DELAWARE CORPORATE LAW BULLETIN

Chancery Court Questions Whether Nominally Designated "Independent" Directors Satisfied Requirements of Stockholders Agreement

*Robert S. Reder**

*Eunice (Chan Mi) Lim***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

***Vanderbilt University Law School, J.D. Candidate, May 2021.*

In refusing to dismiss claims against controlling stockholder and directors, court allows public stockholders their day in court to challenge propriety of partial tender offer and compliance with stockholders agreement

INTRODUCTION

Among its other attributes, the Delaware Court of Chancery ("*Chancery Court*") generally is steadfast in protecting the rights of public stockholders of controlled corporations. Recently, in *In re Coty Inc. S'holder Litig.*, No. 2019-0336-AGB, 2020 WL 4743515 (Del. Ch. Aug. 17, 2020) ("*Coty Stockholder Litigation*"), the Chancery Court demonstrated its commitment to examine not only the terms of protections erected by a controlling stockholder and its board designees for the benefit of minority stockholders, but also whether their actions were faithful to the terms of the minority protections.

In *Coty Stockholder Litigation*, Chancellor Andre G. Bouchard was confronted with a partial tender offer whereby a large stockholder increased its stake from 40% to 60% and a stockholders agreement signed in connection therewith, purportedly to provide various protections to non-tendering stockholders. In refusing to dismiss breach of fiduciary duty and contract claims against the controlling stockholder and defendant-directors, the Chancellor allowed non-tendering stockholders to continue questioning whether various directors deemed by the corporation to be independent actually satisfied the definition of that term in the stockholders agreement. The Chancellor also addressed a number of novel issues, including (i) an abstention defense offered by certain directors, (ii) an interpretive dispute over key provisions of the stockholders agreement, (iii) whether non-tendering stockholders were entitled to enforce the stockholders agreement though not expressly granted that right, and (iv) whether non-tendering stockholders are capable of suffering harm when a de facto stockholder increases its position to mathematical control.

I. FACTUAL BACKGROUND

A. Coty Grows Through Acquisition

In October 2016, Coty Inc. ("*Coty*" or the "*Company*") "more than doubled" its size by acquiring the specialty beauty business of Proctor & Gamble, making Coty "one of the world's largest beauty companies."

By virtue of this transaction, German investment conglomerate JAB Holding Company S.à.r.l. ("*JAB*"), which previously owned a majority of Coty's outstanding shares, saw its stake diluted to 36%.

Following difficulties integrating this large acquisition, in November 2018 Coty retained a new management team led by CEO Pierre Laubies ("*Laubies*"). Laubies also was appointed to the Company's nine-person board of directors (the "*Board*") to serve alongside four high-level JAB executives ("*JAB Directors*") and four individuals who held no management positions at the Company but had various relationships with JAB affiliates ("*Outside Directors*" and, together with Laubies and the JAB Directors, "*Defendant-Directors*"). By February 2019, "management had begun to stabilize the business" and turned to completing a new strategic plan "for future growth" (the "*Strategic Plan*").

B. JAB's Partial Tender Offer; Special Committee Process

In late February, JAB publicly announced its intention to conduct a partial tender offer for enough additional shares of Coty common stock—at a price of $11.65 per share (the "*Offer Price*")—to increase its ownership stake from approximately 40% to approximately 60% (the "*Tender Offer*"). JAB conditioned the Tender Offer on approval by "the independent directors of the Company." While the Offer Price reflected a 21% premium over the previous day's closing price, a 51% premium over the thirty-day average trading price, and a 38% premium over the ninety-day average trading price, it "represented a considerable discount compared to Coty's 52-week high" as well as to an "intrinsic" valuation prepared by a market analyst.

On February 14, the Board formed a special committee of three Outside Directors "to evaluate and determine how to respond to the Tender Offer" ("*Special Committee*"). The Special Committee promptly retained Centerview Partners LLC ("*Centerview*") as its financial advisor. At a February 20 meeting, the Special Committee discussed "each member's potential conflicts of interest in connection with the transaction, including with respect to JAB and its affiliates," ultimately determining that each Special Committee member "does not have any material interest in, or in connection with, the Offer that is different from the interests of the Company's stockholders generally." Apparently, no such determination was made as to independence and disinterestedness from JAB.

As the Special Committee evaluated the proposed transaction—under pressure from JAB to act "in a timely fashion"—Centerview advised that the Tender Offer was coming at a "'highly complex time'

on the heels of a 'new [management] team for Coty.' " Centerview lamented that Coty management "had not completed its strategic plan" or prepared suitable "financial projections," neither of which were "expected to be available until May 2019 at the earliest." Nevertheless, the Special Committee proceeded.

Although the Special Committee asked JAB to increase the "Offer [P]rice," it failed to make an actual counteroffer or propose a minimum acceptable price. JAB refused any price concession, but did agree to a stockholders agreement (the "*Stockholders Agreement*") providing, among other things, for "the election to the Board of at least four directors that are independent from JAB and two new independent directors 'by no later than September 30, 2019.' "

On this basis, on March 17, the Special Committee recommended Board approval of both the Stockholders Agreement and the Tender Offer. That same day, the Board accepted the Special Committee's recommendation, with the JAB Directors recusing themselves from the vote.

C. Tender Offer Completed; Litigation Ensues

In a Recommendation Statement filed with the Securities and Exchange Commission ("*SEC*") and furnished to stockholders to use when deciding whether to accept the Tender Offer (the "*Recommendation Statement*"), Coty stated that, other than the JAB Directors, it was "not aware of any actual or potential material conflicts of interest between any of the Company's executives and directors, including members of the Special Committee, and the Company." Notably, the Recommendation Statement "omitted information regarding the professional history and relationships between JAB and the Outside Directors," including those serving on the Special Committee. Moreover, while the Recommendation Statement incorporated by reference information from various of Coty's previous SEC filings, it "excluded the portions that contain[ed] the Special Committee members' biographical information."

JAB successfully completed the Tender Offer on April 30. Then, in early May, Coty announced third-quarter earnings "which beat analyst expectations," while management confirmed resolution of "supply chain issues" and "previewed the new strategic plan." By May 17, Coty's stock price had increased 25% from the closing price on the date that the Tender Offer was consummated. In September, three new directors with "strong ties to JAB" were added to the Board.

Three Coty stockholders ("*Plaintiffs*") brought suit in Chancery Court, claiming

- in *Count I*, Director-Defendants breached their fiduciary duties because they "knowingly failed to adequately consider whether any member of the Special Committee was actually independent of JAB" and "failed to disclose all material information concerning the Tender Offer and the conflicts of interest of the Special Committee members in the [Recommendation Statement]";
- in *Count II*, JAB, as the de facto controlling stockholder of Coty, breached its fiduciary duties because it "opportunistically timed and priced the Tender Offer so that it undervalued Coty and structured it in a coercive manner";
- in *Count III*, JAB breached the Stockholders Agreement by failing to elect "independent" directors to the Board by September 30, 2019; and
- in *Count IV*, Director-Defendants breached their fiduciary duties by "causing and failing to remedy the Company's continuing breaches of . . . the Stockholders Agreement."

JAB and Defendant-Directors moved to dismiss.

II. CHANCELLOR BOUCHARD'S ANALYSIS

Chancellor Bouchard began by noting that the defendants' motions to dismiss raised four principal issues:

- *First*, "does Count I state a non-exculpated claim for breach of fiduciary duty against Laubies as a director?"
- *Second*, "does Count I state a claim for breach of fiduciary duty against the JAB Directors?"
- *Third*, do Counts III and IV adequately raise claims "for breach of contract and breach of fiduciary duty with respect to the Stockholders Agreement?"
- *Fourth*, does Plaintiffs' complaint adequately allege that the non-tendering Coty stockholders "were harmed by the Tender Offer?"

A. Breach of Fiduciary Duty by Laubies (Count I)

As permitted by section 102(b)(7) of the Delaware General Corporation Law, Coty's certificate of incorporation contains an exculpatory provision protecting its directors from personal damages for breach of their duty of care ("*Exculpatory Provision*"). Thus, to survive Laubies' motion to dismiss Count I, Chancellor Bouchard

pointed out that Plaintiffs must have pled "facts supporting a rational inference that [Laubies] harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom [Laubies] could not be presumed to act independently, or acted in bad faith." After noting that Laubies in effect "concede[d] his lack of independence from JAB by not arguing otherwise," the Chancellor found that Plaintiffs alleged "sufficient facts . . . to support a rational inference that Laubies acted to advance the self-interest of JAB with respect to the Tender Offer." Not only did he vote in his capacity as a member of the Board in accordance with the Special Committee's recommendation of the Stockholders Agreement and the Tender Offer, but he "allegedly 'made sure the projections' . . . used in connection with the Tender Offer 'were understated' and 'kept the market in the dark' about Coty's strategic plan, which 'helped create uncertainty to benefit JAB's plan to acquire majority ownership at the expense of Coty's public stockholders.' "

B. Breach of Fiduciary Duty by the JAB Directors (Count I)

The JAB Directors sought dismissal of Count I on the ground that none of them served on the Special Committee or took part in the Board's final vote approving the Tender Offer. While acknowledging that directors "can avoid liability for an interested transaction by *totally abstaining* from any participation in the transaction," Chancellor Bouchard explained that "the abstention principle . . . is not absolute and often implicates factual questions that cannot be resolved on the pleadings."

In rejecting the JAB Directors' abstention defense for purpose of their motion to dismiss, the Chancellor focused on Plaintiffs' allegations that the JAB Directors "failed to disclose . . . all of their relationships with the Special Committee members" in questionnaires given to all Board members, leading "Coty to distribute a Recommendation Statement that misleadingly portrayed the Special Committee members to be independent." Further, the JAB Directors actually "participated in the key board meeting" and discussed their positive view of the Tender Offer, just before excusing themselves from the Board's formal vote.

This degree of participation led the Chancellor to find it "reasonably conceivable that the JAB Directors did not totally abstain from the process by which the Tender Offer was approved." Accordingly, it was not appropriate to dismiss Plaintiffs' claims against the JAB Directors pending a "fact-specific analys[is] that cannot be conducted on a motion to dismiss."

C. Stockholders Agreement Claims

1. Breach of Contract—JAB (Count III)

The dispute over whether JAB breached the Stockholders Agreement by failing to timely elect "Independent Directors" to the Board became one of contract interpretation. The Stockholders Agreement established a two-part test for independence: *first*, compliance with applicable SEC rules and, *second*, disinterestedness from JAB.

JAB seemingly conceded that none of the Outside Directors satisfied the express terms of the Stockholders Agreement's definition of "Independent Directors." Instead, JAB pointed to a stipulation in the Stockholders Agreement that, *as of the date of the Stockholders Agreement* (that is, March 17, 2019), four of the Outside Directors were "Independent Directors" ("*Independent Directors Stipulation*"). JAB argued that the Independent Directors Stipulation was "forward-looking" in nature, applicable "*on a going-forward basis*" "*until the facts that existed as of March 17, 2019* change in a way that bears on the definition of Independent Director in the contract."

Plaintiffs countered that the Independent Directors Stipulation spoke only "as of" the date of the Stockholders Agreement so as "to preclude a challenge to the authority of the Outside Directors to approve the Stockholders Agreement on behalf of the Company for lack of independence from JAB—nothing more and nothing less." Upon finding that both sides offered "reasonable," albeit divergent, interpretations of the Independent Directors Stipulation, Chancellor Bouchard denied JAB's motion to dismiss Count III. On a motion to dismiss, the Chancellor explained, "the court 'cannot choose between two differing reasonable interpretations of ambiguous documents.' "

JAB argued in the alternative "that Plaintiffs lack standing to bring Count III" because the Stockholders Agreement expressly authorized "Independent Directors," but no one else, to enforce the Company's rights thereunder. However, because this grant of authority was not by its terms exclusive, the Chancellor found that non-tendering stockholders also had the right to bring an enforcement action. In fact, elsewhere in the Stockholders Agreement, exclusive authority was granted to "a subgroup of directors . . . to take specified actions enumerated elsewhere in the Stockholders Agreement," demonstrating that the authors of the Stockholders Agreement knew how to grant exclusive authority when they so intended.

2. Breach of Fiduciary Duty—Defendant-Directors (Count IV)

To support their motion to dismiss Count IV, Defendant-Directors relied on JAB's unsuccessful arguments to dismiss Count III: *first*, the JAB Directors and Laubies reprised JAB's "forward-looking" view of the definition of Independent Directors, and, *second*, the Outside Directors echoed JAB's contention that only Independent Directors were authorized to enforce the Stockholders Agreement. Having already found these arguments wanting, Chancellor Bouchard refused to dismiss Count IV.

D. Harm to Non-Tendering Stockholders

Lastly, both JAB and Director-Defendants argued for dismissal of all claims on the basis that the non-tendering Coty stockholders suffered no harm from the alleged fiduciary duty and contract breaches "because they were not differently situated than they were before the Tender Offer." This argument was grounded on the theory that JAB controlled Coty both before and after the Tender Offer. Specifically, although JAB was an owner of less than 50% of the stock, it enjoyed "*de facto* control" before the Tender Offer by virtue of its ability to "'*exercise*[ ] *control* over the business affairs of the corporation' " and its actual control post-Tender Offer when its stake in the Company exceeded 50%. In short, the Tender Offer did not effect a change of control that prejudiced non-tendering stockholders.

Chancellor Bouchard rejected this approach, noting that a de facto controller may obtain "real benefits from securing mathematical control of a corporation in a transaction and, as a corollary, that other stockholders of the corporation potentially may suffer harm as a result of such a transaction." The Chancellor explained that there is "significant diminution in the voting power of those who thereby become minority stockholders" when someone secures a majority of a corporation's voting shares, citing several actions a controller unilaterally may take that could "alter materially the nature of the corporation and the public stockholders' interests." And while JAB's voting power was admittedly potent before the Tender Offer, Chancellor Bouchard concluded that he could not, at this preliminary stage, "rule out . . . that the [non-tendering stockholders] suffered harm when JAB secured mathematical control of Coty through the Tender Offer." In fact, the Recommendation Statement cited the non-tendering stockholders "loss of the ability to obtain a control premium in the future as a 'negative factor' " to consider in evaluating the Tender Offer.

CONCLUSION

Chancellor Bouchard's blanket rejection of the *Coty Stockholder Litigation* defendants' motions to dismiss demonstrates the Chancery Court's refusal blindly to accept procedural safeguards purportedly put in place to protect minority stockholders. Instead, in the face of well-pled allegations of unfairness, the Chancery Court will examine whether those safeguards were honored in actual practice. In *Coty Stockholder Litigation*, Plaintiffs' allegations concerning the underlying web of entangled interests between JAB and members of the Board, even the nominally Outside Directors, led the Chancellor to require a trial on the merits of Plaintiffs' claims, reaffirming the Chancery Court's commitment to protecting minority stockholders.