Insights:
The Delaware Edition

Skadden

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This issue focuses on important, developing areas of Delaware corporation law and deal litigation, including court assessments on whether a director is sufficiently disinterested and independent to consider a demand impartially, effective mechanisms to fix issues and obtain validation of corporate acts, and guidance on the "credible basis" standard in books-and-records demands.

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If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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Q&A With Delaware Litigation Partner Ed Micheletti

What is the most significant recent development in Delaware, from a litigation standpoint?

The most significant recent development impacting deal litigation in Delaware is the continuing evolution of the *Corwin* doctrine, which was set forth by the Delaware Supreme Court in 2015. The *Corwin* doctrine stands for the proposition that when a merger not subject to entire fairness review (because of a conflicted controlling stockholder) has been approved by a fully informed, uncoerced majority of the disinterested stockholders, the business judgment rule applies, with the only remaining claim being one for waste (which is highly difficult to prove). Since *Corwin* was issued, the Court of Chancery has consistently applied the *Corwin* doctrine to dismiss numerous post-closing deal litigations. Certain decisions also have ruled that when the *Corwin* doctrine applies, the business judgment rule is not "rebuttable" — which, from a practical standpoint and given how hard waste is to prove, essentially ends the case. The Supreme Court also has had occasion to affirm at least three such decisions (including one that applied the concept of the irrebuttable business judgment rule) dismissing actions under the *Corwin* doctrine — *Singh*, *Volcano* and *Comstock* — further entrenching *Corwin* as a solid principle of Delaware law. To my knowledge, there has been only one matter (*Saba Software*) where defendants attempted to dismiss at the pleading phase a post-merger deal litigation under *Corwin*, and were unsuccessful. These issues are addressed in detail in this edition of *Insights: The Delaware Edition*.

What is the latest word on multiforum deal litigation?

As we have explained in prior issues, after *Trulia*, we began seeing a reduction in the historic multiforum litigation dynamic involving breach of fiduciary duty claims relating to a transaction and a quick disclosure settlement before a stockholder vote. Many companies have also adopted forum-selection charter or bylaw provisions picking Delaware as an exclusive forum, which also has helped reduce the number of multiforum litigations.

Does that mean multiforum deal litigation is a thing of the past?

No. We are still seeing multiforum stockholder litigation when deals are announced, though the focus of such cases has typically only been on disclosure claims (as opposed to broader breach of fiduciary duty claims challenging a board's process or the price of the merger). And when faced with a Delaware forum-selection provision, some stockholders have been pursuing these narrower disclosure cases in federal court outside of Delaware under the securities laws. Many of these cases are being resolved on a "mootness" basis, which was acknowledged by the *Trulia* decision as an acceptable manner in which to resolve such claims. In essence, the company issues supplemental disclosures as part of its proxy materials that address plaintiffs' claims, the case is dismissed by the named plaintiff stockholder, and the parties then either negotiate or have the court resolve a mootness fee payment to plaintiffs' counsel. The mootness fee ranges in Delaware post-*Trulia* have trended much lower than the settlement-based fees of the past.

Are there any new trends or issues in the Delaware Court of Chancery to keep an eye on?

We are seeing Section 220 of the Delaware General Corporation Law (DGCL) being used more frequently by stockholders. Section 220 permits stockholders that properly follow the statutory requirements and demonstrate a proper purpose to inspect the corporation's books and records. Stockholders will often use Section 220 in an attempt to inspect books and records for the purpose of "investigating mismanagement," as a precursor to filing a derivative litigation. We discuss some recent examples of this latest trend, and how the court has addressed such Section

220 demands in litigation, in this edition. Also, the Court of Chancery has had several opportunities now to apply Sections 204 and 205 of the DGCL. These statutes provide mechanisms for a corporation, under certain circumstances, to either unilaterally ratify defective corporate acts (under Section 204) or seek judicial relief to validate a corporate act (under Section 205). Several recent Court of Chancery cases have begun to define how these innovative and still relatively new statutory provisions operate and when they apply.

What about new trends or issues in the Delaware Supreme Court?

It's always interesting and important when the Delaware Supreme Court weighs in on a corporate law issue. There have been two recent Delaware Supreme Court decisions — *Sanchez* and *Sandys* — that have examined the question of director independence. Both of these cases emphasized a close examination of the facts and circumstances, and reached the conclusion that certain directors were not considered independent for demand futility purposes. We examine these cases, as well as a number of Court of Chancery cases that address similar issues with different results, in this edition.

Are you waiting on any big decisions that we should keep an eye out for?

Yes. Over the past few years, we have seen an uptick in appraisal actions under Section 262 of the DGCL, which resulted in several interesting rulings. One of the themes that has developed is the question of whether "merger price" is the best evidence of fair value for purposes of deciding the appraisal award. In 2015, the Court of Chancery issued a number of decisions indicating that the fair value of the shares being appraised was best determined by the per-share merger price (less any merger-related synergies). In 2016, a number of decisions reached the opposite conclusion. There are two appraisal cases currently on appeal — *Dell* and *DFC Global* — that present opportunities for the Delaware Supreme Court to weigh in directly about these recent developments. Practitioners are awaiting these decisions, which have the potential to provide significant guidance to the increasingly important area of appraisal litigation.

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Delaware Supreme Court Examines Director Disinterestedness, Independence

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Delaware law provides important tools for directors to maintain control of derivative lawsuits.[1] One such tool is the "demand requirement" embodied in Court of Chancery Rule 23.1, which requires that before a stockholder acts on behalf of the corporation, the stockholder must either demand that the board take action or establish that demand would be futile. The seminal opinion of the Delaware Supreme Court in *Aronson v. Lewis* established the test used by Delaware courts in determining whether a plaintiff stockholder's demand would have been futile: Has the plaintiff stockholder seeking to proceed with a claim on behalf of the company pleaded particularized facts creating a "reasonable doubt" that either (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment? 473 A.2d 805, 814 (Del. 1984).

In two recent opinions — *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016) and *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015) — the Delaware Supreme Court applied the *Aronson* test for demand futility under Rule 23.1. These two opinions, along with other recent cases, illuminate certain guideposts under Delaware law for assessing director independence and disinterestedness. As Chief Justice Leo E. Strine, Jr. observed in *Sanchez*, however, it remains true that "[d]etermining whether a plaintiff has pled facts supporting an inference that a director cannot act independently of an interested director for purposes of demand excusal under *Aronson* can be difficult." *Sanchez*, 124 A.3d at 1019.

Sandys and *Sanchez*

In *Sandys*, a Zynga stockholder brought derivative claims for breach of fiduciary duty against certain directors and officers of the company who sold shares in a secondary stock offering in April 2012. Shortly after the secondary offering, the company's per-share trading price fell dramatically. The plaintiff alleged that the directors and officers traded improperly on the basis of their inside knowledge of the company's declining performance. At the time the complaint was filed, the board was comprised of nine directors, only two of whom had sold shares in the secondary offering. The Court of Chancery held that the plaintiff had failed to allege facts that would create a reasonable doubt as to the ability of a majority of the board to act independently for purposes of considering a derivative demand, and it therefore dismissed the complaint.

The plaintiff appealed, and the Delaware Supreme Court reversed. Specifically, the Supreme Court held that one director was not independent of the company's controlling stockholder/director/CEO for purposes of considering a derivative demand because the director and her husband co-owned a private airplane with the controlling stockholder. The Supreme Court found that the co-ownership "signaled an extremely close, personal bond between [the controlling stockholder and the director], and between their families," and that the "unusual fact" created an inference that the director could not act independently of the controlling stockholder. The court also held that two other

[1] Whether a claim is direct or derivative under Delaware law turns on whether it was the corporation or the suing stockholder, individually, who suffered the alleged harm and who would receive the benefit of the recovery or other remedy. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004).

directors were not independent of the company's controlling stockholder/director/CEO for purposes of considering a derivative demand because the directors were partners of a private equity firm that, in addition to owning Zynga stock, also had invested in a company co-founded by the controlling stockholder's wife and another company where a conflicted member of the board was a director. The court found that this "mutually beneficial ongoing business relationship … might have a material effect on the parties' ability to act adversely toward each other."

In *Sanchez*, the Delaware Supreme Court reversed a finding of the Court of Chancery that a director was independent for purposes of analyzing demand excusal under Rule 23.1. 124 A.3d 1017 (Del. 2015). The Supreme Court held that "it is important that the trial court consider all the particularized facts pled by the plaintiffs about the relationships between the director and the interested party in their totality and not in isolation from each other." Specifically, the court found one director lacked independence because of the alleged facts that the director (1) was the interested director's "close personal friend of a half century," (2) "derives his primary employment from a company over which [the interested director] has substantial control" and "has a brother in the same position." In so ruling, the court noted that plaintiffs' allegation of friendship went beyond "the kind of thin social-circle friendship" that was at issue in *Beam v. Stewart*, where the court rejected a challenge to directors' independence that was based on the allegation that the directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends.'" *Id.* at 1022 (quoting *Beam*, 845 A.2d 1040, 1051 (Del. 2004)).

Other Recent Delaware Opinions

Director independence is commonly understood in the context of stock exchange listing requirements, and while those standards are, in some ways, analogous to the analysis under Delaware law, they are not co-extensive. *Sandys*, 152 A.3d at 131 (Del. 2016). For example, in *Sandys*, while the Delaware Supreme Court considered a director's independence designation under the stock exchange listing requirements in determining independence under Delaware law, it explained that the two inquiries "do not perfectly marry," and stock exchange listing requirements are "relevant under Delaware law," though not dispositive. *Id.* In particular, the analysis under Rule 23.1 is specific to the transaction or board decision the stockholder plaintiff is challenging. There are several other Delaware opinions that address the independence of a director for Rule 23.1 demand excusal purposes that demonstrate the fact-intensive nature of the inquiry, which does not easily lend itself to any bright-line rules.

Opinions Rejecting Challenges to Director Disinterestedness and Independence

In one case, the Court of Chancery examined whether three directors were independent of the company's controlling stockholder for purposes of Rule 23.1, where the stockholder sought to challenge a company's acquisition of another business affiliated with the controlling stockholder. *Greater Pa. Carpenters' Fund v. Giancarlo*, C.A. No. 9833-VCP (Del. Ch. Sept. 2, 2015) (Transcript), *aff'd*, No. 531, 2015 (Del. Mar. 11, 2016) (Order). Specifically, the court found that each director was independent despite allegations that:

- one director had served as the CEO of other businesses in which a venture capital firm had invested, and the same venture capital firm had also invested alongside the controlling stockholder;
- a second director was a long-time partner of a venture capital firm that had co-invested in other businesses alongside the controlling stockholder, because the court found that the plaintiff failed to explain how the venture capital firm's history investing alongside the controlling stockholder was material to the director; and
- a third director was a partner in a private equity firm that had invested in several start-ups affiliated with the controlling stockholder, because the court found that the alleged conflict of interest did "not provide continuous ongoing revenue to" the private equity firm or present an opportunity for the firm to profit from the challenged transaction at issue in the case.

In another case, the Court of Chancery examined whether a director could impartially consider a demand to challenge a services agreement entered into between the company and its alleged controlling entity. *Teamsters Union 25 Health Services & Insurance Plan v. Baiera*, 119 A.3d 44, 59 (Del. Ch. 2015). The court found that the director was independent despite allegations that the director had been an executive of the controlling entity or the controlling entity's parent for 16 years, had been CEO of the controlling entity's affiliate and had been elected to the board of the company shortly after leaving employment with the controlling entity's affiliate.

In a third case, the Court of Chancery examined whether two challenged directors were independent of a compensation committee member who was the subject of the stockholder's derivative claim. *Friedman v. Khosrowshahi*, 2014 WL 3519188, at *11 (Del. Ch. July 16, 2014), *aff'd*, No. 442, 2014, 2015 WL 1001009 (Del. Mar. 6, 2015). The court held that each of the two directors was independent despite allegations that:

- one director had been the controlling stockholder, CEO or a director of other companies at which the compensation committee member had held management positions, and had served alongside the compensation committee member on the board of other companies; and
- the other had provided outside legal services to and later served as in-house counsel at another company at which the compensation committee member had been a senior vice president, and (like the compensation committee member) had joined the company's board as a nominee of the same other company where they had both previously worked.

Opinions Finding That Challenged Directors Were Not Disinterested and Independent

In one case, the Court of Chancery examined whether three directors were independent of a fellow director affiliated with the company's controlling stockholder, where the company's board had approved a transaction in which the controlling stockholder repurchased stock from the company. *Rux v. Meyer*, C.A. No. 11577-CB (Del. Ch. Dec. 16, 2016) (Transcript). The court found that each director was not independent of the company's controlling stockholder because:

- one director was also the CEO of another business of which the controlling stockholder was the founder, former CEO and a current director. The controlling stockholder also owned a 30 percent equity stake in the other business, and he had granted the director voting and purchase rights to that equity stake. The court found that the controlling stockholder "would have a meaningful say on [the director's] continued employment" as CEO of the other company, and that the relationship between the controlling stockholder and the director was "an unusually thick one" so that "one reasonably would doubt" whether the director could act independently;
- another director had held several executive positions at different companies in which the controlling stockholder held significant interests. The court found that "in almost all of the professional dealings" between the director and the controlling stockholder over the two-decade period, the director was "subordinate to and, it is reasonable to infer, dependent on maintaining [the controlling stockholder's] good graces"; and
- a board of another company previously determined that the third director was "too connected" with the controlling stockholder to play a significant role in the merger negotiation between that other company and a company owned by the controlling stockholder.

In another case, the Court of Chancery examined whether five directors could impartially consider a demand to challenge a services agreement entered into between the company and an affiliate of a controlling stockholder. *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016). The court held that each of the five directors was not independent because:

- the first director had been the chief financial officer at the company, had been appointed as interim CEO by the controlling stockholder after the controlling stockholder "clean[ed] house," derived his principal source of income from employment at the company and was not independent under the Nasdaq listing rules;
- the second director was a managing director of an entity that was 33 percent owned by and in a joint venture with the company, and was not independent under Nasdaq listing rules;
- the third director was a consultant to and had been a managing director at the controlling stockholder's affiliate that was the counterparty to the services agreement,

had participated in consulting agreements similar to the services agreements, was a director of entities affiliated with the company and was not independent under the Nasdaq listing rules;

- the fourth director's family owned a minority stake of an entity that was majority owned by the company and had several family members who were employees of the same entity; and
- the fifth director personally participated in the decisions to approve the services agreements, even after indications of problems had arisen, and, although retiring from the board since approving the services agreements, immediately returned to the board after the services agreements were terminated by other directors.

In a third case, the Court of Chancery examined whether three directors of a company were independent for purposes of derivative claims challenging certain loans that the company entered into with a "control group" of affiliated entities that together owned over 90 percent of the company's stock. *Caspian Select Credit Master Fund Ltd. v. Gohl*, 2015 WL 5718592 (Del. Ch. Sept. 28, 2015). The court held that each of three directors was not independent because:

- one director was a "dual fiduciary" who had been nominated to the company's board by the control group while also being a principal at one of the entities in the control group; and
- two other directors each were appointed to the board by the control group, were appointed to several other boards of other companies by the control group and had expectations of future dealings with the control group because all are in the same business of restructuring distressed companies.

Key Takeaways

These opinions continue the development of Delaware law in assessing whether a director is sufficiently disinterested and independent to consider a demand impartially, and thereby whether a stockholder may pursue a claim derivatively on the corporation's behalf. Taken together, they suggest that Delaware courts will examine the totality of a plaintiff stockholder's factual allegations in each situation to evaluate whether a director's personal or business relationships "give rise to human motivations compromising the participants' ability to act impartially toward each other on a matter of material importance." *Sandys*, 152 A.3d at 126. The number of derivative lawsuit filings appears to be increasing, and in many instances, are preceded by a Section 220 demand on the company for books and records to support such a filing. Boards encountering this circumstance should carefully consider, along with their advisers, whether these rulings implicate their ability to maintain control over the corporation's claims under Rule 23.1.

Sections 204 and 205 of Delaware Corporation Law: Effective Tools to Remedy Defective Corporate Acts

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> See page 10 for key takeaways

Since they became effective in 2014, Sections 204 and 205 of the Delaware General Corporation Law (DGCL) have provided mechanisms for a corporation to unilaterally ratify defective corporate acts or seek relief from the Court of Chancery to validate any corporate act under certain circumstances. These provisions filled a perceived gap in the DGCL. Prior to their enactment, a corporation had no tool to fix defective acts or obtain validation of issues causing uncertainty in corporate documents, actions or otherwise. So far, the Court of Chancery has had relatively few opportunities to opine on the use of these statutory provisions.

Purpose and Use of Sections 204 and 205

Before Sections 204 and 205 were added to the DGCL, Delaware case law held that defective corporate acts, transactions or stock issuances that were void or voidable due to a failure to comply with the technical procedural requirements of the DGCL or the corporation's governing documents could not be retroactively ratified or validated on equitable grounds.[1] Sections 204 and 205 provide a practical way to resolve defective corporate acts and other uncertainties facing Delaware corporations "without disproportionately disruptive consequences."[2]

Section 204 is a self-help statute, *i.e.*, ratification can be accomplished without court involvement. Section 204(a) sets forth a road map for a board to remedy what would otherwise be void or voidable corporate acts and stock issuances, and provides that "no defective corporate act[3] or putative stock shall be void or voidable solely as a result of a failure of authorization if ratified as provided in [Section 204] or validated by the Court of Chancery in a proceeding brought under [Section] 205." Pursuant to Section 204, a corporation's board of directors may ratify one or more defective corporate acts by adopting resolutions setting forth the defective corporate act to be ratified, the date on which that act occurred, the reason why it is defective and that the board has approved the ratification of the defective corporate act or acts. A stockholder vote also is required to ratify the defective act if such a vote was required either at the time of the defective corporate act or at the time the board adopts the resolutions ratifying such act.

Section 205 envisions court involvement and allows a corporation, on an *ex parte* basis, to request that the court determine the validity of any corporate act (defective or not) or transaction and any stock, rights or options to acquire stock. Section 205 empowers the court to craft and grant an equitable remedy to validate corporate acts that once "would have been void at law and unreachable

[1] *See, e.g.*, *Blades v. Wisehart*, C.A. No. 5317-VCS, 2010 WL 4638603, at *8 (Del. Ch. Nov. 17, 2010) (requiring "scrupulous adherence to statutory formalities when a board takes actions changing a corporation's capital structure"); *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) ("Stock issued without authority of law is void and a nullity.").

[2] *In re Numoda Corp. S'holders Litig.*, Consol. C.A. No. 9163-VCN, 2015 WL 402265, at *8 (Del. Ch. Jan. 30, 2015).

[3] A "defective corporate act" includes any corporate act or transaction that was within the power granted to a corporation by the DGCL but was thereafter determined to have been void or voidable for failure to comply with the applicable provisions of the DGCL, the corporation's governing documents, or any plan or agreement to which the corporation is a party. *See* 8 Del. C. § 204(h)(1).

at equity."[4] While the statutory language of Section 205 confers substantial discretion and flexibility upon the court to validate certain corporate acts, the court "exercises its powers carefully"[5] and has declined to simply rubber-stamp Section 205 applications without serious consideration of the corporate act at issue and whether the request for validation is a proper use of the statute.

Court's Exercise of Power to Validate Defective Corporate Acts

While Section 204 "facilitates self-help," Section 205 is "for situations where judicial intervention is preferable or necessary."[6] For the first year that Section 205 was in effect, parties sought validation from the court largely relating to issues concerning the existence of corporations, such as confirming the composition of a corporation's board of directors[7] and validating defective stock issuances.[8]

However, in 2015, in *In re Genelux Corp.*, then-Vice Chancellor Donald F. Parsons, Jr. was asked to exercise the court's power under Section 205 to invalidate a purportedly defective corporate act.[9] Genelux sought invalidation of the issuance of 1.5 million shares of its preferred stock to one of its founders because such stock was purportedly issued without authorization and consideration. Genelux argued that because the court may "[d]etermine the validity of any corporate act or transaction and any stock, rights or options to acquire stock" under Section 205(a)(4), it may therefore also determine that such stock is invalid. Vice Chancellor Parsons decided that the plain language of Section 205 was ambiguous and therefore looked to extrinsic evidence, including the legislative synopsis, commentary in a Delaware law treatise and other provisions in Section 205 to determine the statute's intended meaning.

Based on this analysis, Vice Chancellor Parsons held that Section 205 "fundamentally concerns a company having taken an act with the intent and belief that it is valid and later petitioning the Court to correct a technical defect and thereby remedy incidental harm." Accordingly, Vice Chancellor Parsons held that Section 205 does not permit the invalidation of purportedly defective corporate acts.

Court's Exercise of Power to Validate Nondefective Corporate Acts

In *In re Baxter Int'l Inc.*,[10] Chancellor Andre G. Bouchard determined an issue of first impression and validated a corporate act that was not "defective." The company's charter included a classified board provision that required amendment by a super-majority vote. Due to uncertainty regarding whether the language of this provision called for a per-capita or per-share vote, the company's board adopted a resolution stating that it had determined to count votes to amend that provision of the charter on a per-share basis, notwithstanding that it had counted votes on previous amendments on a per-capita basis. The company held the vote at its annual stockholders meeting and, pursuant to its resolution, counted the votes on a per-share basis. The company easily obtained the requisite votes to amend the charter and thereafter filed the amendment with the secretary of state. The company then filed an application requesting that the court validate the charter amendment under Section 205(a)(4), which authorizes the court to determine the validity of any corporate act.[11]

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[4] *Numoda*, 2015 WL 402265, at *7.

[5] *Id.* at *10.

[6] *Id.* at *7.

[7] *See In re Certisign Holding, Inc.*, C.A. No. 9989-VCN, 2015 WL 5136226 (Del. Ch. Aug. 31, 2015); *In re Colfax Corp.*, C.A. No. 10447-VCL (Del. Ch. Apr. 2, 2015) (TRANSCRIPT); *Numoda*, 2015 WL 402265.

[8] *See In re Wine.com, Inc.*, C.A. No. 10401-VCG (Del. Ch. Apr. 16, 2015) (TRANSCRIPT); *In re Cheniere Energy, Inc.*, C.A. No. 9766-VCL (Del. Ch. Aug. 26, 2014) (TRANSCRIPT); *In re Trupanion, Inc.*, C.A. No. 9496-VCP (Del. Ch. Apr. 28, 2014) (TRANSCRIPT).

[9] 126 A.3d 644, 663 (Del. Ch. Oct. 22, 2015), *vacated in part on other grounds by Genelux Corp. v. Roeder*, 143 A.3d 20 (Del. 2016) (TABLE).

[10] C.A. No. 11609-CB (Del. Ch. June 22, 2016) (TRANSCRIPT).

[11] As directed by Chancellor Bouchard, the company gave notice to stockholders in a Form 8-K, but none came forward to challenge the Section 205 application. In addition, although Section 205 relief may be sought through a nonadversarial proceeding, Chancellor Bouchard appointed special counsel to create an adversarial context.

Chancellor Bouchard granted the requested relief, accepting the company's argument that Section 205 is not limited to only defective corporate acts. In his ruling, Chancellor Bouchard considered factors he deemed just and equitable, including that there had "been a history of uncertainty surrounding [the classified board] provision," "the fact that it appears logistically impracticable to make this amendment otherwise" and "the equities favor a per-share voting presumption, which protects the holders of a majority of shares from being disenfranchised." The court also noted that the company had "thoroughly disclosed its decision to count the votes on a per-share basis rather than a per-shareholder basis."

Court's Recent Views on Section 204 Ratification Issues and Resulting 205 Applications

Earlier this year, the Court of Chancery reviewed two actions that highlight potential issues with ratification under Section 204, and related stockholder litigation and Section 205 applications: *Steinberg v. Townley* and *Almond v. Glenhill Advisors LLC*.[12] In both cases, the issue with the Section 204 ratifications related to potentially self-interested board members who purported to have ratified the defective corporate acts.

In *Steinberg*, Wikipad's two-member board of directors took action under Section 204 to ratify a number of defective corporate acts — specifically, improperly approved charter amendments pursuant to which unauthorized stock was issued, which affected the capitalization of the company — and adopted resolutions reflecting those actions. Wikipad stockholders subsequently initiated an action challenging the Section 204 process, claiming that because the resolutions lacked transparency and the directors used the ratification process to implement acts of self-dealing, the directors were unable to properly ratify such acts. Ultimately, the parties reached a settlement on the claims regarding the Section 204 process that resulted in an agreed-upon capitalization table. Thereafter, the parties sought approval of the settlement agreement and jointly moved under Section 205 for validation of the capitalization table.

Vice Chancellor J. Travis Laster validated Wikipad's capitalization table but expressed concern about "inducing a regime where [Section] 205 becomes a new rubber-stamp opportunity for people to shift responsibility [to the Court]." To avoid such a result, Vice Chancellor Laster opined that, if possible, parties should attempt to fix defective corporate acts unilaterally through ratification under Section 204 instead of seeking court approval in the first instance. Because the parties in *Steinberg* had done just that, Vice Chancellor Laster decided that "it would be unfair to the parties who have litigated this matter in this Court not to get the judicial resolution that [Section] 205 … can provide." In addition, Vice Chancellor Laster was persuaded by the parties' representation that if they were required to complete another Section 204 process to ratify the capitalization table, the delay caused by the requisite 120-day notice period would have harmed Wikipad, which needed to secure financing as soon as possible in order to continue doing business.

In *Glenhill*, Herman Miller, Inc. stockholders challenged Herman Miller's acquisition of Design Within Reach (DWR), contending that the acquisition was never consummated due to a number of technical mistakes, primarily that DWR allegedly failed to complete a reverse stock split upon acquisition by Herman Miller, which, if true, meant that Herman Miller owned less than the requisite 90 percent of DWR stock to effectuate a short-form merger. The plaintiffs argued that, as a result, all acts and transactions occurring after the unsuccessful stock split were invalid, including the merger itself.

In response, DWR's board ratified the stock issuances under Section 204, including the original reverse stock split. The ratification was subsequently approved by DWR's stockholders acting by written consent. Thereafter, Herman Miller answered the complaint and asserted several affirmative defenses, including that the

[12] *Steinberg v. Townley*, C.A. No. 12539-VCL (Del. Ch. Feb. 27, 2017) (TRANSCRIPT); *Almond v. Glenhill Advisors LLC*, C.A. No. 10477-CB (Del. Ch. Jan. 31, 2017) (TRANSCRIPT).

complaint failed to state a claim because the purportedly defective acts had been ratified. Also, DWR intervened in the action and, along with Herman Miller, sought Section 205 relief through a counterclaim, requesting validation of its ratification of the alleged defective stock issuances. Herman Miller and DWR then moved for partial summary judgment on their Section 205 counterclaim/request.

Chancellor Bouchard denied the motion, noting that "[t]his is not your plain vanilla … clean mistake case," because three members of the six-member board who participated in the Section 204 ratification process had a personal financial interest in the underlying transaction, raising concerns of self-dealing that potentially infected the ratification process. Chancellor Bouchard ordered a prompt trial, noting that he was concerned with the incomplete state of discovery and "need[ed] to see the whole picture before [he could] pull the trigger on blessing [the ratified acts]."

Key Takeaways

Sections 204 and 205 appear to be effective mechanisms to fix issues and obtain validation of corporate acts from the Court of Chancery that ultimately provide certainty and stability for Delaware corporations. Although the case law construing these provisions is still developing, key takeaways from the court's early rulings include:

- Parties should consider attempting to engage in self-help facilitated by Section 204 by ratifying the corporate act at issue before seeking Section 205 relief from the court.
- To the extent Section 204 is not available or applicable, the court may be amenable to a unilateral Section 205 application.
- The court has indicated that it will not rubber-stamp Section 205 applications but instead will give serious consideration to whether granting such relief is necessary and an appropriate use of the court's power under the statute.
- At least one member of the court has recognized that Section 205 is not limited to defective corporate acts. Therefore, a corporation may seek validation of any corporate act, which the court may grant under certain circumstances.

In sum, Sections 204 and 205 have the potential to be effective tools that corporations and their counsel may employ in appropriate situations to remedy defective corporate acts or provide clarity on issues that, while not necessarily defective, may be causing corporate uncertainty.

Court of Chancery Provides Guidance on 'Credible Basis' Standard for Obtaining Books and Records

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> See page 13 for key takeaways

The Delaware Supreme Court has held that strict adherence to the procedural requirements of Section 220 of the Delaware General Corporation Law "protects the right of the corporation to receive and consider a demand in proper form before litigation is initiated." For this reason, a stockholder making a books-and-records demand has the initial burden to show both that he or she has standing to make such a demand and that the production is necessary. To do so, a stockholder must provide documentary evidence of continuous beneficial or record ownership in the corporation from the time of the alleged wrong. The stockholder also must articulate a "proper purpose" for the request that is reasonably related to a legitimate interest as a shareholder and is not adverse to the corporation's best interests. If the purpose is to investigate or prosecute alleged wrongdoing, the stockholder must demonstrate a credible basis (and not mere speculation) of alleged mismanagement and also explain why each category of documents is "necessary and essential" to fulfill the demand's stated purpose.

Delaware courts have consistently held that the "credible basis" standard is intended to prevent stockholders from engaging in an "indiscriminate" fishing expedition. Accordingly, a generalized statement of possible mismanagement, without more, will not justify production. Rather, a stockholder must provide some evidence of possible mismanagement. Mere disagreement with a business decision, in the absence of evidence from which the court may infer a possible breach of fiduciary duty, does not satisfy the credible basis standard. *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 123, 125 (Del. 2006). Several recent Delaware court decisions indicate that the courts will carefully examine the "credible basis" standard when a stockholder seeks the production of books and records for investigating mismanagement.

Most recently, in *Haque v. Tesla Motors, Inc.*, C.A. No. 12651-VCS (Del. Ch. Feb. 2, 2017), Vice Chancellor Joseph R. Slights III of the Court of Chancery issued an important opinion that provides additional guidance on books-and-records demands. Tesla Motors, a leading manufacturer of luxury electric vehicles, provided guidance to the market in its quarterly reports that demand for its vehicles was high. At various times in 2014 and 2015, however, Tesla reported that it had missed its sales guidance. When its production or deliveries fell short of targets, Tesla consistently maintained that the shortfalls were driven by production issues (*e.g.*, supply chain challenges), not a lack of consumer demand.

The plaintiff questioned whether Tesla's officers and directors had "fabricated" certain explanations for "sales misses" to cover up the fact that demand for Tesla vehicles was lower than reported. The plaintiff twice demanded to inspect Tesla's books and records pursuant to Section 220 "in order to investigate possible breaches of fiduciary duty and mismanagement" by Tesla's board and senior management. Tesla initially rejected both demands but ultimately agreed to make a limited production of documents to the plaintiff. The plaintiff was dissatisfied with the production and filed suit. By stipulation of the parties, the matter was tried by the Court of Chancery on a paper record without deposition or live testimony.

The court found that the plaintiff failed to demonstrate by a preponderance of the evidence a credible basis from which it could infer possible wrongdoing that would warrant further investigation. The court began its analysis by noting that the Delaware Supreme Court has held that "a stockholder's desire to investigate wrongdoing or mismanagement is a 'proper purpose'" under Section 220. The court stated that "at first glance," the plaintiff's desire to investigate whether or not Tesla publicly misled its shareholders stated such a purpose. However, "merely offering a suspicion of wrongdoing is not enough to justify a Section 220 demand," the court stated. Accordingly, the court held, a plaintiff seeking books and records must present "some evidence" to suggest a credible basis from which the court can infer that mismanagement, waste or wrongdoing may have occurred.

The court also noted that this evidentiary burden lies with the plaintiff and is not a mere formality. It may be satisfied by a "credible showing, through documents, logic, testimony, or otherwise, that there are legitimate issues of wrongdoing." In a thorough analysis of each of the alleged misstatements at issue, the court held that it would not be credible to infer wrongdoing or mismanagement based solely on the fact that Tesla occasionally missed its vehicle delivery or production guidance. Indeed, Delaware law "requires more than a divergence between forward-looking statements and subsequent results" in order to provide a credible basis to infer mismanagement or wrongdoing. The court found that "when viewed in the aggregate," the plaintiff's evidence "amounts to nothing more than 'suspicion or curiosity,'" which is insufficient to satisfy the credible basis standard.

The court's recent decision in *Tesla Motors* is consistent with the Court of Chancery's decision in *Beatrice Corwin Living Irrevocable Trust v. Pfizer, Inc.*, C.A. No. 10425-JL (Del. Ch. Aug. 31, 2016), in which Master Abigail M. LeGrow held after a full trial that there was no credible basis to infer a potential *Caremark* claim for breach of fiduciary duty for failure to exercise oversight. The action was brought by the trustees of a trust to inspect Pfizer's books and records for the purpose of valuing the trust's shares and investigating possible mismanagement. The plaintiffs asserted that the company violated accounting and disclosure laws by failing to calculate and disclose a particular deferred tax liability.

In *Pfizer*, the only mismanagement or wrongdoing the plaintiffs addressed was "possible breaches of fiduciary duties" by the Pfizer board of directors for "failing to assure compliance with applicable accounting rules" in relation to the deferred tax liability. None of the evidence the plaintiffs offered to support the credible basis standard, however, was focused on the board's compliance with its oversight duties under *Caremark*. As such, the court held that the plaintiffs failed to establish a credible basis from which the court could "infer that the board utterly failed to implement a reporting system or ignored red flags."

The court also found that an obvious defense to the purported claim — the board's reliance on an audit firm for a complicated accounting issue — existed, and thus it denied inspection pursuant to the protections provided to directors under 8 Del. C. § 141(e). In making this conclusion, the court relied on *Southeastern Pennsylvania Transportation Authority v. AbbVie, Inc.*, C.A. No. 10408-VCG (Del. Ch. Apr. 15, 2015), *aff'd*, 132 A.3d 1 (Del. 2016) (TABLE). Specifically, the court noted that under *AbbVie*, a stockholder did not have a credible basis to investigate mismanagement or wrongdoing where (1) the only identified use by the stockholder for the inspection was to help plead a later claim in litigation, (2) the only available relief the stockholder identified was monetary damages, and (3) the directors who were the potential subject of the suit were protected by an exculpatory charter provision under 8 Del. C. § 102(b)(7). In *AbbVie*, the Section 102(b)(7) exculpation for any potential duty-of-care claim prohibited a finding of actionable wrongdoing. Likewise, the plaintiffs in *Pfizer* focused solely on possible breaches of fiduciary duty by the board of directors for the purpose of evaluating potential shareholder or derivative litigation, and the board's actions were ultimately "fully protected" by 8 Del. C. § 141(e). Thus, the court held that the plaintiffs failed to demonstrate a credible basis.

Like *Tesla*, importantly, the court in *Pfizer* noted that "a stockholder whose stated purpose is investigating mismanagement must provide 'some evidence' to suggest a 'credible basis' from which th[e] Court may infer possible mismanagement, waste, or wrongdoing may have occurred" and that merely offering a suspicion of wrongdoing is insufficient to justify a Section 220 demand.

Key Takeaways

As the cases discussed above demonstrate, Delaware courts continue to strictly construe the "credible basis" standard against stockholders seeking the production of books and records. Although the "credible basis" standard "has been described as the 'lowest possible burden of proof' under Delaware law," the burden is not insubstantial, and stockholders must present at least some evidence from which the court can infer possible mismanagement or wrongdoing to justify production.

The Continuing Evolution of *Corwin* in Delaware Courts

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Recent Delaware Supreme Court and Court of Chancery cases have continued to refine the impact and requirements of *Corwin v. KKR Financial Holdings LLC*,[1] in which the Delaware Supreme Court held that the business judgment rule is "the appropriate standard of review for a post-closing damages action when a merger that is not subject to entire fairness … has been approved by a fully informed, uncoerced majority of the disinterested stockholders."[2] Recent cases have focused on three areas: (1) the scope of the business judgment rule; (2) the adequacy of disclosures and coercion; and (3) the burdens of pleading and proof.

Scope of Business Judgment Rule

The Delaware Supreme Court recently confirmed the application of *Corwin* to tender offers executed under 8 Del. C. § 251(h) and affirmed a decision where the Court of Chancery determined that when *Corwin* applies, the business judgment rule is "irrebuttable," leaving only a claim for waste.

In June 2016, the Court of Chancery in *In re Volcano Corp. Stockholder Litigation*[3] extended *Corwin* to stockholder acceptance of a tender offer executed pursuant to 8 Del. C. § 251(h). When 89.1 percent of Volcano's outstanding shares tendered, lawsuits alleging breach of fiduciary duty followed. Granting the defendants' motion to dismiss, the Court of Chancery held: "[T]he acceptance of a first-step tender offer by fully informed, disinterested, uncoerced stockholders representing a majority of a corporation's outstanding shares in a two-step merger under Section 251(h) has the same cleansing effect under *Corwin* as a vote in favor of a merger by a fully informed, disinterested, uncoerced stockholder majority."[4] In doing so, the court likened the decision to tender to a statutorily required stockholder vote because both actions "effectuat[e a transaction] in the first instance."[5] As a result, a fully informed, disinterested and uncoerced tender under Section 251(h) "irrebuttably invoked" the business judgment rule, leaving only a potential claim for waste (which has been described as a "vestigial … exception" that is very difficult to prove).[6] On February 9, 2017, one day after hearing oral argument, the Delaware Supreme Court affirmed *Volcano* "for the reasons stated in [the Court of Chancery's] decision."[7]

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[1] 125 A.3d 304 (Del. 2015).

[2] *Id.* at 305-06.

[3] 143 A.3d 727 (Del. Ch. 2016).

[4] *Id.* at 747.

[5] *Id.* at 746.

[6] *Id.* at 740, 746-47, 750. In doing so, the Court of Chancery cited to the Delaware Supreme Court's decision in *Singh v. Attenborough*, 137 A.3d 151 (Del. 2016). *Id.* at 740. Writing for the court *en banc*, Chief Justice Leo E. Strine, Jr. stated in *Singh* that the court's decision "to consider ... whether the plaintiffs stated a claim for the breach of the duty of care after invoking the business judgment rule [under *Corwin*] was erroneous." *Singh*, 137 A.3d at 151. He explained that "employing this same standard after an informed, uncoerced vote of the disinterested stockholders would give no standard-of-review-shifting effect to the vote." *Id.* As a result, if *Corwin* applies, "dismissal is typically the result. That is because the vestigial waste exception has long had little real-word relevance. ..." *Id.* at 152.

[7] *In re Volcano Corp. Stockholders Litig.*, No. 372, 2016 (Del. Feb. 9, 2017) (ORDER).

Subsequent Court of Chancery decisions have continued to rely on *Corwin* to dismiss merger litigation and clarified that *Corwin* is applicable to fully informed, uncoerced votes unless there is "*a looming conflicted controller*."[8]

Adequacy of Disclosures and Coercion

Within days of each other, the Delaware Supreme Court and Court of Chancery came to opposite conclusions regarding whether disclosures were sufficient to dismiss allegations under *Corwin*. On March 23, 2017, the Supreme Court issued an order affirming the dismissal of claims under *Corwin* and rejecting the appellant-plaintiff's arguments that failure to disclose the presence of an additional bidder was sufficient to preclude a finding of a fully informed vote on a motion to dismiss.[9]

Eight days later, the Court of Chancery declined for the first time to grant a motion to dismiss under *Corwin* because the plaintiff had adequately alleged that the stockholder vote was not fully informed and had been coerced. In *In re Saba Software, Inc. Stockholder Litigation*, the Court of Chancery found two disclosure claims sufficient to preclude application of *Corwin* on a motion to dismiss.[10] First, the court found the plaintiffs had stated a disclosure claim because the proxy statement did not disclose why the company had missed the Securities and Exchange Commission's (SEC) final deadline to rectify its fraudulent financial statements, which led to the SEC deregistering the company's stock shortly before the vote on the merger.[11] Second, the plaintiff had stated a disclosure claim because the proxy statement failed to disclose "the post-deregistration options available to Saba" that were discussed by the ad hoc committee of the Saba board of directors formed to evaluate the transaction.[12] In addition to disclosure claims, the Court of Chancery also found *Corwin* not applicable on a motion to dismiss because the plaintiff had adequately pleaded that the stockholder vote was coerced, noting: (1) the circumstances of Saba at the time of the vote; (2) the "hell-bent" sales process "in the midst of … regulatory chaos"; and (3) the omitted disclosures that would have directly borne on Saba's circumstances. This resulted in Saba stockholders being "given a choice between keeping their recently-deregistered, illiquid stock or accepting the Merger price … consideration that was depressed by the Company's nearly contemporaneous failure once again to complete the restatement of its financials."[13] The Court of Chancery characterized this choice, if the allegations were proven true, as "no real choice at all."[14]

Burdens of Pleading and Proof

Recent Court of Chancery decisions also have explored who bears the pleading-stage burden under *Corwin*. In *In re Merge Healthcare Inc.*, the court dismissed a complaint under *Corwin* and explained that "[a] plaintiff alleging that a

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[8] *Larkin v. Shah*, C.A. No. 10918-VCS, slip op. at 33 (Del. Ch. Aug. 25, 2016); *id.* at 3 ("In the absence of a controlling stockholder that extracted personal benefits, the effect of a 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."). *See also, e.g., In re Merge Healthcare Inc.*, C.A. No. 11524-CB, slip op. at 21 (Del. Ch. Jan. 5, 2017) (applying *Corwin* to dismiss case pursuant to business judgment rule where stockholder vote was fully informed); *Chester Cnty. Ret. Sys. v. Collins*, C.A. No. 12072-VCL, at 6 (Del. Ch. Dec. 6, 2016) (ORDER) (same); *In re OM Grp., Inc. Stockholders Litig.*, C.A. No. 11216-VCS, slip op. at 42 (Del. Ch. Oct. 12, 2016) (same).

[9] *City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust v. Comstock* [C&J Energy], No. 482, 2016, at 2 (Del. Mar. 23, 2017) (ORDER).

[10] Consol. C.A. No. 10697-VCS, slip op. at 2 (Del. Ch. Mar. 31, 2017). While this is the first denial of a motion to dismiss under *Corwin*, in *In re Comverge, Inc. Shareholders Litigation*, the Court of Chancery declined to grant summary judgment for defendants under *Corwin* because material disputes of fact existed regarding certain disclosure claims. C.A. No. 7368-VCMR, at 8-10 (Del. Ch. Oct. 31, 2016) (ORDER). The *Comverge* motions to dismiss were decided prior to *Corwin*.

[11] *In re Saba Software, Inc.*, slip op. at 32-33. The Court of Chancery distinguished this "why" disclosure claim from others that are routinely rejected, noting that the claim was not related to "a purposeful decision of the Board" but "was a factual development that spurred the sales process and, if not likely correctible, would materially affect the standalone value of Saba going forward." *Id.* at 33.

[12] *Id.* at 36. The Court of Chancery admitted that this type of disclosure has not always been required, but Saba's issues with delisting and deregistration made this "hardly a typical case." *Id.* at 37.

[13] *Id.* at 40-42.

[14] *Id.* at 45 n.99.

stockholder vote was inadequately informed to cleanse a transaction must 'identify a deficiency in the operative disclosure document,' which shifts the burden to the defendants to show that 'the alleged deficiency fails as a matter of law in order to secure the cleansing effect of the vote.'"[15] In *In re Columbia Pipeline Group, Inc. Stockholder Litigation*, the court also dismissed claims under *Corwin* and explained that the "converse" of the burden scheme would not "make[] sense as a practical matter. The idea would be that the defendants would have to come forward and establish affirmatively everything regarding their disclosures."[16] As the Court summarized, "[t]he idea instead, I think, is the plaintiff has to plead something such that it is reasonably conceivable that a disclosure claim could exist, and then we go from there."[17]

[15] C.A. No. 11388-VCG, slip op. at 25-26 (Del. Ch. Jan. 30, 2017). *See also In re Solera Holdings, Inc. Stockholder Litig.*, C.A. No. 11524-CB, slip op. at 19 (Del. Ch. Jan. 5, 2017) (holding that "a plaintiff challenging the decision to approve a transaction must first identify a deficiency in the operative disclosure document, at which point the burden would fall to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of the vote").

[16] C.A. No. 12152-VCL, Tr. at 23 (Del. Ch. Sept. 6, 2016) (TRANSCRIPT) (granting motion to stay discovery pending resolution of motion to dismiss under *Corwin*).

[17] *Id.*

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The Delaware Supreme Court's affirmation of *Volcano* and the Court of Chancery's continued willingness to dismiss litigation under *Corwin* have highlighted the importance of complete disclosure to stockholders prior to their vote or tender. These decisions confirm that Delaware law continues to emphasize the ability of stockholders to decide for themselves how to allocate capital and reward informed stockholder decisions while maintaining the right to hold companies accountable if disclosures fall short. While it is too early to know whether the Court of Chancery's decision in *Saba* represents a shift, the case appears to be an extreme one when compared to other recent decisions applying *Corwin*.[18]

[18] Relatedly, in *In re Paramount Gold & Silver Corp. Stockholders Litigation*, the Court of Chancery dismissed under *Corwin* allegations of an uninformed and coerced vote, but noted an "apparent tension" between *Corwin* and *In re Santa Fe Pacific Corporation Shareholder Litigation*, 669 A.2d 59 (Del. 1985), which "held in the context of a post-closing challenge that a fully informed stockholder vote approving a merger did not preclude review of certain deal protection devices under *Unocal* [*Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)]". Consol. C.A. No. 10499-CB, slip op. at 14-15 (Del. Ch. Apr. 13, 2017). While the Court of Chancery noted that the Delaware Supreme Court "did not discuss or expressly overrule this aspect of *Santa Fe*" in its *Corwin* decision, it concluded that it "need not address the apparent tension" because there was no unreasonable deal protection at issue. *Id.* As a result, this question remains unresolved.

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