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No *Corwin*, No Problem: Chancery Court Discusses *Revlon's* Role in Analyzing Post-Closing Damages Claims Against Target Company Directors

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After rejecting directors' Corwin defense, court concludes that the plaintiffs failed to adequately plead non-exculpated breach of "Revlon duties"

INTRODUCTION

Recently, in *In re USG Corp. S'holder Litig.*, No. 2018-0602-SG, 2020 WL 5126671 (Del. Ch. Aug. 31, 2020) ("*In re USG*"), Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery ("*Chancery Court*") adeptly addressed the interplay between two iconic Delaware Supreme Court decisions in the corporate-sale context: *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) ("*Revlon*") and *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"). *In re USG* featured the sale, *via* merger, of a target company to a strategic buyer in an all-cash transaction. Following completion of the transaction, former target company stockholders sought damages from company directors, alleging that they breached their so-called "*Revlon* duties" in conducting the sale process and approving the sale. The directors sought pleading-stage dismissal on the basis of two alternative defenses: *first*, any alleged breach of fiduciary duty was "cleansed" under *Corwin* by virtue of the stockholder vote approving the transaction, and, *second*, if *Corwin* "cleansing" was not available, the plaintiffs failed to adequately plead breach of fiduciary duties by the directors.

Vice Chancellor Glasscock rejected the *Corwin* defense, pointing to the plaintiffs' allegations of material omissions from disclosure documents furnished to target company stockholders. However, because the directors were exempt from personal damages for breach of their duty of care under the Delaware General Corporation Law section 102(b)(7) ("*DGCL § 102(b)(7)*") exculpatory provision in the target company's charter, the plaintiffs were required to "plead facts making it reasonably conceivable that the . . . directors breached their duty of loyalty or acted in bad faith" to avoid dismissal. In granting the directors' motion to dismiss, the Vice

Chancellor concluded that the plaintiffs' pleadings did not clear this high pleading bar.

To better understand the issues at stake in *In re USG*, it is helpful first to review the legal background for Vice Chancellor Glasscock's analysis.

I. LEGAL BACKGROUND

Despite proclamations by some that *Revlon* has lost relevance, *Revlon* remains an important decision in the corporate-sale context. As Vice Chancellor Glasscock explained in *In re USG*, in accordance with *Revlon*,

> where a board decides to sell the company and thus terminate stockholder ownership, the director[s'] fiduciary duties mandate that they concentrate on securing the best price. Put differently, to comply with *Revlon*, "when a board engages in a change of control transaction, it must not take actions inconsistent with achieving the highest immediate value reasonably attainable."

Some thirty years after *Revlon*, the *Corwin* court provided target company directors with a powerful tool to defend post-closing damages actions alleging breach of so-called "*Revlon* duties." Under *Corwin*, a "fully informed, uncoerced vote of the disinterested shareholders," will in effect "cleanse" any such breach. Notably, as Vice Chancellor Glasscock explained in *In re USG*, the *Corwin* defense is not available in "transactions involving a *controlling stockholder*," at least where "the controller engages in a conflicted transaction." A conflicted transaction "occurs when a controller sits on both sides of the transaction, or is on only one side but 'competes with the common stockholders for consideration.' "

Corwin also addressed the application of *Revlon* to both pre-closing and post-closing litigation challenging corporate-sale transactions. According to the *Corwin* court, "*Revlon* [is] primarily 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. [*Revlon* was] not [a] tool[ ] designed with post-closing money damages claims in mind . . . ." Did this statement signal the demise of *Revlon*, at least in connection with post-closing damages claims against target company directors?

It apparently did not. In *Kahn v. Stern*, 183 A.3d 715 (Del. 2018) (unpublished table decision) ("*Kahn v. Stern*"), the Delaware Supreme Court explained that "*Revlon* remains applicable as a context-specific articulation of the directors' duties" in those cases where *Corwin* cleansing is not available. For a discussion of *Kahn v. Stern*, see Robert S. Reder & Victoria L. Romvary, *Delaware Supreme Court*

Clarifies Pleading Standard in Post-Closing Damages Action Alleging Breach of "Revlon Duties," 72 VAND. L. REV. EN BANC 29 (2018).

This very circumstance arose the following year in *Morrison v. Berry*, No. 12808-VCG, 2019 WL 7369431 (Del. Ch. Dec. 31, 2019) ("*Morrison v. Berry*"). In *Morrison v. Berry*, Vice Chancellor Glasscock (after rejecting the target company directors' *Corwin* defense due to inadequate disclosures) cited *Kahn v. Stern* for the proposition that "*Revlon* applies to the underlying company sale process—and is thus a context-specific lens through which to look at the defendants' duties." When viewed through this "lens," the plaintiff's allegations of director misconduct in conducting a sale process fell short of the high bar for pleading the directors' breach of their duty of loyalty. Accordingly, the Vice Chancellor granted the directors' motion to dismiss. For a discussion of *Morrison v. Berry*, see Robert S. Reder & Lorin Hom, *Chancery Court Dismisses Breach of Fiduciary Duty Claims Against Target Company Directors Despite Unavailability of Corwin Defense*," 73 VAND. L. REV. EN BANC 111 (2020).

Then, in *In re USG*, Vice Chancellor Glasscock presented a more detailed analysis of the *Revlon* "context-specific lens" identified in *Morrison v. Berry*. Before discussing the Vice Chancellor's analysis, it is helpful to review the facts underlying the claims at issue in *In re USG*.

II. FACTUAL BACKGROUND

A. Knauf Offers To Buy USG

Each of Berkshire Hathaway Inc. ("*Berkshire Hathaway*")—led by "famed investor" Warren Buffett ("*Buffett*")—and German building materials manufacturer Gebr. Knauf KG ("*Knauf*") owned significant portions, 30.4% and 10.6% respectively, of USG Corp. ("*USG*" or the "*Company*"). USG, "a manufacturer and distributor of building materials," was "the largest distributor of wallboard in the United States and the largest manufacturer of gypsum products in North America."

Knauf, long desirous of purchasing 100% of USG "to secure a significant beachhead in the North American market," first informed USG of its acquisitive intentions in January 2017. At about that same time, Berkshire Hathaway became disappointed with its USG investment—per Buffet, "not one of my great ideas"—and began working behind the scenes to support Knauf's acquisition of USG. Despite their ongoing discussions, Knauf and Berkshire Hathaway "sought to avoid executing a formal agreement" for as long as possible "to avoid disclosure obligations under U.S. securities laws."

After reaching agreement with Berkshire Hathaway on "a price of $40 per share" on November 29, Knauf presented USG's Chief Executive Officer ("*CEO*") with an all-cash offer to buy the Company for $40.10 per share ("*First Offer*"). By its terms, the First Offer was not to be disclosed to anyone other than USG's board of directors ("*Board*"), its financial advisors, and Berkshire Hathaway. Berkshire Hathaway then informed USG of its support for an all-cash buyout and urged negotiations with Knauf.

The Board rejected the First Offer as "wholly inadequate given [USG's] intrinsic value and therefore . . . not in the best interests of [USG's] stockholders." On March 3, 2018, Knauf raised its offer price to $42 per share ("*Second Offer*"). At that time, Knauf warned it might "change [its] behavior" if USG rejected the Second Offer, raising the possibility of a hostile takeover attempt. Nevertheless, on March 26 the Board rejected the Second Offer, terming it "wholly inadequate" and beneath USG's intrinsic value. The Board's rejection of the Second Offer was supported by its financial advisors' opinion that the Second Offer "was at the low end" of one financial metric and "below the average" for another. USG publicly announced the Board's rejection of the Second Offer.

B. Withhold Campaign

Making good on its threat, on April 10 Knauf publicly announced "its intention to solicit proxies from USG's stockholders" to oppose the Board's "four director nominees" at the upcoming 2018 annual meeting ("*Withhold Campaign*"). In its announcement, Knauf also reserved the right to nominate its own director candidates. Two days later, Berkshire Hathaway publicly announced "its intent to support Knauf and vote against the Board's nominees." Undaunted, USG publicly attacked the Second Offer as "wholly inadequate, opportunistic, and [not reflective of] the intrinsic value of the company." However, following management's recommendation, the Board decided not to disclose its views on the Company's actual intrinsic value in proxy materials distributed to stockholders for the annual meeting.

As the Withhold Campaign heated up, several potential buyers expressed interest in purchasing USG. None, however, resulted in a formal offer. Then, two days before the annual meeting, Buffett told CNBC that "this may have been the first time in 53 years that Buffett and Berkshire Hathaway had voted against a slate of directors." It therefore was no surprise that, at the May 9 annual meeting, holders of

75% of the Company's shares voted against the Board's nominees, a clear vote of no confidence.

C. Knauf Purchases USG

Recognizing the likely success of the Withhold Campaign, and with no competing bidder at the table, on April 30 the Board authorized the CEO to negotiate a Knauf buyout within a price range of $48 to $51 per share. This range was "informed by the Board's view of USG's intrinsic value." On the following day, USG issued a release announcing its determination to begin negotiations with Knauf but not the negotiating range approved by the Board. Then, on May 8, USG countered with a proposal for a $50 per share buyout, which the CEO informed Knauf reflected the Company's intrinsic value. Knauf countered on May 22 at $43.50 per share.

Out of concern that Knauf might walk away from the negotiations to pursue "a hostile acquisition of USG at or below $42[ ] per share," the Board then authorized price negotiations for as low as $44 per share. On June 5, Knauf presented its " 'best and final' offer of $44[ ] per share." Within a week, the Board unanimously approved USG's offer, and the parties signed a merger agreement. Concurrently, Berkshire Hathaway pledged to vote its shares in favor of the transaction. USG distributed proxy materials to USG stockholders ("*Proxy Statement*") ahead of a September 26 special meeting called to vote on the transaction. At the special meeting, USG stockholders "overwhelmingly" approved the transaction. The buyout closed on April 24, 2019.

D. Stockholder Litigation

In August 2018, several USG stockholders ("*Plaintiffs*") challenged the buyout in Chancery Court. After Vice Chancellor Glasscock denied their motion for a preliminary injunction and the transaction closed, Plaintiffs amended their complaint to seek damages from the USG directors ("*Defendant-Directors*") for breach of fiduciary duty. In particular, and echoing *Revlon*, Plaintiffs claimed that "USG's stockholders 'did not receive the highest available value for their equity interest in USG,' and 'suffered the injury of an uninformed stockholder vote.' "

Defendant-Directors moved to dismiss, offering two alternative defenses:

- *First*, they asserted that any potential breach of fiduciary duty effectively was cleansed under *Corwin* when USG stockholders approved the transaction. To that end, Defendant-Directors argued that Knauf *was not* USG's controlling stockholder.

- *Second*, they argued that even if *Corwin* cleansing was not available, the presence of a DGCL § 102(b)(7) exculpatory provision in USG's certificate of incorporation ("*Exculpatory Provision*") required Plaintiffs to "plead facts making it reasonably conceivable that the Defendant directors breached their duty of loyalty or acted in bad faith."

II. VICE CHANCELLOR GLASSCOCK'S ANALYSIS

Vice Chancellor Glasscock addressed, in turn, Defendant-Directors' two principal defenses:

- *First*, the Vice Chancellor determined that although Plaintiffs failed to establish that Knauf controlled USG, *Corwin* cleansing was unavailable because Plaintiffs adequately pled that stockholder approval "was not fully informed due to a material omission in the Proxy Statement."
- *Second*, the Vice Chancellor found that Plaintiffs' pleadings failed to establish that Defendant-Directors breached their duty of loyalty or acted in bad faith in approving the buyout. On this basis, he granted Defendant-Directors' motion to dismiss.

A. Corwin Defense

1. Knauf Was Not USG's Controlling Stockholder

Because Knauf owned substantially less than 50% of USG stock, to demonstrate control by Knauf, Plaintiffs were required to "allege facts that support[ed] a reasonable inference of either '(i) control over the corporation's business and affairs in general or (ii) control over the corporation specifically for purposes of the challenged transaction.' " Plaintiffs focused on the latter inference, arguing that Knauf exercised its control over USG through its influence over the sale process. In this vein, Plaintiffs argued that Knauf "had the ability to take 'retributive action in the wake of rejection by an independent board' " *via* the Withhold Campaign. Alternatively, Plaintiffs implied (though did not directly plead) that Knauf and Berkshire Hathaway worked together as a control block to bully the Board into approving the buyout.

Vice Chancellor Glasscock rejected both of these arguments. *First*, because Knauf was only a 10.6% stockholder, Plaintiffs faced a "steep uphill climb to plead . . . Knauf was USG's controlling stockholder." Absent from Plaintiffs' pleadings, the Vice Chancellor noted, was any indication of a "controller's 'ability to dominate the corporate decision-making process' that is important to the controlling stockholder analysis." In fact, the Vice Chancellor noted that if Knauf had been in control, it could have nominated directors friendly to Knauf rather than pursuing the Withhold Campaign. In addition, because such campaigns are not inherently retributive and could be launched by any stockholder, the Withhold Campaign could not have been a "retributive act."

Second, the Vice Chancellor rejected Plaintiffs' implicit control block allegation. While Knauf and Berkshire Hathaway had a "concurrence of self-interest" favoring a sale, in contrast to Knauf's desire to pay as low a purchase price as it could negotiate, Berkshire Hathaway's desire to maximize the purchase price "allied with the other unaffiliated stockholders." Moreover, the Vice Chancellor saw "meager allegations of coordination between Knauf and Berkshire Hathaway," much less "a meeting of the minds."

2. Stockholder Vote Was Not Fully Informed

Vice Chancellor Glasscock turned to an analysis of whether Plaintiffs' complaint "supports a rational inference that material facts were not disclosed [in the Proxy Statement] or that the disclosed information was otherwise materially misleading." If Plaintiffs satisfied this pleading burden, Defendant-Directors would then have the burden "to 'establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of the vote.' "

Of the several disclosure issues pled by Plaintiffs, the Vice Chancellor found one sufficient to render the Proxy Statement materially misleading for purposes of *Corwin*: "[T]he Board determined USG had an intrinsic value [of $50 per share], . . . the Board did not disclose this material fact, and . . . by not disclosing its intrinsic valuation the Board's other disclosures, namely its representations that the Acquisition was favorable to USG's stockholders, were rendered materially misleading." In this connection, the Vice Chancellor found "a substantial likelihood that a reasonable stockholder would have considered the Board's oft[-]mentioned view of intrinsic [value] important in deciding how to vote."

Defendant-Directors countered that the Board's view of intrinsic value was apparent from the Proxy Statement's description of the price negotiations with Knauf. The Vice Chancellor disagreed, explaining that disclosure of "negotiating price is not indicative of a view of intrinsic value." And more important, "*the Proxy Statement discloses that the Board determined not to disclose its view of intrinsic value*."

Accordingly, "USG's stockholder vote was not fully informed" and, therefore, *Corwin* was not available to support dismissal.

B. Failure To State a Non-Exculpated Claim Against Defendant-Directors

Though *Corwin* was not available to support dismissal, in light of the Exculpatory Provision, Plaintiffs faced the not insignificant burden of pleading that Defendant-Directors breached their duty of loyalty in approving the buyout. Doing so required pleading facts "supporting a rational inference that the director[s] 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."

1. No Self-Interest or Lack of Independence

Because "Delaware law presumes the independence of corporate directors," to establish a lack of independence, Plaintiffs were required to plead facts making it "reasonably conceivable" that "the directors are beholden to the [interested party] or so under [its] influence that their discretion would be sterilized." Plaintiffs argued that Defendant-Directors "lacked independence . . . because of their alleged fear of Knauf." Specifically, "Plaintiffs contend that after Knauf succeeded in its Withhold Campaign, the Board abandoned its standalone plan for USG, rushed or abandoned other potential buyers, and acceded to [Knauf's buyout proposal] even though it had 'misgivings' about the deal." Further, Defendant-Directors (other than the CEO) "were interested in [a buyout by Knauf] because a public ouster by Knauf would have imperiled their other business and career interests, which they were not willing to sacrifice in light of their relatively small financial interest in a higher sale price."

Vice Chancellor Glasscock found Plaintiffs' pleadings not just "conclusory," but insufficient to overcome Delaware's presumption of directorial independence. The mere fact that the Board approved the transaction at $44 per share shortly after it rejected the Second Offer was not sufficient to demonstrate a lack of independence where "Plaintiffs offer no reasonable basis from which to conclude that the Board's decision to accept the later $44[ ] offer was the result of 'extraneous considerations or influences.'" Moreover, the Board's alleged "[f]ear" that Knauf might pursue a hostile takeover "is a nod to reality" rather than "a disabling extraneous influence." Finally, the Vice Chancellor rejected the notion that Defendant-Directors acted "in selfish defense of their outside reputational interests," as "any reputational loss that could come from a public loss to Knauf had already occurred," *via* the Withhold Campaign, by the time the Board approved the transaction.

2. Absence of Bad Faith

Next, Vice Chancellor Glasscock explained that "[a] director acts in bad faith where he or she 'intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties.' " In other words, "demonstration of bad faith requires acts or omissions taken against the interest of [USG], with scienter." Plaintiffs argued that the Board acted in bad faith by (i) omitting material information from the Proxy Statement and (ii) failing to satisfy its *Revlon* duties in connection with the sale.

i. Proxy Statement Omissions

The Vice Chancellor explained that the pleading standard faced by a plaintiff seeking to establish an omission as an act of bad faith "is *entirely distinct* from the required pleading to show an uninformed vote under *Corwin*." In fact, "[n]owhere does the standard for pleading a material non-disclosure or materially misleading disclosure under *Corwin* refer to, or incorporate, any inquiry regarding knowledge and purpose of the non-disclosure." By contrast, "where the same omissions or misleading disclosures are pled as evincing bad faith, the pleading is subject to a finer-toothed comb—that of scienter—which is among our law's most straightened." "An adequate pleading of bad faith," therefore, "must plead that the [omission] was 'intentional and constitute[d] more than an error of judgment or gross negligence.' "

Consistent with their attack on Defendant-Directors' *Corwin* defense, Plaintiffs premised their bad faith claim on the Board's having withheld its view of USG's intrinsic value from the Proxy Statement "so that USG's stockholders would approve a transaction that the Board did not believe offered USG's stockholders fair value." While this omission was sufficient to negate the *Corwin* defense, the Vice Chancellor explained that to establish bad faith, "Plaintiffs must plead that the Defendant directors intentionally withheld their view of intrinsic value in conscious disregard of their fiduciary duties." Having already found that the Board neither lacked independence nor was self-interested, thereby negating any "reasonable inference that the disclosure deficiency emanated from extraneous influences or considerations," the Vice Chancellor explained that "Plaintiffs thus must allege bad faith 'in the disclosures themselves.' "

"Considering the other disclosures in the Proxy Statement," Vice Chancellor Glasscock noted that "it is not reasonably conceivable that the Proxy Statement 'represents the knowingly-crafted deceit or knowing indifference to duty that would show bad faith.' " In effect, when the Board disclosed the negotiating range, "it was no secret to USG's stockholders that the Board preferred to sell USG for more than $44[ ] per share." Further, if the Board was trying to hide the intrinsic value of the Company from stockholders, it would not have disclosed in the Proxy Statement "*that the Board had chosen not to make that very disclosure*."

ii. Revlon Claims

Plaintiffs also argued that because the Board failed to conduct a reasonable sales process, Defendant-Directors "failed to comply with duties imposed under *Revlon*." Vice Chancellor Glasscock characterized Plaintiffs' reference to "*Revlon* duties" as "something of a misnomer." Rather, he explained that "fiduciary duties are loyalty and care, in any situation—the specific situation, however, dictates the actions required for fulfilment of those duties." In the context of a sale transaction, "*Revlon* can provide a contextual inquiry about whether the [ ] Defendants' choices were 'reasonable under the circumstances as a good-faith attempt to secure the highest value reasonably attainable.' "

To trigger a *Revlon* analysis, Plaintiffs "set forth copious allegations designed to demonstrate the unreasonableness of the Board's sale process," particularly "that the Board ultimately capitulated to a sale to Knauf at only $44[ ] [per share] when it had repeatedly stated that Knauf's takeover attempts at $42[ ] per share undervalued USG." In light of the Exculpatory Provision, however, "an allegation implying that a Defendant failed to satisfy *Revlon* is insufficient on its own to plead a non-exculpated breach of the duty of loyalty." Instead, "a sufficient pleading must reasonably imply that the directors' failure to act reasonably to maximize price was tainted by interestedness or bad faith." And, "absent sufficient allegation[s] of directors' 'improper intent, a plaintiff must point to "a decision [that] lacked any rationally conceivable basis" associated with maximizing stockholder value to survive a motion to dismiss.' "

Vice Chancellor Glasscock found it "not reasonably conceivable" that Defendant-Directors "acted outside of the corporate interest, or intentionally disregarded that interest." Plaintiffs "may contend that the Board negotiated poorly, perhaps unreasonably, but that alone is insufficient to plead bad faith." In this connection, the Vice Chancellor highlighted that the Board was "against the ropes after being trounced by its two largest stockholders in the Withhold Campaign." In fact, the Board's management of the sales process—"[t]he Board obtained counsel and advice from financial professionals; sought competing bids; negotiated for a higher price; and attempted to persuade Knauf that the Board's view of value was correct"—was "a far cry from the 'extreme set of facts' necessary to support a reasonable inference that USG's Board acted in bad faith in its sale process." In short, "a pleading from which I can merely infer an unreasonable sales process *is not enough* to overcome" the Exculpatory Provision.

CONCLUSION

In *In re USG*, Vice Chancellor Glasscock followed what has now become a familiar playbook in addressing Defendant-Directors' motions to dismiss:

- *First*, he considered whether a *Corwin* defense was available to cleanse the alleged breach. In this connection, he first determined that Plaintiffs had not adequately pled that Knauf was USG's controlling stockholder. Due to material nondisclosures in the Proxy Statement, however, the *Corwin* defense failed.
- *Next*, he addressed whether Plaintiffs adequately pled actions constituting a breach of the duty of loyalty, including bad faith acts, on the part of Defendant-Directors. Although allegations of material omissions from the Proxy Statement defeated the *Corwin* defense, they were not sufficient to establish bad faith on the part of Defendant-Directors. Moreover, Plaintiffs' complaints about the sale process and the resulting sale price came up short.

Ultimately, Vice Chancellor Glasscock granted Defendant-Directors' motion to dismiss, demonstrating the high bar to liability imposed by the Exculpatory Provision.

The Vice Chancellor's opinion offers perhaps the clearest explanation to date of how damages claims asserting breach of so-called "*Revlon* duties" will be analyzed post-*Corwin*. As *Corwin* instructs, "*Revlon* 'duties' should not be confused with the *Revlon* standard of review [i.e., enhanced scrutiny], applicable principally outside the damages context, under which directors must act reasonably" (quoting *In re USG*). In a post-closing damages setting, "*Revlon* can provide a contextual inquiry" about the propriety of a board's actions regarding a sale transaction. But allegations that directors acted unreasonably—

while perhaps sufficient to trigger the *Revlon* standard of review for purposes of a plea for *pre-closing equitable relief*—will not survive a motion to dismiss a *post-closing damages claim* in the presence of a DGCL § 102(b)(7) exculpatory provision. In such case, the pleadings must adequately allege "conflicted interests or lack of independence on the part of the directors," or, absent that, "the scienter requirement compels . . . 'a finding of bad faith . . . where "the nature of [the director's] action[s] can in no way be understood as in the corporate interest." ' "