DELAWARE CORPORATE LAW BULLETIN

Chancery Court Finds *Corwin* Applicable to Third-Party Buyout of a Company Controlled by a Large Stockholder

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Grants pleading-stage dismissal of damages claim despite allegations of "unique benefits" to the controlling stockholder and material misstatements and omissions in disclosure documents

INTRODUCTION

When target company stockholders seek damages from corporate directors following the closing of a third-party buyout, the directors frequently base their defense on the Delaware Supreme Court's now-iconic ruling in *Corwin v. KKR Fin. Holdings*, *LLC,* 125 A.3d 304 (Del. 2015) ("*Corwin*"). Under *Corwin*, if the challenged transaction has been approved by an uncoerced majority vote of disinterested stockholders, Delaware courts will apply the deferential business judgment standard of review to a damages claim. Usually, this will result in a pleading-stage dismissal. The benefits of Corwin "cleansing" were extended to two-step acquisitions (*i.e.*, a tender offer followed by medium-or short-form mergers) in *In re Volcano Corp. S'holder Litig*., 143 A.3d 727 (Del. Ch. 2016), *aff'd*, 156 A.3d 697 (Del. 2017) ("*Volcano*"). (For a discussion of *Volcano*, *see* Robert S. Reder, *Delaware Chancery Court Extends "Cleaning Effect" of Stockholder Approval Under* KKR *to Two-Step Acquisition Structure*, 69 VAND. L. REV. EN BANC 227 (2016)).

In the case of a third-party buyout of a target company with a large stockholder, a plaintiff may seek to avoid pleading-stage dismissal under *Corwin* by establishing that the large stockholder was a "controlling stockholder" who received "a unique benefit by extracting something uniquely valuable" not shared with the other stockholders. If plaintiff is successful, the court will apply the entire fairness standard of review, "Delaware's most onerous standard" requiring defendants to "establish 'to the court's satisfaction that the transaction was the product of both fair dealing *and* fair price.' " In that case, defendants likely will not obtain a pleading-stage dismissal.

Recent decisions of the Delaware Court of Chancery ("*Chancery Court*") have made it clear that the size of a stockholder's stake in a target company is no predictor of the outcome of a controlling stockholder analysis. In *Rouse Properties, Inc. Fiduciary Litigation,* C.A. No. 12194-VCS, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018) (*"Rouse"*), the Chancery Court decided that a 33.5% stockholder *was not* in control. But less than three weeks later, the Chancery Court ruled in *Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) ("*Tesla*"), on the basis of a very different record, that a 22.1% stockholder *was* in control. (For discussions of *Rouse* and *Tesla*, respectively, *see* Robert S. Reder, *Chancery Court Finds Corwin Applicable to Merger Transaction Negotiated with 33.5% Stockholder*, 72 VAND. L. REV. EN BANC 51 (2018), and Robert S. Reder, *Chancery Court Determines that 22.1% Stockholder Controls Corporation, Rendering* Corwin *Inapplicable*, 72 VAND. L. REV. EN BANC 61 (2018)).

A determination that a particular target company stockholder is "controlling" does not end the *Corwin* analysis. Instead, the *Corwin* defense may remain available unless the court also concludes that the controlling stockholder was engaged in a "conflicted transaction." A conflicted transaction may be one "in which the controller stands on both sides of the deal" (e.g., where the controlling stockholder is buying out the shares of the other stockholders) or, alternatively, a third-party buyout "where the controller gets a unique benefit by extracting something uniquely valuable to the controller."

In *English v. Narang*, C.A. No. 2018-0221-AGB, 2019 WL 1300855 (Del. Ch. Mar. 20, 2019) ("*English*"), the Chancery Court again considered the availability of a *Corwin* defense in connection with a third-party buyout of a company with a large stockholder. Plaintiffs alleged that the large stockholder, indisputably in control, pushed for the buyout to satisfy his need for immediate liquidity, a "unique benefit" not shared with others. Chancellor Andre G. Bouchard rejected plaintiffs' allegations and, after determining that target stockholders were fully informed, granting pleading-stage dismissal to the defendant directors.

I. FACTUAL BACKGROUND

A. NCI Launches a Sale Process

NCI, Inc. ("*NCI*" or the "*Company*") "provides enterprise solutions and services to United States 'defense, intelligence, health and civilian government entities.' " NCI had two classes of common stock outstanding: publicly-traded Class A shares having one vote per share, and privately-held Class B shares having ten votes per share but convertible into Class A shares on a one-for-one basis. NCI's founder, Charles K. Narang ("*Narang*"), owned all of the Class B shares which, together with his Class A shares, gave him a 34% economic stake in the Company but a 83.5% voting stake. As a result, Narang clearly was NCI's "controlling stockholder." Narang served as Chairman of the Board and CEO of NCI until October 1, 2015, at which time he retired as CEO. In addition to Narang, NCI's board of directors (the "*Board*") consisted of Mr. Narang's successor as Company CEO and five independent directors.

Shortly after Narang's retirement as CEO, the Board hired two financial advisors and launched a sales process that spanned 18 months. After some preliminary conversations, on March 8, 2017, H.I.G. Capital, L.L.C., a private equity firm ("*HIG*"), proposed to purchase the Company for $18 per share in cash. Three days later HIG raised its offer to between $19 and $21 per share. During an April 2017 investor call in connection with the Company's year-end earnings release (the "*Investor Call*"), NCI's CEO "underscored that NCI possessed a lot of untapped potential, noted improving market conditions that bode well for NCI's success, and expressed confidence in NCI's ability to execute [its strategic] plan." As a result of this bullish presentation, the Company's "stock price immediately jumped."

Thereafter, four other parties—a mix of private equity and strategic—submitted bids in the same range as HIG's. Ultimately, HIG raised its bid to $20 per share while the other bidders dropped out due to a variety of reasons: concern with "risks" associated with NCI's business, "uncertainty of the timing of NCI's turnaround plan" and, in one case, "synergies . . . lower than previously expected." After a several week exclusivity period, HIG cemented its bid at $20. At the time, NCI's stock was trading at $21.20 per share. Nevertheless, the Company's financial advisors were able to render fairness opinions and the Board authorized the signing of a merger agreement with HIG (the "*Merger Agreement*").

The Merger Agreement provided for a two-step acquisition—a cash tender offer followed by a merger—and contained a number of typical "deal protections," including a "no solicitation" provision and a "fiduciary out" entitling the Board to accept an unsolicited, superior third-party offer, subject to matching rights for HIG and payment by NCI of a termination fee "representing approximately 4% of the implied enterprise value of the Transaction." In addition, Narang signed a "tender and support agreement" in favor of the transaction. NCI stockholders other than Narang tendered approximately 73.6% of the outstanding shares, enabling HIG to complete the second-step merger and close the acquisition four days later on August 15, 2017.

B. Litigation Ensues

Some seven months after completion of the merger, two former NCI stockholders filed suit in the Chancery Court, alleging breach of fiduciary duty by the members of the Board on the grounds they "sanctioned a process and price that was not entirely fair" and "failed to disclose material information" to NCI stockholders. The defendant directors moved to dismiss, citing the "cleansing" impact, under *Corwin*, of the tender of shares by NCI stockholders. Plaintiffs countered that *Corwin* was inapplicable because, *first*, "Narang orchestrated a sale of the company for less than fair value to address a personal need for liquidity prompted by his retirement as the company's CEO at seventy-three years of age" and, *second*, "the other stockholders who tendered their shares were not fully informed when they did so because the recommendation statement for the transaction was misleading and omitted material information." Rejecting both these contentions, Chancellor Bouchard granted defendant directors' motion to dismiss.

II. CHANCELLOR BOUCHARD'S ANALYSIS

Chancellor Bouchard segmented his analysis into two parts: *first*, was Narang, as NCI's controlling stockholder, "conflicted . . . because of his need for liquidity" and, *second*, was the successful tender offer "not fully informed based on three alleged deficiencies" in the related disclosures? If the Chancellor answered either question in the affirmative, then a *Corwin* defense would not have been applicable, pleading-stage dismissal would have been denied, and the defendant directors would have faced a trial in which they bore the burden of establishing the "entire fairness" of the transaction.

A. No Controlling Stockholder Conflict

Plaintiffs argued that the "unique benefit" driving Narang to push for the HIG buyout derived from his need "to liquidate his position as part of his estate planning and wealth management strategy" following his retirement as CEO at age 73 "because 'his NCI holdings accounted for nearly all of his net worth.' " Two Chancery Court decisions delineate the parameters of this issue:

- In *N.J. Carpenters Pension Fund v. infoGroup, Inc*., No. Civ.A. 5334–VCN, 2011 WL 4825888 (Del. Ch. Sept. 30, 2011, *revised*, Oct. 6, 2011) ("*infoGroup*"), the court found that a 37% stockholder received a unique benefit from a third-party buyout where the stockholder "desperately needed liquidity," "owed over $12 million" from litigation settlements, "had over $13 million of debt," "had not received a salary since leaving his job," and "planned to launch a new business to be funded with his own money." Further, the stockholder's liquidity issues were "repeatedly discussed" with the target company's board of directors.

- By contrast, then-Chancellor (now Delaware Supreme Court Chief Justice) Leo E. Strine Jr. found no unique benefit in *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012) ("*Synthes"*), even though plaintiffs pointed to "hints" that a 52% stockholder "was anxious to get out of Synthes and that this anxiety drove the strategic process . . . in a way that was unfair to the minority." Chancellor Strine emphasized the "very narrow circumstances" under which an "immediate need for

> liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment." Specifically, he required proof of "a crisis, fire sale where the controller, in order to satisfy an exigent need . . . agreed to a sale of the corporation without any effort to make logical buyers aware of the chance to [buy], give them a chance to do due diligence, and to raise the financing necessary to make a bid that would reflect the genuine fair value of the corporation."

Chancellor Bouchard concluded that the allegations presented to him in *English* were much closer to the fact pattern in *Synthes* than in *infoGroup*. According to the Chancellor, plaintiffs' complaint "contains no concrete facts from which it reasonably can be inferred that Narang had an exigent or immediate need for liquidity." Rather, the complaint "was devoid of factual support . . . for conceiving that [Narang] wanted or needed to get out of [NCI] at any price, as opposed to having [millions] of reasons to make sure that when he exited, he did so at full value." In direct contrast to plaintiffs' allegations, the Chancellor noted there was no evidence that "Narang had *any*—much less significant—debt obligations, needed to exit his position in NCI in order to pursue a new business venture, or had admitted to others a need for liquidity." Further, as opposed to a "fire sale," "the sales process extended over a period of more than eighteen months," the Company's financial advisors "contacted numerous potential buyers," and the Board "included five directors other than Narang . . . whose independence is not seriously questioned."

B. Tendering Stockholders Were Fully Informed

In attacking the disclosures made to NCI stockholders regarding the tender offer, plaintiffs pointed to three potential areas of concern: management-prepared financial projections that understated the Company's financial position, "potential conflicts arising out of post-close opportunities for NCI's management," and "potential conflicts affecting NCI's financial advisors." Chancellor Bouchard concluded that "each of plaintiffs' challenges . . . fails to show that NCI's stockholders were not fully informed when deciding whether to tender their shares . . . ."

1. *Financial Projections*. Plaintiffs complained that the financial projections furnished to potential purchasers and disclosed to stockholders "understated the Company's upside and overstated certain risk factors," particularly in light of the CEO's bullish presentation during the Investor Call. The Chancellor rejected this argument, characterizing the statements made on the Investor Call as "puffery"

that did not "contradict[ ] any aspect of the Company Projections sufficiently to support a reasonable inference that they were false or misleading."

2. *Post-Closing Employment*. Plaintiffs argued that members of NCI management must have held undisclosed pre-closing discussions with HIG to secure their post-merger employment with the Company because "such arrangements were announced on the day of closing." Plaintiffs theorized that these arrangements detracted from the purchase price negotiated in the Merger Agreement. The Chancellor characterized this argument as "speculative." Instead, he noted, "the only non-speculative, reasonable inference that can be drawn . . . is that post-close employment discussions occurred at some point after execution of the Merger Agreement and before the announcement in the Form 8-K filing issued on the closing date."

3. *Financial Advisor Conflicts*. Plaintiffs complained about a lack of detail in disclosures concerning the NCI financial advisors' prior work for HIG and affiliated companies. The Chancellor disagreed, opining that the "omitted facts" about past work for HIG "would [not] have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available concerning the financial advisors' incentives in connection with the sale process."

CONCLUSION

While Chancellor Bouchard's opinion in *English* does not really break any new ground, it is a very useful summary of the degree of evidence required by the Chancery Court for a plaintiff to avoid a *Corwin* defense. Mere conclusory allegations will not be sufficient to defeat a pleading-stage motion to dismiss, whether in the context of demonstrating that a controlling stockholder allegedly in need of liquidity received a "unique benefit" in connection with a third-party buyout, or attacking disclosures made to target company stockholders in connection with their decision to tender into (in the case of a two-step acquisition) or vote in favor of (in the case of a one-step acquisition) a buyout transaction.