DELAWARE CORPORATE LAW AND LITIGATION:
WHAT HAPPENED IN 2015 AND WHAT IT MEANS FOR YOU IN 2016

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Delaware has long been known as the corporate capital of the world, and it is now the state of incorporation for 66 percent of the Fortune 500 and more than half of all companies whose securities trade on the NYSE, Nasdaq and other exchanges. Each year, the Delaware courts issue a number of significant opinions having tremendous importance to businesses, those who manage them and those who counsel them. Many of those recent cases are discussed in this Annual Update, which is intended to provide sufficient detail so as to be helpful to in-house counsel, but is also written in a way so that the often-long and complex Delaware decisions can be easily understood by directors and other fiduciaries. Takeaway observations are also provided. This Annual Update may help you focus on the right issues, ask the right questions and, along the way, protect yourself and your company.

Delaware's preeminence in business law starts with its corporate code (the Delaware General Corporation Law or DGCL) and alternative entity statutes, which are continuously reviewed and enhanced with innovations designed to meet the expanding needs of corporate and financial America. The Delaware Court of Chancery and the Delaware Supreme Court have helped the state maintain its preeminence by striking a balance in the application of these laws between entrepreneurial risk-taking by management and the right of investors to demand that management put the best interests of the corporation about all others.

Delaware's courts are now the most popular and preeminent venues in the United States for resolving business disputes and challenges to actions by boards of directors, such as breach of fiduciary duty claims, merger and acquisition litigation and virtually any issue implicating corporate governance and compliance with Delaware's business laws. In fact, for more than ten years, an annual assessment conducted by the United States Chamber of Commerce has ranked Delaware first among the court systems in all 50 states, noting the Delaware courts' fairness and reasonableness, competence, impartiality and timeliness in resolving disputes. Year after year, decisions from the Delaware courts demonstrate that its judges are neither stockholder nor management biased. Indeed, Delaware's guiding principles remain: strict adherence to fiduciary duties; prompt enforcement of articles of incorporation, bylaws and merger agreements; and the maximization of stockholder value.

The Business Judgment Rule – a rule that prevents judges from second-guessing the decisions of directors who reasonably inform themselves of important information before making decisions, who are free of economic or other disabling conflicts of interest, and whose only agenda is that of advancing the best interests of the corporation – remains alive and well in Delaware. While the facts and legal analyses confronting directors are usually complex, so long as independent directors can articulate why, in their best judgment, they acted as they did and why they believed those actions were in the best interests of the corporation, the Delaware courts will typically respect their decisions.

In addition to an annual review of Delaware law developments, DLA Piper also publishes an easy-to-read guide titled “Avoiding Personal Liability as a Director,” which is available at dlapiper.com.

Henry duPont Ridgely and John L. Reed
Justice Henry duPont Ridgely, who retired on January 31, 2015 from the Delaware Supreme Court, joined DLA Piper effective March 16, 2015. He is a member of the firm’s Corporate and Litigation practices, based in the Wilmington, Delaware office.

Justice Ridgely has a distinguished record of more than 30 years of service on the Delaware bench. Before his tenure of more than a decade on the Delaware Supreme Court, Justice Ridgely was a judge on Delaware’s Superior Court for 20 years, including 14 years as President Judge with a full caseload and statewide responsibility for the court’s budget and personnel. During that period, the Delaware courts earned a number one ranking from the United States Chamber of Commerce, which Delaware has maintained for more than ten years.

While on the Delaware Supreme Court, Justice Ridgely participated in more than 700 published opinions, including every major decision issued during his tenure involving directors’ and officers’ liability, merger and acquisition disputes, contests for corporate control, and other issues impacting corporate law and governance.

Justice Ridgely’s knowledge and experience are a tremendous asset for DLA Piper’s corporate clients and lawyers. With 66 percent of the Fortune 500 and half of all public companies incorporated in Delaware, he has played a significant role in shaping the country’s corporate law. During 2015, Justice Ridgely was selected to be an Advisor to the American Bar Association’s Business Law Section.

At DLA Piper, Justice Ridgely’s practice focuses on advising corporations, boards, special committees and individual directors and officers on transaction structure, fiduciary duties, and managing and defending litigation at the trial and appellate level. He is also available to act as a mediator, arbitrator or independent monitor.

Justice Ridgely has received numerous honors and awards and, in 2015, was presented with the Order of the First State, which is the highest recognition awarded by the Governor of Delaware. He is a Member of the American Law Institute and is a Life Fellow of the American Bar Foundation. From 2008 until 2014, he represented the Appellate Judges Conference (which includes federal circuit judges and state supreme court justices from across the nation) in the American Bar Association’s House of Delegates. He also served as the Judicial Advisor to the ABA’s Business Law Section and as a Member of the American Inns of Court Leadership Council. He has served as a Trustee of the American Inns of Court Foundation and as a Director of the American Judicature Society.

In addition to his judicial activities, Justice Ridgely has authored law review articles and has participated in national and international panels for legal and policy organizations such as the ABA, Practicing Law Institute, the Tulane Corporate Law Institute and the Weinberg Center for Corporate Governance. He has also lectured throughout the world on corporate law topics. In addition, he taught as an Adjunct Professor of Law at George Washington University Law School and serves on the law school’s Business and Finance Law Advisory Board. Justice Ridgely’s community service includes his present service as a Trustee and Vice President of the Biggs Museum of American Art and a Trustee of St. Andrew’s School.

Justice Ridgely received his B.S. in Business Administration from Syracuse University in 1971, his J.D. from The Catholic University of America Columbus School of Law in 1973, and his LL.M. in Corporation Law from George Washington University Law School in 1974. He was awarded an Honorary Doctor of Laws by Widener University School of Law in 2010.
EXCUSLATORY CHARTER PROVISIONS CAN BE USED TO OBTAIN EARLY DISMISSAL OF STOCKHOLDER LAWSUITS

Section 102(b)(7) of the DGCL permits Delaware corporations to adopt a charter provision exculpating directors from monetary damages for breach of the fiduciary duty of care. In a decision jointly resolving two appeals — In re Cornerstone Therapeutics Inc. Stockholder Litigation and Leal v. Meeks, 115 A.3d 1173 (Del. 2015) — the Delaware Supreme Court clarified seemingly conflicting Delaware case law on when a Section 102(b)(7) provision can be asserted. The decision sought to answer this question: in an action seeking damages against corporate fiduciaries for entering into an interested transaction that is “presumptively subject to entire fairness review, must the plaintiff plead a non-exculpated claim against the disinterested, independent directors to survive a motion to dismiss by those directors?”

In answering the question presented, the Supreme Court announced a new bright-line rule: “A plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board’s conduct — be it Revlon, Unocal, the entire fairness standard, or the business judgment rule.”

Background: Two Appeals With Similar Factual Scenarios

The two appeals involved mostly the same basic factual scenarios. Both were stockholder actions seeking damages based on mergers accomplished with controlling stockholders, which had representatives on the board, and which acquired all the remaining shares in the company that they did not own. In addition, the mergers were “negotiated by special committees of independent directors, were ultimately approved by a majority of the minority stockholders, and were [closed] at substantial premiums to the pre-announcement market price.”

Because in both instances the controlling stockholder did not avail itself of the going-private transaction safe harbor announced last year by the Supreme Court in Kahn v. M&F Worldwide Corp.,
Under that standard, the defendant directors and controlling stockholder bear the burden of proving that the transaction was accomplished through a fair process and was completed at a fair price.

The charters of both companies contained a provision modeled after Section 102(b)(7) of the DGCL. The Court of Chancery denied the defendants’ motions to dismiss because it read the precedent of the Supreme Court as requiring, notwithstanding a 102(b)(7) provision in the company’s charter, that if “the underlying transaction was subject to the entire fairness standard of review, and the plaintiffs were therefore able to state non-exculpated claims against the interested parties and their affiliates, all of the directors were required to remain defendants until the end of the litigation.”

The Competing Arguments

The independent directors relied on a 2001 decision from the Supreme Court in Malpiede v. Townson, 780 A.2d 1075 (Del. 2001), which held that in a challenge to the sale of a company governed by Revlon obligations, plaintiffs seeking damages against independent directors who are protected by a Section 102(b)(7) charter provision must plead non-exculpated claims (e.g., claims that the directors acted disloyally or in bad faith) against each director, or face dismissal. The independent directors contended that this rule should govern here as well, notwithstanding that the underlying transaction was subject to the entire fairness standard of review applicable to interested transactions.

In arguing the opposite, plaintiffs relied heavily on a series of Supreme Court decisions issued from 1999 to 2001 in Emerald Partners v. Berlin, 726 A.2d 1215 (Del. 1999) & 787 A.2d 85 (Del. 2001), and in particular pointed to the following language from the most recent holding in that case: “When entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying money damages can be made only after the basis for their liability has been decided [on a fully-developed record].”

On this basis, the plaintiffs argued that they were entitled to an “automatic inference that a director facilitating an interested transaction is disloyal because the possibility of conflicted loyalties is heightened in controller transactions, and the facts that give rise to a duty of loyalty breach may be unknowable at the pleading stage.” Thus, in the plaintiffs’ view, the sufficiency of any asserted loyalty or bad faith claim need not be addressed, and therefore the effect of a 102(b)(7) charter provision is irrelevant at a motion to dismiss stage where the underlying transaction is subject to entire fairness review.

The Court Resolves Any Perceived Conflict In Delaware Law And Announces A Clear Rule

As an initial matter, the Supreme Court rejected the plaintiffs’ suggested inference, noting that settled Delaware law demands that each director has a right to be “considered individually when the directors face claims for damages in a suit challenging board action,” which inquiry [generally] begins with “presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation.” These presumptions operate even when a director serves on the board with a controlling stockholder, or where the controlling stockholder itself is “subject to liability for breach of the duty of loyalty if the transaction was not entirely fair to the minority stockholders.”

As to the apparent conflict between Malpiede and Emerald Partners, the Court explained that the conflict, although reasonably divined in the Court below and among the parties, was false because the plaintiffs in Emerald Partners had pled non-exculpated claims that were “intertwined” with the duty of care claims; thus, the invocation of the 102(b)(7) provision was premature. For example, the plaintiffs alleged that (1) the affiliated directors improperly had participated in deliberations of the independent directors, (2) the controlling director(stockholder) improperly had communicated with the investment advisor and, and (3) the independent directors (i) failed to negotiate an exchange ratio, (ii) disregarded the committed process and (iii) failed to seek an updated fairness opinion. The Court cautioned that the Emerald Partners decisions must be cabined to the facts of that case and not be read so broadly.

The Court then announced the following clear rule regarding a plaintiff’s pleading obligations:

When a director is protected by an exculpatory charter provision, a plaintiff can survive a motion to dismiss by that director defendant by pleading facts supporting a rational inference that the director harbored self-interest adverse to the stockholders’ interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith. But the mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness standard to the transaction, and can thus state a duty of loyalty claim against the interested fiduciaries, does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each director who moves for dismissal.

After clarifying the law, the Court remanded both cases “to determine if the plaintiffs have sufficiently pled non-exculpatory claims against the independent directors.”
Public Policies Underlying The Court’s Decision

The Court listed several policy-based reasons for its rule:

■ “Adopting the plaintiffs’ approach . . . would likely create more harm than benefit for minority stockholders in practice.”

■ “For more than a generation, [Delaware] law has recognized that the negotiating efforts of independent directors can help to secure transactions with controlling stockholders that are favorable to the minority.”

■ “[R]espected scholars have found evidence that interested transactions subject to special committee approval are often priced on terms that are attractive to minority stockholders.”

■ Plaintiffs’ suggested rule “would create incentives for independent directors to avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders would cause them to remain as defendants until the end of any litigation challenging the transaction.”

■ Plaintiffs’ suggested rule “might also provide incentives for a controlling stockholder to proceed by means of a tender offer to the minority stockholders, and thus potentially avoid the need to actively negotiate with a special committee.”

■ “Establishing a rule that all directors must remain as parties in litigation involving a transaction with a controlling stockholder would thus reduce the benefits that the General Assembly anticipated in adopting Section 102(b)(7).” namely “that directors would not be willing to make decisions that would benefit stockholders if they faced personal liability for making them.”

Takeaways:

■ This decision greatly enhances the effectiveness of charter provisions modeled after Section 102(b)(7) of the DGCL. It is now clear that the sufficiency of the plaintiff’s loyalty or bad faith claims, to the extent they are asserted, must be addressed on a motion to dismiss. If they cannot independently survive a motion to dismiss, and the independent directors in issue are protected by Section 102(b)(7) charter provisions, then those directors should be dismissed from the case, notwithstanding the presence of the controlling stockholder or affiliate directors in the case.

■ The Court’s decision does not displace or alter the rule that “[i]nterested fiduciaries, often the proverbial deep-pocketed defendants, will continue to be required to prove that the transaction was entirely fair to the minority stockholders, because the plaintiffs’ well-pled claims against the interested parties in a controller transaction cannot be dismissed before trial, regardless of whether the independent directors remain as defendants.”

■ The Court noted that “if plaintiffs do not have sufficient evidence to plead non-exculpated claims against the independent directors at the pleading stage, they may bring such claims later. Because most transactions are brought immediately after – or even before – the announcement of the challenged, but still typically unconsummated, transaction, plaintiffs will usually have ample time to bring well-pled claims that the independent directors breached their duty of loyalty within the three-year statute of limitations period.”
CREDITORS CAN ASSERT DERIVATIVE CLAIMS AGAINST DIRECTORS FOR BREACH OF FIDUCIARY DUTY

In Quadrant Structured Products Co. v. Vertin, 115 A.3d 535 (Del. Ch. 2015), the Court of Chancery announced a bright-line standard governing the threshold inquiry of when a creditor can maintain a derivative suit against directors for breach of fiduciary duty. The Court held that a creditor need only establish that the company was balance sheet insolvent at the time the suit was filed and that the creditor’s standing will not be extinguished if the company rides back into solvency during the litigation.

The opinion is perhaps more important, however, for its comprehensive historical review of Delaware law on the relationship between creditors and a board of directors. There has been so much confusion in this area that the opinion is a “must read.” What you think you know may be wrong — and questions remain.

Background

Athilon Capital Corporation sells credit protection to large financial institutions and its subsidiary writes credit default swaps on collateralized debt obligations. After formation, the company secured $700 million in financing ($600 million of which was debt, in the form of notes of variously tiered preferences, all of which would mature in the year 2035 or after) and, on that basis, had guaranteed more than $50 billion in credit default swaps. After the financial crisis struck, Athilon’s GAAP financial statements showed a net worth of negative $513 million in 2010 and it suffered substantial downgrades of its securities.

Noting the opportunity, EBF & Associates, L.P. acquired a substantial number of Athilon’s notes at fire sale rates (e.g., par value of $149.7 million for $37 million). EBF later acquired all of Athilon’s equity and reconstituted the board to two EBF executives, the CEO of Athilon and two independent directors (one of whom was a former EBF employee).

Quadrant, an Athilon creditor, filed a derivative action in the Court of Chancery in October 2011, asserting numerous claims, including a derivative claim that the board breached its fiduciary duties by making interest payments on the junior subordinated notes owned by EBF. Quadrant also had alleged the Athilon
Delaware courts have applied the following rules:

Gheewalla essentially eliminated these principles. After Gheewalla, creditors could enforce a derivative action is extinguished upon the company becoming solvent again. Second, they contended that to be successful, Quadrant must establish, in addition to balance sheet insolvency, that Athilon had no reasonable prospect of returning to solvency, i.e., that the Company was “irretrievable insolvent.”

**Myths Debunked; Current State of the Law Explained**

Before addressing the defendants’ arguments, the Court reviewed in detail the modern evolution in Delaware law concerning whether and what fiduciary duties directors owe to the company’s creditors and, therefore, when and under what circumstances creditors could enforce those duties. The Court noted that the apex of this area of the law was the Delaware Supreme Court’s decision in *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). Specifically, before *Gheewalla*, the following was believed to be true:

- “The fiduciary duties owed by directors extended to creditors when the corporation entered the vicinity of insolvency.”
- “Creditors could enforce the fiduciary duties that directors owed them through a direct action for breach of fiduciary duty.”
- “Under the trust fund doctrine, the directors’ fiduciary duties to creditors included an obligation to manage the corporation conservatively as a trust fund for the creditors’ benefit.”
- “Because directors owed fiduciary duties both to creditors and stockholders, directors faced an inherent conflict of interest and would bear the burden of demonstrating that their decisions were entirely fair.”
- “Directors could be held liable for continuing to operate an insolvent entity incurring greater losses for creditors under a theory known as ‘deepening insolvency.’”

*Gheewalla* essentially eliminated these principles. After *Gheewalla*, Delaware courts have applied the following rules:

- “There is no legally recognized ‘zone of insolvency’ with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.”
- “Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty.”

- “The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm’s value.”
- “Directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties.”
- “Delaware does not recognize the theory of ‘deepening insolvency.’ Directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors.”
- “When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stack, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders. Just as in a solvent corporation, common stock ownership standing alone does not give rise to a conflict of interest. The business judgment rule protects decisions that affect participants in the capital structure in accordance with the priority of their claims.”

**Creditors Maintain Standing Despite a Corporation’s Return to Solvency**

The Court held that when a corporation becomes insolvent, “the creditors replace the stockholders as the equitable owners of the firm’s assets and the initial [residual] beneficiaries of any increases in value.” Thus, “[i]n the corporation’s insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.”

With these principles in mind, the Court rejected the Defendants’ assertion that creditors should be subject to a continuous insolvency requirement and held that a creditor retains standing to sue derivatively on behalf of an insolvent company for so long as it remains a creditor of the company. Just like the continuous ownership rule applicable to stockholder plaintiffs, this is a bright-line test because a creditor either owns a company debt or it does not. The Court noted that, “whether the corporation is solvent or insolvent is not a bright-line inquiry” because “a troubled firm could move back and forth across the insolvency line such that a continuing insolvency requirement would cause creditor standing to arise, disappear, and reappear again.” This, the Court noted, could result in a “failure of justice.”
The Court also addressed a practical consequence of its ruling: that during the course of the same litigation, both stockholders and creditors could gain standing to sue on behalf of the corporation. Creditors (whether senior or junior) and stockholders often will have competing theories as to how aggressive a board’s business strategy should have been. Thus, if both bring derivative claims simultaneously, the Court is left with multiple adverse plaintiffs. However, the Court observed that, post-Gheewalla, Delaware courts have applied the business judgment rule to directors of “solvent, barely solvent, and insolvent corporations” alike. Because that standard applies across the board, the Court can adequately referee the competing theories that might be asserted by creditors and stockholders in a given case.

**Irretrievable Insolvency is Not the Standard**

The “irretrievably insolvent” standard derives from the Court’s exercise of discretion in appointing a receiver. Specifically, Delaware courts will not appoint a receiver unless there is “no reasonably prospect that the business can be continued,” because such appointment is a “drastic act” that displaces the corporation’s board of directors. Here, the Court noted that neither Gheewalla nor other Delaware cases have eliminated the balance sheet test in favor of “irretrievable insolvency” in the context of a creditor derivative fiduciary duty claim.

**The Balance Sheet Test**

The Court then clarified the “balance sheet” test in the context of creditor-derivative claims. Specifically, the Court noted that Delaware courts have held on numerous occasions that the “balance sheet” test “is not a bright-line rule based on GAAP figures.” That is, keeping in mind that book value of assets often differ from market value, “a corporation is insolvent under that test when it has liabilities in excess of a reasonable market value of assets held.” This approach, the Court opined, “takes into account the realities of the business world in which corporations incur significant debt in order to seize business opportunities.”

The Court also noted that the continued application of the balance sheet test in this context will aid in maintaining consistency among the related legal doctrines relating to state law fraudulent transfer claims, the comparable Bankruptcy Code fraudulent transfer provisions and the “standard[s] for determining whether a Delaware corporation has a cause of action against its directors for declaring an improper dividend or improperly repurchasing stock,” all of which apply a similar form of the balance sheet insolvency test.

Applying the principles above, the Court denied the defendants’ motion for judgment in its favor. In October 2011, Athilon’s balance sheet showed a $300 million deficit in stockholders equity under GAAP. The Court noted that although these GAAP figures were not dispositive of insolvency, “[t]he deficit is sufficiently large to create an issue of fact.” Moreover, keeping in mind that a company is insolvent “[if the total debt discount] − i.e., the difference between the amount of its debt claims and the fair market value of those debts − is greater than the fair market value of its equity,” because the “total debt discount on three outstanding issues of Athilon notes it then held was $215.2 million, while the fair value of Athilon’s equity . . . was $45.5 million,” Quadrant had established that there remained a genuine issue that Athilon was insolvent. Ultimately, after a five day trial, the Court of Chancery rejected Quadrant’s claims including that Athilon was insolvent. *Quadrant Structured Products Co. v. Vertin*, 2015 WL 6157759 (Del. Ch. Oct. 20, 2015).

**Takeaways:**

- The Court reaffirmed the post-Gheewalla principle that the “transition point that effects [the] fiduciary duty analysis [in the context of the company’s creditors] is insolvency itself.”
- Solvency achieved during the course of a litigation will not ipso facto deprive a creditor plaintiff of its standing to prosecute derivative claims.
- The balance sheet insolvency test probably will apply as the threshold showing a creditor must establish to pursue derivative claims on behalf of an insolvent corporation.
- The balance sheet insolvency test is not a black-and-white test. That is, book value is not the only means of determining whether a company’s debts exceed its assets: the Court may assess an asset’s reasonable market value.
- An important question that remains post-Quadrant is, as a company slides in and out of insolvency, who actually speaks for the corporation? That is, as the company’s financial health moves along the spectrum, and considering that directors of distressed companies still are protected by the business judgment rule, whose interests trump whose and when? The Court recognized dual standing for stockholders and creditors, but whose interests or views should be given the greater weight when assessing the board’s “business judgment”?
- It also remains to be seen if the Delaware Supreme Court will uphold an extension of equitable standing that permits both creditors and stockholders to sue derivatively even when an insolvent corporation returns to solvency. In Schoon v. Smith, 953 A.2d 196, 208 fn. 46 (Del. 2008) the Delaware Supreme Court explained that “because Gheewalla merely substitutes creditors for shareholders” in the “limited setting” of insolvency, “it does not represent an extension or enlargement of the scope of the equitable standing doctrine.” The Court of Chancery’s decision in Quadrant does extend the equitable standing doctrine by recognizing dual standing for shareholders and creditors. Dual standing is different than one constituency being “substituted” for the other.
DELAWARE CONTINUES TO CLARIFY DIRECTORS’ DUTIES WHEN MANAGING THE SALE OF THE COMPANY

A Recap of 2014

In C&J Energy Services, Inc. v. City of Miami General Employees’ and Sanitation Employees’ Retirement Trust, 107 A.3d 1049 (Del. 2014), the Delaware Supreme Court reviewed what it labeled an “unusual preliminary injunction” and reversed an order of the Court of Chancery enjoining a business combination between C&J Energy Services and a division of Nabors Industries Ltd. In a November 24, 2014 bench ruling, the Court of Chancery (i) enjoined the C&J Energy stockholder vote to approve the merger for 30 days, (ii) mandated that C&J Energy shop itself during the 30-day period in contravention of the Merger Agreement between the parties, and (iii) declared, at the outset, that the solicitation of proposals pursuant to the imposed go-shop period would not constitute a breach of the no-shop clause and similar deal protection mechanisms in the Merger Agreement.

The Supreme Court, in an en banc panel that included Justice Ridgely, used the case as an opportunity to further clarify the Revlon standard of review, which derives from Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), a seminal decision in 1986 by the Supreme Court. There, the Revlon board decided to sell the company, and what followed was a bidding competition. The Revlon court held that a selling board is charged with maximizing the company’s value for the benefit of the stockholders when the company’s sale is inevitable. However, there is “no single blueprint” that must be adhered to in order to satisfy Revlon. The doctrine does not necessitate, among other things, that a selling board maintain the right to terminate an agreement in favor of a superior offer that later arises, engage in an active market check, or even accept the deal with the highest monetary value. Rather, once Revlon is triggered, the court reviewing the sales process will apply a heightened standard of review, reflecting narrowed judicial deference to the business decisions of the board. Revlon, accordingly, once triggered, requires only that the selling board act within a range-of-reasonableness under the circumstances, effectively obligating
the board to perform its fiduciary duties of care and loyalty with the objective of attaining the best sale price for the company realistically attainable through a wholesome sales process.

The Revlon standard of review has been continuously expanded upon. In 2009, the Supreme Court decided Lyondell Chemical Co. v. Ryan, 970 A.2d 235 (Del. 2009), which reinforced the principle that Revlon does not create new fiduciary duties for directors, but merely requires the board to perform its fiduciary responsibilities with the objective of maximizing the sale price of the enterprise once a sale is inevitable. As explained in C&J Energy, Revlon’s progeny has shown that a target company and its board of directors may be subjected to narrower judicial deference in at least five scenarios:

- **First**, as seen in Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994), the doctrine applies where a company commences an “active bidding process” with the goal of selling itself or reorganizing the business with a “clear break-up of the company.”
- **Second**, when a target company “abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company” as a response to a bidder’s advance.
- **Third**, where control of the company is transferred from unrelated stockholders to a controlling stockholder.
- **Fourth**, as in Revlon itself, a complete cashout of the target company’s stockholders, given that the stockholders will no longer maintain an interest in the target company, suggesting that their primary interest is maximized value.
- **Fifth**, when a board considers even a single offer, calling for the directorship to be adequately informed as to the deal price and the value of the company, while simultaneously engaging in an “effective” market check. However, only the board can put the company in play. As the Supreme Court articulated in Lyondell, the selling company and its board, in order to trigger Revlon, must “embark[] on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control.”

The Court of Chancery, in entering a preliminary injunction, determined that the C&J Energy board did not suffer from a conflict of interest and was fully informed as to the company’s value. Nonetheless, because the board failed to engage in an “active” market check and affirmatively shop C&J Energy pre-signing or post-signing, the court concluded that there was a “plausible” violation of the board’s Revlon duties, concurrently implying that Revlon required the C&J Energy board to possess an “impeccable knowledge of the value of the company that it is selling.”

The Court of Chancery decision was reversed on multiple grounds, but with respect to Revlon, the Supreme Court noted that there is “no specific route that a board must follow when fulfilling its fiduciary duties” upon entering Revlon-land. To the extent that the Court of Chancery mandated that the C&J Energy board “actively shop the company in order to satisfy Revlon, the Supreme Court said it did so incorrectly. C&J Energy thus reiterates that a board may “pursue the transaction that it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so.” Importantly, though, such market check merely needs to be “effective,” as opposed to “active.” In essence, an effective market check is one whereby “interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal.” Of course, the latitude and freedom of stockholders to accept or reject their board’s preferences must also be considered in determining the effectiveness and propriety of a market check.

**Corwin v. KKR Fin. Holdings LLC**

The Delaware Supreme Court’s 2015 decision in Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015), held that the approval of the merger by a fully informed, disinterested stockholder majority invoked the business judgment rule standard of review.

The appeal arose out of a purported class action by stockholders of KKR Financial Holdings LLC (the “Company”) challenging a stock-for-stock acquisition of the Company by KKR & Co. L.P. (“KKR”). The stockholder plaintiffs asserted that the entire fairness standard of review applied to the transaction as KKR was a controlling stockholder because the Company’s primary business was financing KKR’s leveraged buyout activities and the Company was managed by an affiliate of KKR under a management agreement.

In granting the defendants’ motion to dismiss pursuant to Rule 12(b)(6), the Court of Chancery held that plaintiffs’ allegations did not support a reasonable inference that KKR was a controlling stockholder of the Company. The Court of Chancery reasoned that KKR did not control the Company’s board of directors such that those directors could not freely exercise their judgment in determining whether to approve and recommend to the stockholders a merger with KKR. The Court also found that KKR owned less than one percent of the shares of the Company, had no right to appoint any directors, and had no contractual right to veto any board action. The Court of Chancery also held that, even if the majority of the Company’s board was not disinterested or independent, business judgment review...
still applied because the merger was approved by a majority of disinterested Company stockholders in a fully informed vote.

On appeal, the plaintiffs contended that the Court of Chancery erred in holding that KKR was not a controlling stockholder of the Company. The plaintiffs also contended that, even if the Court of Chancery were correct in determining that KKR was not a controlling stockholder, the Court should not have dismissed the complaint because they had adequately pled a claim under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In response, the defendants argued that plaintiffs’ Revlon argument had not been fairly raised in the Court of Chancery and that, in any event, the transaction was subject to the business judgment rule because it had been approved by a fully informed, uncoerced stockholder vote. The Supreme Court agreed with the defendants and affirmed the Court of Chancery’s dismissal of the complaint in its entirety.

The Supreme Court explained that the *Unocal* and *Revlon* standards were not designed for application in post-closing money damages cases and instead were “designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing.” The Court emphasized that *Unocal* and *Revlon* “were not tools designed with post-closing money damages claims in mind, the standards they articulate do not match the gross negligence standard for director due care liability.” Moreover, the doctrine articulated by the Court of Chancery is limited to situations involving fully informed, uncoerced stockholder votes, and it will not apply if material, troubling facts regarding director behavior are not disclosed to stockholders. When a transaction is not subject to the entire fairness standard of review, the “long-standing policy” of Delaware law “has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves.”

Finally, the Court rejected the plaintiffs’ contention that *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), required the Court of Chancery to give the informed stockholder vote no effect in determining the standard of review. The Court instead agreed with the Court of Chancery’s narrow interpretation of *Gantler* as a decision solely intended to clarify the meaning of the term “ratification” and not, as plaintiffs argued, on the question of what standard of review applies if a transaction not subject to the entire fairness standard is approved by a fully informed and voluntary vote of disinterested stockholders.

**Takeaways:**

- The C&J Energy case is a clarification, if not a reiteration, of what *Revlon* requires of boards when selling companies, namely: (a) *Revlon* created no fiduciary duties in excess of the duties of loyalty and care, but simply requires that such fiduciary obligations be performed with the objective of maximizing the sale price of the enterprise when the company is put up for sale; (b) there is no judicially prescribed set of actions required to satisfy the heightened standard of review; and (c) *Revlon* is triggered only in a narrow set of circumstances and not merely because the target company is involved in a change of control transaction. Consequently, passive, yet effective, post-signing market checks are sufficient to satisfy *Revlon*, provided that stockholders are free to participate in an uncoerced vote on the transaction, the board is adequately informed as to both the deal and its company’s value, and third-party bidders are posed only with reasonable obstacles in making a superior offer for the target company.

- While *Revlon*, and cases like *QVC* and *Lyondell*, shed light on some of the ways a selling board may trigger the heightened standard of review, directors at target companies must take care to conscientiously consider whether the sales process of their company requires that they exercise their fiduciary duties with the goal of maximizing the sale price of the enterprise, even if a conventional change of control transaction is not involved. Despite the holding in *C&J Energy*, the borders of *Revlon*-land remain movable and arguably unclear. Indeed, the Delaware Supreme Court did not engage in a *Revlon* review of the C&J Energy-Nabors transaction, but assumed “for the sake of analysis” that the doctrine was “invoked,” leaving largely unanswered the question of whether a deal departs from *Revlon*-land when contractual provisions dilute majority stockholder authority and grant the minority a right to share pro rata in any future sale of the company.

- *C&J Energy* also addresses the Court of Chancery’s role as a court of equity with broad discretion. Notwithstanding such latitude, it is inappropriate for the court to “blue-pencil” a contract and alter the rights of the parties to the merger agreement. Here, the Delaware Supreme Court noted that the Court of Chancery’s mandate that C&J Energy engage in a 30-day go-shop period and determination that such shopping would not constitute a breach of the Merger Agreement was not an appropriate exercise of equitable authority.
RISKS TO FINANCIAL ADVISORS FOR AIDING AND ABETTING BREACHES OF FIDUCIARY DUTY IN M&A TRANSACTIONS CONTINUE TO EVOLVE

All of our Annual Updates since 2012 have discussed the focus of plaintiffs’ attorneys on the roles of bankers in an effort to enjoin, or seek money damages from, otherwise independent third-party transactions. This year is no different.

The History

This new tactic gained traction in 2011 in In re Del Monte Foods Company Shareholders Litigation, 25 A.3d 813 (Del. Ch. 2011), when the Court of Chancery temporarily enjoined a premium merger transaction, finding a reasonable probability that the board of directors of Del Monte Foods Company breached its fiduciary duties in the course of selling the Company. The decision was driven, in large part, by conflicts of interest suffered by Del Monte’s financial advisor who, unbeknownst to Del Monte, approached its private equity clients to stir up interest in the Company. The financial advisor was then engaged to advise on the offers but never disclosed that it stirred up the interest and that it planned to provide buy-side financing. The bidders all signed a “no teaming” provision, but ultimately Del Monte did not accept any bids. Later, the financial advisor approached two bidders and advocated a joint effort, which violated the “no teaming” provision. This time, a deal was reached.

The Court found that the board’s decision to allow the joint bid was “unreasonable” because it eliminated Del Monte’s “best prospect for price competition.” The Court also found that it was “unreasonable” for the board to permit its financial advisor to provide buy-side financing at a time when no price had been agreed to and there was a “go-shop” process to run. The case settled for US$89.4 million, and the Court approved the settlement in December 2011, with Del Monte paying US$65.7 million and the financial advisor paying US$23.7 million. The Court awarded US$23.3 million in attorney’s fees.

In 2012, the Court of Chancery, in In re El Paso Corporation Shareholder Litigation, 41 A.3d 432 (Del. Ch. 2012), denied a
motion to enjoin a merger between El Paso Corporation and Kinder Morgan, Inc. However, the Court severely criticized the actions of El Paso’s management and its financial advisor. El Paso’s financial advisor owned approximately 19 percent of Kinder Morgan (valued at US$4 billion) and controlled two board seats. The conflicts were fully disclosed and a second financial advisor was brought in to handle the sale. Nonetheless, the first advisor continued as the lead advisor on a spinoff option and helped El Paso craft the second advisor’s engagement letter in a way that provided for a fee only if the company was sold as a whole.

While the Court ultimately concluded that, in the absence of a competing bid, the El Paso stockholders should have the opportunity to decide whether or not they like the price notwithstanding the conflicts, the Court went on to state that “[a]lthough an after-the-fact monetary damages claim against the defendants is not a perfect tool, it has some value as a remedial instrument, and the likely prospect of a damages trial is no doubt unpleasant ….” The case settled for US$110 million.

The outcomes in 2013 were different because the Court of Chancery’s opinion in In re Morton’s Restaurant Group Shareholders Litigation, 74 A.3d 656 (Del. Ch. 2013), demonstrated that a second financial advisor, when properly engaged and actively involved, can help to overcome a merger challenge based upon a primary financial advisor’s alleged lack of independence. The complaint alleged that Morton’s board of directors breached its fiduciary duties by acting in bad faith when it allowed the investment bank that ran the sales process to provide financing for the buyer after learning that the high bidder could not otherwise secure financing. The Court found this process did not create an inference of bad faith: “[t]he decision to let [the financial advisor] finance the high bidder’s deal while hiring a second advisor to provide unconflicting advice, rather than risk losing a bid at a high premium to market, does not create an inference of bad faith.”

Also in 2013, the Court of Chancery, in Miramar Firefighters Pension Fund v. AboveNet, Inc., 2013 WL 3995257 (Del. Ch. July 31, 2013), granted defendants’ motion to dismiss where the plaintiff failed to allege facts supporting an inference that the board knew of alleged deficiencies in the financial advisor’s analysis and where the board refused to allow the financial advisor to provide stapled financing to a potential acquiror and, in SEPTA v. Volgenau, 2013 WL 4009193 (Del. Ch. Aug. 5, 2013), aff’d, 91 A.3d 562 (Del.) (TAUF) dismissed a claim of advisor conflict based upon the allegation that a US$8.4 million fee paid only upon the completion of the deal. All things considered, bankers appeared to be turning things around in 2013, but then came 2014.

On March 7, 2014, the Court of Chancery issued its decision in In re Rural Metro Corporation Shareholders Litigation, 88 A.3d 54 (Del. Ch. 2014), holding RBC Capital Markets, LLC liable for aiding and abetting breaches of fiduciary duty by the board of directors of Rural/Metro Corporation in connection with Warburg Pincus LLC’s acquisition of Rural. The case proceeded to trial against RBC even though Rural’s directors, as well as a financial advisor serving in a secondary role, settled before trial. The Court’s 91-page opinion makes clear that when financial advisors step outside their roles as advisors, and take active steps to manipulate a company’s sale for their own self-interests, they risk incurring liability for aiding and abetting a breach of fiduciary duty.

Rural was a public corporation that provided ambulance and fire protection services. Rural had one national competitor, American Medical Response (“AMR”), a subsidiary of Emergency Medical Services Corporation (“EMS”). During the summer of 2010, Rural began looking at potential strategic alternatives and formed a Special Committee in August 2010, which considered three potential options: (1) continue to pursue the standalone business plan; (2) pursue a sale of the Company; or (3) pursue a business combination to take advantage of synergies available.

In December 2010, rumors circulated that EMS was pursuing strategic alternatives. RBC gave certain directors of Rural an overview of the EMS process and suggested Rural as a potential partner in the process. At the same time, RBC recognized that if Rural engaged in a sales process led by RBC, then RBC could use its position as sell-side advisor to secure buy-side roles with private equity firms bidding for EMS. In making its pitch to the Special Committee, however, RBC did not disclose that it planned to use its engagement as Rural’s financial advisor to secure financing work from the bidders for EMS. Counsel for the Special Committee advised of the potential conflict and, if RBC was selected, to be particularly vigilant about the integrity of the process and to consider appointing a second independent firm.

RBC was selected but ran a process that the Court found favored its own interest in gaining financing work by prioritizing bidders involved in the EMS process over those who were not. In addition to an M&A advisory fee of US$5.1 million, RBC hoped for staple financing fees of US$14-20 million for the Rural deal and US$14-35 million by financing a portion of any EMS deal.

When RBC began soliciting bids, it discovered that most larger firms were conflicted out due to non-disclosure agreements signed during the EMS process. Nevertheless, RBC pressed on, and received six indications of interest. The Special Committee, but not the full Board, met to discuss these results in February 2011. RBC gave a presentation that included no valuation metrics. One director asked for and was given an analysis of potential LBO returns, showing that at US$18 per share, an LBO would result in five-year internal rates of return exceeding 20%. This information was not shared with the other directors.

It was not until March 15, 2011, that Rural held another meeting of its full Board. RBC’s presentation again included no valuation metrics. The Board adopted a resolution granting the Special Committee authority to seek a purchase of RBC. At the same
time, RBC internally worked on securing a US$590 million staple financing package for Warburg, anticipating US$8-16 million in fees from this work.

Only Warburg offered a formal bid for Rural, at US$17.00 per share on March 22, 2011. After some negotiation, Warburg offered US$17.25 on March 25, saying that it was Warburg’s “best and final offer,” and that it expired on March 28. RBC spent March 26 attempting to get a piece of the financing for Warburg’s bid. RBC then submitted valuation materials to its internal fairness committee, but later tweaked the valuations in ways that made the offer more appealing. On March 27, 2011, the Board accepted Warburg’s US$17.25 offer. At 9:42 pm, the Board received Warburg’s valuation information — the first valuation information the Board ever received during this process. At 11:00 pm, the meeting began, and the Board approved the merger after midnight.

Plaintiff alleged that RBC aided and abetted breaches of duty both during the sales process and by inducing disclosure violations. With a fiduciary relationship between Rural’s Board and its stockholders readily established, the Court turned to whether there was a breach of fiduciary duty by Rural’s Board. The Court noted the Revlon standard of review applied, whereby directors must have “act[ed] reasonably to seek the transaction offering best value reasonably available to stockholders.” The Court therefore asked “whether the defendant directors employed a reasonable decision-making process and reached a reasonable result.”

Before turning to the merits of the sale process, the Court considered whether Rural Metro’s exculpatory charter provision — modeled after Section 102(b)(7) of the Delaware General Corporation Law (DGCL), which exculpates directors from liability for breaches of the fiduciary duty of care — precludes liability for aiding and abetting a breach of fiduciary duty. The Court held that the statute only covers directors for breach of fiduciary duty, not aids and abettors. Because Section 141(e) of the DGCL encourages directors to rely on advice from experts, the Court held there are “sound reasons” why the legislature might wish to exculpate directors, but not experts advising the Board.

The Court then considered whether several decisions of the Board fell outside the range of reasonableness. First, the Court held that the decision to run the sales process in parallel with the EMS auction fell outside the range of reasonableness because RBC did not disclose that a parallel process advanced RBC’s self-interest in gaining a role in the financing of bidders for EMC. RBC favored those bidders over others. Second, the Court held that the decision to continue the sales process fell within the range of reasonableness, despite the fact that the Special Committee received six indications of interests at substantial premiums, because multiple private equity sources recommended deferring sale. Third, the Court held that the Board decision to accept Warburg’s bid of US$17.25 per share fell outside the range of reasonableness because the Board failed to provide active and direct oversight of RBC: “When it approved the merger, the Board was unaware of RBC’s last minute efforts to solicit a buy-side financing role from Warburg, had not received any valuation information until three hours before the meeting to approve the deal, and did not know about RBC’s manipulation of its valuation metrics.”

Having established that certain decisions of the Board fell outside the range of reasonableness, thereby establishing a breach of fiduciary duty, the Court determined that RBC knowingly participated when it, for improper motives of its own, misled the directors into breaching their duty of care. The Court gave short shrift to RBC’s argument that its engagement letter with Rural, which contained a generalized acknowledgment that the financial advisors might extend acquisition financing to other firms, somehow insulated RBC from liability because the actual conflict was not disclosed. The Court held that RBC proximately caused the breach of fiduciary duty and harm to Rural “by causing the Company to be sold at a price below its fair value” and that “RBC’s self-interested manipulations caused the Rural process to unfold differently than it otherwise would have.”

For similar reasons, the Court held that RBC aided and abetted the Board’s breach of its fiduciary duty of disclosure by causing the Board to include inaccurate valuation materials in its Proxy Statement, and causing the Board to provide false and misleading statements about RBC’s incentives in the Proxy Statement.

In October 2014, the Court issued its opinion on damages in In re Rural/Metro Stockholders Litigation, 102 A.3d 205 (Del. Ch. 2014). The Court: (i) determined that Rural’s stockholders suffered US$91.3 million in damages from both director and financial advisor misconduct; (ii) allocated 83 percent of the damages (US$78.5 million) to RBC; and (iii) held that RBC’s liability could not be reduced to account for damages attributable to directors who settled prior to trial but who would have otherwise qualified for protection under Rural’s exculpatory provision. The opinion provides an extensive analysis of allocation of liability between directors and officers and those who may aid and abet a breach of fiduciary duty (like financial or other advisors) under Delaware’s Uniform Contribution Among Tortfeasors Law (DUCACTL), 10 Del. C. § 6301, et seq. The Rural Metro case was appealed and affirmed by the Delaware Supreme Court in late 2015. See RBC Capital Markets LLC v. Jervis, 2015 WL 7721882 (Del. Nov. 30, 2015), which is discussed below.

**The 2015 Cases**

On October 20, 2015, in Tibco Software Inc. Stockholders Litigation, the Court of Chancery denied a financial advisor’s motion to dismiss a claim of aiding and abetting a breach of its client directors’ fiduciary duty even while dismissing the claims...
asserted the directors themselves under Section 102(b)(7) of the DGCL. Several weeks earlier, the Court of Chancery issued a similar ruling against a financial advisor in In re Zale Corp. Stockholders Litigation (“Zale I”), but the Court reversed its own decision and dismissed the claim asserted against the financial advisor (“Zale II”) soon after an intervening decision of the Supreme Court in Carwin v. KKR Financial Holdings LLC, issued the day after Zale I was handed down. Finally, in perhaps the mostly hotly anticipated opinion of the year in Delaware, on November 30, 2015, the Delaware Supreme Court affirmed the judgment of the Delaware Court of Chancery in RBC Capital Markets v. Jervis, holding that RBC Capital Markets aided and abetted a breach of fiduciary duty by the directors of Rural/Metro Corporation in connection with Rural/Metro’s 2011 sale.

The emerging line of cases on financial advisor liability have involved claims for damages after the underlying merger closed. All of the recent financial advisor liability cases have involved a finding that a target company’s directors (sometimes allegedly misled by their financial advisor) failed to act “reasonably,” which created a predicate breach of fiduciary duty for which aiding and abetting liability was a possibility. Because of the presumption provided by the business judgment rule, Delaware law generally requires more than “unreasonable” conduct for a fiduciary breach. However, plaintiffs in the financial advisor cases asserted that a mere failure to act reasonably, is the standard for a care breach, and what options and strategies it had to potentially capture some or all of the $100 million.” Although this alleged failure was not sufficient to state a claim for breach of the duty of loyalty or good faith, the Court concluded that “it is reasonably conceivable that the [allegations regarding the share count error] would sustain a duty of care claim . . . that could form the predicate breach for an aiding and abetting claim” against the financial advisor. In particular, the Court was concerned that the board of directors never considered a reformation claim and failed to ask its financial advisor how the error occurred and whether the financial advisor ever discussed the error with Vista. Although the directors were exculpated from liability for this alleged breach of the duty of care pursuant to the 102(b)(7) exculpatory provision in TIBCO’s charter, the breach could be a predicate for aiding and abetting liability for the defendant bank.

The Court then turned to whether Plaintiff sufficiently stated a claim against the defendant bank for aiding and abetting the directors’ alleged breach. The Court refused to dismiss that claim finding it “reasonably conceivable that [the financial advisor’s] alleged failure to disclose this material information to the Board created an information vacuum at a critical juncture when the Board was still assessing its options.” The Court also noted Plaintiff’s allegation that the financial advisor may have been motivated to conceal the information by a desire to protect its fee, which was largely contingent on the merger transaction closing.

**TIBCO Software**

In re TIBCO Software Inc. Stockholders Litigation, 2015 WL 6155894 (Del. Ch. Oct. 20, 2015), arose out of the acquisition of TIBCO by private equity fund Vista Equity Partners V, L.P., in which stockholders of TIBCO received $24 per share representing an aggregate equity value for the transaction of approximately $4.144 billion. The defendant bank had served as TIBCO’s financial advisor. Plaintiff alleged that both Vista and TIBCO entered into the transaction under a mistaken belief that the aggregate equity value was $4.244 billion based on a capitalization spreadsheet that double-counted certain TIBCO shares that were used by Vista during the bidding process and also by the defendant bank in its fairness analysis. The error was not discovered until after the merger agreement was signed, prompting stockholders to sue to enjoin the merger and seek to reform the merger agreement. The Court of Chancery denied plaintiff’s motion to enjoin the merger, finding that it had failed to demonstrate a reasonable probability of proving by clear and convincing evidence (the standard for reformation) that Vista and TIBCO had specifically agreed that the merger would be consummated at a $4.244 billion value.

After discovery, Plaintiff amended its complaint and asserted claims for reformation, breach of fiduciary duty against the directors, aiding and abetting and malpractice against the defendant bank and unjust enrichment. The Court granted motions to dismiss all of these claims, except for a claim against the defendant bank for aiding and abetting an alleged breach of fiduciary duty, concluding that Plaintiff failed to allege an offer by Vista to purchase all the TIBCO shares on the basis of an implied equity value of $4.244 billion (instead of a price per share). However, for purposes of the motions to dismiss, the Court of Chancery was willing to credit Plaintiff’s allegation that the board “failed to adequately inform itself about the circumstances of the Share Count Error and what options and strategies it had to potentially capture some or all of the $100 million.” Although this alleged failure was not sufficient to state a claim for breach of the duty of loyalty or good faith, the Court concluded that “it is reasonably conceivable that the [allegations regarding the share count error] would sustain a duty of care claim . . . that could form the predicate breach for an aiding and abetting claim” against the financial advisor. In particular, the Court was concerned that the board of directors never considered a reformation claim and failed to ask its financial advisor how the error occurred and whether the financial advisor ever discussed the error with Vista. Although the directors were exculpated from liability for this alleged breach of the duty of care pursuant to the 102(b)(7) exculpatory provision in TIBCO’s charter, the breach could be a predicate for aiding and abetting liability for the defendant bank.

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Zale Corp.

In re Zale Corp. Stockholders Litigation, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015), reconsideration granted, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015), addressed a proposed sale by a large shareholder of a corporation. In September 2013, Golden Gate Capital notified Zale that it intended to sell its shares (totaling 23.3% of Zale's outstanding common stock) into the public market. Zale and Golden Gate engaged a financial advisor as lead underwriter and filed a Form S-3. Four days later, Signet Jewelers Limited reached out to Zale, informing its directors that Signet was considering making an offer to acquire Zale. A month later, Signet offered to purchase all of Zale’s outstanding common stock for $19 per share in an all-cash deal. The offer also required Golden Gate to agree to vote in favor of the merger. In response, Golden Gate promptly cancelled its proposed public offering.

Plaintiff stockholders of Zale alleged that the financial advisor previously informed the board of directors it had “limited prior relationships and no conflicts with Signet,” and, according to plaintiffs, the Zale board purportedly made no further inquiry of the potential for conflicts based on that representation. Plaintiffs alleged that the financial advisor in fact had received approximately $2 million in fees from Signet in the year prior to the merger agreement and previously had made a presentation to Signet advocating a purchase of Zale. A senior banker on the Zale engagement had been a member of the team that previously pitched the idea to Signet.

On motions to dismiss brought by defendants, the Court of Chancery analyzed various alleged conflicts on the part of the Zale directors, but found that none of such allegations constituted breaches of the directors’ loyalty and that the plaintiffs had not sufficiently alleged bad faith with respect to the directors’ actions. The Court next analyzed Plaintiffs’ claims that the directors breached their duty of care because, although the directors were exculpated from liability based on the 102(b)(7) provision, the due care analysis was relevant to the aiding and abetting claim against the financial advisor, finding sufficient allegations at the pleading stage of (i) “knowledge” of the underlying breach of duty of care by the Zale directors, because a senior banker on the Zale engagement also had been a member of the earlier pitch to Signet, and (ii) “participation” in the breach because the financial advisor allegedly delayed disclosing the conflict until after the merger agreement was signed.

On October 29, 2015, however, the Court of Chancery reversed its own decision, based on the Supreme Court’s intervening decision in KKR. In KKR, the Supreme Court clarified that in post-closing damages actions (such as Zale I), the business judgment rule standard of review is invoked, even where Revlon otherwise might apply, if the underlying transaction was submitted to and then approved by an uncoerced, fully informed vote of a majority of disinterested stockholders. KKR therefore required the Zale directors’ conduct in approving the underlying merger to have been reviewed under the deferential business judgment rule standard. As the Zale II Court explained, the “threshold for finding a breach of the duty of care in the Revlon reasonableness context is lower than in the business judgment rule context . . . [which] is predicated upon concepts of gross negligence.” Unlike the “searching” reasonableness review, gross negligence has been described as “reckless indifference or a gross abuse of discretion.”

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In Zale II, although the Court previously had found that the Zale directors’ conduct was unreasonable (under Revlon), the Court found that the Plaintiffs had not adequately alleged that the directors had been so negligent as to rise to “reckless indifference or a gross abuse of discretion.” Accordingly, on reconsideration, the aiding and abetting claim against the financial advisor was also dismissed because there was no basis for a predicate fiduciary duty breach by the board.

RBC Capital Markets

The history of the RBC Capital Markets LLC v. Jervis, 2015 WL 7721882 (Nov. 30, 2015), and the Court of Chancery’s ruling are discussed above. On appeal, the Delaware Supreme Court agreed with the Court of Chancery’s findings with regard to the following process-related deficiencies: (1) the sale process was designed to run in parallel with a bidding process for Rural/Metro’s principal competitor, Emergency Medical Services Corporation (“EMS”), which deterred EMS and the bidders for EMS from participating in bids for Rural/Metro; (2) that faulty sale process design was caused by RBC’s efforts, unbeknownst
to the Rural/Metro Board, to get on buy-side financing trees for private equity firms bidding for EMS; (3) RBC provided the Rural/Metro Board with inadequate and misleading valuation information, without affording the Board adequate time to review that material before it approved the private equity firm’s final bid; and (4) RBC actively pursued opportunities to provide staple financing to the private equity buyer, and shared confidential information about the Rural/Metro Board’s “bottom line” on price with the private equity firm, at the same time it was engaged in final price negotiations with the private equity firm on behalf of Rural/Metro. In evaluating the Board’s conduct under Revlon, the Court affirmed the Court of Chancery’s determination that the Revlon standard of review begins to apply from the time that a board initiates a sale process to the exclusion of other strategic alternatives. The Court also affirmed the Court of Chancery’s finding that “the Board violated its situational duty by failing to take reasonable steps to attain the best value reasonably available to stockholders,” but that the conduct did not rise to the level of gross negligence.

RBC argued to the Supreme Court that a third party cannot knowingly participate in a Board’s breach of the duty of care because such breaches are, by definition, only grossly negligent, and therefore lack the level of intentionality necessary for a third party to “knowingly participate” in them. The Delaware Supreme Court rejected this contention. It explained that “[i]t is the aider and abettor,” not the predicate fiduciary, “that must act with scienter,” and affirmed the trial court’s holding that “if the third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting.”

The Court cautioned that its holding was a “narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to prevent directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of the duty of care.” The Court added that the scienter requirement “makes an aiding and abetting claim among the most difficult to prove.” Notably, the Court expressly declined to adopt the trial court’s description of a financial advisor’s role in M & A transactions as a “gatekeeper.” The Court explained that this “amorphous ‘gatekeeper’ language would inappropriately expand [its] narrow holding here by suggesting that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim.”

**Takeaways:**

- The Revlon standard of review begins to apply when a board commences a sale process to the exclusion of other alternatives. In order to avoid triggering Revlon, boards should ensure that any sales process is part of an overall strategic review of all alternatives.

- When Revlon applies and the Court determines a board’s conduct falls outside the range of reasonableness, such a finding is a sufficient predicate for third-party aiding and abetting liability, even if the directors are exculpated from liability.

- While financial advisors are not labeled “gatekeepers,” they may still face liability if they contributed to a board’s failure to meet its duties.

- How Delaware courts resolve the apparent tension between Corwin – which stated that “Unocal and Revlon are primarily designed to give stockholders and the Court of Chancery the tools of injunctive relief …[t]hey were not tools designed with post-closing money damages in mind, the standards they articulate do not match the gross negligence standard for director due care liability under Van Gorkom” – and RBC which held that “if [directors] were subject to Revlon duties, and their conduct was unreasonable,” they could be deemed to have violated their “situational duty” even if they did not act with gross negligence – remains to be seen. Two of our Annual Updates since 2012 have discussed the focus of plaintiffs’ attorneys on the roles of bankers in an effort to enjoin, or seek money damages from, otherwise independent third-party transactions. This year is no different.
In two post-trial opinions resolving cases brought pursuant to Delaware’s stockholder appraisal rights statute, 8 Del. C. § 262, the Court of Chancery once again emphasized the importance of the sale process and a reliable discounted cash flow (DCF) valuation in reaching a “fair value” determination. Under Section 262, stockholders who do not vote in favor of a merger and make a proper demand on the corporation may petition the Court of Chancery to determine the “fair value” of their stock. “Fair value” represents “the value to a stockholder of the firm as a going concern, as opposed to the firm’s value in the context of an acquisition or other transaction.” To determine fair value, the Court independently evaluates the evidence and may consider techniques or methods that are generally considered acceptable in the financial community and otherwise admissible in court. Depending on the case, the Court may rely upon a DCF analysis, a comparable transactions analysis, a comparable companies analysis, or the merger price itself. Delaware courts tend to favor a DCF model over other available methodologies in an appraisal proceeding. However, the Delaware Courts now observe that a DCF analysis has “much less utility” in cases where the transaction was an arm’s-length merger.

**Historical Background**

The acceptable method of valuing companies in appraisal actions is well established. The Court determines the value of the corporation as a going concern “based upon the ‘operative reality’ of the company at the time of the merger[.]” M.G. Bancorp, Inc. v. LeBeau, 737 A.2d 513, 524 (Del. 1999), regardless of synergies obtained from the consummation of the merger. M.P.M. Enters., Inc. v. Gilbert, 731 A.2d 790, 797 (Del. 1999), and the valuation cannot include speculative elements of value.
arising from the merger’s “accomplishment or expectation.” 8 Del. C. § 262(h). See also Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 507 (Del. Ch. 2010) (“The entity must be valued as a going concern based on its business plan at the time of the merger, and any synergies or other value expected from the merger giving rise to the appraisal proceeding itself must be disregarded”) (emphasis added), aff’d, 11 A.3d 214 (Del. 2010). Valuation “requires an examination of ‘all factors and elements which reasonably might enter into the fixing of value,’ including market value, asset value, earning prospects, and the nature of the enterprise, which are ‘known or susceptible of proof as of the date of the merger.’” Id. (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983)).

The principle that a merger provides the best evidence of value has its origins in an observation made in a fiduciary duty case:

> The most persuasive evidence of the fairness of the ... price is that it was the result of arm’s-length negotiations between two independent parties, where the seller ... was motivated to seek the highest available price, and a diligent and extensive canvass of the market had confirmed that no better price was available.

> The fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subjective thought process of a valuation expert) is viewed as strong evidence that the price is fair.


Several years later, the Court of Chancery began considering the outcome of auctions and arm’s-length processes involving independent third-party buyers as providing the best indication of value in appraisal cases. In Union Ill. 1995 Inv. Ltd. P’Ship v. Union Financial Group, Ltd., 847 A.2d 340 (Del. Ch. 2004), then-Vice Chancellor (now Chief Justice) Strine used the merger price as reliable evidence of fair value because there was a fair, open, and competitive auction, a large number of prospective buyers were contacted, and the merger consideration was material for a debt-ridden company trying to avoid insolvency. Id. at 357-358. The facts in Union Ill. fell squarely within the language of Van de Walle. Thereafter, the Court in Highfields Capital, Ltd v. AXA Fin., Inc., 939 A.2d 34, 42 (Del. Ch. 2007) deferred to the merger price where there was a non-insider buyer, an arm’s-length process with no structural impediments to a superior offer, no one came along during the period between announcement and closing, and the subject company had an unprofitable future.

This approach survived scrutiny by the Delaware Supreme Court in Golden Telecom, Inc. v. Global GT LP, 11 A.3d 214 (Del. 2010), where the issue was materially different. In Golden Telecom, the defendant corporation appealed the Court of Chancery’s appraisal valuation and asked the Supreme Court, unsuccessfully, to declare a rule requiring the Court of Chancery to defer to the merger price in an appraisal proceeding; “Therefore, we reject Golden’s contention that the Vice Chancellor erred by insufficiently deferring to the merger price, and we reject its call to establish a rule requiring the Court of Chancery to defer to the merger price in any appraisal proceeding.” The Golden Telecom appellants argued that in an appraisal proceeding the Court of Chancery should be constrained by the merger price. In other words, after Golden Telecom, the Court of Chancery is not required to rely exclusively on the merger price if there was a strong process, but Golden Telecom did not declare the merger price irrelevant to a determination of “fair value” under Section 262 of the DGCL. To the contrary, Golden Telecom instructed the Court of Chancery to obey the statutory mandate “that the court shall take into account all relevant factors.”

Thus, the Court of Chancery remains free to embrace the transaction price not only as some evidence of value, but even in the appropriate case as the best evidence of value. This is consistent with the “all factors and elements which reasonably might enter into the fixing of value” standard laid down in Weinberger. This latitude was recognized by the Court of Chancery right after Golden Telecom. See Olson v. ev3, Inc., 2011 WL 704409, at *10 (Del. Ch. Feb. 21, 2011) (“Although no presumption attaches to the deal price for purposes of appraisal, the ability of target fiduciaries to obtain a premium to market implies that they successfully extracted a portion of the value that the acquirer planned to create and that the merger consideration therefore exceeds the fair value of the stand-alone entity as a going concern.”) (emphasis added) (citations omitted).

The 2015 Decisions

Three decisions from the Court of Chancery in 2015 followed the principle that the transaction price can be the best evidence of value.

In In re Appraisal of Ancestry.com, 2015 WL 399726 (Del. Ch. Jan. 30, 2015) the Court of Chancery determined that the merger price of $32.00 per share represented the fair value of the company after considering that Ancestry did not prepare management projections in the ordinary course of business and finding that experts valuations based upon a discounted cash flow analysis were “imperfect.” After noting a “robust” sales process, the Court found that fair value was “best represented by the market price.”

In Merlin Partners LP v. Autolina, Inc., 2015 WL 2069417 (Del. Ch. Apr. 30, 2015), the Court of Chancery concluded that the merger price of $1.05 per share was the best indication of fair value at the time of the merger because there was a conflicts-free
sale and negotiation process and there were no reliable cash flow projections from which to conduct a DCF analysis. The Plaintiff had used the Company’s projections for its proposed valuation but the Court found that Autolinfo’s projections were a first attempt and were specifically prepared to “paint the most optimistic and bright current and future condition of the company” as possible for purposes of a sale. Autolinfo’s expert relied on the merger price and the Court found that it could place “heavy weight” on a merger price in the absence of any other reliable valuation analysis. In concluding that the deal price represented fair value, the Court noted that the merger was the result of a competitive and fair auction because Autolinfo: (1) retained an investment bank experienced in the transportation industry using an incentive-based fee structure; (2) contacted numerous companies in the sales process; (3) formed a special committee; (4) was sold at a premium to market; and (5) had no other topping bid emerge between announcement and closing of the merger.

In In re LongPath Capital, LLC v. Ramtron International Corporation, 2015 WL 4540443 (Del. Ch. June 30, 2015), the Company ran a sales process that involved its advisor contacting twenty-four potential buyers and executing nondisclosure agreements with six of those potential buyers before agreeing on a final deal price of $3.10 per share. The Plaintiffs demanded appraisal and argued that fair value was $4.96 per share. The Court of Chancery concluded that there were no reliable means of conducting a meaningful valuation and thus looked to the merger price as a starting point before deducting synergies and finding that the fair value at the time of the merger was $0.03 below the deal price of $3.10 per share. The Court determined that Plaintiffs’ DCF analysis was not appropriate because it relied on management projections prepared by newer employees who were creating multi-year projections for the first time. The Court also noted that the projections were created in anticipation of litigation and/or a hostile takeover bid. Instead, the Court found it could give “one-hundred percent weight” to the merger price as evidence of fair value because the merger resulted from a fair process. The Court determined that it was appropriate to subtract the deal’s net synergies of $0.03 per share (which was reached by netting negative revenue synergies and transaction costs from Ramtron’s estimate of positive synergies) from the merger price to reach a fair value determination of $3.07 per share.

Takeaway:

- These decisions show the importance of a robust, conflicts-free sale process. The Delaware courts may well “tend to favor a DCF model in appraisal proceedings,” but they will nevertheless rely entirely upon or give substantial weight to the merger price to determine fair value where there is a comfortable record for doing so.
In Hill International, Inc. v. Opportunity Partners L.P., 119 A.3d 30 (Del. 2015), the Delaware Supreme Court affirmed the Court of Chancery’s mandatory injunction barring Hill International, Inc. (“Hill”) from conducting any business at its 2015 annual meeting, other than convening the meeting for the sole purpose of adjourning it for a minimum time period, in order to permit its stockholder plaintiff Opportunity Partners (“Opportunity”) to present certain items of business and director nominations at the meeting.

The issue in the decision was Hill’s advance notice bylaw. On April 30, 2014, Hill disclosed in its 2014 definitive proxy statement that it anticipated that its 2015 annual meeting would be “on or about June 10, 2015” and that stockholders who wished to submit a proposal for the 2015 annual meeting must submit their proposal no later than April 15, 2015. The next year, on April 13, 2015, Opportunity delivered to Hill a notice of its intent to propose business and nominate two directors at Hill’s 2015 annual meeting. On April 30, 2015, Hill filed its definitive proxy statement for its 2015 annual meeting and announced that its 2015 annual meeting would be held on June 9, 2015. On May 5, 2015, Hill took the position that Opportunity’s April 13 notice was defective because it failed to include information about the director nominees required by the bylaws. On May 7, Opportunity delivered another notice to Hill that contained two different proposals from what was in its April 13 notice and also included the same two nominations for election to Hill’s Board contained in its April 13 letter. On May 11, Hill notified Opportunity that its notice was untimely under Hill’s advance notice bylaw and that its proposals and nominations would be excluded from the 2015 annual meeting. Opportunity then filed suit in the Court of Chancery.

ADVANCE NOTICE BYLAWS ARE STRICTLY CONSTRUED ACCORDING TO THEIR PLAIN MEANING
Hill's advance notice bylaw provided as follows:

To be timely, a stockholders' notice must be delivered to or mailed and received at the principal executive offices of the Corporation not less than sixty (60) nor more than ninety (90) days prior to the meeting; provided, however, that in the event that less than seventy (70) days' notice or prior public disclosure of the date of the annual meeting is given or made to stockholders, notice by a stockholder, to be timely, must be received no later than the close of business on the tenth (10th) day following the day on which such notice of the date of annual meeting was mailed or such public disclosure was made, whichever first occurs.

The Court of Chancery Decision

Hill argued that the disclosure in its 2014 definitive proxy statement that the annual meeting would be “on or around June 10, 2015” constituted prior public disclosure of the date of the meeting such that Opportunity was required to notify Hill of its intent to propose business and nominations not less than 60 days prior to the meeting. In response, Opportunity argued that the first notice of the date of the meeting was not given until April 30, 2015, less than 70 days prior to the date of the annual meeting, such that its May 7 notice was timely.

The Court of Chancery agreed with Opportunity. The Court concluded that although Hill could have triggered the requirements of its advanced notice bylaw by announcing the specific date of its annual meeting prior to the filing of its definitive proxy statement, it did not do so, and thus, Opportunity had 10 days from the date of the filing announcing the specific meeting date. Because the May 7 notice was timely under that reading, the Court held that Hill violated the plain language of its bylaws.

The Supreme Court Ruling

On appeal, the Supreme Court held that Hill’s “clear and unambiguous” advance notice bylaw required Hill to provide notice of the specific date of its annual meeting, and not a range of possible dates, in order to trigger the applicable time periods under the advance notice bylaw. The Court explained:

The plain meaning of “the date” means a specific day – not a range of possible days. The 2014 Proxy Statement’s reference to “on or about June 10, 2015” does not refer to “the date” of Hill’s 2015 Annual Meeting. Rather, “on or about” refers to an approximate, anticipated, or targeted time frame that is intended to encompass more than one “date” – i.e., June 10 – apparently in order to give Hill some flexibility in scheduling. Thus, the 2014 Proxy Statement did not provide “prior public disclosure of the date” of Hill’s 2015 Annual Meeting.

In issuing its ruling, the Supreme Court also provided guidance on alternatives to addressing the issue presented. The Court suggested that corporations could tie the notice period for timely stockholder proposals and director nominees to the anniversary date of the corporation’s prior annual meeting or by publicly announcing the specific date of its annual meeting prior to the sending of notice of such annual meeting in the manner required by Section 222 of the DGCL, which requires that such notice be sent not more than 60 days prior to the annual meeting.

Takeaway:

- Corporations with advance notice bylaws that tie the notice period for stockholder proposals and nominations to the current year’s meeting date rather than the anniversary of the prior year’s annual meeting or the mailing of the prior year’s proxy statement cannot rely on an announcement of an expected or anticipated meeting date. In that regard, corporations may want to take the Delaware Supreme Court up on its suggestion and consider amending their advance notice bylaws to tie the notice period to the anniversary of the prior year’s annual meeting or the date of mailing of the prior year’s proxy statement.
In United Technologies Corp. v. Treppel, 109 A.3d 553 (Del. 2014), an en banc panel of the Supreme Court that included Justice Ridgely unanimously reversed the Court of Chancery’s ruling denying a corporation’s request to restrict the use of books and records obtained by a stockholder under Section 220 of the DGCL to use in a Delaware proceeding pursuant to the corporation’s exclusive forum selection bylaw.

**Background**

In Treppel, a stockholder of United Technologies Corp. sent the Company a letter in August 2012, demanding that it sue certain of its officers and directors following an announcement, in June 2012, that the Department of Justice was investigating the Company for violations of federal law. A month earlier, in July 2012, another stockholder, Harold Grill, sent the Company a demand under Section 220 of the DGCL to inspect the Company’s books and records in relation to the DOJ investigation. The Company provided Grill with certain documents and he then filed a derivative action. That action was dismissed for failure to make a pre-suit demand and for failure to establish that demand was excused.

While Grill’s action was pending, United’s board of directors considered Treppel’s demand and advised him that it determined that pursuing the requested action was not in the Company’s best interests. Treppel then served a request for books and records under Section 220 to investigate the basis of the Company’s refusal to take action. The Company agreed to provide Treppel with certain books and records, but conditioned the production on him executing a confidentiality agreement containing a provision requiring that all actions arising out of the inspection be brought exclusively in the Delaware courts.
The Court of Chancery Decision

Treppel rejected United’s conditions and filed an action in the Court of Chancery pursuant to Section 220 demanding that the Company permit the inspection without any use restrictions. The Company argued that Treppel’s desire to use such information in a proceeding outside of Delaware “negated” the “proper purpose” he was required to show in order to conduct the inspection. The Company also argued that even if Treppel demonstrated a proper purpose, the Court has the discretionary power under Section 220(c) to limit the use of information obtained from the inspection to proceedings brought only in a Delaware court. The Court held that Section 220(c) did not contemplate the imposition of such a restriction.

The Supreme Court Decision

On appeal, the Supreme Court noted that Section 220(c) gives the Court of Chancery broad power and discretion to impose limitations and restrictions on an inspection of books and records. Importantly, the Court further held that such power includes not only the power to limit the scope of the inspection itself, but also the power to limit the use of the information provided. The Court cited multiple cases where the Court of Chancery denied a stockholder’s request for books and records because the stockholder would not have had standing to pursue the underlying claim even if the inspection request had been granted. The Court stated that a stockholder’s right under Section 220 is a “‘qualified’ one” and that nothing in the text of Section 220 limits the Court of Chancery’s power to restrict the stockholder’s inspection rights when the corporation’s legitimate interests are threatened.

Having determined that the Court of Chancery had the statutory power to impose the restrictions requested by the Company, the Supreme Court remanded the case for the Court of Chancery to consider several factors in exercising its discretion, including (i) the fact that the matter Treppel sought to investigate was already the subject of derivative litigation, and (ii) the Company’s legitimate interests in having consistent rulings on Delaware law issues “and having those rulings made by [Delaware] courts,” as reflected by the fact that the Company adopted a forum selection bylaw, which, according to the Court, represented a “non-case-specific determination by its board of directors that internal affairs litigation involving the company should proceed in a single forum.” The Court explained that these factors “involve a legitimate concern on United Technologies’ part that it and its stockholders could face excessive costs and the risk of inconsistent rulings if Treppel were to file suit elsewhere.”

Takeaway:

While the Delaware Supreme Court’s ruling left it up to the Court of Chancery to determine whether to impose a forum use restriction under Section 220 based on the specific facts of the case, the Treppel decision is a clear indication that the Delaware Supreme Court recognizes that reducing costs and avoiding duplicative, multi-forum litigation is a legitimate corporate interest.
In Calma v. Templeton, 2015 WL 1951930 (Del. Ch. April 30, 2015), the Court of Chancery denied a motion to dismiss a claim that the board of directors of Citrix Systems, Inc. (“Citrix” or the “Company”) breached their fiduciary duties in awarding compensation to outside directors under a generally applicable equity incentive plan that previously had been approved by stockholders. In connection with denying the motion to dismiss, the Court (i) determined that the demand was futile and the entire fairness standard of review applied because the awards to the outside directors were made by the recipient directors themselves, and therefore the directors granting the awards were not disinterested; and (ii) in light of the lack of meaningful limits or specific parameters for awards to non-employee directors, the Court found that stockholder approval of the plan as a whole did not constitute approval of the specific decisions of the board to make the grants in question. Delaware companies and practitioners should take note of this important decision and assess their director compensation practices accordingly.

**Background**

In May 2005, a majority of the stockholders of Citrix provided omnibus approval of an equity-based compensation plan applicable to Citrix’s directors, officers, employees, consultants and advisors (the “Plan”) and designed to “attract[] and retain[] the best available individuals for service as directors of the Company.” The Plan’s only limits were the total number of shares available under the Plan (the Plan had made available 48.6 million total shares, of which 16 million shares could be awarded as restricted share units (“RSUs”)) and that no beneficiary could receive more than one million RSUs in a single calendar year. As of the date of the filing of the Complaint, one million RSUs carried a fair value of $55 million. The terms of the Plan empowered the Company’s Compensation Committee (the “Committee”) to determine “each [a]ward to be granted by the Company under the Plan including the employee, director, officer, consultant or advisor to receive the [a]ward and the form of the [a]ward,” subject only to the amount of stock limitations. As of the time of the filing of the Complaint, eight out of the nine members of the Company’s Board of Directors (the “Board”) were outside directors, including all three directors who were members of the Committee.

In 2011, the Committee recommended, and the Board approved, an increase in the annual grant of RSUs to outside directors from 3,333 (in 2010 and previous years) to 4,000. In 2011, 2012, and 2013, each non-employee director then received 4,000 RSUs, with grant date fair values of $339,320, $283,160, and $253,360, respectively. Thus, including all other cash and stock option consideration, director compensation ranged from $303,360 to $425,570 during that time period, with one director earning $662,935 in 2013 because of a one-time grant of 10,000 RSUs for joining the Board that same year.

Plaintiff filed a derivative suit relating to the RSU awards, asserting claims of breach of fiduciary duty, waste of corporate assets and unjust enrichment. Defendants moved to dismiss for failure to state a claim and for failure to make a pre-suit demand.

The Rales Demand Futility Test Governs Where A Committee Made The Challenged Decision, And The Committee Is Comprised Of Less Than A Majority Of The Board

Plaintiff asserted that demand was excused as futile because a majority of the Board (1) stood on both sides of the decision in 2011 to increase the annual awards of RSUs and (2) were “interested,” as each received a personal financial benefit from the decision.

Although the parties had agreed that the Court should apply the demand futility test enunciated in Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (which applies where a decision of the board is challenged), the Chancellor instead applied the demand futility test as set forth in Rales v. Blasband, 634 A.2d 927 (Del. 1993) (which applies where the plaintiff does not challenge “a decision of the board in place at the time the complaint is filed”), reasoning that the Complaint, although styled as challenging the Board’s approval of an increase to the annual awards of RSUs from 3,333 to 4,000, the actual decisions stemmed from the Committee. Moreover, the Court held that the award decisions could not be imputed to the Board as a whole because the Committee was comprised of a number of directors (three) totaling less than half of the Board. Thus, the Court determined that Rales was the appropriate standard.
Applying *Aronson*, the Court found that the Plaintiff pled that demand was futile. Under that test, derivative claims must be dismissed under Court of Chancery Rule 23.1 unless “based on the particularized facts alleged, Plaintiff creates ‘a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand.’” “[A] director is not disinterested if he or she ‘appear[s] on both sides of a transaction [or] expect[s] to derive a personal financial benefit from it in the sense of self-dealing.’” Here, notably, the Court rejected the Defendants’ argument that a director that receives compensation from the corporation is not deemed “interested” unless the Plaintiff can demonstrate that the compensation received was material to the director, which Defendants argued the Plaintiff had not done. The Court rejected that argument, reasoning that, although under existing Delaware law, “directors are generally not considered interested under *Aronson* or *Rales* simply because [they] receive compensation from the company[,] [] a derivative challenge to director compensation is different because the law is skeptical that an individual can fairly and impartially consider whether to have the corporation initiate litigation challenging his or her own compensation, regardless of whether or not that compensation is material on a personal level.” Here, because eight of the nine Citrix directors in office when the Complaint was filed received the awards of RSUs in issue, for purposes of determining whether demand was futile, a majority of the board had “a strong financial incentive to maintain the status quo by not authorizing any corrective action that would devalue their current holdings or cause them to disgorge improperly obtained profits.” Thus, the Court held that a majority of the Board was interested and demand was excused.

Defendants also argued that Section 141(h) is a “statutory grant of Business Judgment Rule protection for director compensation decisions,” such that, because Plaintiff did not allege with particularity that the Board acted in bad faith or did not exercise its business judgment, demand [was] not excused.” The Chancellor rejected this argument, explaining that although Section 141(h) grants directors the authority to set their compensation, it is “not a statutory safe harbor mandating business judgment standard of review for director compensation decisions.”

**Absent Adequate Stockholder Ratification, The “Entire Fairness” Standard Applies**

A stockholder rebuts the presumption that directors exercised valid business judgment in approving a transaction by establishing that “at least half of the directors who approved a business decision are not independent or disinterested.” If the stockholder makes such a showing, the court “reviews the directors’ decision under the entire fairness standard, in which case the directors must establish ‘to the court’s satisfaction that the transaction was the product of both fair dealing and fair price.’” Because all three members of the Committee received some of the awards of RSUs that the Committee approved, the Court found that the Plaintiff had adequately rebutted the business judgment presumption.

To avoid entire fairness review, Defendants raised the affirmative defense of common law stockholder ratification, contending that the awards of RSUs are thus subject to review under the waste standard. Defendants asserted that the awards “were the result of the Board administering the [previously shareholder-approved] [Plan] and were made pursuant to, and in full compliance with, that [Plan].” On the other hand, Plaintiff contended that because the Plan itself had set “no meaningful limits.” Defendants still bore the burden to establish entire fairness. Thus, the question presented was “whether advance stockholder approval of a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation that may be awarded in a given year is sufficient to establish a ratification defense” as to compensation awards made later and pursuant to that plan.

In answering this question, the Court reviewed Delaware case law over the past sixty years, concluding that the case law supports two principles of common law stockholder ratification relevant to director compensation: (i) “[T]he affirmative defense of ratification is available only where a majority of informed, uncoerced, and disinterested stockholders vote in favor of a specific decision of the board of directors;” and (ii) “[V]alid stockholder ratification leads to waste being the doctrinal standard of review for a breach of fiduciary duty claim.”

With respect to the Plan in issue, the Court held that the May 2005 stockholder vote did not “ratify” – in advance – anything. The Court noted that because the Plan’s only limitations were the total shares available under the Plan and the total number of shares any single beneficiary could receive in a given calendar year, the Citrix stockholders were never asked to approve – and thus did not approve – any action bearing specifically on the magnitude of compensation for the Company’s non-employee directors.” Likewise, they were “not asked to approve any action specific to director compensation.” As one million RSUs carried a fair value of $55 million, the Court determined it was conceivable that the members of the Compensation Committee could, without following any objective standards or requirements, award themselves and the other members of the Board up to the equivalent of $55 million in RSU compensation in a given year. Thus, the Court found that the Plan lacked the controls that would support finding valid ratification and therefore the May 2005 vote was not a valid advance approval of the later-in-time awards of RSUs.
The Chancellor noted that at the 2012 and 2013 annual stockholder meetings, the stockholders voted in favor of amending the Plan to increase the total number of shares available under the Plan and “to ratify[,] confirm[,] and approve[]’ the Plan in all respects. But . . . Citrix stockholders were not specifically asked to ratify the [awards of RSUs] granted the prior year.” Although the relevant proxy statements disclosed the previous years’ director compensation, the Court held that such disclosure was not a valid “equivalent” to a vote on that specific issue.

Having established that the entire fairness standard of review applies, the Court then evaluated whether it was “reasonably conceivable” that the RSU awards were not entirely fair in order for the claim to survive a motion to dismiss. Defendants argued that the compensation practices were in line with those of the Company’s “peer group,” comprising fourteen companies including Amazon.com, Google, Microsoft, and Cisco. The Court determined that factual questions about the fairness of the RSU awards in relation to comparable companies could not be resolved at the motion to dismiss stage.

The Plaintiff Failed To State A Claim For Waste, But Stated A Claim For Unjust Enrichment

Noting that to state a claim for waste, a stockholder must establish that the business decision in issue cannot be attributable to any rational business purpose, or, in other words, the ‘directors ‘authorize[d] an exchange that [was] so one sided that no business person of ordinary, sound judgment could conclude that the corporate has received adequate consideration,’ i.e., the transfer of corporate assets was a ‘gift,’” the Court held that Plaintiff had failed to make such a showing. The Chancellor reasoned that, unlike other cases where stock option grants had been awarded above and beyond existing compensation, in this case, the awards in issue were the directors’ compensation.

Finally, because the Plaintiff’s unjust enrichment claim was based on the directors’ having awarded themselves the RSUs in issue, and because the Defendants’ counterarguments relied solely on the premise that the awards did not constitute a breach of fiduciary duty, the Court denied the Defendants’ motion to dismiss the unjust enrichment claim.

Takeaways:

- Delaware corporations should take note of this decision and carefully consider taking immediate steps to avoid any adverse effects from it, including (i) inclusion of an annual limit specifically on director compensation, with stockholder approval; (ii) implementing a formula-based award scheme for directors and obtaining stockholder approval for such formulas; and (iii) obtaining stockholder approval for past director grants to avoid stockholder challenges.

- The above suggestions seem like overkill. Perhaps this is an area where there needs to be a change in the law. Virtually all interested transactions in which “entire fairness” is the standard of review are voluntary transactions. Director compensation is different because directors are entitled to compensation. There is nothing voluntary about it and the only people with authority to make the determination are the directors themselves. An officer cannot do it because it raises questions about delegation of the board’s authority and, because the officer’s compensation is determined by the board, any decision by any officer would be conflicted as well. Director compensation is a situation where the “rule of necessity” comes into play. The decision cannot be avoided by the board and perhaps a new standard should be developed to address the problem. Because courts are not well-suited to set compensation, until a new standard is developed, stockholder approval of reasonable limits on compensation is the necessary approach.
In *Gorman v. Salamone*, 2015 WL 3905598 (Del. Ch. July 31, 2015), the Court of Chancery held that a stockholder-adopted bylaw amendment that purported to grant stockholders the authority to remove corporate officers over the objection of the corporation’s board of directors was invalid under Delaware law because it would allow stockholders to “make substantive business decisions” for the corporation and thereby “unduly interfere with directors’ management prerogatives” under Section 141(a) of the General Corporation Law of the State of Delaware (the “DGCL”).

The impetus for this dispute was a voting agreement which provided, among other things, for the election of the Company’s chief executive officer as a director, but if for any reason the CEO were to cease to serve as the chief executive officer, the stockholders party to the agreement were required to vote their shares to remove the CEO from the board and to elect the new CEO to the board.

John Gorman, the Company’s majority stockholder, acted by written consent to amend the bylaws of the Company to provide, among other things, that “[a]ny officer may be removed, with or without cause, at any time by the Board or by the stockholders acting at an annual or special meeting or acting by written consent pursuant to Section 2.8 of these Bylaws. The Board shall, if necessary, immediately implement any such removal of an officer by the stockholders.” Gorman then removed Gary Salamone as the Company’s CEO and elected himself to fill the resulting vacancy. Following his self-appointment as CEO, Gorman sought to appoint a new director to serve in his newly vacant director seat. After taking those steps, Gorman filed an action in the Court of Chancery seeking confirmation that Salamone was no longer the CEO or a director of the Company.

The Court held that the amended bylaw was invalid: “Delaware law does not allow stockholders to remove directly corporate officers through authority purportedly conferred by a bylaw.” The Court rejected Gorman’s argument that Section 142(b) of the DGCL, which provides that “[o]fficers shall be chosen in such manner . . . as [is] prescribed by the bylaws or determined by the board of directors”) and Section 142(e) of the DGCL (providing that “[a]ny vacancy occurring in any office . . . shall be filled as the bylaws provide,” permitted the adoption of a bylaw that would allow stockholders to remove and replace officers. The Court explained that neither Section 142(b) nor Section 142(e) deal with how officers can be selected and how any vacancy in an office can be filled. Thus, the Court found that the amended bylaw was not authorized by Section 142 of the DGCL.

In addressing the argument that stockholders generally have the power under Section 109 of the DGCL to adopt and amend bylaws “relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees,” the Court held that the amended bylaw was outside the scope of Section 109. Importantly, the Court noted that the amended bylaw required the board to “immediately implement any such removal of an officer by the stockholders;” thereby interfering with the decision-making process of the board, which “could compel board action, potentially in conflict with its members’ fiduciary duties.” The Court held that the ‘stockholders’ right to remove officers for any (or no) reason would unduly constrain the board’s ability to manage the Company.”

Another portion of the amended bylaw stated that “[a]ny vacancy occurring in any elected office of the Corporation may be filled by the Board except that any such vacancy occurring as a result of the removal of an officer by the stockholders shall be filled by the stockholders.” While the Court did not address the validity of this portion, the Court observed that “[p]ermitting stockholders to set the mode for officer replacement would allow them to dictate a procedure, and would not necessarily step unduly on management’s toes.”

**Takeaway:**

- The DGCL and Delaware’s corporate jurisprudence have consistently maintained the separation between the roles of stockholders and management. Stockholders elect the board and have a right to vote on major things such as amendments to the charter and the sale of the company or substantially all of its assets. Otherwise, the board runs the Company.

The *Gorman* decision is just another indication that absent a legislative change, Delaware courts will maintain that divide.
“FOR CAUSE” REMOVAL REQUIREMENT UNENFORCEABLE UNLESS THE COMPANY HAS A CLASSIFIED BOARD

As a general matter, charter and bylaw provisions are presumed to be valid. But the DGCL expressly prohibits the adoption of a charter provision or bylaw that is contrary to the laws of Delaware. See 8 Del. C. § 102(b)(1); 8 Del. C. § 109(b). In a December 21, 2015, transcript ruling in VAALCO Energy Inc., Consol. C.A. No. 11776-VCL (Del. Ch.), the Court of Chancery squarely addressed the validity of a charter and bylaw provision that provided directors could only be removed “for cause.” The Court held that the removal only for cause requirement in VAALCO’s charter and bylaws was invalid because it conflicted with 8 Del. C. § 141(k).

Section 141(k) of the DGCL provides that “[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares entitled to vote at an election” with two express exceptions: (1) when the board is classified as provided in Section 141(d); or (2) where a corporation has cumulative voting, if less than the entire board is to be removed. Neither exception applied in VAALCO’s circumstances so the removal only for cause requirement was void because it conflicted with the statute.

Takeaway:

In recent years many corporations have declassified their boards of directors and VAALCO was one of them. When the stockholders of VAALCO voted to do so, they did not have the opportunity to vote to eliminate the director removal only for cause provisions in the company’s charter and bylaws. It was pointed out to the Court of Chancery that at least 175 corporations have similar removal only for cause provisions. This was of no moment because the provisions in the VAALCO’s charter and bylaws are contrary to law. Corporations with similar provisions and circumstances should amend their charter and bylaws to eliminate the removal for cause requirement. Otherwise, activists may demand it and seek attorney’s fees for accomplishing the change either through litigation or agreement. The VAALCO case confirms the settled public policy that there can be no limitation on the right of stockholders to remove a director without cause except for the narrow exceptions expressly provided within Section 141(k).
Section 205 of the DGCL was enacted in 2014 and conferred on the Court of Chancery exclusive jurisdiction to hear a petition brought by a corporation, director or stockholder to “determine the validity of” or to “ratify” a corporate act or stock that would otherwise be considered defective or incurable. In In re Genelux Corp., 126 A.3d 644 (Del Ch. 2015) the Court of Chancery held (in a matter of first impression) that Section 205 cannot be used to declare a corporate act void, but rather can only be used to validate defective corporate actions.

The issue before the Court was whether certain stock of Genelux Corporation (“Genelux” or the “Company”) had been validly issued to the company’s co-founder and former chief executive officer, Dr. Aladar Szalay (“Dr. Szalay”) in 2009, almost six years before the lawsuit was filed. The answer would determine the outcome of the election of certain directors to the Company’s board of directors. In addition to the Company’s claim under Section 205 that Dr. Szalay’s stock was invalid, a current director of the company filed a companion claim under Section 225 seeking to invalidate the election of two directors on the basis that Dr. Szalay’s stock was invalid.

The Company argued the Court of Chancery’s power under Section 205 to determine that the stock was invalid because it was wrongfully issued is inherent in the power under Section 205 to determine the validity of any stock. Dr. Szalay argued that, based on the overall structure of the statute, the relief available under Section 205 is the validation of presumed defective and otherwise incurable acts, not the invalidation of acts presumed by a company or a stockholder to be valid. Moreover, Dr. Szalay argued that because Section 205 has no relevant statute of limitations, to hold otherwise would put all stockholders at risk of having their equity positions challenged under any theory of wrongdoing and at any time, no matter when the shares were issued.

Finding the statutory language ambiguous, the Court analyzed the legislative history of the statute. The Court noted the confusion that existed in prior Delaware case law regarding which defective corporate actions were voidable (and capable of ratification), and which actions were void (and incapable of ratification). The Court examined the legislative summary of the House Bill 127, that became new Sections 204 and 205, and concluded that “the Delaware Legislature apparently did not intend to enhance by statute the powers of the Delaware courts to set aside or invalidate a defective corporate act or stock—as that could be done before the statutes were passed and still can be done today.” Instead, the Court determined 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.” The Court found the Company’s interpretation of Section 205 to be inconsistent with the statute’s inherent presumption that the company intended the act and believed it to be valid at the time it was taken, and rejected the notion that the Delaware General Assembly intended to grant the court jurisdiction to sanction the renunciation of a prior corporate act.

The Court also questioned the company’s use of Section 205 to participate in what was really a Section 225 claim, noting that “[t] is not so clear . . . whether corporations have standing to file a claim under Section 225(a) or (b).” As the Court dismissed the Plaintiffs’ complaint on multiple other grounds, it determined that it did not need to reach a decision of whether the company’s use of Section 205, recruitment of a director to assert a Section 225 claim and other allegedly inequitable conduct warranted dismissal.

**Takeaway:**
- The scope of Section 205 will have to be resolved by the Delaware Supreme Court. The Genelux case was appealed but later withdrawn so the issue will have to wait for another day in another case. Until then, corporations should think twice about taking a legislative tool provided by Delaware to help them and endeavoring to use it offensively against its stockholders. Even if technically lawful, inequitable acts have been consistently rejected by the Delaware courts.
FORMER DIRECTOR ENTITLED TO ADVANCEMENT OF LEGAL EXPENSES AS INTERVENOR IN ACTION WHERE HIS CONDUCT WAS AT ISSUE

In *In re Genelux Corp.*, 2015 WL 6390232 (Del. Ch. 2015), the Delaware Court of Chancery held that Dr. Aladar Szalay (“Szalay”), a former director and officer of Genelux Corporation (“Genelux” of the “Company”), was entitled to advancement of his fees and expenses incurred as an intervenor in an action brought by Genelux and another director to invalidate Dr. Szalay’s Genelux stock (pursuant to Section 205 of the DGCL) and his election of two Genelux directors pursuant to Section 225 of the DGCL. The Court also awarded Dr. Szalay his fees on fees for prosecuting the advancement action.

Genelux argued, inter alia, that Dr. Szalay was not entitled to advancement under either Genelux’s bylaws or the indemnification agreement because: (1) Dr. Szalay intervened in the Section 205/225 Action for personal reasons unrelated to his status as a former Genelux director and officer; and (2) Dr. Szalay initiated his involvement in the Section 205/225 Action without obtaining board approval as required by Genelux’s bylaws and the indemnification agreement.

The Court determined that Dr. Szalay had a corporate interest in intervening in the Section 205/225 Action because the proceeding sought to invalidate actions taken by Szalay in his capacity as a Genelux director (i.e., the issuance of the disputed shares). The Court also rejected Genelux’s contention that Szalay could not seek advancement given his failure to obtain board approval for his intervention in the 205/225 Action. The Court held that Dr. Szalay’s intervention was defensive in nature and “were the Court to rule in favor of Genelux in the 205/225 Action, Szalay could be barred on collateral estoppel grounds from arguing that he had discharged his fiduciary duties properly in connection with the challenged actions.”

The Court also found that it would be inequitable to deny Szalay’s claim for advancement where the underlying proceeding threatened Szalay’s interests more than the interests of the named defendants, noting that “to hold otherwise would allow the Company to allege misconduct of a director in his capacity as a fiduciary and to attempt to invalidate his personal property rights and related corporate rights without naming him a defendant, thereby forcing him either to intervene in the action at his own expense or risk losing important rights.”

Finally, the Court also awarded Dr. Szalay advancement for a separate action pending in California in which Dr. Szalay was a named defendant. The Court rejected the Company’s argument that the request for advancement was moot because Genelux’s insurance carrier already agreed to pay those fees, noting that “[t]his Court has recognized an indemnitee’s ability to seek advancement and indemnification from multiple sources with which it has contractual rights to do so.”

**Takeaway:**

- This is a case of first impression. Whether it is upheld or not, directors and corporations should evaluate the indemnification and advancement provisions in their articles and bylaws to make sure they comport with both the law and each constituencies’ expectations.
In In re El Paso Pipeline Partners, L.P. Derivative Litigation, 2015 WL 1815846 (Del. Ch. Apr. 20, 2015), the Court of Chancery (Vice Chancellor J. Travis Laster) issued a post-trial opinion finding that the general partner of a limited partnership failed to form a subjective good faith belief that a particular transaction was in the best interests of the company, as was required under the limited partnership agreement (the LP agreement). The Court found that the general partner's breach caused the partnership to overpay by some $171 million and awarded that difference to the partnership, to be paid by the general partner. Shortly after trial, the general partner consummated a related-party merger that brought an end to the limited partnership's existence. The general partner moved to dismiss the litigation, contending that because the Plaintiff styled his claim as derivative, the closing of the merger meant that the case should be dismissed. In a separate opinion, In re El Paso Pipeline Partners, L.P. Derivative Litigation, 2015 WL 7758609 (Del. Ch. Dec. 2, 2015), the Court held that the claim that the general partner was liable for breach at the partnership was a “dual-natured claim with aspects that are both derivative and direct” and denied the motion to dismiss.

**Background**

All of the involved entities are in the oil and gas industry. The partnership, El Paso Pipeline Partners, L.P., was controlled by El Paso Corporation (the parent) through the parent’s ownership of the partnership’s general partner, El Paso Pipeline GP Company, L.L.C. (the GP). The parent also owned 52 percent of the partnership’s common units, with the remaining trading on the NYSE. Most of the GP's board members were employed directly by the parent.

The transaction in issue was a form of “dropout,” a transaction common to the industry, which involves a parent disposing of an asset by selling it to a subsidiary for cash or equivalent. In the context of this case, because the company was structured as a partnership – i.e., a pass-through entity – it could distribute...
cash to investors in a more tax efficient manner than the parent, a corporation, which is taxed at the corporate level and then at the investor level. Thus, the partnership’s cash flows were more highly valued to investors, and it effectively could issue equity at a much lower cost of capital than could the parent. By accomplishing dropdowns in return for cash it had raised at the partnership level, the parent “captured the tax benefit and obtained capital at the lowest possible cost.”

By 2012, the parent and the partnership had completed nine dropdown transactions. In each instance, the parent proposed a sale of assets to the partnership for a mix of cash and assumption of debt. The GP then convened an ad hoc special committee, which hired outside legal and financial advisors to assist in the transaction. After minimal back-and-forth, the special committee recommended the dropdown, which would be completed in short order.

**The Challenged Dropdown**

The parent proposed in October 2010 that the partnership purchase 49 percent of the outstanding shares in another of its subsidiaries for $948 million in mixed cash and debt, and included an option for the partnership to purchase 13 percent of the outstanding shares in yet another subsidiary for $325 million, or 2 percent for $50 million in mixed cash and debt in that same company (the additional term and, overall, the proposal). As before, the parent and partnership engaged in minimal back-and-forth. The special committee initially countered at $900 million, which the parent accepted. Following that agreement, the parties settled on removing the option, rendering the additional term part of the deal. The GP eventually agreed to purchase 15 percent of the subsidiary in the additional term. The parent announced the dropdown in November 2010 at $1.412 billion (the challenged dropdown).

**The General Partner Breached The LP Agreement Due To A Weakened And Biased Deal Process**

The LP agreement required the GP to form a subjective belief that conflicted transactions, such as the challenged dropdown, are in the best interests of the partnership. That is, it “did not require that the [GP] make a determination about the best interests of the common unitholders as a class or prioritize their interests over other constituencies.” But that is what the special committee, on behalf of the GP, did instead of determining that the dropdown was in the best interests of the Partnership.

The Court found, for at least three reasons, that the deal process relating to the challenged dropdown was weak and biased, resulting in the special committee’s failure to form a subjective good faith belief that the transaction was in the best interests of the partnership.

**The special committee’s preoccupation with the challenged dropdown’s accretive benefits to parent**

The Court found that the special committee had “fixed myopically” on the potential accretion to the partnership’s common unit holders. That is, once the transaction closed, the partnership could increase distributions to its investors. The Court observed, however, that accretion “says nothing about whether the buyer is paying a fair price,” and therefore whether the purchaser would benefit from the transaction in the long-run. The Court found that the special committee had set out to accomplish the deal mostly benefitting the parent.

**The special committee member’s actual views and “conscious disregard of lessons learned”**

In a previous dropdown, one of the special committee members believed a 51 percent stake in the subsidiary that would become the subject of the challenged dropdown was valued fairly at $725–780 million, with the remaining 49 percent valued at $711–764 million. After countering at $860–870 million, that previous committee approved the purchase of a 51 percent stake at $963 million. Thereafter, one of the members stated that “next time we will have to negotiate harder.”

In addition, the committee members individually expressed reservations in accomplishing future dropdowns that would include same types of assets, in part owing to the deteriorating marketplace for that asset. Nonetheless, the GP approved purchasing the remaining equity in the very same subsidiary as the prior dropdown, with the special committee allowing the prior dropdown’s price to set the bar during negotiations, without ever having challenged the parent effectively on the deal price. The special committee also failed to require its financial advisor to analyze the two major components independently.

**Financial advisor’s biased work product and the Special Committee’s failure to identify deficiencies**

In sum, the Court found that the financial advisor’s “actions demonstrated that the firm sought to justify the parent’s asking price and collect its fee”:

- When asked to analyze if the deteriorating marketplace had affected the attractiveness of the assets in the proposal, the financial advisor only asked the parent. In addition, the financial advisor was asked to analyze other recent comparables. The financial advisor pulled press releases of other transactions, and performed no further examination.

- As to other aspects of the proposal, the financial advisor had recycled slides from a previous presentation and manipulated the numbers, and in at least one case reducing the information.
The financial advisor “craft[ed] [...] a visually pleasing presentation designed to make the [proposal] look as attractive as possible.” For example, it abandoned the majority-minority acquisition groupings it used previously in advising on prior dropdowns, without ever explaining why. In addition, the financial advisor manipulated its DCF analysis by applying the partnership’s cost of capital (thus reflecting the measure of risk in the cash flows of the acquirer, not the asset), adjusting the discount rates to reflect that the proposal lie more in the center of the DCF range, and providing a more attractive set of multiples. The financial advisor never explained its adjustments to the special committee.

The special committee never questioned the financial advisor on any of these points. The Court concluded from the evidence that “the Committee members went against their better judgment and did what Parent wanted, assisted by a financial advisor that presented each dropdown in the best possible light, regardless of whether the depictions conflicted with the advisor’s work on similar transactions or made sense as a matter of valuation theory.”

**Damages Award**

Based on the foregoing, the Court found that the special committee, and by virtue of that the GP, breached its affirmative duty to form a subjective good faith belief that the challenged dropdown was in the best interests of the partnership. The Court determined damages on an expectation damages basis — i.e., the difference between the actual challenged dropdown deal price and what the partnership would have paid had the GP not breached the LP agreement. The Court adopted the analysis of the plaintiff’s expert that the partnership overpaid by $171 million.

**The Court of Chancery Denied Defendants’ Attempt to Dismiss Plaintiff’s Claim Following GP’s Merger, Noting “Dual-Nature” of Claims**

Shortly after trial, the GP completed a related party merger that extinguished the limited partnership. As Plaintiff’s claim was derivative, the GP moved to dismiss the claim on the basis that Plaintiff lacked standing to pursue a derivative claim by reason of the merger: In denying the motion to dismiss in a separate opinion, *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, 2015 WL 7758609 (Del. Ch. Dec. 2, 2015), the Court refused to adopt the GP’s “bipolar” view of classification of the breach of contract claim as exclusively direct or exclusively derivative that “[g]ranting the motion to dismiss would generate a windfall for the General Partner at the expense of the unaffiliated limited partners for whose indirect benefit this suit was originally brought.”

If forced to choose, then the Court noted the claim would be direct. However, the Court believed the “more appropriate way” to view the cause of action was as a “dual-natured” claim with aspects that are both derivative and direct, stating as follows:

Treating a dual-natured claim as derivative for purposes of claim initiation achieves the important goals of screening out weak claims and providing an efficient and centralized mechanism for conducting the Litigation. Treating a dual-natured claim as direct for purposes of claim continuation preserves the ability of investors to pursue legitimate claims, promotes accountability, and provides a superior mechanism for doing so than secondary litigation challenging the transaction that eliminated the plaintiff’s standing to sue derivatively.

With the Court treating the claim as dual in nature so that Plaintiffs can pursue it, the Court noted that it could implement the liability award through a pro rata recovery for the limited partners unaffiliated with the GP.

**Takeaways:**

- **Independence and process matter:** Ultimately, this case is emblematic of the consequences that flow from a weakened deal process and prone subsidiary. Here, a parent-dominated entity failed to maintain an active and robust negotiation process with its parent corporation, and indeed demonstrated that it sought terms that most benefitted the parent. In short, the subsidiary (i) acquired an asset for which it previously had expressed disfavor; (ii) agreed to a price it knew or should have known was inflated beyond the true value of the asset; (iii) failed to negotiate effectively with a party that it previously had recognized insisted on inflated prices, and (iv) failed to adequately manage and assess its financial advisor’s process and work product. Instead, as the Court recognized, the deal closed with the subsidiary having “fixated myopically” on the dividend potentials resulting from the deal. The Court’s opinion, and the facts of this case, should serve as a warning to committees tasked with making deal recommendations: independence and process matter.

- **A special committee should know its role:** If special committee members cannot articulate why a transaction is in the best interests of the company, which was the contractually required standard here, there is no defense. Perhaps the record prevented the special committee from making any attempt to present credible testimony that they acted in the partnership’s best interest, less they be accused of making up their testimony for trial. Lesson learned: competent counsel can help you get it right from the beginning, so that if you cannot avoid being sued, at least you will have a record that will help you win.
CURBING STOCKHOLDER LITIGATION: FURTHER DEVELOPMENTS ON EXCLUSIVE FORUM AND FEE-SHIFTING PROVISIONS

In an effort to control the phenomena of multi-forum litigation, in which plaintiffs bring the same suit in multiple jurisdictions simultaneously, corporations began adopting, either by charter amendment or bylaw approval, exclusive forum and/or fee-shifting provisions. Exclusive forum provisions require that lawsuits over the internal affairs of a Delaware corporation be brought in Delaware. Fee-shifting provisions, which have been clouded in controversy, are essentially “loser pays” provisions. Recent Delaware legislation impacted both of these types of provisions.

History of Exclusive Forum Provisions

In 2013, the Court of Chancery, in Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013), held that boards of directors of Delaware corporations may adopt exclusive forum bylaws that are binding on stockholders. The Court addressed the validity of the bylaws under the DGCL as well as the question of whether bylaws enacted by a board of directors without stockholder involvement can be enforced, as a contractual matter, against stockholder plaintiffs.

The Court made two primary holdings. First, Section 109(b) of the DGCL permits an exclusive forum selection bylaw because it allows a corporation’s bylaws to “contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees.” The Court held that forum selection bylaws “easily meet these requirements.” Second, forum selection provisions are enforceable against stockholder plaintiffs, even though the bylaws were board-enacted, because bylaws are part of a flexible contractual relationship between stockholders and a corporation. Based on the certificate of incorporation, stockholders understand whether a particular board of directors has the power to enact bylaws. If the certificate of incorporation grants a board the power to unilaterally amend the corporation’s bylaws, as permitted by Section 109(a), then the board may enact bylaws and thereby unilaterally alter the flexible contract.

The Chevron case upheld as facially valid a bylaw that provided for exclusive jurisdiction in Delaware, but in a 2014 case involving a Delaware corporation – City of Providence v. First Citizens Bancshares, Inc., et al., 2014 WL 4409816 (Del. Ch. Sept. 8, 2014) – the company’s bylaw provided for exclusive jurisdiction in the United States District Court for the Eastern District of North Carolina, or, if that Court lacks jurisdiction, any North Carolina state court with jurisdiction. Delaware’s new Chancellor, Andre C. Bouchard, upheld the bylaw based on the same rationale in Chevron and dismissed the case.

The Delaware case law was important, but when the company and management faced lawsuits in other states that they really need the exclusive forum provisions to be enforced – and that required non-Delaware courts to accept their validity and enforce them. Some courts refused to enforce such provisions not adopted by a stockholder-approved charter amendment or adopted by management on anything other than a “clear” day. For example, in Roberts v. TriQuint Semiconductor, 2014 WL 4147465 (Cir. Ct. Or. Aug. 14, 2014), an Oregon court refused to enforce a forum selection bylaw adopted at the same time as the merger agreement being challenged by stockholders because of “the closeness of the timing of the bylaw amendment to the board’s alleged wrongdoing, coupled with the fact that the board enacted the bylaw in anticipation of this exact lawsuit.”

History of Fee-Shifting Provisions

In ATP Tour, Inc. et al. v. Deutscher Tennis Bund et al., 91 A.3d 554 (Del. 2014), the Delaware Supreme Court, sitting en banc, held that a Delaware corporate bylaw that requires a losing claimant to pay the legal fees and expenses of the defendants is not invalid per se, and if otherwise enforceable can be enforced against losing claimants whether or not they were already stockholders when the relevant bylaw provision was adopted.

In 2006, the board of directors of ATP Tour, Inc. a Delaware non-stock (also known as a membership) corporation adopted a bylaw providing that if any member or members brought or supported a claim against the corporation or any other member, the claimant would then be obligated (and if more than one claimant, jointly and severally obligated) to pay the legal fees and expenses of those against whom the claim was brought if the claimant “does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought…” Members of ATP Tour, Inc. filed claims against the corporation and the board. A federal district court, having found for the defendants on all counts, certified the question of the fee-shifting provision to the Delaware Supreme Court.

Citing Section 109(b) of the DGCL for the baseline rule that the bylaws may contain any provision not inconsistent with law or the
corporation’s certificate of incorporation, the Court noted that bylaws are presumptively valid and that a bylaw that “allocated risk among parties in intra-corporate litigation would appear to satisfy the DGCL’s requirement that bylaws ‘must relat[e] to the business of the corporation, the conduct of its affairs, and its rights and powers or the rights and powers of its stockholders, directors, officers or employees.’” Although the corporation in this case was a non-stock corporation, the analysis is applicable to stock corporations and non-stock corporations alike, with the members of non-stock corporations being analogous to stockholders.

The Court held that no principle of common law prohibits directors from enacting fee-shifting bylaws and that because contracting parties may modify the “American Rule” under which litigants pay their own costs to provide that “loser pays,” a fee-shifting bylaw (bylaws being “contracts among a corporation’s shareholders”) would be a permissible contractual exception to the American Rule. The Court noted further that an intent to deter litigation, as a fee-shifting provision inherently does, was not invariably an improper purpose.

The Court did note, however, that the enforceability of such a bylaw provision would depend on the manner in which it was adopted and the circumstances under which it was invoked, and that “[b]ylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose.”

After ATP, many corporations adopted fee-shifting bylaw provisions. Others adopted a wait and see approach because of legislative initiatives in Delaware.

**Legislation**

The 2015 Amendments to the DGCL made several changes affecting corporations’ efforts to curtail shareholder litigation:

As to exclusive forum provisions, a new Section 115 was added to expressly permit a corporation to adopt a provision in its charter or bylaws that requires internal corporate claims to be brought exclusively in “any or all of the courts” in Delaware. Corporations can select another jurisdiction, however; Section 115 also prohibits a corporation from selecting a non-Delaware jurisdiction (or an arbitral forum) as the exclusive forum for deciding internal corporate claims.

As to fee-shifting provisions, a new Section 102(f) and amended Section 109(b) prohibit stock corporations from adopting “loser-pays” fee-shifting charter or bylaw provisions for certain types of stockholder litigation and other intra-corporate disputes. Under the new provisions, neither the charter nor the bylaws can include a provision that would impose liability on a stockholder for attorneys’ fees or expenses of the corporation (or any other party) in connection with “internal corporate claims,” which Section 115 defines as any claim (including a derivative claim brought in the right of the corporation): (i) that is based on a violation of a duty by any person in his or her capacity as a current or former director, officer or stockholder, or (ii) for which the DGCL vests the Delaware Court of Chancery with the jurisdiction to decide. Agreements on fee shifting signaled individual stockholders are not prohibited. An amendment to Section 114(b) provides that the ban on fee-shifting provisions does not apply to non-stock memberships corporations.

**Takeaways:**

- While the new amendments purport to ban a Delaware corporation from selecting arbitration as an exclusive forum, mandatory arbitration for corporate governance disputes may nonetheless be the next challenge. One could argue that certain actions expressly permitted by the DGCL should be excluded – e.g., 211 (annual meetings), 220 (books and records), 225 (votes and elections) and 262 (appraisal) actions – because the DGCL authorizes them without condition, but the rationale for exempting even these actions from a validly adopted charter or bylaw provision is not clear if a charter provision explicitly states that the provision is being adopted pursuant to the Federal Arbitration Act. An argument could be made that the Delaware amendment may be preempted under such circumstances.

- While a “loser pays” system is now banned in Delaware, in 2014, Oklahoma became the first state to adopt a law mandating fee shifting in stockholder derivative suits. Of course, fee-shifting provisions were never one-sided because if the corporation loses, it pays plaintiff’s counsel. That is the current state of the law. The question now is this: are there other solutions to dealing with the problem? What about expressly imposing the American Rule – i.e., each side bear their own costs – by charter or bylaw? What about a provision that limits the plaintiff’s fees to actual time incurred or imposes a cap of no more than two times the actual time incurred? What about a financial litmus test for plaintiffs? What about no fees, or at least no premium or actual time, unless the plaintiff can demonstrate that he or she shopped around for the best deal available from counsel? What about a provision shifting fees against a plaintiff who files an action in violation of an exclusive forum provision? The validity of charter or bylaw provisions that prohibit fee shifting at all or limit fees in some way are potential issues yet to be addressed by either the Delaware courts or the Delaware General Assembly.
THE NEW GLOBAL ARBITRATION ADVANTAGE: THE DELAWARE RAPID ARBITRATION ACT

The State of Delaware is offering something new for parties that would rather arbitrate than litigate in a public courtroom - and its offering has global reach.

The Delaware Court of Chancery and the Delaware Supreme Court are renowned for their business law expertise and their speed for resolving business disputes. Complex business cases have been decided in the Court of Chancery — with discovery, motion practice, trial and a thorough written opinion — in as little as 30 days. When an appeal is taken to the Delaware Supreme Court, the appeal is adjudicated promptly. The speedy and expert resolution of business disputes is part of the Delaware brand. Delaware’s litigation process saves money and enables an enterprise to focus on business by cutting down on the time wasted on litigation.

Traditional forms of arbitration actually have taken longer than most Delaware court proceedings. Now, however, the new Delaware Rapid Arbitration Act (DRAA), 10 Del. C. Ch. 58, effective May 2, 2015, places a Delaware brand on the arbitration of complex business disputes that also will save businesses money and time. By expressly referencing the DRAA in an arbitration agreement, the parties are deemed to have consented to the provisions and benefits of the Act. This is a welcome addition to the panoply of benefits the State of Delaware provides to business entities formed under Delaware law.

How the DRAA Works

The DRAA is straightforward. Business entities, at least one of which must be formed under Delaware law, may agree in writing to submit to arbitration under the DRAA any controversy existing at the time of the agreement or arising after its effective date. More than one million Delaware business entities qualify to use the DRAA, including more than 66 percent of Fortune 500 companies and more than half of all US public companies.

With unique provisions, the DRAA builds expedited case management into the Delaware arbitration process in several important ways. The Act requires all arbitrations to be completed within 120 days. Only by unanimous agreement of the parties may this deadline be extended, and then only to 180 days. If an Arbitrator does not comply with this mandate, there are financial penalties for the Arbitrator.

Time is also saved under the DRAA — and litigation is avoided — by giving the Arbitrator the sole authority to decide any issue on the scope of the arbitration. As to review, the parties may contract for (i) no review of the Arbitrator’s decision, (ii) review before an Appellate Arbitrator selected by the agreement with a process defined in the agreement, or (iii) an Appellate Arbitrator appointed by the Delaware Court of Chancery. If the parties do not limit the review in this way, the review is conducted by the Delaware Supreme Court in conformity with the Federal Arbitration Act, 9 U.S.C. § 1 et seq., but only if a challenge is taken within 15 days of the final award.

Scope of the Relief

Improvements to the arbitration process under the DRAA do not come with any sacrifice of the traditional benefits of arbitration as a form of private dispute resolution. Unless the parties limit the authority of the Arbitrator by agreement, the Arbitrator may grant legal or equitable relief, including damages, specific performance or injunction.

Still Private and Confidential

Significantly, and unlike trial proceedings, arbitral hearings are still private and confidential. The parties may select an Arbitrator with appropriate expertise for their dispute, and the seat of arbitration may be anywhere in the world under the DRAA. Costs are generally lower, and an award is more easily enforced under the New York Convention and the Panama Convention, than a court judgment. These international conventions require the enforcement by contracting states of arbitration agreements and arbitral awards.

Selection of an Arbitrator

The parties may identify the Arbitrator or a process for selecting one or more Arbitrators. If neither is done, the Delaware Court of Chancery may appoint one or more Arbitrators upon request. Arbitrators do not have to be from Delaware, but experienced Delaware practitioners are certainly available for consideration, especially if the Delaware Court of Chancery is making the selection.

Geographic reach of the DRAA

An arbitration proceeding under the DRAA can be held anywhere in the world and the ability to apply Delaware’s new brand of rapid arbitration anywhere the parties choose makes the DRAA especially attractive.
Throughout 2015, the Delaware Court of Chancery continued its trend of closely scrutinizing disclosure-only settlements in class action merger litigation, questioning the broad releases provided to defendants in exchange for supplemental disclosures that provide little (if any) benefit to the class. In several cases, the Court rejected proposed settlements altogether: See e.g., Acevedo v. Aeroflex Holding Corp., C.A. No. 7930-VCL (Del. Ch. July 8, 2015) (TRANSCRIPT); In re Riverbed Tech., Inc. S’holders Litig., 2015 WL 5458041 (Del. Ch. Sept. 17, 2015); and In re Aruba Networks, Inc. S’holders Litig., C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015) (TRANSCRIPT). This trend began in 2014, with the Court of Chancery rejecting disclosure-only settlements on at least three separate occasions, including one decision by then-Chancellor (now Chief Justice) Strine. See In re Medicis Pharm. Corp. S’holders Litig., C.A. No. 7857-CS (Del. Ch. Feb. 26, 2014) (TRANSCRIPT); Rubin v. Obagi Medical Products, Inc., et al., C.A. No. 8433-VCL (Del. Ch. Apr. 30, 2015) (TRANSCRIPT); In re Theragenics Corp. S’holders Litig., C.A. No. 8790-VCL (Del. May 5, 2014 (TRANSCRIPT). In the aftermath of the court’s rulings in 2014 and 2015, several plaintiffs also voluntarily withdrew proposed disclosure-only settlements and/or requested the dismissal of their claims. See Berk v. Covance Inc., C.A. No. 10440-VCL; In re Advent Software, Inc. S’holders Litig., C.A. No. 10623-VCL; In re Orbitz Worldwide, Inc. S’holders Litig., C.A. No. 10711-VCMR; and In re Procera Networks, Inc., C.A. No. 10951-VCL. In the Orbitz case, however, Plaintiffs subsequently withdrew their proposed order dismissing the case and that case remains pending. In a recent meeting of the ABA Business Law Section, Vice Chancellor J. Travis Laster echoed the well-known concerns
regarding the proliferation of merger litigation, noting “[w]e are now dealing with an epidemic. When dealing with an epidemic you have to come back and look at your system.” He further foreshadowed an impending change in dealing with disclosure settlements, “[w]e are going in a different direction. What has been enough is no longer enough.”

September 19, 2015 ABA Business Law Section Annual Meeting. This systemic change was articulated in a landmark opinion by Chancellor Andre G. Bouchard in *In re Trulia, Inc. S’holder Litig.*, 2016 WL 270821 (Del. Ch. Jan. 22, 2016), where the Court rejected a proposed settlement and set forth a new proposed framework for analyzing disclosure claims in the future, warning litigants of “increasingly vigilant” scrutiny of such claims. As explained by Chancellor Bouchard “to the extent that litigants continue to pursue disclosure settlements, they can expect that the Court will be increasingly vigilant in scrutinizing the ‘give’ and the ‘get’ of such settlements to ensure that they are genuinely fair and reasonable to the absent class members.”

*Acevedo v. Aeroflex Holding Corp., C.A. No. 7930-VCL (Del. Ch. July 8, 2015)*

The first sign in 2015 of upheaval in the historical practice of approval of disclosure-only settlements came in a transcript ruling in *Acevedo v. Aeroflex Holding Corp.*, a case involving a proposed settlement consisted of supplemental disclosures and two deal modifications – the reduction of a termination fee (from $32 million to $18 million) and the reduction of the matching rights period by one day. Vice Chancellor Laster questioned the value of the settlement consideration and ultimately concluded that the relief obtained was insufficient to support the “intergalactic” or “broad class-wide release that extinguish[ed] all claims against” defendants that the parties had sought.

In rejecting the proposed settlement and plaintiff’s fee award of $825,000, Vice Chancellor Laster emphasized the importance of context in valuing settlement consideration and fee awards. In the hearing, he focused extensively on the deal modifications, observing that this relief did not match the alleged problems with the merger and that plaintiff “fixed something that didn’t need fixing . . . and [argued] that it’s worthy of a release and fee.” He noted that this relief might “be worth something to someone” but it had little to no value here. Thus, with respect to a proposed fee award, plaintiff could not simply rely on formulas or guidelines set forth in prior cases.


In *In re Riverbed Tech., Inc. S’holders Litig.*, the Court considered a settlement of plaintiffs’ claims in which Riverbed made additional disclosures in exchange for the “broadest possible release” of all federal and state claims in connection with the transaction. Plaintiffs’ counsel also sought $500,000.00 in attorneys’ fees for the “benefit conferred” on the class. When the parties sought the Court’s approval of the settlement, a Riverbed shareholder (who is also a Fordham Law School professor specializing in corporate and securities law) objected, noting that the supplemental disclosures were “essentially valueless.”

Vice Chancellor Glasscock began his opinion by explaining that his role was to ensure “that those acting for the benefit of others perform with fidelity, rather than doing what comes naturally to men and women—pursuing their own interests.” He went on to describe the “agency problem” inherent in representative litigation: a plaintiff’s attorney may favor a quick settlement where further litigation will “not generate an additional fee as lucrative” to the attorney as “accepting a quick and moderate fee, then pursuing other interests.” The Court noted that the interest of the individual shareholder-plaintiff is often so small “that it serves as scant check on the perverse incentive” of the plaintiff’s attorney. And while the adversarial system would usually help ameliorate this agency problem, the Court observed that, in M&A litigation, defendants’ primary goal is to consummate the transaction, which requires terminating the litigation. Where the interests of the defendant and plaintiff are aligned, it is incumbent upon the Court to determine whether the proposed settlement is actually fair to the class.

In examining the “meager benefit” achieved by the settlement vis-à-vis the broad release that defendant received, Vice Chancellor Glasscock stated that “in another factual scenario,” he would be inclined to reject the settlement. But, he noted that, given “the past practice” of the Court to approve settlements that confer an insignificant benefit but permit a broad release, the parties had “a reasonable expectation” that this settlement would be approved. In particular, the Court held that “[i]f it were not for the reasonable reliance of the parties on formerly settled practice in this Court . . . the interests of the Class might merit a rejection of a settlement encompassing a release that goes far beyond the claims asserted and the results achieved.’”

While the Court approved the settlement on the basis of the parties’ reasonable expectation, it noted that this factor “will be diminished or eliminated going forward in light of this Memorandum Opinion,” as well as other recent decisions from the Court. The Court also rejected plaintiffs’ counsel’s fee request, finding that the benefits achieved were “too modest” to justify an award of $500,000.00, reducing the amount to $300,000.00. In *In re Intermune Inc. S’holder Litig.*, C.A. No. 10086-VCN (Del Ch. Dec. 29, 2015) (TRANSCRIPT), the Court approved a settlement on a similar basis, but reduced the attorneys’ fee award from $470,000 to $325,000 and noted “[t]his is an evolving area of our law, and I acknowledge that I do not know how it will turn out.”

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In a separate opinion in Riverbed, the Court awarded $10,000 in attorneys’ fees and $837 in personal costs to the objector to the settlement, finding that, despite being unsuccessful, the objection was in the benefit of the stockholders and significantly impacted discussion of disclosure-only settlements at a pivotal time. In re Riverbed Tech., Inc. S’holders Litig., 2015 WL 7769861 (Del. Ch. Dec. 2, 2015). The Court noted that “[f]or this reason, I conclude, a departure from the American Rule may be warranted, and equity may support a fee award to an objector; where the efforts of the objector better enabled the Court to act in the interests of the class, even where the suggestions of the objector were not adopted by the Court.”


Reiterating the Court’s belief that the proliferation of merger litigation represents a “systemic” problem that has resulted in a “misshapen legal system,” Vice Chancellor Laster rejected a proposed disclosure-only settlement of litigation that had been filed objecting to Hewlett-Packard’s $2.7 billion acquisition of Aruba Networks and dismissed the case.

In an October 9, 2015 settlement hearing in the case, the Court cited the “inadequacy of the representation” of plaintiffs’ counsel for the shareholder class as the basis for his rejection of the settlement, as well as for dismissal of the case, for the following reasons: (i) the Court held that it did not believe the case “was meritorious when filed,” identifying a number of positive features that negated potential concerns about the merger deal, (ii) the Court believed the discovery efforts of plaintiffs’ lawyers were weak, with plaintiffs’ counsel having taken only two depositions and consulting with only a single financial expert, (iii) the Court expressed concern over the broad stating that “settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem” and noting the “repeat-process phenomenon” has resulted in a “misshapen legal regime.”


It did not take long for the Delaware Court of Chancery to reaffirm its disfavor of disclosure-only settlements in 2016. In a January 22, 2016 landmark opinion, Chancellor Bouchard refused to approve a proposed settlement arising from Zillow, Inc.’s acquisition of Trulia based solely on supplemental disclosures. More importantly for practitioners, however, the Court offered its “perspective that disclosure claims arising in deal litigation optimally should be adjudicated outside of the context of a proposed settlement so that the Court’s consideration of the merits of the disclosure claims can occur in an adversarial process without the defendants’ desire to obtain an often overly broad release hanging in the balance.” The Court suggested that such adjudication could occur either through a preliminary injunction motion or through plaintiffs’ counsel’s application for an award of attorneys’ fees after defendants supplement their proxy materials with additional disclosures.

The supplemental disclosures at issue in Trulia involved the common complaint of plaintiff stockholders regarding the information disclosed relating to the financial advisor’s analysis. The Court noted that “[t]he essence of a fair summary is not a cornucopia of financial data, but rather an accurate description of the advisor’s methodology and key assumptions. In my view, disclosures that provide extraneous details do not contribute to a fair summary and do not add value for stockholders.” After reviewing the disclosures already contained in the proxy statement, including a 10-page summary of Trulia’s financial advisor’s work, the Court held that the disclosures were not “material or even helpful to Trulia’s stockholders.” The Court rejected the settlement because “from the perspective of Trulia’s stockholders, the ‘get’ in the form of the Supplemental Disclosures does not provide adequate consideration to warrant the ‘give’ of providing a release of claims to defendants and their affiliates, in the form submitted or otherwise.”

The more important aspect of the case was the Court’s suggestions of how to address the well-known concerns about deal litigation in general, including that “far too often such litigation serves no useful purpose for stockholders,” but “serves only to generate fees for certain lawyers who are regular players in the enterprise of routinely filing hastily drafted complaints on behalf of stockholders on the heels of the public announcement of a deal and settling quickly on terms that yield no monetary compensation to the stockholders they represent.” The Court acknowledged the current litigation dynamic, with “the threat of an injunction to prevent a transaction from closing” incentivizing defendants to obtain deal protection through broad releases of claims. The Court noted that this system had resulted in 94.9% of transactions of $100 million or more in 2014 generating lawsuits and, therefore, the system was in need of reexamination.

The Court observed that “the optimal means by which disclosure claims in deal litigation should be adjudicated is outside the context of a proposed settlement,” and offered two proposals for such adjudication.

First, disclosure claims could be judicially reviewed in the context of a preliminary injunction motion, “in which case the adversarial process would remain intact and plaintiffs would have the burden to demonstrate on the merits a reasonable likelihood of proving that ‘the alleged omission or misrepresentation is material.’” Second, plaintiffs’ counsel could apply for attorneys’ fees “after defendants voluntarily decide to supplement their proxy...
materials by making one or more of the disclosures sought by plaintiffs, thereby mooting some or all of their claims. In that scenario, where securing a release is not at issue, defendants are incentivized to oppose fee requests they view as excessive.” And if defendants do not oppose an application for a mootness fee, “the Court would have some indication of the reasonableness of the fee request.” Defendants would not receive a release from a mootness dismissal, but “the filing of a stipulation of dismissal likely represents the end of fiduciary challenges over the transaction as a practical matter.”

Chancellor Bouchard further warned that “practitioners should expect that the Court will continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the ‘give’ and the ‘get’ of such settlements in light of the concerns discussed above.” Disclosure-only settlements will not be approved unless the supplemental disclosures are truly meaningful and the proposed release of claims is sufficiently narrow:

To be more specific, practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently. In using the term “plainly material,” I mean that it should not be a close call that the supplemental information is material as that term is defined under Delaware law.

The Court also suggested that, “[w]here the supplemental information is not plainly material, it may be appropriate for the Court to appoint an amicus curiae to assist the Court in its evaluation of the alleged benefits of the supplemental disclosures, given the challenges posed by the non-adversarial nature of the typical disclosure settlement hearing.”

With the new structure for addressing disclosure claims, the Court recognized that plaintiffs’ counsel may be more inclined to file such claims in other forums in hopes of finding courts more likely to sign-off on such settlements. The Court noted that corporations could address this issue by enacting exclusive forum provisions in their bylaws. Moreover, the court opined that the “historical predisposition that has been shown towards approving disclosure settlements must evolve” and the Court expressed “hope and trust that our sister courts will reach the same conclusion if confronted with the issue.”

Takeaways:

■ The Court of Chancery has made clear that the rules of play have changed – corporations can no longer expect to obtain routinely global releases of all claims arising out of merger transactions for disclosure-only settlements.

■ The Court of Chancery’s heightened scrutiny appears to be working on curbing the number of meritless lawsuits, at least to some extent. According to a recent study, 87.7% of completed transactions experienced litigation in 2015, with 52.9% of deal litigation going to Delaware (if permitted), down from 94.9% and 63%, respectively, in 2015. See Can, Matthew D. and Davidoff Solomon, Steven, Takeover Litigation in 2015 (January 14, 2016) (available at SSRN: http://ssrn.com/abstract=2715890)

■ Companies will continue to be creative in their quest to obtain global releases and attendant deal protection. Forum selection clauses can be crafted to be waivable by a company. Whether companies will waive forum selection clauses to achieve a global release in another forum may turn upon whether other jurisdictions agree that the historical practice of approving disclosure settlements must evolve. Another possible strategy is to enter into relatively cheap cash settlements with plaintiffs, of which plaintiffs’ counsel recover up to a third of fees, in exchange for the broad releases that companies’ crave. Given that most deals are in the hundreds of millions or billions, such fees amount to little more than a rounding error and a small price to pay to achieve deal certainty.
WHAT TO LOOK FOR IN 2016

In 2016, we can expect merger activity to grow, but given Delaware’s crackdown on disclosure-only settlements, the challenges will either be more targeted or the releases obtained in settlements will be limited. An unanswered question is whether companies will waive Delaware as the exclusive forum to get a broader release elsewhere.

Post RBC, the question is whether there will be a more expansive reasonableness inquiry in cases challenging the sale of the company or will market checks evolve to moot these claims as in Corwin?

High profile executive and director compensation seem to be generating more litigation, with cases against Goldman Sachs and Viacom being two to watch in 2016.

Corporate law reform will continue to be a subject of debate and possible legislation, including efforts to work around or mitigate the concerns raised by Delaware’s 2015 ban on fee-shifting provisions, appraisal arbitrage, to name a few.
2015 Amendments to the Delaware General Corporation Law

The following amendments became effective on August 1, 2015, except that the amendments relating to defective corporate acts (Sections 204 and 205) are effective only as to corporate acts on or after August 1, 2015:

§ 102, Corporation Name

Amended Section 102(a) adds an exception to the requirement that a corporation’s name be distinguishable from the names of all other registered Delaware business entities. Specifically, the Division of Corporations may waive this requirement, without prejudicing the rights of the person who has registered such name, if “[1] the corporation or a predecessor entity previously has made substantial use of such name or a substantially similar name, [2] the corporation has made reasonable efforts to secure such written consent, and [3] such waiver is in the interest of the State.”

§§ 102, 109, 114, 115, Prohibitions on Fee-Shifting Provisions in Certificates and Bylaws

In response to the Delaware Supreme Court’s decision in ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014), which held that a bylaw making members of a non-stock corporation liable in certain instances for the corporation’s attorneys’ fees and expenses in internal corporate disputes was facially valid, Delaware General Assembly amended the DGCL to prohibit fee-shifting provisions in the certificates of incorporation and bylaws of stock corporations. New Section 115 authorizes corporations to include in a certificate or bylaws provisions requiring that “internal corporate claims” be brought only in Delaware courts. The statute also provides that no such provision may prohibit bringing internal corporate claims in Delaware. It is silent, however, as to whether a certificate or bylaw provision may identify a non-Delaware forum as an additional forum in which internal corporate claims may be litigated.

§§ 152, 157, Stock Issuance, Options & Rights

Amendments to Sections 152 and 157 improve flexibility in issuing stock, options and rights. Section 152 now permits the board of directors to delegate to officers or a committee the authority to issue stock in one or more transactions, so long as the empowering resolution fixes (1) a maximum number of shares that may be issued, (2) the timeframe in which such stock may be issued, and (3) a minimum amount of consideration. The statute also clarifies that any formula by which the amount of consideration is determined may include or be made dependent on “facts ascertainable outside the formula.” Thus a board of directors may authorize stock to be issued pursuant to “at the market” programs without having to separately authorize each individual stock issuance. Amended Section 157, which governs the creation and issuance of rights and options to purchase stock, also now permits that any formula by which the amount of consideration is determined may include or be made dependent on facts ascertainable outside the formula.

§§ 204, 205, Ratification & Validation of Defective Corporate Acts

Section 204, which took effect on April 1, 2014, provides for a process for ratifying putative stock issuances or corporate acts that otherwise would be void or voidable for “failure of authorization.” In 2015, the General Assembly amended seven aspects of Section 204:

1. Amendments to several of the statute’s subsections clarify that multiple defective corporate acts can be remedied in a single ratification process.
2. Section 204(b)(2) now provides for a process for ratifying an election of a corporation’s initial directors where the directors were not named in the certificate and the incorporator failed to appoint them.

3. Sections 204(d) and (f) have been amended to clarify that shares of “putative stock” (or stock that was issued pursuant to a defective corporate act) shall not be entitled to vote on the ratification of a defective corporate act nor counted for quorum purposes.

4. Amendments to Section 204(e) refine the requirements imposed on corporations to file certificates of validation in instances where the defective corporate act being ratified would have required the filing of a certificate under another DGCL provision.

5. Amended Section 204(g) provides that public companies can give notice of having ratified a defective corporate act by making a public filing under the Securities Exchange Act of 1934 and that, where ratification of defective corporate acts is approved by written consent of the stockholders pursuant to Section 228, notice required by Section 204(g) may be satisfied by including such notice in the notice that is required by Section 228(e).

6. Amendments to Section 204(h) modify two definitions. “Failure of authorization” was expanded to encompass the failure of the board of directors or any officer of the corporation to approve an act that would have required such approval for its due authorization. Next, “validation effective time” was amended to include that the directors may fix a future validation effective time as to a defective corporate act where such validation need not be submitted to the stockholders for approval and no certificate of validation need be filed.

7. Section 204(i) was amended to clarify that Section 204 supplements the principles of ratification under the common law, including the “pre-incorporation doctrine,” under which a corporation can “adopt[] or endorse[] any act or transaction taken by or in the name of the corporation prior to the commencement of its existence.”

Section 205 – Section 204’s companion statute – provides for a judicial process for determining the validity of defective corporate acts or the ratification thereof. In 2015, Section 205 was amended include conform this Section to the amendments to Sections 204(g) and (h), namely that Section 205’s 120-day challenge period commences from the later of the giving of notice under Section 204(g) and the validation effective time.

§ 245(c), Restated Certificate of Incorporation

Amendment clarifies that a restated certificate of incorporation filed under Section 245 shall state that it only “restates and integrates and does not further amend [the certificate] [] except, if applicable, as permitted under [Sections 242(a)(1) and 242(b)(1)].”

§§ 362, 363, Public Benefit Corporations

The General Assembly approved three major changes relaxing some of the standards applicable to public benefit corporations. First, amended Section 362 has eliminated the requirement that a public benefit corporation include in its name the words “public benefit corporation,” or “P.B.C.” or “PBC.” so long as before issuing unissued shares or disposing of treasury shares, notice is provided to any person to whom such stock is issued or who acquires such treasury shares that the corporation is a public benefit corporation. This requirement is waived where the issuance is made under the Securities Act of 1933 or the corporation has a class of stock registered under the Securities Exchange Act of 1934. Second, amended Sections 363(a) and (c) relax the voting requirements to convert to or from a public benefit corporation from 90% to 66 2/3% of the outstanding shares. Third, Section 363(b) now provides, similar to Section 262, for a “market out” exception to the statutory right to appraisal of holders of stock of a corporation that is not a public benefit corporation that becomes a public benefit corporation.

§ 391, Access to Public Records

The Secretary of State may issue, in exchange for the statutorily-prescribed fees, public records by photocopy or electronic image copy, and, in no event, shall be required to produce such records in any other form. Unlike the other DGCL amendments, this amendment took effect immediately upon its enactment into law.

2015 Amendments to Delaware’s Alternative Entity Statutes

Eliminating Default Class and Group Votes

Amendments eliminating default rules associated with the requirements of “class” or “group” votes. All the amendments are effective prospectively, with three exceptions: § 17-806 (revocation of dissolution); § 17-204(3) (execution of certificate of cancellation); and § 17-214(a) (election to be a limited liability limited partnership).

§ 18-204(c); § 17-204(c); § 15-123, Proxies

Amendments clarify that these statutes, which govern powers of attorney, also govern proxies. The amendments also clarify that limited liability company agreements and limited partnership agreements may define when powers of attorney or proxies will be deemed irrevocable.

§ 18-407; § 17-403(c), Irrevocable Delegations

Amendments clarifying that any delegation by a member or manager of a limited liability company, or a general partner of a limited partnership, of rights and powers to manage the business and affairs of the entity is irrevocable if the delegation states that it is irrevocable, unless the limited liability company agreement or limited partnership agreement provides otherwise.

§ 18-1105(a)(5); § 17-1107(a)(5); § 15-1207(a)(5), Access to Public Records

Similar to the amendment to DGCL Section 391 (described above), the Secretary of State may issue, in exchange for the statutorily-prescribed fees, public records by photocopy or electronic image copy, and, in no event, shall be required to produce such records in any other form. Unlike the other alternative entity law amendments, this amendment took effect immediately upon its enactment into law.
ABOUT DLA PIPER

DLA PIPER WORLDWIDE

DLA Piper is a global law firm located in more than 30 countries throughout Africa, the Americas, Asia Pacific, Europe and the Middle East, positioning it to help companies with their legal needs around the world.

Our Corporate and Securities group, with 250 lawyers in the US and 550 worldwide, represents clients pursuing sophisticated transactions. We advise on public and private equity and debt securities offerings, mergers and acquisitions and reorganizations. In addition to offering comprehensive transactional services, we advise on corporate governance, IT, tax, compensation and technology issues. Learn more at dlapiper.com.

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DLA Piper’s integrated, experienced teams represent private equity funds as well as their principals, management teams, institutional investors, financing sources and portfolio companies in all types of transactions and industries. Our clients range from emerging managers to “unfunded” sponsors, to traditional sponsors managing billions of dollars in committed capital. Along with providing legal services, we introduce clients to the opportunities, relationships and insights afforded by our global platform. We are proud to have been ranked #1 globally for total private equity and venture capital deal volume in 2011 and again in 2012 by Dow Jones Private Equity Analyst.

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Our Mergers and Acquisitions group acts each year as counsel on a large number of mergers and acquisitions transactions. In 2014, for the fourth consecutive year, DLA Piper retained its number one ranking globally for overall deal volume, according to mergermarket’s league tables for legal advisors. In 2013 alone, that publication noted, we handled 385 transactions valued at approximately US$31 billion. We are consistently ranked among the top US firms in number of announced and completed deals.

DLA PIPER IN DELAWARE

DLA Piper’s Wilmington, Delaware office is an integral part of the firm’s national and international practice and significantly enhances the firm’s capacity to provide full-service solutions to our clients in all significant areas of business law. DLA Piper’s Delaware lawyers are established trial and transactional lawyers recognized by Chambers USA: America’s Leading Lawyers for Business, with substantial experience in handling matters in multiple venues focusing on the core areas for which Delaware is nationally and internationally renowned.

The corporate lawyers in DLA Piper’s Delaware office represent corporations, boards of directors, individual officers and directors, special board committees and large investors. In addition to counseling on corporate and governance issues, this practice involves advising on deal structure and compliance with fiduciary duties as well as representation in the Delaware courts.

The litigation aspect of the corporate practice covers class actions and derivative breach of fiduciary claims, corporate control disputes, merger and acquisition litigation, actions involving the interpretation of charter provisions and bylaws, actions by directors and/or officers seeking advancement and/or indemnification, stockholder appraisal actions, stockholder requests for books and records, internal corporate investigations, litigation arising out of transactions involving subsidiaries, tender offers, asset sales, capital restructurings, stockholder meetings and votes, dissolutions, corporate reporting and compliance programs and other matters involving corporate governance and the Delaware General Corporation Law.

Also resident in DLA Piper’s Wilmington office is a former two-term governor and nine-term congressman of Delaware, whose extensive state and federal experience provides a unique understanding of a wide array of issues faced by businesses that are either incorporated in Delaware or deal with Delaware entities.