Insights:
The Delaware Edition

Skadden

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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.

In a case of first impression, the Court of Chancery held recently that officers, like directors, owe their companies a duty of oversight, although the scope of that will vary with their responsibilities. Two other Chancery rulings involved transactions where a founder played a role in the deal and subsequent litigation. In one case, a special committee was praised for its approach to control the acquisition process to prevent any conflict taint, while in the second case the court found that a special committee failed to prevent the CEO from steering a sale process to benefit himself, and it awarded shareholders damages against him and the buyer. In two other recent cases, the court penalized parties who destroyed documents, imposing an adverse inference in one case and default judgment in the other.

The Court of Chancery Holds That Corporate Officers, Like Directors, Owe a Duty of Oversight

Contributors

Edward B. Micheletti / Partner

Rupal Joshi / Associate

> See page 4 for key points

On January 25, 2023, Vice Chancellor Laster of the Court of Chancery issued a significant decision, finding as a matter of first impression that corporate officers owe a duty of oversight akin to the oversight duties owed by corporate directors under *In re Caremark International Inc. Derivative Litigation* (*Caremark*). In *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. No. 2021-0324-JTL (Del. Ch.) (Jan. 25, 2023), the court denied a motion to dismiss, concluding that plaintiffs adequately alleged that McDonald's global chief people officer breached his oversight duties by ignoring red flags regarding workplace misconduct and engaging in such misconduct himself.

The decision addresses several notable issues. While the court ruled that corporate officers have oversight duties that mirror the two prongs of *Caremark* — *i.e.* (i) good faith effort to put in place reasonable information and reporting systems and (ii) action in response to red flags — the decision leaves open questions regarding the specifics of these duties and their practical application. The case was subsequently dismissed on other grounds, so it remains to be seen if the Delaware Supreme Court will have an opportunity to weigh in these open issues in the near future.

Key Aspects of the Motion to Dismiss Ruling

Corporate officers owe oversight duties. The court rejected the officer's primary argument that officers do not owe oversight duties.

- In its analysis, the court drew heavily on the *Caremark* decision itself, holding that a duty of oversight is also owed by corporate officers. The court stated that "[t]he same policies that motivated [the Court] to recognize the duty of oversight for directors apply equally, if not to a greater degree, to officers."[1]

[1] *Id.* at 2.

- The court coupled this reliance on the policies of *Caremark* with existing Delaware Supreme Court case law holding that officers owe the same fiduciary duties as directors. Specifically, the court noted that "[t]he Delaware Supreme Court has held that under Delaware law, corporate officers owe the same fiduciary duties as corporate directors, which logically includes a duty of oversight."[2] The court also pointed to academic authorities, decisions outside of Delaware and the general obligations of corporate officers as agents of the board of directors as additional sources supporting the conclusion that officers have oversight duties.

The scope of an officer's oversight duties is context driven. The court further highlighted that, "[a]though the duty of oversight applies equally to officers, its context-driven application will differ."[3]

- "Some officers, like the CEO, have a company-wide remit," the court explained, while "[o]ther officers have particular areas of responsibility, and the officer's duty to make a good faith effort to establish an information system only applies within that area."[4]
- By way of example, the court noted that "the Chief Financial Officer is responsible for financial oversight and for making a good faith effort to establish reasonable information systems to cover that area," while "[t]he Chief Legal Officer is responsible for legal oversight and for making a good faith effort to establish reasonable information systems to cover that area."[5]
- The court also noted that "[a]n officer's duty to address and report upward about red flags also generally applies within the officer's area" but stated that "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."[6]

Pleading a breach of an officer's oversight duties requires allegations of disloyal conduct amounting to bad faith. As with traditional *Caremark* duties of directors, "establishing a breach of the officer's duty of oversight requires pleading and later proving disloyal conduct that takes the form of bad faith."[7] In other words "[t]he officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags."[8]

- For instance, to plead a "red flags" claim: "a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty."[9]
- With respect to the specific allegations in this case, the court concluded that plaintiffs had pled the existence of red flags indicating that sexual harassment occurred at the company and also alleged facts supporting a reasonable inference that the officer knew about the red flags. Based in part on allegations that the global chief people officer had engaged in acts of sexual harassment himself, the court held that plaintiffs had stated a claim that the officer acted in bad faith by consciously ignoring red flags of sexual harassment, which caused the company harm.

Oversight claims against officers are derivative. Notably, the court highlighted that oversight claims remain derivative. Therefore, "the board controls" the "claims unless a stockholder can plead demand futility or show wrongful refusal," which the court described as "the bulwark" against oversight claims against officers.[10]

- In the court's words, "[t]he oversight duties of officers are an essential link in the corporate oversight structure. The bulwark against the stockholders liberally asserting

[2] *Id.*

[3] *Id.* at 41.

[4] *Id.* at 2.

[5] *Id.* at 41.

[6] *Id.* at 2.

[7] *Id.*

[8] *Id.* at 3.

[9] *Id.*at 54 (citing *See Lebanon Cnty. Empls.' Ret. Fund v. AmerisourceBergen Corp.*, 2020 WL 132752, at *20 (Del. Ch. Jan. 13, 2020)).

[10] *Id.* at 36.

oversight claims against officers is not the invalidity of the legal theory. Rather, it is the fact that oversight claims are derivative, so the board controls the claim unless a stockholder can plead demand futility or show wrongful refusal. It is those doctrines, applied at the pleading stage under Rule 23.1, that minimize the risk of oversight claims against officers, not the absence of any duty of oversight."[11]

- The court also implied that holding that officers have their own oversight duties might allow boards of directors to hold officers accountable for officer-level conduct without directors "facing oversight liability themselves."

Well-pled allegations of sexual harassment constitute a breach of the duty of loyalty. Further, the court concluded that, under Delaware law, the allegations of the officer's acts of sexual harassment "constituted a breach of duty in themselves."[12]

- Specifically, the court stated that "[w]hen a fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, the fiduciary acts in bad faith" and that "a CEO or other corporate officer who uses a position of power to harass, intimidate, or assault employees clearly acts for a purpose other than that of advancing the company's interests."[13]
- Therefore, the court held that allegations of conduct such as sexual harassment, which is engaged in for selfish reasons, support an inference that the fiduciary acted in bad faith and disloyally and states a claim for breach of fiduciary duty.

[11] *Id.* at 37.

[12] *Id.* at 5.

[13] *Id.* at 61.

Key Points

The *McDonald*'s decision addresses several significant topics important for both corporate officers and their boards of directors that are worth highlighting, and there are lessons to be drawn from it for corporations and their officers.

- For the first time, a Delaware court held that corporate officers "owe[] a duty of oversight," which includes both "an obligation to make a good faith effort to put in place reasonable information systems" so that officers "obtain the information necessary to do [their] job and report to the CEO" and an obligation to not "consciously ignore red flags indicating that the corporation [is] going to suffer harm."
- Notably, as with traditional Caremark duties of directors, pleading and ultimately establishing a breach of a corporate officer's duty of oversight requires well-pled allegations of "disloyal conduct that takes the form of bad faith." As with oversight claims against directors, appropriate processes and record-keeping are critical, so that officer oversight and reporting efforts are documented in response to any challenge to officer conduct.
- Application of an officer's oversight duties is context driven, with different officers having varying scopes of oversight responsibility. For instance, "[s]ome officers, like the CEO, have a company-wide remit." The court did not provide any specific guidelines or expectations about how officers should establish and document their oversight process. As a practical matter, the exact scope and contours of specific officer oversight duties may differ from company to company, and also within a company, officer to officer. How officers document their efforts may also vary. Future case law guidance may also help shed more light on the parameters of officer duties.
- Based on the court's holding, including that "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain," officers, like directors, should remain mindful of the big picture and mission-critical risks to the company and be able to demonstrate that they are not consciously ignoring red flags that could cause the company harm.
- Oversight claims against corporate officers remain derivative, so a stockholder can only bring a claim on behalf of the company by pleading demand futility or wrongful refusal, which the court opined may minimize the risk of oversight claims against officers. The court ultimately dismissed this action after concluding that the McDonald's board was capable of considering a demand relating to the officer, and thus, demand was not excused.
- In another novel holding, the court also held that allegations against a corporate officer of sexual harassment "constituted a breach of duty in themselves," because "a CEO or other corporate officer who uses a position of power to harass, intimidate, or assault employees clearly acts for a purpose other than that of advancing the company's interests."

Post-Trial *Oracle* Ruling Provides a Roadmap for Navigating Transactions With an Influential Fiduciary on Both Sides of the Deal

Contributors

Edward B. Micheletti / Partner

Peyton V. Carper / Associate

> See page 8 for key points

The mere *potential* for a prominent, highly respected officer, director and minority holder to influence a board's decision to approve a deal where the minority holder sits on both sides is insufficient to confer controller status and invoke entire fairness review, the Delaware Court of Chancery held post-trial in *In re Oracle Corporation Derivative Litigation*.[14]

The May 2023 ruling by Vice Chancellor Glasscock also commends the robust process employed by a "well-functioning" independent special committee with independent advisors. Companies and corporate practitioners considering a potentially conflicted transaction can look to *Oracle* for guidance about how to successfully navigate such a transaction and avoid pitfalls.

Background

Between 2006 and 2015, Oracle Corporation closed over 100 strategic acquisitions. At a January 2016 meeting of Oracle's board of directors, Oracle management identified Netsuite Corporation as a potential takeover target. Before management's presentation, Larry Ellison — director, officer, founder and "face" of Oracle — left the room and recused himself from the discussion. Ellison, who also co-founded and served as a director of Netsuite, owned 39.8% and 28.4% of Netsuite and Oracle stock, respectively.

After discussion, the board decided to explore a potential transaction with Netsuite and authorized Safra Catz, Oracle's chief executive officer, to connect with Netsuite's executives to gauge interest. When word of the possible acquisition reached Evan Goldberg, Netsuite's other co-founder, he expressed his displeasure to Ellison. Ellison shared details of Oracle's strategy for Netsuite post-acquisition and reassured Goldberg that, in the event of a transaction, Oracle planned to retain Netsuite's management.

In March 2016, the board, minus Ellison, who recused, approved the creation of a special committee of independent directors to negotiate the potential Netsuite transaction. The special committee was empowered to assess alternatives, negotiate the transaction, and approve or reject the transaction. The special committee retained independent legal and financial advisors,[15] and implemented "rules of recusal" that "prohibited Ellison from discussing the Transaction with anyone but the Special Committee; required Oracle employees brought in to assess the Transaction to be made aware of Ellison's recusal; and forbade Oracle officers and other employees from participating in the negotiation process absent Special Committee direction." Over a seven-month span, the special committee met 15 times to evaluate the transaction.

In June 2016, the special committee and Netsuite exchanged multiple offers and counteroffers. Eventually, frustrated that Netsuite's counterproposals were not proportional to the special committee's moves, the special committee declined

[14] C.A. No. 2017-0337-SG (Del. Ch. May 12, 2023)

[15] Skadden advised the special committee.

to counter and was "prepared to let the deal die." In mid-July 2016, negotiations resumed and the special committee communicated its best and final offer of $109 per share, one dollar less than the ceiling Oracle had set internally. Netsuite accepted the same day. The transaction closed in November 2016.

In 2017, stockholder plaintiffs initiated a lawsuit against the board and certain Oracle officers alleging that Oracle overpaid for Netsuite. Central to plaintiffs' complaint were allegations that Ellison used his outside influence to cause Oracle to acquire Netsuite at a premium. Over six years, the action took a "circuitous and procedurally complex path to trial" that involved, *inter alia*, the court's issuance of six memorandum opinions; the creation of a special litigation committee which in a "surprising" move declined to take over the derivative litigation or dismiss it; a motion to intervene; numerous amended complaints; and plaintiffs' voluntary dismissal of several defendants. At the time the court issued its post-trial decision, only Ellison and Catz remained as defendants.

Applicable Standard of Review

Though Ellison, as a director and officer, stood on both sides of the transaction, the court found that, throughout the process, he appropriately insulated himself from the board's discussion of the deal. Specifically, Ellison withdrew from Oracle's consideration of a Netsuite acquisition *before* management's initial presentation to the board and the remaining directors empowered an independent special committee to negotiate the transaction on Oracle's behalf.

By the time of trial, plaintiffs no longer contended that two of the three special committee members were dependent on Ellison or otherwise conflicted. After trial, plaintiffs dropped their challenge against the third committee member that was based on the member's "reliance" on Ellison to help her become a CEO in the technology industry. (The court described this failed theory as having "some odor of denigrating the abilities of women executives to succeed based on their own merits.")

Ultimately, the court held that the special committee process was adequate to cleanse Ellison's conflict. Thus, the court held that the transaction would be analyzed under the business judgment rule unless plaintiffs could prove either that: (i) Ellison was a "controller" on both sides of the deal or (ii) Ellison on his own, and through Catz, misled the Oracle board and the special committee, thereby rendering the transaction a product of fraud.

No Controlling Stockholder

The court rejected plaintiffs' argument that Ellison was a controller, first observing that, with less than 30% of Oracle's voting stake, Ellison did not exert "hard" control over the company. Instead, the court focused on whether Ellison dominated Oracle's corporate conduct, and found that claim lacked merit, saying that Ellison did not exercise control generally in regard to Oracle's operations. Ellison had relinquished executive control years earlier when he stepped down as chief executive officer, and the board was not afraid to stand opposed to Ellison.

Nor did Ellison attempt to exert control over the Netsuite acquisition, even though, as the court remarked, he could have "if he had so desired." As a director and officer, Ellison "scrupulously avoided influencing the transaction." Additionally, the board (without Ellison), created a special committee fully empowered to negotiate an acquisition and consider alternatives, including not buying NetSuite. Ellison's lack of contact with the special committee coupled with the fact that the special committee "vigorously bargained" on price and "demonstrated a willingness to walk away" from the transaction lead the court to conclude that the transaction was not a controlled transaction; rather "[t]his transaction was negotiated at arm's length by a fully empowered Special Committee."

Plaintiffs argued that, nonetheless, Ellison wielded transaction-specific control because (i) he proposed the transaction; (ii) his Netsuite holdings were coercive in that Netsuite principals felt an obligation to sell; and (iii) he drove the deal through Catz, who acted as Ellison's "surrogate."

The court found assertions (i) and (iii) completely unsupported by the trial record. Though Ellison had been a long-time proponent of an eventual Oracle/Netsuite transaction, at the time management presented Netsuite as a target, Ellison did not advocate for or against the transaction. And, the court emphasized that the independent and disinterested special committee, aided by its "highly experienced" independent advisors, ran the transaction, not Catz. Catz, as Oracle's CEO, was "fundamental to the ultimate deal," but her actions "demonstrate[d] loyalty to the company, not Ellison's conflicted interest."

Finally, with respect to the claim that Ellison forced Netsuite to sell, the court found that any influence Ellison exerted at Netsuite did not amount to control over Oracle.

In short, the court acknowledged that, while Ellison was a "force" at Oracle, that did not translate in the context of this transaction to Ellison acting as a controller and did not warrant an entire fairness review solely because he had the potential to assert influence over the board: "The concept that an individual — without voting control of an entity, who does not generally control the entity, and who absents himself from a conflicted transaction — is subject to entire fairness review as a fiduciary solely because he is a respected figure with a *potential* to assert influence over the directors, is not Delaware law."

No "Fraud on the Board"

Plaintiffs also argued that Ellison and Catz perpetrated a "fraud on the board" by failing to disclose facts relating to Netsuite's value, as well as Ellison and Catz's purported interactions with Netsuite, tainting the special committee's decision-making process.

The court held that none of plaintiffs' alleged omissions were material. For example, it rejected plaintiffs' theory that Ellison misled the Oracle board by failing to disclose his belief that Oracle would "crush" Netsuite (its purported competitor) and depress its stock price unless Netsuite changed course based on Ellison's advice. Among other reasons, the court noted that Netsuite and Oracle were not significant competitors and that Netsuite was in the process of making changes based on Ellison's critiques.

Another claim grounded on Ellison's failure to disclose the phone call with Netsuite's Goldberg in which he mused that Oracle would retain Netsuite management was also rejected. The court held, based on the trial evidence, that this did not impact the special committee's process. Though the court acknowledged best practices dictate erring on the side of disclosure, Ellison's "non-committal statements" to Goldberg were consistent with and typical of Oracle's practice in past acquisitions.

The court also found claims that Catz mislead the special committee by failing to disclose preliminary discussions about price with Netsuite executives, and by creating artificially inflated projections, were not supported by the evidence at trial.

Ultimately, because the court rejected both of plaintiffs' theories as to why the transaction warranted entire fairness review, the court applied the business judgment rule and found in favor of Ellison and Catz.Court Finds Mindbody

Key Points

- The *Oracle* decision provides a roadmap for how to successfully navigate a situation where a founder, director and officer with a significant reputation and influence sits on both sides of a deal.

- The court took a very pragmatic approach to assessing control, concluding that plaintiffs fell short at trial of demonstrating that Ellison *actually* either dominated Oracle at the time of the transaction, or attempted to wield control specifically in connection with the Netsuite acquisition. Even assuming that Ellison "had the potential to influence the transaction," he did not attempt to, and did not interfere with the special committee's process. Indeed, the court emphasized Ellison's early and complete recusal from any aspect of the special committee's process as an important factor in its decision.

- In many respects, the *Oracle* decision turns on the integrity and effectiveness of the special committee process. Having a properly empowered special committee comprised of independent, disinterested directors was crucial. Moreover, the trial record clearly reflected an independent and robust process: In addition to considering alternatives to Netsuite, the special committee was prepared at one point "to let the deal die rather than increase Oracle's offer."

- The *Oracle* decision also underscores the importance of having experienced, independent advisors to assist with a special committee process, particularly when dealing with founders or highly regarded business executives with significant influence in a particular industry, even where they hold less than mathematical control. The court commented favorably on how the special committee's process was run, including the special committee's decision early on to implement rules of the road governing recusals and to ensure any conflicted director or potential controller did not infect the committee's process. For this reason, and others, the court noted that "[t]he record… demonstrates that the special committee, aided by its advisors, negotiated in a hard-nosed fashion that reduced the deal price in a way that — given Ellison's greater interest in [Netsuite] than in Oracle — was against Ellison's interest."

- The focus of merger litigation is often on the "sell side" of the deal, with arguments focusing on the target company board's decision to enter into a merger. The *Oracle* opinion is a prime example of the plaintiff bar focusing instead on the "buy side," targeting Oracle as the acquiror, and being brought derivatively against Oracle directors and officers. Parties on the buy side of transactions, particularly with controllers or highly influential fiduciaries with a less-than-majority interest that may be on both sides of the deal, should be mindful that their buy-side process may be the subject of litigation.

Court Finds Mindbody CEO Liable Under *Revlon* and That Buyer Aided and Abetted Disclosure Violations

Contributors

Arthur R. Bookout / Counsel

Peyton V. Carper / Associate

William H. Spruance / Associate

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In March 2023, the Delaware Court of Chancery issued a rare decision holding an officer personally liable for damages for breach of fiduciary duty under a post-closing Revlon enhanced scrutiny analysis. Specifically, the Chancellor's post-trial opinion in *In Re Mindbody, Inc. Stockholder Litigation*[16] imposed liability on the target's CEO for sale process failures in connection with the buyout of a technology company by a private equity firm. The opinion also held the CEO liable for presenting misleading disclosures to stockholders to get the acquisition approved, and held the acquiror liable for aiding and abetting those misleading disclosures.

Officers and directors of Delaware corporations, private equity sponsors, investors and practitioners should pay close attention to *Mindbody*'s guidance on post-closing judicial review of sale process requirements and proxy disclosures.

Background

Based on the evidence at trial, the court found that, after nearly two decades of building Mindbody, Inc., its CEO and director, Richard Stollmeyer, had grown "physically and emotionally exhausted." For personal reasons, he desired liquidity, and by early 2018, he was ready to sell.

The court found that, after receiving what Stollmeyer characterized as a "mind blowing" presentation about the amount of money portfolio company chief executives could make while working under the umbrella of the eventual buyer, Vista Equity Partners Management, LLC (Vista), he became "smitten" with Vista and "effectively greased the wheels for Vista" to emerge as the acquiror from the board's sale process. The court catalogued the several instances in which Stollmeyer gave the board no information or only partial information about his conversations with Vista. For example, before Mindbody's board of directors had even discussed a sale of the company, Stollmeyer alerted Vista that he was looking for a "good home" for the company in the near term.

Vista expressed interest in acquiring the company at a "substantial premium" to its stock price. In response to Vista's interest, the board established a transaction committee, which developed guidelines to manage communications with potential acquirors. However, the court found that Stollmeyer "ignored" the guidelines, including by tipping Vista about the board's upcoming formal sale process. The company's banker also tipped Vista as to Stollmeyer's target deal price of $40 per share. With this information, the court found that Vista, which was known for very aggressive and quick negotiations, "bragged" internally that it was "'able to conduct all of [its] outside-in work before the process launched'" and to "'move swiftly in the process to provide the board with a highly certain offer within 3 days of receiving data room access.'"

Vista submitted an offer to acquire the company for $35.00 per share and imposed a 24-hour deadline for acceptance. The board countered with $40.00, and Vista replied with its "best and final" offer of $36.50. On December 23, 2018, the company and Vista entered into a merger agreement at $36.50 per share. Though the merger agreement provided for a 30-day go-shop period, Stollmeyer went on vacation half-way through the go-shop period and instructed management to decline go-shop presentations in his absence unless "urgent."

[16] C.A. No. 2019-0442-KSJM (Del. Ch. Mar. 15, *revised* Mar. 21, 2023).

Under the merger agreement, Vista had rights to review the company's proxy statement and was "obligated" to notify the company if it was aware of any material omitted facts. The court found that the proxy statement "sterilized" Stollmeyer's interactions with Vista — omitting (among other things) any reference to multiple important meetings he had with Vista and Vista's statement about paying a "substantial premium." On February 14, 2019, the company's stockholders approved the merger and the transaction closed the next day.

Plaintiffs brought suit arguing that the board and breached their fiduciary duties by tilting the sale process in Vista's favor and by failing to disclose material information in the proxy statement. Plaintiffs also contended that Vista and others aided and abetted those breaches. Prior to trial, plaintiffs settled with or dismissed all defendants except Stollmeyer and Vista.

Claims Against the CEO

Process Claims

The court first evaluated plaintiffs' claim for breaches of fiduciary duty against Stollmeyer, in his role as an officer for the company, for improperly tilting the sale process in favor of Vista. The court characterized the facts as illustrating a "paradigmatic" *Revlon* claim, which it described as a situation where "a conflicted fiduciary who is insufficiently checked by the board [] tilts the sale process toward his own personal interest in ways inconsistent with maximizing stockholder value."

The court found that Stollmeyer suffered a disabling conflict because of his desire for a quick sale and near-term liquidity, and the expectation that he would receive post-merger employment and significant equity-based incentives as a Vista portfolio company executive. The court similarly found the record "riddled with instances" where Stollmeyer tilted the sale process in Vista's favor.

The court also found that Stollmeyer, in his role as CEO, had left the board "in the dark" about the extent of his personal interests or his interactions with Vista. The board knew nothing of Stollmeyer's need for liquidity or desire for a near-term exit, and knew nothing about his preference for Vista or Vista's head start in the sale process. The court determined that the board had failed to adequately oversee Stollmeyer and that Stollmeyer's breaches of fiduciary duties in failing to disclose certain information to the board rendered the sale process outside the "range of reasonableness" required to satisfy enhanced scrutiny under *Revlon*.

In assessing damages for Stollmeyer's breaches of fiduciary duty for "corrupt[ing] the [sale] process," the court assented to plaintiffs' lost-transaction theory of damages (*i.e.*, the amount that Vista would have paid per share in an uncorrupted process). Based on "internal Vista bets" about where the deal price would land, the court rejected plaintiffs' claim that Vista would have paid $40.00 per share (the high-end of Vista's internally approved price range), and found that it would have paid $37.50, or $1.00 more than the deal price, per share. The court awarded $1.00 per share in damages.

Disclosure Claims

The court next analyzed plaintiffs' disclosure claims as an independent ground for liability. The court found that Stollmeyer was in a "unique position of informational asymmetry" because he was the only person at the company who knew the full nature of his interactions with Vista. The court found that Stollmeyer knowingly withheld information from the stockholders and created a false narrative about his interactions with Vista. The court observed that perhaps one of the disclosure issues, standing alone, would not meet the required materiality standard, but taken together, the partial and complete omissions rendered the proxy statement materially misleading.

The court awarded "nominal" damages because plaintiffs made no attempt to prove the reliance and causation elements required for the compensatory damages they sought. However, the court stated that nominal damages "need not be minimal," and acknowledged its equitable discretion when there is an "obvious wrong" and no "mathematical basis for deriving a damages figure." Using this discretion, the court examined prior case law and awarded $1.00 per share in damages, overlapping with the damages awarded under the process claim.

Aiding and Abetting Claim Against the Buyer

Plaintiffs advanced two theories for aiding and abetting liability against Vista. First, plaintiffs alleged that Vista aided and abetted Stollmeyer's sale process breaches. The court rejected this argument as untimely because plaintiffs waited almost three years to specifically identify the claim and only expressly argued it for the first time after trial.

Second, plaintiffs alleged that Vista aided and abetted Stollmeyer's disclosure violations. The court centered its analysis on whether Vista "knowingly participated" in Stollmeyer's violations. For knowledge, the court found that Vista knew the extent and content of its pre-merger interactions with Stollmeyer and knew they were not fully disclosed in the proxy statement. The court found the required participation in Vista's "contractual obligation … to correct any material omissions" in the proxy statement. Thus, the court determined that Vista knowingly participated in the breach by not speaking up when contractually required to do so. The court imposed joint and several liability on Vista for the $1.00 per share in damages.

Key Points

- Delaware courts expect officers to act under the direction of the board and to keep the board informed of their actions and motivations. Both sides of the director-officer relationship need to be mindful of the expectations of Delaware law when it comes to oversight and disclosure at the board level. This includes the obligation of officers to inform directors of early-stage communications with potential acquirors and any potential conflicts.
- Directors have an obligation under Delaware law to disclose material information to stockholders in advance of a stockholder vote. In the merger context, most post-closing stockholder class actions seeking money damages in the Delaware courts include disclosure claims, at a time when the company cannot supplement or correct disclosures. As a result, it is vital for corporate fiduciaries to make judgment calls about what disclosures should be made well in advance of any litigation being filed.
- The *Mindbody* decision suggests that a successful post-trial disclosure claim will require a remedy, even if it is just a "nominal" damages award. In *Mindbody*, that nominal figure was $1 per share, or about $46 million total, based on the outstanding number of shares at issue, excluding shares held by the CEO. Whether or not that becomes a default "nominal" figure in future cases with post-closing disclosure violations remains to be seen.
- In *Mindbody*, the acquiror was jointly and severally liable for the officer's disclosure-related fiduciary duty breach in part because of language in the merger agreement that obligated it to notify seller if it became aware that any disclosures were materially misleading or incomplete. Acquirors should carefully review and understand their obligations under the respective merger agreement, and consider their contractual obligations with their advisors when reviewing merger-related disclosures.

Premium on Preservation: Recent Delaware Rulings Underscore the Importance of Preserving Documents

Contributors

Gregory P. Ranzini / Associate

TJ Rivera / Associate

> See page 15 for key points

Document discovery plays an essential role in litigation. Litigants and courts rely on documentary exhibits, along with witness testimony about such exhibits, to create a trial record. As a result, courts expect that parties will take reasonable steps to preserve documents. When they fail to do so, heated disputes over spoliation can arise. In some egregious cases, these spoliation fights can grow to overshadow the substantive issues in the case, or even influence or dictate the outcome.

Two recent Delaware opinions address the types of sanctions that are potentially available under Delaware law for spoliation of evidence, and when they will be imposed.

- In ***Harris v. Harris***, the Court of Chancery for the first time imposed an adverse inference at the motion to dismiss stage and held that it could do so without treating the inference as a formal discovery sanction under Rule 37.
- In ***BDO USA, LLP v. EverGlade Global, Inc.***, Chancellor Kathaleen St. J. McCormick of the Delaware Court of Chancery, sitting by designation as a Delaware Superior Court judge, granted default judgment as a discovery sanction under a theory of *respondeat superior*.

These cases serve as reminders for Delaware litigants and practitioners alike that document discovery is not just a formality to observe on the way to the "real" litigation. Rather, the courts take discovery conduct seriously and will not hesitate to grant relief when the interests of justice so require.

Spoliation Sanctions

In general, a party in litigation or who has reason to anticipate litigation has an affirmative duty to preserve evidence that might be relevant in the lawsuit.[17] Spoliation in this context means the destruction, or failure to take steps to prevent the destruction, of potentially relevant evidence.

Sanctions against spoliating parties may include:

- Adverse inferences.
- Case dismissal.
- Default judgment.
- Fee-shifting.[18]

Before imposing discovery sanctions for spoliation, the court must make a predicate, evidence-based finding of intentional or reckless destruction of evidence "to deprive another party of the information's use in the litigation."

Harris v. Harris

Harris v. Harris involved a complicated and protracted dispute over control of a closely held family company, in which the defendants allegedly looted the company and then successively redomiciled it from New Jersey to Delaware and then back to New Jersey, in an apparent effort to evade causes of action under New Jersey law and to frustrate books and records demands under Delaware law.

[17] *See BDO USA, LLP v. EverGlade Glob., Inc.*, C.A. No. N22C-12-063 KSM CCLD, slip op. at 21 (Del. Super. Jan. 31, 2023) (citing *Beard Rsch., Inc. v. Kates*, 981 A.2d 1175, 1185 (Del. Ch. 2009)); *see also Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 216 (S.D.N.Y. 2003).

[18] *See* Del. Super. Ct. Civ. R. 37(b)(2)(F).

During this period, the defendants made a practice of deleting their text messages — with at least one defendant later admitting that she did so to prevent them from being produced in discovery. The defendants moved to dismiss for lack of personal jurisdiction under Court of Chancery Rule 12(b)(2), arguing that the court did not have jurisdiction over their actions as fiduciaries of a New Jersey corporation.[19]

A plaintiff's burden of showing personal jurisdiction is "an evidentiary burden, not a pleading burden," and courts can order jurisdictional discovery into a defendant's contacts with Delaware. Here, text messages between the parties might have shed light on whether the defendants purposely availed themselves of the benefits of Delaware law. But the defendants deleted those messages, raising an as-then-unsettled question: If jurisdictional discovery would be frustrated by spoliation, may an adverse inference be drawn at the motion to dismiss stage? The court answered this question in the affirmative.

The court found that plaintiffs had presented sufficient evidence of spoliation that the court could draw an adverse inference that it had personal jurisdiction over the plaintiffs' claims against two of the defendants. The court pointed to "extensive allegations" in the complaint that "ma[d]e it reasonable to infer that [these defendants] were sufficiently involved in the [transaction at issue] to support service of process under the Long-Arm Statute," including unusual transfers of company funds to these defendants, and close business and personal ties to the other defendants.

"At a minimum," these allegations would have supported jurisdictional discovery. However, because these defendants spoliated evidence bearing on their involvement in the transaction — including by deleting approximately 70,000 text messages — requiring the plaintiffs to pursue further jurisdictional discovery was "unwarranted," and the plaintiffs were entitled to "a pleading-stage inference that [these defendants] were part of a conspiracy to engage in Delaware-directed acts sufficient to support personal jurisdiction."

This was not, the court stressed, a discovery sanction under Rule 37. Therefore, the court held that it could draw this inference without making the preliminary evidentiary finding of spoliation required by that rule, because "the adverse inference only pertains to whether the plaintiffs have established a *prima facie* case for the exercise of personal jurisdiction at the pleading stage."

Recognizing that referring to this as an "adverse inference" when it was not granted as a discovery sanction could be "confusing," the court explained that its decision should be understood as "simply engaging in the normal practice of drawing a reasonable inference based on the non-conclusory factual allegations in a verified complaint and the other evidence of record that a court can consider for purposes of a Rule 12(b)(2) motion."

BDO USA, LLP v. EverGlade Global, Inc.

BDO v. EverGlade pitted consulting firm BDO USA, LLP against an upstart rival, EverGlade Global, Inc., that a former BDO partner, Eric Jia-Sobota, founded prior to his departure from the firm.

BDO initially brought arbitration and a related action for injunctive relief in the U.S. District Court for the District of Columbia against EverGlade and Mr. Jia-Sobota, alleging a breach of the BDO partnership agreement. BDO subsequently "became the target of a social media smear campaign" that, at least in part, "appeared to draw on information obtained by Jia-Sobota when he was a BDO partner." BDO sued EverGlade in the Delaware Court of Chancery in connection with the smear campaign.

In response, EverGlade initiated an internal investigation. According to the court, Mr. Jia-Sobota took steps to stymie this investigation, denying EverGlade's discovery vendor access to certain online accounts and scrubbing documents from his work laptop, phone and other devices. Over the course of about seven months, "Jia-Sobota destroyed an enormous amount of evidence."

[19] *See Harris v. Harris*, C.A. No. 2019-0736-JTL (Del. Ch. Jan. 16, 2023).

When court-ordered discovery revealed Mr. Jia-Sobota's misconduct, BDO moved for sanctions against EverGlade, including default judgment. In a last-ditch effort to avoid consequences for the spoliation, EverGlade moved to dismiss the case for lack of subject matter jurisdiction. Chancellor McCormick, concerned about overextending equitable authority over a claim involving speech, requested designation as a Delaware Superior Court judge to continue hearing the case.

The court then held a two-day evidentiary hearing to evaluate EverGlade's role in the spoliation. EverGlade admitted that Mr. Jia-Sobota had engaged in spoliation but sought to distance itself from its own CEO, arguing that his actions as a nonparty should not be attributed to the company. BDO and EverGlade agreed that the court should analyze the issue under the standard of *respondeat superior*, or vicarious liability. However, EverGlade argued that because "administering social media campaigns" was not within Mr. Jia-Sobota's scope of employment, EverGlade could not be held vicariously liable either for the alleged smear campaign itself or for Mr. Jia-Sobota's efforts to destroy evidence about it.

In an opinion issued after the evidentiary hearing, Chancellor McCormick brushed aside EverGlade's arguments, applied *respondeat superior* and concluded that Mr. Jia-Sobota spoliated evidence within the scope of his employment. The court found that the relevant "act" for the spoliation analysis was not "Jia-Sobota's management of EverGlade's social media presence," but rather Mr. Jia-Sobota's discovery conduct, holding that "the analysis more logically centers on the employee's obligation with respect to the litigation, including the obligation to manage and preserve evidence."

BDO satisfied all three parts of the "scope of employment" test for *respondeat superior*.

- First, Mr. Jia-Sobota's destruction of evidence was an act "of the kind he is employed to perform" because, as an employee, he was responsible for preserving evidence.
- Second, Mr. Jia-Sobota's acts "occur[red] within the authorized time and space limits" because he used EverGlade computers to destroy the evidence and did so from his home office while working at home.
- Third, Mr. Jia-Sobota's acts were "activated, in part at least, by a purpose to serve the master," because he acted "to shield EverGlade and himself from having their roles in the campaign uncovered" — even if his primary motivation was to benefit himself.

The court also noted "the basic policy consideration that corporations might otherwise escape accountability for egregious actions were they off the hook when their CEOs destroy evidence to frustrate an opposing party's case."

The court then turned to BDO's request for a default judgment. BDO's sanctions motion came early in the litigation, with discovery and Rule 12 motions practice ongoing. Still, the rules allow for dispositive relief as a discovery sanction. Under Rule 37(b), the Superior Court may grant default judgment upon a finding of reckless or intentional spoliation, and only when "no other sanction would be more appropriate under the circumstances."

Here, the court found that Mr. Jia-Sobota destroyed an enormous amount of evidence using multiple methods. For example, he factory-reset devices to remove all user data and used a program called CCleaner to destroy the files in his work laptop. When confronted about this, Mr. Jia-Sobota first insisted that he did not remember destroying evidence before recanting that testimony and claiming, unconvincingly, "that he destroyed evidence out of fear that BDO would do something to him if BDO acquired evidence of the smear campaign."

For its part, EverGlade admitted that the spoliation was intentional, but it argued that the court should grant, at most, adverse inferences, because the spoliation had not denied BDO evidence related to certain elements of its claim (such as whether the campaign was defamatory). The court rejected this argument and granted default judgment in favor of BDO, holding that "sanctions serve more than remedial purposes — they also punish and deter," and finding that "[i]f punishment is appropriate anywhere, it is here."

Key Points

- Delaware courts continue to enforce the duty of parties and counsel in Delaware litigation to preserve evidence and to participate in discovery in good faith. As a result, it is important to consider preservation obligations when litigation is anticipated and commenced, and good practice to take steps to monitor preservations efforts as the litigation proceeds.
- The *BDO* decision explains that preserving documents for discovery may be within the scope of employment for an employee of a Delaware corporation who possesses responsive documents. Therefore, a corporation should be mindful to take appropriate steps to ensure that its employees comply with preservation efforts.
- Delaware courts have wide discretion for imposing sanctions for spoliation. Among other things, Delaware courts may draw adverse inferences on threshold questions such as personal jurisdiction. Spoliation of evidence can therefore have the potential to create complications from the very outset of a case, underscoring the need to focus on preservation.

Contacts

Litigation

Cliff C. Gardner
302.651.3260
cgardner@skadden.com

Paul J. Lockwood
302.651.3210
paul.lockwood@skadden.com

Edward B. Micheletti*
302.651.3220
edward.micheletti@skadden.com

Jenness E. Parker
302.651.3183
jenness.parker@skadden.com

Jennifer C. Voss
302.651.3230
jennifer.voss@skadden.com

Mergers & Acquisitions

Faiz Ahmad
302.651.3045
faiz.ahmad@skadden.com

Steven J. Daniels
302.651.3240
steven.daniels@skadden.com

Allison L. Land
302.651.3180
allison.land@skadden.com

Richard H. West
302.651.3178
richard.west@skadden.com

Corporate Restructuring

Joseph O. Larkin
302.651.3124
joseph.larkin@skadden.com

Carl Tullson
302.651.3180
carl.tullson@skadden.com

*Editor

Special thanks to **Stephen F. Arcano** and **Richard J. Grossman**.

One Rodney Square / 920 N. King St. / Wilmington, Delaware 19801 / 302.651.3000

One Manhattan West / New York, NY 10001 / 212.735.3000