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By John C. Coffee, Jr.

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By Jeremy Kidd

SEC Settlements After Dodd-Frank

By Urska Velikonja

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Skadden Discusses Delaware's Corwin Case and the High Bar for Post-Closing Damages

By Joseph Larkin and Shaivlini Khemka November 29, 2016

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The Delaware Supreme Court's landmark decision in *Corwin v. KKR Financial Holdings LLC,* 125 A.3d 304 (Del. 2015) articulated a new defendant-friendly rule for post-closing damages actions for breaches of fiduciary duties. The Delaware Supreme Court held that where a transaction "not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders," the deferential business judgment standard of review will apply, leaving only a claim for waste. The *Corwin* decision was followed shortly by an order in *Singh v. Attenborough*, 137 A.3d 151 (Del. 2016) (ORDER), in which the Supreme Court, applying *Corwin*, explained that "[w]hen the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result … because the vestigial waste exception has long had little real-world relevance, [and] because it has been understood that stock-holders would be unlikely to approve a transaction that is wasteful."

As a practical matter, the *Corwin* case has created a high bar for plaintiff stockholders to pursue a post-closing damages claim. The Delaware Court of Chancery has now applied *Corwin* to dismiss a number of cases at the pleading stage, which are described below. In each case, the court found that (i) the stockholder vote approving the merger was fully informed, (ii) the transaction did not involve a controller, and (iii) under *Corwin*, plaintiffs' claims were subject to the business judgment rule standard of review.

The *Comstock* Decision

City of Miami General Employees v. Comstock, C.A. No. 9980-CB, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016) involved a stockholder challenge to the merger between C&J Energy Services, Inc. (C&J) and a subsidiary of Nabors Industries Ltd. (Narbors). In November 2014, Vice Chancellor John W. Noble issued a preliminary injunction enjoining the merger until after C&J complied with a court-mandated, 30-day go-shop provision. In December 2014, the Supreme Court reversed that order. Subsequently, in March 2015, the transaction closed after receiving approval of approximately 97.6 percent of the shares of C&J stock that voted on the transaction. After closing, the plaintiff amended its complaint seeking post-closing damages for alleged breaches of fiduciary duties by C&J's board and its officers arising from any allegedly conflicted sales process. For the first time, the plaintiff also alleged disclosure claims.

Although the court noted that "plaintiff did not heed the preference under Delaware law for disclosure claims to be litigated before a stockholder vote so that if a disclosure violation exists, it can be remedied by curing the informational deficiencies, thus providing stockholders with the opportunity to make a fully informed decision," the court still considered the disclosure claims as part of its *Corwin* analysis. Specifically, the court stated that it was required to address the plaintiff's disclosure claims to determine the appropriate standard of review under *Corwin*. Ultimately, the court rejected the plaintiff's disclosure claims that, in essence, were the same "tell me more" type disclosures that the Delaware courts have consistently held are inadequate to state a colorable disclosure claim. In doing so, the court reiterated that "Delaware law does not require disclosure of a play-by-play of negotiations leading to a transaction or of potential offers that a board has determined were not worth pursuing" and that "quibbles with a financial advisor's work simply cannot be the basis of a disclosure claim."

With respect to the fiduciary duty claims, the plaintiff argued that entire fairness applied because: "(1) a majority of the C&J board was interested in the Nabors transaction because of their desire to obtain board seats in the surviving entity, and (2) that Comstock [the CEO and chairman of C&J,] tainted the process by which the board considered the transaction." The court rejected both arguments, holding that (i) "enticement of a future seat on the board of the company surviving a merger is not sufficient to disqualify that director from making a disinterested decision on the basis of financial interest," (ii) "Comstock's large [10 percent] equity position helped to align his interest with stockholders … and there was no temptation for Comstock to tip the scales in favor of a transaction that would give him control of the combined entity," and (iii) in any event, the plaintiff failed to adequately allege the "type of duplicitous conduct" that Delaware courts have condemned. Because the plaintiff was unable to plead facts sufficient to invoke entire fairness review, the court held that the presumption of the business judgment rule applied under *Corwin* and dismissed the action. The court also dismissed claims against certain officers and aiding-and-abetting claims against the buyer and C&J's financial advisor.

The *Larkin* Decision

One day after *Comstock* was issued, Vice Chancellor Joseph R. Slights III provided additional guidance on *Corwin's* application in *Larkin v. Shah*, C.A. No. 10918-VCS, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016).

Larkin involved Teva Pharmaceuticals Industries, Ltd.'s (Teva) acquisition of Auspex Pharmaceuticals, Inc. (Auspex) in a $3.5 billion all-cash deal structured as a two-step medium form merger pursuant to Section 251(h) of the DGCL. The merger closed in May 2015 after stockholders owning 78 percent of Auspex's outstanding common stock (including 70 percent of shares not contractually bound to support the transaction) voted to approve the transaction in the first step of the two-step process. Former Auspex stockholders brought a post-closing damages action alleging that the Auspex board, several of whom were affiliated with different venture capital funds and were therefore alleged to be motivated to monetize their investments, breached their fiduciary duties by running a flawed sales process that ultimately led to an inadequate merger price.

The plaintiffs' "showcase theory" was that entire fairness applied to the transaction because "the venture capital funds …controlled the Auspex board and, spurred by self-interest, caused the conflicted board to approve an ill-advised transaction with Teva at the expense of Auspex's other stockholders." Alternatively, the plaintiffs alleged that entire fairness applied because "a majority of the Auspex board labored under actual conflicts of interest throughout the process of negotiating and approving th[e] merger." After finding that the plaintiffs had failed to plead facts that the transaction involved a controlling stockholder, the court held that "[i]n the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors." In reaching that conclusion, the court addressed the following overarching question: "[W]hat did *Corwin* mean by 'a transaction not subject to the entire fairness standard'?"

The court expressly rejected the plaintiffs' "rigorously literal reading" of *Corwin* that "*all* transactions subject to entire fairness for *any reason* cannot be cleansed under *Corwin*" (emphasis in original). Instead, the court agreed with the defendants that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving controlling stockholders." The court's decision was motivated by three primary reasons: (i) a plain reading of *Corwin* itself, along with supporting authority and underlying context, (ii) recent guidance from the Court of Chancery including Vice Chancellor Tamika Montgomery-Reeves' decision in *In re Volcano Corp. Stockholder Litigation*, 143 A.3d 727 (Del. Ch. 2016) (discussed below), and (iii) policy rationales that animate Delaware's controlling stock- holder jurisprudence, namely, that "[c]oercion is deemed inherently present in controlling stockholder transactions of both the one-sided and two-sided variety, but not in transactions where the concerns justifying some form of heightened scrutiny derive solely from board- level conflicts and lapses of due care." The court dismissed the complaint in its entirety because the plaintiffs had not attempted to plead a waste claim.

The *Volcano* and *OM Group* Decisions

In *In re Volcano Corp. Stockholder Litigation*, Vice Chancellor Montgomery-Reeves rejected the plaintiffs' post-closing damages claims arising from the transaction between Volcano Corporation and Philips Holdings USA, finding that stockholder acceptance of a tender offer has the same cleansing effect under *Corwin* as stockholder approval pursuant to a traditional long-form merger. The court held that because Volcano's stockholders were fully informed as to all material facts regarding the merger, the plaintiffs were subject to an irrebuttable presumption under the business judgment rule.

In so holding, Vice Chancellor Montgomery-Reeves rejected the plaintiffs' attempt to distinguish tender offers from stockholder votes for purposes of application of the *Corwin* analysis. Specifically, the vice chancellor rejected the following two arguments: (i) tender offers differ from statutorily required stockholder votes "based on 'the lack of any explicit role in the [DGCL] for a target board of directors responding to a tender offer'" (citation omitted) (alteration in original), and (ii) "a first-step tender offer in a two-step merger is arguably more coercive than a stockholder vote in a one-step merger." With respect to the first argument, the court explained that the target board, even in the case of two-step mergers, is obligated to adopt a resolution approving the merger agreement and declaring its advisability. Further, "in recommending that its stockholders tender their shares in connection with a [two-step] merger, the target corporation's board has the same disclosure obligations as it would in any other communication with those stockholders." With respect to the coercion argument, the court noted that the requirements under Section 251(h) alleviate any such coercion because the first-step tender offer must be for all of the company's outstanding stock, the second-step merger must be effected as soon as practicable after the first-step tender offer, the same consideration must be paid in both the first- and second-steps, and appraisal rights are available in two-step mergers.

Additionally, the court reiterated *Corwin*'s concerns about judicial second-guessing of economic decisions made by disinterested and fully informed stockholders and noted that the *Corwin* decision itself uses the terms "approve" and "vote" interchangeably.

Most recently, Vice Chancellor Slights applied *Corwin* in *In re OM Group, Inc. Stockholders Litigation*, C.A. No. 11216-VCS, 2016 WL 5929951 (Del. Ch. Oct. 12, 2016). The *OM Group* litigation arose from a merger between OM Group, Inc. (OM) and Apollo Global Management, LLC (Apollo). The plaintiffs brought a post-closing rescissionary damages action for alleged breaches of fiduciary duties by OM's board of directors and an aiding-and-abetting claim against OM's merger partner, Apollo. The aiding-and-abetting claims were voluntarily dismissed. The plaintiffs argued that the stockholder vote should be disregarded because it was "the product of OM's incomplete and misleading public disclosures…regarding a director conflict, the extent to which the OM Board appreciated and managed the banker conflicts and material details of an indication of interest received by the OM Board during the post-signing go-shop."

Applying *Corwin*, Vice Chancellor Slights dismissed the complaint "because a majority of fully informed, uncoerced, disinterested stockholders voted to approve the merger and [p]laintiffs [did] not allege that the transaction amounted to waste." In so holding, the court noted that the complaint alleged "no facts from which one could infer that a majority of the OM Board was interested in the transaction or that the OM Board labored under the influence of a controller." Further, upon analyzing the plaintiffs' disclosure claims, the court found that there was "no material omission and no materially misleading partial disclosure" regarding indications of interest from an alternate bidder; there were "no facts from which [the court could] reasonably infer that the omitted facts relating to [an OM director's] connection to Apollo reflect an actual conflict or are otherwise material"; and that "[t]he OM stockholders were fully apprised of [OM's financial advisor's] past work with Apollo and of the contingent nature of its engagement by the OM Board."1

Key Takeaways

The Court of Chancery's recent string of decisions applying *Corwin* have some important takeaways for practitioners and parties to deal litigation.

- Delaware courts will continue to defer to the decisions of independent and disinterested target company boards, and of disinterested, noncoerced and fully informed stockholders, to approve transactions. In fact, as of the date of this article, all the cases where the Court of Chancery applied the *Corwin* analysis have resulted in dismissals.
- The law underlying *Corwin* continues to develop. For example, one interesting issue emerging from these recent decisions is the perception that the Court of Chancery appeared to take a broader view of *Corwin* in *Larkin* than in other cases, such as *Comstock*. In *Larkin,* Vice Chancellor Slights interpreted *Corwin* to hold that "[i]n the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the ***irrebuttable*** business judgment rule, ***even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors***" (emphasis added). In reaching that conclusion, the court read *Corwin* to hold that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder." The *Larkin* court's formulation of *Corwin* seems to place a higher barrier to plaintiffs in post-closing merger litigation than in other recent cases such as *Comstock*. Because the case law is still evolving, it remains worthwhile to monitor closely how the Court of Chancery applies *Corwin* to noncontroller transactions going forward.

- While *Comstoc*k suggests that disclosure claims may be considered post-closing as part of the *Corwin* analysis, other recent decisions from the Court of Chancery (*see Nguyen Barrett*, C.A. No. 11511-VCG, 2016 WL 5404095 (Del. Ch. Sept. 28, 2016) and *In re Columbia Pipeline Group Stockholder Litigation*, C.A. No. 12152-VCL (Del. Ch. May 25, 2016) (TRANSCRIPT)) strongly indicate that disclosure claims should be brought before the stockholder vote when the purported harm of an uninformed vote may still be remedied. Accordingly, stockholder plaintiffs may not be able to seek tactical gain by deferring disclosure claims until after stockholders vote and the disclosures can no longer be supplemented.

ENDNOTE

1 In one recent decision, *In re Comverge Shareholders Litigation*, C.A. No. 7368-VMCR (Del. Ch. Oct. 31, 2016), Vice Chancellor Montgomery-Reeves stopped short of entering summary judgment for the defendants under *Corwin* because the court found that some of the plaintiffs' disclosure claims presented a mix of factual issues and questions of law that required further development before they may be decided as a matter of law. It bears mentioning, however, that the court had denied a motion to dismiss on the plaintiffs' claims almost a year before the Supreme Court issued its decision in *Corwin*.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the article, "After Corwin, Court of Chancery Provides Additional Guidance on Application of Business Judgment Rule to Post-Closing Damages Claims," published in the firm's November 17, 2016, issue of "Insights: The Delaware Edition," which was edited by Skadden partner Edward B. Micheletti and is available here.

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