Corwin, MFW and Beyond: Developing Trends in Delaware Disclosure Law

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> See page 5 for takeaways

Over the last several years, Delaware corporate law practitioners have traced numerous legal developments that dramatically reduced the injunction practice that dominated M&A litigation in Delaware for nearly three decades,[1] changing the development of Delaware disclosure law jurisprudence. Corporate law practitioners formerly benefited from a near-constant stream of judicial rulings resolving motions for expedited proceedings, expedited discovery and preliminary injunctions that focused, in part, on disclosures issued to stockholders in connection with mergers and other transactions. Those decisions generated a quick-paced, iterative body of case law that continually updated practitioners and transaction participants on the court's current thinking on disclosures, and enabled the court to address disclosures to stockholders on a "real-time" basis.

As injunction practice has declined, corporate disclosure law in Delaware is evolving at a slower pace, primarily through application of the Delaware Supreme Court's decisions in *Corwin v. KKR Financial Holdings LLC* (*Corwin*), in the absence of a controlling stockholder, and *Kahn v. M & F Worldwide Corporation* (*MFW*), when a controlling stockholder is present. These decisions, typically issued months or even years after a transaction has closed, affect the relevant standard of review but do not afford transaction participants the opportunity to correct disclosure deficiencies before a stockholder vote.

In the absence of a conflicted controller, under *Corwin*, a fully informed vote of disinterested, uncoerced stockholders will extinguish breach of fiduciary duty claims, leaving only claims for waste. As a result, in cases that do not involve controlling stockholders, the litigation often focuses on whether a stockholder vote was truly "fully informed." Where a controlling stockholder is present, under *MFW*, a merger may nevertheless be subject to review under the deferential business judgment rule when it has been approved by an independent, disinterested and properly empowered special committee and a nonwaivable, fully informed and uncoerced vote of a majority of the minority stockholders. In that context, one focus in litigation is whether the unaffiliated stockholder vote was "fully informed." As a result, the Court of Chancery continues to opine on stockholder plaintiffs' long-favored disclosure topics — such as financial projections, management conflicts and financial advisor conflicts — but now does so through the lens of *Corwin* and *MFW*, on a much slower, less frequent basis.

In addition, although requests to enjoin mergers are now exceedingly uncommon, the rare preliminary injunction decision may complement the development of disclosure law in Delaware. Moreover, as more defendants begin to contest applications for "mootness" fees made by stockholder plaintiffs in federal securities merger litigation, courts outside of Delaware are starting to weigh in on disclosure issues.

Delaware Courts Continue To Test the Adequacy of Disclosures Under *Corwin*

As noted above, a critical element of the *Corwin* test is a "fully informed" stockholder vote. In two recent cases applying *Corwin*, the Delaware Court of Chancery opined on the adequacy of disclosures issued in connection with mergers involving financial projections, management conflicts and financial advisor conflicts, with differing outcomes.

[1] *See, e.g.*, our July 18, 2018, client alert "M&A Litigation Developments: Where Do We Go From Here?"; Jan. 23, 2018, client alert "Key Developments in Delaware Corporation Law in 2017"; Nov. 21, 2017, client alert "Continuing Trends in M&A Disclosure Litigation"; Nov. 17, 2016, client alert "Forward Momentum: Trulia Continues To Impact Resolution of Deal Litigation in Delaware and Beyond"; May 19, 2016, client alert "Court of Chancery Continues Clarify Views of Disclosure-Based Deal Litigation Settlements"; and Nov. 16, 2015, article "Del. Scrutiny of M&A Settlements Leads to Varying Decisions," (*Law360*).

In *English v. Narang*, C.A. No. 2018-0221-AGB (Del. Ch. Mar. 20, 2019), the Court of Chancery applied the *Corwin* doctrine to dismiss a fiduciary challenge to a merger following what the court ultimately held to be a fully informed stockholder vote. In that case, stockholder plaintiffs challenged a transaction whereby NCI, Inc. (NCI) was acquired by a third party for cash through a tender offer followed by a merger. NCI's founder and retired CEO, who held 83.5% of the company's voting power, received the same per-share consideration as NCI's minority stockholders. Following the stockholder vote on the transaction, the defendants moved to dismiss the action under *Corwin*. The stockholder plaintiffs opposed the motion, arguing that NCI's founder was conflicted with respect to the transaction because he faced a liquidity need as part of his estate planning and wealth management strategy, and the stockholder vote was not fully informed.

The court rejected the argument that NCI's founder was conflicted, finding the liquidity theory insufficiently pled. The court also rejected each of the disclosure challenges raised by the plaintiffs, including allegations that the board materially misrepresented NCI's financial outlook by disclosing financial projections that "understated the Company's upside and overstated certain risk factors;" failed to disclose "when, and the extent to which, discussions occurred regarding post-close employment opportunities for NCI management;" and failed to disclose "potential conflicts of interest affecting NCI's financial advisors," including that each financial advisor had previously performed work for the company.

By contrast, in *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, C.A. No. 2017-0421-KSJM (Del. Ch. June 21, 2019), the Court of Chancery denied motions to dismiss claims challenging Virtu Financial Inc.'s (Virtu) acquisition of KCG Holdings, Inc. (KCG), finding that alleged disclosure deficiencies defeated application of the *Corwin* defense. The stockholder plaintiffs' 96-page complaint, which was bolstered by documents obtained in discovery in connection with the plaintiffs' motion for a preliminary injunction in June 2017, alleged, among other things, that in the months leading up to the transaction, KCG's long-time financial advisor had provided Virtu with confidential information about KCG's bond-trading platform, BondPoint, which KCG planned to divest, and simultaneously advised KCG on an alternative restructuring plan while "pressur[ing] the Board to pursue a transaction with Virtu." The plaintiffs also alleged that once Virtu made its best and final offer of $20 per share, KCG's CEO indicated that he believed the price was "too low" but would support the merger if he could negotiate a satisfactory compensation and retention pool for himself and his management team, which the board authorized. Additionally, according to the complaint, the night before the board approved the $20 per-share price, KCG's CEO and management team revised the company's financial projections to be more pessimistic, and after the board approved those revisions over email, KCG's new financial advisor based its fairness opinion on the more pessimistic projections, which fell in the middle of the new discounted cash flow analysis.

The court held that the defendants could not invoke a defense under *Corwin* because the plaintiffs had identified "significant deficiencies" in the proxy statement that rendered the stockholder vote uninformed. Those "deficiencies" included a failure to disclose detailed information about the BondPoint divestiture strategy; that the CEO initially indicated that the $20.21 per-share counteroffer was "too low," but later supported the $20 per-share deal price while negotiating a compensation pool for himself and his management team; and "the more optimistic, earlier projections presented during the merger negotiations and the circumstances surrounding the creation of the later revised projections."

Disclosures Continue To Play a Key Role in Cases Involving Controlling Stockholders

Disclosure law has developed in the context of *MFW* as well. In one decision earlier this year, *Olenik v. Lodzinski*, No. 392, 2018 (Del. Apr. 5, 2019), the Delaware Supreme Court reversed the Court of Chancery's application of *MFW* to dismiss claims, holding that the challenged transaction was not premised on *MFW*'s dual procedural protections "ab initio," but affirmed the Court of Chancery's dismissal of disclosure claims in connection with its *MFW* analysis. The dismissed claims included a failure to disclose that the financial advisor's initial contribution analysis did not support the ownership split for the transaction; that the financial advisor was "pressured" to revise its analysis to support the final ownership split; and that the company was "motivated to sell" due to its "dire need for cash." As to the first category of disclosures, the court explained that although the proxy did not discuss changes in the analysis, it stated both the analysis methodology and the company's annual projections, and thus "[i]nvestors were free to place the emphasis where warranted." With respect to the second category, the court reasoned that the company need not adopt "plaintiff's characterization of the facts." And as to the third category, the company's motivation for selling, the court found that "the Board was not obliged to characterize [the company's] position, particularly when the facts were disclosed and neither the Special Committee nor the Board actually concluded that [the company] was distressed and needed to sell."

In addition, the court has expanded *MFW*'s scope beyond "transformative" transactions to apply to other corporate decisions. In *Tornetta v. Musk*, C.A. No. 2018-0408-JRS (Del. Ch. Sept. 20, 2019), the Court of Chancery denied a motion to dismiss breach of fiduciary duty claims against Elon Musk and Tesla's board of directors arising from the board's and stockholders' approvals of an incentive-based compensation plan for Musk that the plaintiff alleged had a maximum potential value of $55.8 billion. However, in its ruling, the court advised future transaction participants that, by following the procedures set forth in *MFW*, non-extraordinary transactions too could be subject to business judgment review, opening the door to a broader application of the doctrine. Of course, as with merger cases, for *MFW* to apply, the corporate decision must be approved by a *fully informed* vote of unaffiliated stockholders, once again spotlighting the importance of robust disclosures.

In Rare Cases, Injunctions Continue To Develop the Law on Disclosures

Although merger injunction applications in Delaware are rare, in one case this year, the Court of Chancery had the opportunity to opine on disclosure claims in real time, prior to a stockholder vote.

In *FrontFour Capital Group LLC v. Taube*, C.A. No. 2019-0100-KSJM (Del. Ch. Mar. 11, 2019), following an expedited trial, the Court of Chancery enjoined two cross-conditioned mergers pending the issuance of corrective disclosures, but denied the plaintiffs' request for a "curative shopping process." The case involved a challenge to a combination of three affiliated entities — Medley Management, Inc., Medley Capital Corporation and Sierra Income Corporation. Because the proposed transaction posed "significant conflicts," each of the three entities formed a special committee in an effort to simulate arm's-length dealings. Ultimately, a deal was reached whereby Sierra would first acquire Medley Capital and then Medley Management in two cross-conditioned mergers, with Sierra as the surviving combined entity. After Medley Capital issued the proxy statement relating to the proposed mergers, multiple third parties expressed interest in an alternative deal with Medley Capital. The special committee considered these expressions of interest and ultimately determined not to engage or pursue them.

The plaintiffs, stockholders of Medley Capital, sought to enjoin the merger. The court held that the entire fairness standard of review applied and that the defendants failed to prove that the mergers were entirely fair, concluding that "a deeply flawed process obscure[d] the fair value of [the company]." The court further held that certain deal protections failed under enhanced scrutiny and also concluded that Medley Capital's directors violated their duty of disclosure because the proxy statement created "the misleading impression that the Special Committee process at Medley Capital was effective," "replicated arm's-length negotiations amid the conflicts tainting the Proposed Transactions," and failed to disclose other third-party indications of interest. As a result, the court enjoined the defendants from holding a stockholder vote or from consummating the merger until corrective disclosures were made, stopping short of ordering a "curative shopping process" that would have "strip[ped] an innocent third party of its contractual rights."

Contested Mootness Fee Applications May Contribute to the Development of Disclosure Law Going Forward

Another area in which corporate disclosure law may develop is in the context of contested mootness fee applications in federal securities actions challenging disclosures issued in connection with mergers.

In one recent decision, *Scott v. DST Systems, Inc.*, C.A. No. 1:18-cv-00286-RGA (D. Del. Aug. 23, 2019), the United States District Court for the District of Delaware denied contested mootness fee applications in two lawsuits challenging the disclosures issued in connection with SS&C Technologies Holdings, Inc.'s (SS&C) acquisition of DST Systems, Inc. (DST). After DST announced its planned merger with SS&C and issued its preliminary proxy statement, three DST stockholders (two in the District of Delaware and one in the Western District of Missouri) filed suit, alleging that the proxy contained material misstatements or omissions in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934. Several months after DST issued supplemental disclosures mooting the disclosure claims, the plaintiffs filed mootness fee applications, claiming that the supplemental disclosures provided a "substantial benefit" to DST's stockholders. The supplemental disclosures fell into three categories: projections of unlevered free cash flow, inputs and assumptions underlying the financial advisor's discounted cash flow analysis, and multiples used for the financial advisor's comparable companies and selected precedent transaction analyses. In denying the fee application, the court held that the plaintiffs failed to carry their burden of showing that any of the alleged omissions (and supplemental disclosures) were material as a factual matter.

Although contested fee applications are not yet common, they may appear with more frequency in the coming months, especially as courts continue to issue case law favorable to corporate defendants.

Takeaways

- Over the past year, Delaware fiduciary duty disclosure law has continued to develop at a measured pace under *Corwin* (in cases where no controlling stockholder is present) and *MFW* (in cases where a controlling stockholder is involved in the transaction).
- Under either the *Corwin* or *MFW* frameworks, a fully informed stockholder vote — meaning that stockholders have the material information necessary to make an informed decision about a particular proposed transaction — remains the key element.
- Recent cases addressing a variety of disclosure claims — including, among other things, financial projections, management conflicts and financial advisor conflicts — demonstrate how, through the lens of *Corwin* and *MFW*, the Court of Chancery continues to develop Delaware's disclosure law jurisprudence, still carefully analyzing the alleged misstatements or omissions to determine whether information is material given the particular facts of the case.
- Other than in connection with an exceedingly rare attempt to stop a stockholder vote based on inadequate disclosures, Delaware courts are evaluating disclosure claims post-closing to determine whether or not *Corwin* or *MFW* should apply to a board's decision to enter into a transaction (and thus whether business judgment review should apply to protect such a decision). As a result, Delaware courts are typically addressing disclosure claims months or years after a stockholder vote and the closing of a transaction, at a time when disclosure violations can no longer be remedied by supplemental or clarifying disclosures. Accordingly, consulting with legal advisers in advance of a stockholder vote about the best way to position the company and the board to defend themselves post-closing is paramount.
- Outside of the *Corwin* and *MFW* contexts, Delaware disclosure issues arise less frequently, but the rare decision involving a preliminary injunction or a contested federal securities mootness fee application also complements the development of Delaware corporate disclosure law.