum provision in their charter or bylaw, in the hopes that it might be easier to pursue a disclosure-based settlement in a non-Delaware forum. We have seen evidence of this already.
  - Plaintiffs may avoid state law claims altogether and instead pursue claims under the federal securities laws that are pertinent to merger or acquisition litigation, such as claims under Section 14a of the Securities Exchange Act. These types of federal law claims may not be covered by the applicable forum selection provision.
- It remains to be seen whether other states will follow Delaware's lead in embracing *Trulia*'s enhanced scrutiny of disclose-based settlements. Regarding deal litigation brought solely in other jurisdictions, at least two other forums (courts in North Carolina and California) have acknowledged *Trulia* and requested litigants to provide supplemental information regarding the materiality of the disclosures and how they justified the releases sought. In one North Carolina action, the judge approved a disclosure-based settlement over a *Trulia*-based objection.

Recent Delaware Cases Clarify Existing Limits and Adopt Novel Condition in Books-and-Records Demands

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Recent Delaware cases have helped clarify the limits of what the Court of Chancery will consider in a books-and-records demand under 8 Del. C. § 220, and one case has adopted a novel condition that defendants may seek to incorporate in future actions.

In 2015, the Court of Chancery held in *Southeastern Pennsylvania Transit Authority v. AbbVie, Inc.*, as a matter of first impression, that when a stockholder demands books and records for the sole stated purpose of building a case for future litigation, that stockholder must provide a credible basis to suspect possible wrongdoing that would lead to a "non-exculpated" claim — *i.e.*, a claim for which money damages would not be exculpated under 8 Del. C. § 102(b)(7).[1] In *AbbVie*, stockholders demanded books and records related to a failed merger between AbbVie, Inc. and Shire plc. The Court of Chancery found that the stockholders' only purpose was to pursue derivative litigation for breach of fiduciary duty.[2] In denying the stockholders' demand for books and records, the court found no credible basis to suspect wrongdoing because "the corporate wrongdoing which [a stockholder] seeks to investigate must necessarily be justiciable," and the facts alleged "fail[ed] to show a credible basis that the Company's directors have breached their duty of loyalty."[3] In a one-paragraph affirmation, the Delaware Supreme Court, sitting *en banc*, agreed that there was "no viable use" for the books and records sought.[4]

The impact of *AbbVie* is still unclear, however, because it may be possible for plaintiffs to avoid the *AbbVie* holding simply by stating additional purposes in their demand letters. Less than a month after the Delaware Supreme Court affirmed the *AbbVie* ruling, the Court of Chancery distinguished *AbbVie* both on the facts and on the stockholder's stated purposes.[5] In *Yahoo!*, a stockholder sought to investigate possible wrongdoing related to the hiring and firing of a highly compensated executive.[6] Relying heavily on the series of Delaware decisions that culminated in *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006), the Court of Chancery distinguished *AbbVie* on its facts — finding that the plaintiff had alleged facts from which there was a credible basis to suspect nonexculpated wrongdoing by Yahoo! directors and officers — and noting, without elaboration, that the stockholder "ha[d] not similarly limited its potential uses of the fruits of its investigation."[7]

Relying on the general principle articulated by the Delaware Supreme Court in *United Technologies Corp. v. Treppel*, 109 A.3d 553 (Del. 2014), which held that 8 Del. C. § 220(c) confers "broad discretion to the Court of Chancery to condition a books and records inspection," the Court of Chancery broke new ground by accepting Yahoo!'s request for a novel condition to production: It required that any materials produced under the court's order be incorporated by reference in any future plenary actioncomplaint that the plaintiff filed.[8] While

[1] *Se. Pa. Transit Auth. v. AbbVie, Inc.*, C.A. Nos. 10374-VCG, 10408-VCG, 2015 WL 1753033, at *13 (Del. Ch. Apr. 15, 2015), *aff'd*, No. 239, 2015, 2016 WL 235217 (Del. Jan. 20, 2016).

[2] *Id.* at *13.

[3] *Id.* at *13, *17.

[4] *Se. Pa. Transit Auth. v. AbbVie, Inc.*, No. 239, 2015, 2016 WL 235217, at *1 (Del. Jan. 20, 2016).

[5] *Amalgamated Bank v. Yahoo! Inc.*, --- A.3d ---, C.A. No. 10774-VCL, 2016 WL 402540, at *22-23 (Del. Ch. Feb. 2, 2016) (appeal pending)

[6] *Yahoo!*, 2016 WL 402540, at *16-20.

[7] *Id.* at *22. Citing to *Seinfeld v. Verizon Communications, Inc.*, 909 A.2d 117 (Del. 2006), the Court of Chancery quoted examples from the Delaware Supreme Court of proper purposes stockholders could state that would not be impeded by an exculpation provision, such as seeking an audience with the board of directors, preparing a stockholder resolution or mounting a proxy fight. *Id.*

[8] *Id.* at *31 (quoting *United Technologies Corp.*, 109 A.3d at 557-58).

the Court of Chancery noted that the condition "protect[ed] the legitimate interests of both Yahoo and the judiciary by ensuring that any complaint that Amalgamated files will not be based on cherry-picked documents," it also stressed that the condition did "*not change the pleading standard* that governs a motion to dismiss."[9] The Court of Chancery stated that "'all well-pleaded factual allegations' still w[ould] be accepted as true" and "plaintiff also w[ould] be entitled to 'all reasonable inferences.'"[10] Thus, even though the entire production would be incorporated by reference into any follow-on complaint, "if a document or the circumstances support more than one possible inference, and if the inference that the plaintiff seeks is reasonable, then the plaintiff receives the inference."[11]

* * *

The Court of Chancery also recently clarified the utility of allegations for which breach of fiduciary duty claims would be time-barred.[12] In *Citigroup*, stockholders demanded books and records to investigate potential wrongdoing for a breach of fiduciary duty claim under the "oversight" theory of liability articulated in *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). The stockholders alleged three instances of purported misconduct as support for their demand, including one action for which any breach of fiduciary duty claim would be time-barred. The Court of Chancery found that the time-barred allegation was "useful … in determining whether there is a credible basis to investigate" because it could help evidence a pattern of potential misconduct.[13] Drawing a distinction between the "credible basis" inquiry and the scope of production, however, the Court of Chancery declined to order production of documents related to the time-barred allegation because it was "too remote in time to support liability."[14]

It is unknown whether the Court of Chancery would be willing to consider time-barred allegations at all if a plaintiff were not investigating potential wrongdoing for a future *Caremark* claim, which requires a plaintiff to prove facts showing a "sustained or systematic failure of the board to exercise oversight," or if the time-barred conduct could otherwise be segregated from other allegations relating to a broader course of behavior.[15] Nevertheless, the trio of cases discussed above provides important context for any company considering how to respond to a books-and-records demand.

[9] *Id.* at *32 (emphasis in original).

[10] *Id.* (citation omitted).

[11] *Id.* (citation omitted).

[12] *In re Citigroup Inc. Section 220 Litig.*, Consol. C.A. No. 11454-VCG, Tr. at 17, 35-36 (Del. Ch. Nov. 5, 2015) (TRANSCRIPT).

[13] The Court of Chancery also ordered production of documents related to additional allegations that were not time-barred.

[14] *Id.* at 36-37; *see also id.* at 43.

[15] *Caremark*, 698 A.2d at 971.

Delaware Supreme Court Enhances Protections for Controlling Stockholder Buyouts

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The Delaware Supreme Court's affirmance in *Swomley* should encourage transaction planners to follow the *MFW* requirements in structuring buyouts by controlling stockholders, recognizing that litigation challenging such transactions can be resolved on a motion to dismiss if the *MFW* pathway is followed. In doing so, however, there should be no ambiguity with respect to whether the initial proposal is conditioned on a majority-of-the-minority vote to avoid raising any unnecessary confusion on that point at the pleading stage.

In November 2015, the Delaware Supreme Court bolstered the protection afforded to majority or controlling stockholders seeking to buy out the minority, provided that the transaction is structured in accordance with the requirements it had earlier set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (MFW). In a summary order, the court affirmed Vice Chancellor J. Travis Laster's transcript ruling in *Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014) (TRANSCRIPT), which held that it is appropriate to determine at the pleading stage whether a controlling stockholder transaction complies with *MFW*'s requirements and is, therefore, within the protective ambit of the business judgment rule. *Swomley v. Schlecht*, No. 180, 2015 (Del. Nov. 19, 2015) (ORDER).

The court's affirmance is significant because it resolves the issue raised by *MFW*'s Footnote 14 — which noted that the pleading in that action would have survived a motion to dismiss — that led at least some commentators to believe that whether a transaction complied with *MFW*'s structural requirements could only be decided on a motion for summary judgment or after a full trial on the merits. The *Swomley* affirmance confirms that the benefit of disposing with litigation challenging the transaction at the pleading stage is available to a controlling stockholder who chooses to comply with *MFW* by providing minority stockholders with the protections afforded by the combination of an independent special committee and a "majority-of-the-minority" vote.

The '*MFW* Standard' for Reviewing Controlling Stockholder Transactions

Although it had been nibbling at the question since 2005's *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005), in its 2013 opinion in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013), *aff'd*, *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), the Delaware Court of Chancery squarely addressed the issue 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.

In that opinion, then-Chancellor Leo E. Strine, Jr. concluded that the business judgment rule would apply to controlling stockholder transactions if the following six conditions were satisfied: "(i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *In re MFW*, 67 A.3d at 535.

As explained by Chancellor Strine, such a rule would "provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection." *In re MFW*, 67 A.3d at 502-03. The court reasoned that those two protections in tandem are more valuable to stockholders than the more abstract benefits derived from a higher standard of review, because there is a "strong incentive [ ] created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests …" and which "replicates the arm's-length merger steps of the DGCL by 'requir[ing] two independent approvals.'" *Id.* at 528 (quoting *Cox Commc'ns*, 879 A.2d at 618).

Moreover, for transactional planners, the rule provides "a basis to structure transactions from the beginning in a manner that, if properly implemented, qualifies for the business judgment rule, the benefit-to-cost ratio of litigation challenging controlling stockholders for investors in Delaware corporations will improve, as suits will not have settlement value simply because there is no feasible way for defendants to get them dismissed on the pleadings." *In re MFW*, 67 A.3d at 504.

On appeal, the Delaware Supreme Court affirmed Chancellor Strine's decision and approved the new standard. However, it modified the duty-of-care condition to require that the special committee meet its duty "in negotiating a fair price," signaling that perhaps a more fact-intensive inquiry would be required to apply the business judgment standard to a controlling stockholder transaction. *MFW*, 88 A.3d at 645. That modification, and the much discussed Footnote 14 of the court's opinion, led some commentators to suggest that the court intended for the *MFW* standard to be applied only after discovery. *Id.* at 645 n.14.

A subsequent Court of Chancery decision in *ACP Master Ltd. v. Sprint Corp.*, lent further support to this theory when Vice Chancellor Laster indicated that Sprint had put forth the "strongest possible" case that it met *MFW*'s requirements by conditioning its transaction *ab initio* on special committee approval and a majority-of-the-minority vote, yet still denied Sprint's motion to dismiss. C.A. No. 8508-VCL, trans. at 101 (Del. Ch. June 18, 2014). In denying Sprint's motion, the court determined that, per the pleadings and making all inferences in the plaintiff's favor, the majority-of-the-minority vote (which passed by a large margin) was a "mixed bag" that could have been coerced, thus negating the objectives of *MFW*. *Id.* at 102-04. Specifically, among other things, the plaintiff alleged or the court inferred that the transaction at issue did not offer a large premium because the preannouncement value of the transferred assets was depressed; that certain investors' incentives were misaligned prior to the vote; and that the majority tainted the vote by threatening "significant dilution to the minority stockholders if they rejected the merger." *Id.* at 103-04. Nonetheless, the court noted that the parties could revisit the *MFW* analysis on summary judgment, and that if the facts indicated that no coercion existed with regard to the vote, *MFW* would apply. *Id.* at 109.

Swomley Clarifies MFW Standard as Applied at the Pleading Stage

In upholding *Swomley*, the Delaware Supreme Court resolved the issue as to whether a lower court could evaluate the *MFW* six-factor test at the pleading stage. *Swomley* involved a challenge to a merger by which SynQor, Inc. was acquired by a management group that owned approximately 46 percent of the company. Following the road map set forth in *MFW*, the merger was conditioned on (i) the approval of an independent and fully empowered special committee and (ii) a majority vote of the unaffiliated stockholders who owned 54 percent of the company prior to the merger. The special committee recommended in favor of the transaction, which was then approved by 61 percent of the unaffiliated stockholders.

In dismissing the plaintiffs' complaint after the transaction closed, Vice Chancellor Laster held that the *MFW* standard could be applied at the pleadings stage. The court cited the decade-old *In re Cox Communications* decision, stating that "*the whole point* of encouraging this structure was to create a situation where defendants ... could obtain a *pleading-stage dismissal* against breach of fiduciary duty claims." *Swomley*, C.A. No. 9355-VCL, trans. at 66 (emphasis added). The court went on to point out that the *MFW* standard "was born with the goal of establishing a technique, a practice, a structure, where, at the pleading stage, defendants could show that they were not subject to a breach of fiduciary duty challenge." *Id.* at 67 (emphasis added).

In applying *MFW*'s six-factor test at the pleading stage, Vice Chancellor Laster stated that the court's role is "to consider whether the plaintiffs have pled facts sufficient to call into question the existence of [the six elements of the MFW test], at least when those elements have been described in a public way suitable for judicial notice, such as board resolutions and a proxy statement ..." *Swomley*, C.A. No. 9355-VCL, trans. at 69-70. While noting there was some ambiguity as to whether the offer was conditioned at the outset on a nonwaivable "majority-of-the-minority" vote, the court was satisfied that, to the extent there was any ambiguity, it was resolved at the board meeting where the transaction was first raised, before any negotiations took place. *Id.* at 70-71. The court found no issue regarding any of the remaining *MFW* elements, noting that it was not enough for plaintiffs to claim unfair price as a means of showing that the committee did not satisfy its duty of care. *Id.* at 71-73. Rather, the plaintiffs had to allege facts showing gross negligence, a showing "that really requires recklessness ... a very tough standard to satisfy." *Id.* at 73.

Noting the increase in price negotiated by the special committee, as well as other improvements to the proposed transaction, the court found that the plaintiffs' allegations attacking the methodology underlying the fairness opinion were insufficient to state a claim that the committee failed to meet its duty of care in negotiating a fair price. *Swomley*, C.A. No. 9355-VCL, trans. at 73-74. The court also rejected plaintiffs' allegations that the vote was coercive because the alternative to the merger was the maintenance of an unattractive status quo as opposed to pursuing other potential options, noting that "the question for coercion is whether you can return to the status quo," not whether there might be some more favorable alternative. *Id.* at 76. Finally, the court answered in the negative its own question as to whether SynQor's status as a private company meant that the *MFW* factors did not apply, pointing out that "[h]istorically, we haven't made any distinctions between public companies and private companies." *Id.* at 66.

Delaware Supreme Court Provides Guidance on Aiding-and-Abetting Liability for Financial Advisors

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On November 30, 2015, the Delaware Supreme Court issued a much-anticipated opinion in *RBC Capital Markets, LLC v. Jervis*, No. 140, 2015, 129 A.3d 816 (Del. 2015). The Supreme Court unanimously affirmed the Court of Chancery's decisions in *In re Rural/Metro Corp. Stockholders Litigation*, which held a financial advisor liable for aiding and abetting a board's breaches of fiduciary duty during a sale of control transaction. In so ruling, the Supreme Court confirmed the viability under Delaware law of aiding-and-abetting claims based on breaches of the duty of care. The Supreme Court stressed, however, that the requirement of establishing scienter on the part of the alleged aider and abettor makes such claims "among the most difficult to prove," and described its holding as "a narrow one," arising from the "unusual facts" of the case.

Background

On March 28, 2011, Rural/Metro Corporation (Rural) entered into a merger agreement with Warburg Pincus LLC, a private equity firm, to sell Rural for $17.25 per share. Stockholder plaintiffs brought class claims for breach of fiduciary duty against the board, alleging that the sale process was not reasonable under *Revlon*, and that the proxy statement issued in connection with the merger was materially misleading. The plaintiffs included claims against Rural's financial advisors — RBC Capital Markets, LLC (RBC) and Moelis, LLC — for aiding and abetting the board's breaches of fiduciary duty.

Days before trial, Moelis and the board agreed to pay $5 million and $6.6 million, respectively, to settle the claims against them. The case proceeded to trial, with claims pending against RBC alone. In March 2014, the Court of Chancery issued its post-trial opinion, finding RBC liable for aiding and abetting the board's breaches of the duty of care. *In re Rural/Metro Corp. Stockholders Litig.*, 88 A.3d 54, 63 (Del. Ch. 2014).

In his opinion, Vice Chancellor J. Travis Laster found that in December 2010 the board formed a special committee to explore strategic alternatives, including the possible acquisition of a business owned by its chief competitor, Emergency Medical Services (EMS). The court went on to find, however, that the board had not expressly authorized the special committee to initiate a sale process at that time. Nevertheless, the court found that the special committee proceeded as if Rural was for sale and interviewed several financial advisors, ultimately selecting RBC to serve as its primary financial advisor. According to the court, RBC pitched the board on the efficacy of coordinating the timing of the Rural sale with the sale of EMS but did not disclose its plan to use the Rural engagement as an "angle" to provide financing to potential bidders for EMS.

The court held that RBC's desire to obtain financing work for the EMS acquisition also drove it to favor certain bidders in the Rural sale process. Specifically, the court found that RBC's "two-track" auction process enabled it to prioritize EMS bidders so they would include RBC in their financing trees. The court also explained that RBC continued to drive this dual track process despite receiving negative feedback about its timing and design. The vice chancellor found that this "faulty design prevented the emergence of the type of competitive dynamic among multiple bidders that is necessary for reliable price discovery," as many of the large private equity firms were "sidelined" because of the EMS process, and the timing was not right for the logical strategic bidders. As a result, Warburg (which had withdrawn from the EMS process) was able to price its offers aggressively.

The court also found that in the last days before the merger was approved, RBC unsuccessfully lobbied Warburg to provide "stapled financing" for the Rural acquisition. The court held that during this time, RBC purposely manipulated its fairness analysis in order to make the Warburg offer look more attractive.

Moelis and RBC provided written financial analyses, and RBC orally opined that the merger was fair to the Rural stockholders at $17.25 per share, or roughly $437 million equity value. According to the court, the board had never before received any valuation for the company and received these analyses just three hours before the board met to consider the transaction. Nevertheless, the board approved the merger, and it closed in June 2011 following approval by Rural's stockholders.

The Court of Chancery concluded that the board's actions beginning in December 2010 were subject to enhanced scrutiny under *Revlon*, and that the plaintiffs had proven the board's decisions in the sale process were outside the range of reasonableness. The vice chancellor further held that the proxy statement Rural issued in connection with the transaction was materially misleading as to several issues, including RBC's financial analysis and its undisclosed conflicts of interest arising from its use of the Rural deal as an "angle" to obtain business from an EMS transaction. Finally, the court held that RBC was liable for aiding and abetting the board's breaches of fiduciary duty. In a later opinion, the Court of Chancery held that the Rural stockholders had suffered damages of $4.17 per share, or roughly $91.3 million, before interest. *In re Rural/Metro Corp. Stockholders Litig.*, 102 A.3d 205 (Del. Ch. 2014). It further held that, under the Delaware Uniform Contribution Among Tortfeasors Act (DUCATA), RBC was liable for 83 percent of those damages, amounting to about $75.8 million.

Supreme Court's Opinion in *RBC Capital Markets*

In a lengthy opinion, Justice Karen L. Valihura, writing for a unanimous court *en banc*, affirmed all of the Court of Chancery's holdings.

As to the breaches of fiduciary duty, the Supreme Court affirmed the Court of Chancery's conclusion that under *Revlon*, the board's overall course of conduct in the sale process was outside the range of reasonableness. In support of that conclusion, the Supreme Court pointed to the board's lack of awareness regarding RBC's conflicts and the "two-track" bidding process. Because the board was ill-informed, it "took no steps to address or mitigate RBC's conflicts." In addition, the Supreme Court agreed that the board was not adequately informed as to Rural's stand-alone value, which, based on the evidence adduced at trial, exceeded what Warburg or another private equity buyer would have paid. Finally, the Supreme Court affirmed the Court of Chancery's holding that the proxy statement was materially misleading, because it did not accurately represent the valuation analysis RBC conducted and did not disclose RBC's "unquestionably material" conflicts of interest. Although not specifically discussed in Justice Valihura's opinion, it would seem that this latter holding — that the proxy statement was materially misleading — was a necessary predicate for the court's application of *Revlon* enhanced scrutiny notwithstanding the Rural stockholders' vote to approve the merger, which, under the recent Delaware Supreme Court opinion in *Corwin v. KKR Financial Holdings LLC*, would otherwise have operated to invoke the protections of the business judgment rule.

As to the claim against RBC for aiding and abetting, the Supreme Court affirmed the vice chancellor's "narrow holding" that if a third party, such as a financial advisor, "knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting." Justice Valihura discussed the requirement of showing that the alleged aider and abettor acted with scienter, or an "illicit state of mind," consisting of "actual or constructive knowledge that their conduct was improper." The Supreme Court held that RBC had "intentionally duped" the board and "knowingly induced" its breaches by failing to disclose its interest in obtaining work in the EMS transaction and using the Rural deal to bolster that effort, and by failing to disclose its "eleventh-hour" attempts to secure a role in Warburg's financing of the Rural transaction. RBC's knowing participation also included modifying its valuation analysis. Thus, the court affirmed the Court of Chancery's determination that RBC, with "manifest intentionality," misled the Rural board into breaching its duty of care, resulting in a poorly timed sale that involved a process not designed to obtain the best price reasonably available.

In upholding RBC's liability on the theory of aiding and abetting, the Supreme Court also rejected RBC's argument that the presence of a second financial advisor, Moelis, broke the chain of proximate causation between RBC's actions and any damages suffered by the stockholders.

In perhaps the most important passage of Justice Valihura's opinion, the court addressed the argument that recognizing a claim against third parties, who cannot be protected by exculpatory provisions under 8 Del. C. § 102(b)(7), "would create an anomalous imbalance of responsibilities where a non-fiduciary may be held liable for an unintentional violation of a fiduciary duty by a fiduciary." The court called such a concern "overstated" because RBC had committed "fraud on the board" and was liable for aiding and abetting because, for its own motives, it "'intentionally duped' the directors into breaching their duty of care." The court cautioned that this holding was "a narrow one," justified by the "unusual facts proven at trial," which RBC did not challenge on appeal. The court further stated that its opinion "should not be read expansively" to suggest that a financial advisor could be liable for aiding and abetting merely because it failed "to *prevent* directors from breaching their duty of care." In the same vein, it expressly rejected language from the court below, which had described financial advisors as "gatekeepers." The Court of Chancery's "amorphous 'gatekeeper' language," according to Justice Valihura's opinion, "does not adequately take into account the fact that the role of a financial advisor is primarily contractual in nature," and adhering to it "would inappropriately expand our narrow holding here by suggesting that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor."

Finally, the Supreme Court affirmed the Court of Chancery's finding that the quasi-appraisal value of Rural at the time of the merger was $21.42 per share, and that the stockholder class therefore suffered damages of $4.17 per share — roughly $91.3 million, before interest. In so ruling, the court affirmed the vice chancellor's determination that, under DUCATA, RBC was liable for 83 percent of the total damages. The court also held that RBC was not prejudiced by the decision of the board defendants and Moelis to settle days before trial, because RBC had the opportunity to develop a record during trial that could have satisfied its burden to prove that the other defendants were "joint tortfeasors" for purposes of DUCATA. The court also affirmed the vice chancellor's application of the unclean hands doctrine to preclude RBC from seeking contribution from the settling defendants for the disclosure claim or the aspects of the sale process claim relating to the final approval of the merger.

Implications

One of the most closely watched issues of Delaware corporation law in 2016 will be the application of the *RBC Capital Markets* opinion going forward. In particular, the impact of *RBC Capital Markets* will depend on how exactingly the Court of Chancery adheres to the scienter pleading requirement — which the Delaware Supreme Court discussed at length and expressly described as a "form of protection" for financial advisors facing aiding-and-abetting claims. In addition, all parties involved in deal-related lawsuits will benefit from several points of guidance contained in the *RBC Capital Markets* opinion:

- The Delaware Supreme Court emphasized that claims against third parties such as financial advisors for aiding and abetting a breach of fiduciary duty are "among the most difficult to prove" because of the difficulty of adequately pleading an "illicit state of mind" on the part of the third-party aider and abettor, which requires facts suggesting that the third party "intentionally duped" the directors into breaching their fiduciary duties.
    - Moreover, because the aiding-and-abetting claims involved in *RBC Capital Markets* were predicated on the finding that the directors breached their duty of care under *Revlon*, the effect of a fully informed stockholder

vote — which, under *Corwin v. KKR Financial Holdings LLC*, insulates the transaction from such challenges by invoking the business judgment rule — may further limit plaintiffs' ability to prevail on aiding-and-abetting claims in future cases.

  - In its first post-*RBC Capital Markets* case dealing with aiding-and-abetting claims against a financial advisor, the Supreme Court in *Singh v. Attenborough* re-emphasized the difficulty of pleading scienter, stating that it was "skeptical" that there was "a rational basis to infer scienter" based on the allegations in the *Singh* case — which involved the advisor's late disclosure of a business pitch it had made to the acquirer that was then considered by the target board, determined to be immaterial and fully disclosed in the proxy.

- The Supreme Court in *RBC Capital Markets* reaffirmed that the relationship between a financial advisor and the board of directors is a contractual relationship, not one in which the financial advisor can be targeted for its actions on the theory that it acted as a "gatekeeper" responsible for ensuring that the members of a board of directors satisfy their fiduciary duties. The *RBC Capital Markets* opinion clarifies that as long as the board is "active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts," it remains within the board's judgment to consent to a conflict of interest on the part of its financial advisor, although this informed consent "does not give the advisor a 'free pass' to act in its own self-interest and to the detriment of its client."
- Notwithstanding the importance of the legal conclusions in *RBC Capital Markets*, the court's analysis was grounded on the "unusual facts proven at trial," which the Supreme Court reviewed in careful detail. Boards of directors and financial advisors should consult with legal counsel in considering how the teachings of *RBC Capital Markets* might apply to the particular facts and circumstances they face.

Court of Chancery Addresses Fundamental Issues of Derivative Litigation

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These opinions provide helpful guidance to corporate law practitioners on fundamental issues of derivative litigation and reinforce the willingness of the Delaware Court of Chancery to continue to refine its approach to claims where a stockholder seeks to stand in the shoes of a corporation. It remains to be seen whether other members of the court will apply the new lines of reasoning discussed above, or whether the Delaware Supreme Court will ultimately weigh in to resolve any lingering uncertainty over dual-natured claims and the proper scope of the *Aronson* and *Rales* test for demand futility.

The Delaware Court of Chancery recently issued a trio of notable opinions involving stockholder derivative actions. The opinions addressed fundamental issues of law such as whether particular kinds of stockholder claims are derivative (or may be brought directly by a stockholder), the appropriate test for determining whether a presuit demand that the board bring claims on behalf of the company would have been futile (*i.e.*, demand futility) and the tension between such a demand futility analysis and the relevant standard of review.

In re El Paso Pipeline Partners, L.P. Derivative Litigation

In December 2015, the court issued an opinion finding that a derivative claim brought on behalf of an entity that had merged out of existence would thereafter be treated as a claim brought directly by the plaintiff. In characterizing the claim as direct rather than derivative, the court permitted the plaintiff to pursue the claim and a pro rata recovery of a $171 million damages award.

Earlier in the case, the court had ruled that the general partner of El Paso Pipeline Partners, L.P. (EP MLP) was liable for $171 million in damages on claims brought derivatively by a unitholder. EP MLP was set up to buy assets from a parent company and to use those assets to distribute cash flows to unitholders. The partnership agreement of EP MLP established a process of "Special Approval" for these transactions, which required a three-member committee from the general partner's board to believe in good faith that the transaction was in the best interests of EP MLP. The court concluded after trial that the committee failed to do its job because it did not subjectively believe that EP MLP's purchase of a 49 percent interest in a pipeline business and a 15 percent interest in another company were in the best interests of the partnership.

EP MLP subsequently merged into a related party and ceased to exist. The general partners then moved to dismiss the plaintiff's derivative claim, arguing that the plaintiff did not have standing to continue to pursue claims on behalf of a nonexistent entity. In resolving that motion, the court characterized the claim as "dual-natured," stating that "the plaintiff should be able to continue to litigate a dual-natured cause of action post-merger as a direct claim." A claim is dual-natured in this context when it could be characterized as both a derivative and direct claim. Recognizing the potential for a future controversy over dual-natured claims, the court noted that although the Delaware Supreme Court has recognized dual-natured direct/derivative claims, there are "other decisions that have characterized similar claims as purely derivative." The court ultimately determined that claims with direct and derivative features should be characterized as derivative at the outset of a case. But after a plaintiff demonstrates that a demand on the board was wrongfully denied or would have been futile and survives a Rule 23.1 motion to dismiss, such claims could be characterized as direct later in the case if the entity is merged out of existence. The court reasoned that treating a claim as "derivative for purposes of claim initiation achieves the important goals of screening out weak claims" while treating the "claim as direct for purposes of claim continuation preserves the ability of investors to pursue legitimate claims, promotes accountability, and provides a superior mechanism for doing so than secondary litigation challenging the transaction that eliminated the plaintiff's standing to sue derivatively." The court's dual-natured characterization of direct/derivative claims provides more flexibility to plaintiffs bringing suits involving harm to an entity by limiting a plaintiff's reliance on the continued existence of the entity.

In re EZCORP Inc. Consulting Agreement Derivative Litigation

A month later, in January 2016, the court issued an opinion granting in part and denying in part the defendants' motions to dismiss derivative claims for breach of fiduciary duty challenging certain consulting agreements. Of particular importance is the court's analysis of the applicable standard of review for a transaction's approval when a controlling stockholder has interests in both parties to a potential transaction or "stands on both sides" of a deal.

In this case, a stockholder of EZCORP brought a derivative action challenging the fairness of three annual consulting agreements between EZCORP and Madison Park LLC, an affiliate of EZCORP's controlling stockholder. The consulting agreements provided Madison Park with annually increasing fees in exchange for advisory services. The plaintiff argued that those agreements constituted self-dealing on behalf of the controlling stockholder and that the audit committee of EZCORP breached its fiduciary duties by rubber-stamping the agreements.

The court applied the heightened entire fairness standard of review, which requires a defendant to prove both fair price and fair process for a challenged transaction, and denied the defendants' motions to dismiss in part. The court observed that Delaware law is not settled on the applicable standard of review for a related-party transaction involving a controlling stockholder. In selecting the entire fairness standard of review rather than the deferential business judgment rule, the court relied on historical precedent and distinguished certain other Court of Chancery cases that had applied business judgment review to similar transactions. In *Friedman v. Dolan*, for example, the court applied the business judgment rule to a board's decision to pay compensation to a company's founder and his son, who controlled 73 percent of the voting power of the company and held the right to elect three-quarters of the board. In *Dolan*, the court held "[e]ntire fairness is not the default standard for compensation awarded by an independent board or committee, even when a controller is at the helm of the company." The court conceded that the question of what standard of review to apply to a transaction where a controlling stockholder receives a benefit is one that "only the Delaware Supreme Court can resolve." Ultimately, the Delaware Supreme Court decided not to accept an interlocutory appeal.

This opinion is also noteworthy because the court discussed the scope of the *Aronson v. Lewis* test for demand futility as it relates to the applicable standard of review for controlling stockholder transactions. The court limited the breadth of the *Aronson* test, where a demand on the board to pursue litigation is found to be futile if particularized allegations create a "reasonable doubt" either that the directors are "disinterested and independent" or that "the challenged transaction was otherwise the product of a valid business judgment." The Supreme Court in *Aronson* held that if a stockholder plaintiff fails to establish demand futility, a board's refusal to sue is subject to business judgment review. The court discussed post-*Aronson* case law in detail and expressed the view that *Aronson* should not "limit the substantive application of the entire fairness framework" to a controlling stockholder transaction. In other words, "[a]bsent further guidance from the high court," *Aronson* should not limit the application of heightened entire fairness review to transactions where a controlling stockholder receives a special benefit.

Thomas Sandys v. Mark J. Pincus, et al. and Zynga, Inc.

Most recently, in February 2016, the court granted the defendants' motion to dismiss the plaintiff's derivative claims for failure to plead demand futility. Applying the demand futility test established by the Delaware Supreme Court in *Rales v. Blasband*, under which demand may be excused if a plaintiff alleges particularized facts establishing a reason to doubt that "the board of directors could have properly exercised its independent and disinterested judgment in response to a demand," the court concluded that demand was not excused for any of the plaintiff's claims. This is notable because the court applied the standard from *Rales* — which traditionally applies only where the board on which demand would be made did not make an underlying business decision for the transaction challenged in litigation — in circumstances where the *Aronson v. Lewis* test could traditionally apply, and discusses its belief that the *Rales* test could be used universally to assess questions of demand futility.

In this case, a purported stockholder brought claims regarding Zynga's 2012 secondary offering, arguing that the board had breached its fiduciary duties by approving the secondary offering and amending "lock-up" agreements with underwriters. By doing so, the plaintiff claimed, certain board members misused confidential information and were able to sell their Zynga shares based on nonpublic knowledge that Zynga's value would drop. The plaintiff also raised a *Caremark* claim for lack of oversight against the board for failing to ensure adequate controls were in place and failing to disseminate material information before the offering.

The Zynga board on which any demand to bring derivative litigation would have been made was the same board that approved the challenged secondary offering. In such circumstances, the Court of Chancery would traditionally apply the *Aronson* test. Nonetheless, the court applied the *Rales* test to all three of the plaintiff's claims and found that demand was not excused.

The court gave several reasons for this break from the traditional demand futility analysis. According to Chancellor Andre G. Bouchard, Rales "provides a clearer, more straightforward formulation to probe the core issues in the demand futility analysis for each board member who would be considering plaintiff's demand." Rather than focusing on whether a majority of the board who approved the secondary offering would also have considered a demand, he analyzed whether a majority of the board was disinterested and independent. Notably, the court indicated that the *Rales* decision could be applied more widely and replace the *Aronson* test.

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