Two Court of Chancery Deal Litigation Decisions Provide Helpful Guidance

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Chelsea Therapeutics: Post-Closing Bad Faith Claim a 'Rare Bird' in Delaware Absent Allegations of Self-Interestedness or Lack of Independence

In *In re Chelsea Therapeutics International LTD Stockholders Litigation*, Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery dismissed claims that Chelsea Therapeutics International Ltd.'s (Chelsea) board of directors acted in bad faith by selling Chelsea to Lundbeck A/S (Lundbeck) at an amount substantially below its standalone value. Specifically at issue were the board's instructions to its financial advisor to ignore one set of financial projections in opining on the fairness of the sale, as well as the board's choice to disregard a second set of projections before recommending the transaction to Chelsea's stockholders. The plaintiffs did not otherwise challenge the board members' interests or independence but rather argued that such actions were "inconceivable as anything other than actions against the interests of the stockholders" and therefore must constitute bad faith. In dismissing the claims, the court noted that bad faith was a "rare bird," further highlighting the difficulty stockholders of Delaware corporations face in bringing post-closing bad faith claims against otherwise unconflicted boards.

Background

Chelsea researched and developed a drug called Northera, which treated symptomatic neurogenic orthostatic hypotension (NOH). Prior to Northera's Food and Drug Administration (FDA) approval, a market check had yielded no potential buyers. Following Northera's approval, several potential buyers expressed a renewed interest in Chelsea, including Lundbeck. When negotiating the transaction, the Chelsea board had been reviewing and relying upon three sets of projections for the company. The "Base Case" assumed one possible application for Northera — the treatment of NOH. The "Adjusted Base Case" made the same assumption but reflected higher net sales due to an increase in Chelsea's sales force. The "No-Midodrone Projections" assumed a hypothetical scenario where Northera's competitor, Midodrone, would be removed from the market. None of the projections reflected results of a study that Chelsea had commissioned that analyzed potential revenue streams from applications of Northera that were not yet FDA approved.

Immediately after the transaction was announced, the plaintiffs sought a preliminary injunction to prevent the transaction from closing. The plaintiffs alleged, among other things, that the proxy was deficient because it omitted the No-Midodrone Projections and the results of the study analyzing potential uses for Northera. Although these projections were not disclosed, the proxy did disclose that the board had considered the No-Midodrone Projections and concluded they were too speculative and, thus, instructed the financial advisor not to take them into account. The court denied the injunction, finding that the projections and study were highly speculative and therefore the existing disclosures were sufficient.

The plaintiffs subsequently pursued a post-closing action for damages where they renewed their arguments regarding the purported disclosure violations and additionally claimed that Chelsea's directors had breached their duty of loyalty by knowingly selling the company at a price substantially below its standalone value. The bad faith allegations mirrored the disclosure violations — specifically, that the directors had improperly instructed their financial advisors to exclude the No-Midodrone Projections when opining on the fairness of the transaction, and that the directors themselves had ignored the commissioned study when evaluating the company's value, which indicated a higher value for the company. The plaintiffs argued that excluding these projections allowed the financial advisor to determine the transaction was fair when it was not and allowed the directors to recommend an inadequate price. The plaintiffs argued that there was no conceivable basis on which it was in the interest of the stockholders for the board and its financial advisors to exclude these projections, and that the directors, despite their independence and disinterestedness, "must have" acted in bad faith.

Court's Analysis

Based on the record created at the preliminary injunction hearing, the court rejected the plaintiff's disclosure violations, holding that the board did not have a duty to disclose the No-Midodrone Projections or results of the study (and their implications for value) due to their speculative nature.

In dismissing the bad faith claim on its merits, the court declined to reach the issue of whether a fully informed stockholder vote could cleanse bad faith board action under the holdings of *Corwin v. KKR Financial Holdings LLC*. Similarly, the court did not decide whether *Corwin* could apply in the context of a tender offer.

Rather, in its analysis, the court compared a bad faith claim to waste and noted that "like waste, [bad faith] is a rara avis." The court explained that to state a bad faith claim, a plaintiff must plead either an "extreme set of facts" to show that "disinterested directors were intentionally disregarding their duties" or that "the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." The court further noted that the plaintiffs relied "on the most difficult path to overcome dismissal of a claim based on bad faith: that the action complained of is otherwise inexplicable, so that bad faith — a motive other than the interest of the [c]ompany — *must* be at work."

The court found that, contrary to the plaintiffs' allegations, it was readily explicable that the board would exclude such highly speculative projections. The court reasoned that there were no assurances that Midodrone would be taken off the market or that Northera would be proven capable of treating additional conditions and then approved by the FDA for those uses. The court also noted that if the omitted projections would have reflected a realistic valuation, another bidder would have likely emerged throughout the 20-month-long sales process. Thus, the plaintiffs failed to plead facts that demonstrated the directors' decision to disregard the projections was so egregious that it was reasonably conceivable the board acted in bad faith.

In re Books-A-Million, Inc. Stockholders Litigation: Delaware Court of Chancery Applies '*MFW*' Framework to Going-Private Transaction and Dismisses Claims on Motion to Dismiss

In his recent *Books-A-Million* opinion, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery clarified the obligations of controlling stockholders in going-private transactions under the "*MFW*" framework. Noting that compliance with the *MFW* framework can be tested on a motion to dismiss, the court dismissed breach of fiduciary duty claims against the Books-A-Million board of directors and its controlling stockholders.

Background

Following an inquiry from a third party (identified in the proxy as Party Y), the controlling family stockholders (the Anderson Family) of Books-A-Million, Inc. (BAM) made a proposal to acquire the remaining minority shares for $2.75 per share, a 65 percent premium over the average closing price for the past 90 days. The proposal contemplated the formation of a special committee of independent directors with its own financial and legal advisers. The proposal also stated that the Anderson Family would not move forward with the transaction unless it was approved by a special committee and that any agreement would need to include a nonwaivable majority of the minority condition. The Anderson Family expressly stated that it was only interested in purchasing BAM's minority shares and would not sell its shares to a third party.

In response to the Anderson Family proposal, the board formed a special committee (the Special Committee) consisting of the three BAM directors not affiliated with the Anderson

Family. Shortly after retaining counsel, one member of the Special Committee, Ronald G. Bruno, disclosed that, even though he qualified as an independent director under Nasdaq rules, he had certain social and civic ties to the Anderson Family that may otherwise call his independence into question. The Special Committee and its counsel met later that same day (without Bruno in attendance) and determined that it would be preferable if Bruno did not serve on the Special Committee to avoid any possible challenges to its independence. Bruno resigned that same day and the Special Committee retained Houlihan Lokey to serve as its financial advisor.

In light of the Anderson Family's plan to finance its proposal using the company's existing credit facility, the Special Committee decided to evaluate alternative transaction structures. Houlihan Lokey also contacted three other entities despite the Anderson Family's expressed intention not to sell any of their shares. Ultimately, only Party Y submitted an indication of interest at a price of $4.21 per share, conditioned on due diligence and other matters. Party Y also rejected the idea of making a minority investment, indicating that it was only interested in purchasing a controlling stake.

Recognizing that there was no viable path forward with Party Y, the BAM board determined to continue negotiations with the Anderson Family only. After several rounds of negotiations, the Anderson Family and the Special Committee agreed on $3.25 a share, with the Anderson Family maintaining a right to terminate the transaction if 10 percent or more of the minority stockholders sought to exercise their appraisal rights. On July 13, 2015, Houlihan Lokey delivered an opinion that the $3.25 per share contemplated by the family's proposal was fair to minority stockholders from a financial point of view. The Special Committee and Bruno attended Houlihan Lokey's presentation, and Bruno was subsequently excused during the Special Committee's deliberations. The Special Committee members then deliberated and voted to recommend the Anderson Family's offer to the full board.

The merger consideration valued the company's minority interest at $21 million. The merger was financed through borrowings under the company's credit facilities, and the company's three top executives entered into rollover agreements. On October 22, 2105, BAM filed its definitive proxy statement, and the Anderson Family's proposed buyout was submitted to BAM's stockholders on December 8, 2015. Approximately 66.3 percent of the shares not affiliated with the Anderson Family or any Section 16 BAM officer approved the merger. The transaction closed on December 10, 2015.

Stockholder Litigation and Court's Analysis

Following announcement of the transaction, the minority stockholders filed suit for breach of fiduciary duty against (i) the two members of the Special Committee, (ii) Bruno, as the resigned Special Committee member who later voted in favor of the transaction, (iii) the Anderson Family's two board representatives, and (iv) the three members of BAM's executive management who entered into the rollover agreements.

In reviewing the plaintiffs' challenges to the BAM transaction, the court first noted that "compliance with the *M&F Worldwide* structure can be tested on a motion to dismiss." Citing *Swomley v. Schlecht*,[1] the court stated that "[i]f the defendants have described their adherence to the elements identified in *M&F Worldwide* 'in a public way suitable for judicial notice, such as board resolutions and a proxy statement,' then the court will apply the business judgment rule at the motion to dismiss stage unless the plaintiff has 'pled facts sufficient to call into question the existence of those elements.'"

The court then turned to the plaintiffs' specific allegations and held that they "do not support a reasonably conceivable inference that any of the *M&F Worldwide* conditions were not met," and therefore the business judgment rule would apply. Taking each of the *MFW* elements in turn, Vice Chancellor Laster concluded as follows:

- **The Anderson Family conditioned the transaction *ab initio* upon the approval of an independent and empowered Special Committee and a nonwaivable majority of the minority stockholder vote**. In so finding, the court rejected the plaintiffs' argument that the Anderson Family's 2015

[1] 2014 WL 4470947, at *20 (Del. Ch. Aug. 27, 2014) (TRANSCRIPT), *aff'd* 128 A.3d 992 (Del. 2015) (TABLE).

proposal was a continuation of a prior offer made by the Anderson Family in 2012, which did not contain these minority protections. The complaint acknowledged that a special committee had previously rejected the 2012 offer, thereby terminating it.

- **The Special Committee was independent.** The plaintiffs mounted two separate collateral attacks on the Special Committee's independence. First, the plaintiffs alleged that Bruno was not independent from the Anderson Family and that he tainted the Special Committee's independence by sitting in on Houlihan Lokey's July 13, 2015, fairness opinion presentation. The court found, however, that Bruno's early resignation from the Special Committee was a "commendable step for Bruno and the Committee to take," and therefore, no decision needed to be made regarding his independence. The court so held notwithstanding Bruno's presence during Houlihan Lokey's presentation. Specifically, the court stated that "[u]nder different circumstances, the participation of a director whose independence was compromised might be problematic," but "the allegations of the Complaint do not support a reasonably conceivable inference that having Bruno present solely for Houlihan Lokey's fairness presentation prevents the Merger from meeting this element of the *M&F Worldwide* test."

  Second, the plaintiffs alleged that the Special Committee acted in bad faith by refusing to continue negotiations with Party Y, which had previously offered up to $4.21 per share of BAM. The court first paused to consider whether a "good faith" requirement even existed under *MFW* and ultimately concluded that a pleading of "subjective bad faith is a theoretically viable means of attacking the *M&F Worldwide* framework." Relying heavily on *Mendel v. Carroll*,[2] however, the vice chancellor rejected the plaintiffs' arguments holding that there could be no finding of bad faith where (i) the Anderson Family had no obligation to sell its controlling stake, and (ii) the Anderson Family did not overreach or exploit the minority in making its proposal. Under those circumstances, the court stated that "[u]nder the rule of *Mendel*, the Committee could not have acted loyally by deploying corporate power against the Anderson Family to facilitate a third party deal."

- **The Special Committee was empowered to select its own advisers and say no definitively.** Citing the proxy and BAM's board resolutions, the court found that the Special Committee was granted the requisite authority to select its own advisers and further that the BAM board committed not to proceed with the transaction without a favorable recommendation from the Special Committee.

- **The Special Committee fulfilled its duty of care in negotiating a fair price.** After noting that the standard of conduct for the duty of care remains gross negligence on a motion to dismiss, the court held that the Special Committee had fulfilled its duty by meeting 33 times over five months, seeking alternative buyers, considering alternative structures, rejecting the Anderson Family's initial offer, negotiating over noneconomic terms and ultimately obtaining a sale price 20 percent higher than the Anderson Family's initial offer.

- **The minority was informed and its vote was not coerced.** The plaintiffs did not assert any disclosure claims and did not otherwise allege that the vote was coerced. Accordingly, the court found that the fifth and sixth *MFW* requirements were satisfied.

After determining that the transaction satisfied the elements of *MFW*, the court applied the business judgment rule and dismissed all causes of action with prejudice.

[2] 651 A.2d 297 (Del. Ch. 1994).

Implications

Chelsea Therapeutics and *Books-A-Million* add to a recent body of Delaware jurisprudence that narrows the path for plaintiffs to successfully pursue a post-closing damages case and indicate that courts are willing to dismiss lawsuits at the pleading stage.

Specifically, *Chelsea Therapeutics* indicates that when a company's charter includes an exculpatory provision and there are no allegations of extreme facts, Delaware courts appear willing to dismiss conclusory bad faith claims when unaccompanied by specific allegations of interestedness or lack of independence.

Chelsea Therapeutics also confirms that plaintiffs continue to focus on disclosure of management projections and that there is no per se rule regarding their disclosure. Although the court determined that the specific omitted projections were not material, it also focused on their highly speculative characteristics and noted that such speculative nature was disclosed in the proxy. Accordingly, if a board is considering disclosing management projections, it should carefully determine whether the projections were actually relied upon and, if they were not, why they were not. If the board ultimately chooses not to rely on certain projections, strong consideration should be given as to whether the rationale for that decision should be documented and disclosed.

The *Books-A-Million* opinion confirms that Delaware courts are willing to apply the deferential business judgment rule where controlling stockholders seeking to take a company private heed the advice set forth by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 645 (Del. 2014). However, *Books-A-Million* suggests that controlling stockholders would be well advised to make even their initial offers conditioned upon both the approval of an independent and empowered special committee and nonwaivable majority of the minority vote.

Books-A-Million also confirms that Delaware courts will consider application of the *MFW* framework on a motion to dismiss provided that the transaction documents sufficiently describe the transaction's compliance with each of the six *MFW* elements. Specifically, documents subject to judicial notice, including proxy statements and board resolutions, should be reviewed not only for compliance with state and federal disclosure laws but also for their descriptions of the company's and interested parties' adherence to the elements identified in *M&F Worldwide*.