

DELAWARE CORPORATE LAW BULLETIN

Delaware Courts Diverge on Whether “Cleansing Effect” of *Corwin* Applies to Duty of Loyalty Claims

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Comstock requires a finding that entire fairness review is inapplicable before Corwin triggers business judgment deference.

Larkin applies Corwin’s “cleansing effect” to all transactions absent a controlling stockholder.

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INTRODUCTION

This past August brought two new editions in the “cleansing effect” saga that has unfolded since the Delaware Supreme Court’s 2015 decision in *Corwin v. KKR Financial Holdings LLC*.¹ *Corwin* provided an *ex post* vehicle, in a post-closing damages action, for directors to overcome an alleged breach of their duty of care. The *Corwin* Court ruled that a fully-informed, disinterested stockholder vote approving a one-step merger triggers application of the deferential business judgment standard of review, resulting in dismissal of plaintiffs’ claims that defendant directors breached their duty of care.²

The Delaware Court of Chancery adopted the *Corwin* approach in *In Re Zale Corp.*, dismissing an aiding and abetting claim against a target board’s sell-side advisor after finding the predicate breach of duty of care by the target board was “cleansed” upon a fully-informed stockholder vote under *Corwin*.³ The Delaware Supreme Court affirmed in *Singh v. Attenborough*, further clarifying that *Corwin* triggers irrebuttable application of business judgment deference, resulting in automatic dismissal of plaintiffs’ claims that defendant directors breached their duty of care.⁴

Neither *Corwin* nor *Singh* squarely addressed the questions whether the cleansing effect of a fully-informed, disinterested stockholder applies to breaches of directors’ duty of loyalty or to transaction structures other than one-step mergers.⁵ The Chancery Court addressed the *latter* question in *In re Volcano Corp.*, extending the “cleansing effect” of *Corwin* to a two-step acquisition under section 251(h) of the Delaware General Corporation Law (“DGCL § 251(h)").⁶ That is, according to the *Volcano* Court, the uncoerced tender of a majority of a target company’s outstanding shares into a first-step tender offer may satisfy *Corwin*’s fully-informed, disinterested

1. *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).

2. *Id.*; see also Robert S. Reder, *Delaware Supreme Court Clarifies “Cleansing Effect” of Fully-Informed Stockholder Vote*, 69 VAND. L. REV. EN BANC 219 (2016).

3. *In re Zale Corp. Stockholders Litig.*, No. CV 9388-VCP, 2015 WL 6551418 (Del. Ch. Ct. 29, 2015). For a discussion of the Chancery Court decisions in *Zale*, see Robert S. Reder & Stephanie Stroup Estey, *Sell-Side Financial Advisors in the M&A Crosshairs*, 68 VAND. L. REV. EN BANC 279 (2016).

4. Reder & Estey, *supra* note 3; see also Robert S. Reder, *Delaware Supreme Court Clarifies “Cleansing Effect” of Fully-Informed Stockholder Vote*, 69 VAND. L. REV. EN BANC 219 (2016).

5. *Singh v. Attenborough*, No. 645, 2015, 2016 WL 2765312 (Del. 2016); see Reder, *supra* note 2.

6. *In re Volcano Corp. Stockholder Litig.*, 2016 Del. Ch. LEXIS 99, C.A. No. 10485-VCMR (Del. Ch. June 30, 2016). For a more detailed analysis of *Volcano*, see Robert S. Reder, *Delaware Chancery Court Extends “Cleansing Effect” of Stockholder Approval Under KKR to Two-Step Acquisition Structure*, 69 VAND. L. REV. EN BANC 227 (2016).

stockholder approval requirement, thereby triggering business judgment deference.

Resolution of the *former* question has proven a bit more elusive. On consecutive days in August, the Chancery Court decided two cases—*Comstock*⁷ and *Larkin*⁸—that applied business judgment deference to claims that target company directors breached their duty of loyalty in sale of control transactions. Notably, these decisions approached *Corwin* in somewhat conflicting ways. *Comstock* suggested that the business judgment presumption should apply under *Corwin* only to transactions that are not subject to an entire fairness review. *Larkin*, by contrast, held that that business judgment deference should apply even to transactions that would merit entire fairness review, except those involving a controlling stockholder.

I. COMSTOCK

A. Factual Background

In *Comstock*, stockholders of C&J Energy Services, Inc. (“C&J”) sought post-closing damages from C&J directors and officers (including Chairman and CEO Jerry Comstock) following C&J’s merger (the “Nabors Transaction”) with a subsidiary of Nabors Industries Ltd. (“Nabors”) that operated Nabors’ oil production services business (the “Oil Services Business”). Comstock became Chairman and CEO of C&J Energy Services, Ltd., the surviving entity in this merger (“New C&J”).⁹

After lengthy negotiations, C&J’s board approved the Nabors Transaction. Nabors received \$940 million in cash and a majority stake in New C&J, while the C&J stockholders exchanged their shares for a minority interest in New C&J. Although C&J’s stockholders emerged with a minority position in New C&J, the C&J board viewed the transaction as an acquisition by C&J of the Oil Services Business from Nabors. To lend the former C&J stockholders some measure of protection from Nabors’ majority position, C&J’s seven-member board was guaranteed four seats on the New C&J board for five years. In addition, Nabors agreed in a side letter to provide Comstock with certain bonus and severance payments. C&J’s financial advisors “calculated that the transaction was worth \$30.76 per share for C&J’s stockholders, compared to C&J’s share price of \$32.50 at the time and

7. City of Miami General Employees’ and Sanitation Employees’ Retirement Trust v. Comstock, C.A. No. 9980-CB, Slip. Op. (Del. Ch. August 24, 2016) [hereinafter “Comstock”].

8. Larkin v. Shah, C.A. No. 10918-VCS, Slip. Op. (Del. Ch. August 25, 2016) [hereinafter “Larkin”].

9. This merger was structured to in effect reincorporate C&J in Bermuda, a tax haven.

[their] determination that C&J was worth \$37.38 at the time on a standalone basis.”¹⁰

In response to an action by a C&J stockholder challenging the Nabors Transaction, the Court of Chancery preliminarily enjoined the merger and ordered the C&J board to form an independent committee to solicit competing bids. Three potential bidders emerged, but none made an offer deemed superior to the Nabors Transaction. Then the Delaware Supreme Court lifted the preliminary injunction, permitting C&J to proceed with a stockholder vote on the Nabors Transaction. Nearly ninety-eight percent of the shares represented at the meeting (roughly eighty-two percent of the shares outstanding) voted to approve the merger. After the closing, plaintiff amended its complaint to seek, among other things, damages from C&J’s directors and officers, alleging that they (i) breached their fiduciary duties in putting together the Nabors Transaction and (ii) made material misstatements and omissions in the proxy disclosures provided to stockholders.

B. Chancellor Bouchard’s Analysis

Chancellor Andre G. Bouchard first addressed the proxy disclosure claim. The Chancellor criticized plaintiff for its “calculated delay” in failing to include the disclosure claim in its initial pre-closing complaint, noting that it might be susceptible to a laches defense.¹¹ However, he ultimately decided to consider the claim on its merits, because a *Corwin* inquiry begins with consideration of whether a potentially cleansing stockholder vote was fully informed. After determining that plaintiff’s proxy disclosure allegations were inadequate to survive defendants’ motion to dismiss, the Chancellor explained that, “under a straightforward application of *Corwin* and *Attenborough*,”¹² the appropriate standard for reviewing plaintiff’s post-closing damages action would be the business judgment rule “unless plaintiff can establish a basis for applying entire fairness”¹³

Chancellor Bouchard ultimately concluded that entire fairness was inapplicable. According to the Chancellor, a majority of C&J’s directors were neither interested in the Nabors Transaction nor lacking in independence.¹⁴ Further, the inducements granted to Comstock to

10. *Comstock*, at 10.

11. *Id.* at 22.

12. *Id.* at 42.

13. *Id.* at 42 n.76.

14. “[T]he enticement of a future seat on the board of the company surviving a merger is not sufficient to disqualify that director from making a disinterested decision on the basis of financial interest.” *Id.* at 44.

continue his employment with New C&J did not taint the board's approval process.¹⁵

Interestingly, Chancellor Bouchard acknowledged that plaintiff's allegations relating to infirmities in the sales process "presumably would be sufficient to sustain a claim under the enhanced scrutiny standard of *Revlon*, but . . . that standard is not applicable to a post-closing action for damages where the transaction has been approved by an uncoerced, fully-informed vote of the stockholders."¹⁶ Consequently, the Chancellor dismissed plaintiff's post-closing fiduciary duty claims against the C&J directors *via* application of the business judgment presumption.¹⁷

II. LARKIN

A. Factual Background

In *Larkin*, Teva Pharmaceuticals Industries, Inc. ("Teva") acquired Auspex Pharmaceuticals, Inc. ("Auspex") in a transaction valued at \$3.5 billion, effected as a two-step merger pursuant to DGCL § 251(h). Teva was the winning bidder, by a margin of \$500 million, in a three-month sales process that began with conversations with twenty-two potential bidders.¹⁸ Stockholders owning seventy-eight percent of Auspex's outstanding common stock tendered their shares in the first step of the transaction.¹⁹ The merger then closed without a stockholder vote by operation of DGCL § 251(h).

Plaintiffs were former Auspex stockholders seeking post-closing damages from the Delaware Court of Chancery based on alleged breaches by the Auspex board of their fiduciary duties. Plaintiffs anchored their complaint on three directors' ties to venture capital funds that, together with these directors, collectively owned roughly twenty-seven percent of Auspex. Plaintiffs claimed that such ownership either gave the funds "effective control" of Auspex or otherwise created conflicts due to the venture capital funds' unique

15. In fact, "Comstock's ownership of a ten percent stake in C&J created a strong countervailing incentive for him to maximize the value of C&J's stock." *Comstock*, at 47.

16. *Id.* at 54.

17. Chancellor Bouchard also dismissed the fiduciary duty claims against the C&J officers, noting that "officers owe the same fiduciary duties as directors" and "plaintiff's fiduciary duty claims challenging actions taken by [the officers] . . . also must be dismissed." *Id.* at 54–55.

18. *Larkin*, at 48.

19. Stockholders owning twenty-seven percent of the outstanding shares signed support agreements with Teva when the merger agreement was signed, meaning that "roughly seventy percent of outstanding shares not contractually bound to support the transaction tendered." *Id.* at 15.

need for liquidity, which influenced the board to accept a “hurried, all-cash” sale, even if it was not the best deal reasonably available or the ideal time to sell.²⁰

B. Vice Chancellor Slight’s Analysis

Vice Chancellor Joseph R. Slight III ultimately dismissed the complaint on the basis of *Corwin*, stating, “In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.”²¹ Thus, once the Vice Chancellor determined that (i) the funds did not control Auspex by virtue of their aggregate share ownership²² or exercise undue influence over the Auspex board,²³ and (ii) the transaction was approved (via tender offer) by disinterested, uncoerced, and fully-informed Auspex stockholders,²⁴ he applied the irrebuttable presumption of the business judgment rule and dismissed plaintiffs’ claims.

III. THE *CORWIN* QUESTION

Both *Comstock* and *Larkin* invoked the cleansing effect of *Corwin* to dismiss post-closing damages actions against directors alleged to have breached their fiduciary duty of loyalty in connection with sale of control transactions. However, Chancellor Bouchard and Vice Chancellor Slight—acting just one day apart—followed noticeably

20. Specifically, plaintiffs alleged that the funds wanted to engineer a sale before anticipated favorable results for Auspex’s key pharmaceutical product were released, which would cause Auspex’s stock price to spike and require a more drawn-out sales process. *Id.* at 54–55.

21. See *Singh v. Attenborough*, No. 645, 2015, 2016 WL 2765312 (Del. 2016); *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015); *In re Volcano Corp. Stockholder Litig.*, 2016 Del. Ch. LEXIS 99, C.A. No. 10485-VCMR (Del. Ch. June 30, 2016).

22. Vice Chancellor Slight found the allegations of the existence of a control stockholder to be “slim to nonexistent,” characterizing the funds’ combined ownership as “a small block in controller contexts . . .” *Larkin*, at 36.

23. In dismissing this claim, the Vice Chancellor noted that:

Plaintiffs ask the Court to make an extraordinary inference: that rational economic actors have chosen to short-change themselves. With this internal conflict in mind, this court has been reluctant to find a liquidity-based conflict absent the presence of additional circumstantial indicators of conflict that elevate this fundamentally implausible idea to the level of reasonably conceivable.

Id. at 40.

24. In this connection, the Vice Chancellor, applying *Volcano*, observed that plaintiffs withdrew their disclosure claims “in the course of briefing.” *Id.* at 52.

different paths in ultimately deciding to apply the favorable presumption of the business judgment rule.

In *Comstock*, Chancellor Bouchard stated, “[b]ecause the Nabors transaction is not subject to entire fairness review and the business judgment presumption applies under *Corwin*,”²⁵ the fiduciary duty claims must be dismissed. Thus, under *Comstock*’s reading of *Corwin*, if the transaction had been subject to entire fairness review—presumably for *any* reason—then it would not have been appropriate to give the C&J directors the benefit of business judgment deference. The Chancellor found direct support for this interpretation in the very language of *Corwin*: “when a transaction *not subject to the entire fairness standard* is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies.”²⁶

By contrast, Vice Chancellor Slight’s determined in *Larkin* that, following the requisite fully-informed vote of disinterested stockholders, *Corwin* operates to cleanse *any* alleged breach of fiduciary duty by a corporate director, whether the allegations relate to the duty of care or the duty of liability. For this purpose, the fact that entire fairness may be the applicable standard for reviewing a breach of loyalty claim is irrelevant. *Larkin* delineates only one exception to this rule: when entire fairness review is triggered by a transaction involving a controlling stockholder, either a controlling stockholder-buyout of public stockholders or a third party-buyout in which a controlling stockholder is accorded favorable treatment relative to public stockholders.

Vice Chancellor Slight’s cited three reasons for this holding:

- *First*, the Vice Chancellor—like Chancellor Bouchard—cited express (but different) language from *Corwin* in support of his conclusions. Specifically, according to the Vice Chancellor, the *Corwin* Court stated that business judgment deference is appropriate for “a disinterested stockholder majority that determines that a transaction *with a party other than a controlling stockholder* is in their best interests.”²⁷ In fact, “even if the plaintiffs had pled facts from which it was reasonably inferable that a majority of . . . directors were not independent, the business judgment standard of review would still apply.”²⁸

25. *Comstock*, at 54.

26. *Corwin*, 125 A.3d at 309; see also *Larkin*, at 27.

27. *Larkin*, at 28 (quoting *Corwin*, 125 A.3d at 309).

28. *Id.* at 19 (quoting *Corwin*, 125 A.3d at 305, 306 n.1).

The Vice Chancellor characterized the more limiting language cited by plaintiffs (and by Chancellor Bouchard in *Comstock*) as “a rigorously literal reading of the text . . . that superficially supports their position.”²⁹ Vice Chancellor Slight’s sided with the Auspex defendants’ “more discriminating interpretation” of *Corwin*.³⁰

- *Second*, the Vice Chancellor emphasized language from *Volcano* and *Singh* suggesting that *Corwin* ought to apply broadly.³¹ For instance, the *Volcano* Court explained that “upon a fully-informed vote by a majority of the company’s disinterested, uncoerced stockholders, the business judgment rule irrebuttably applies to a court’s review of the transaction.”³²
- *Third*, the Vice Chancellor reasoned that treating transactions involving controlling stockholders different from other entire fairness transactions “harmonizes *Corwin* with the policy rationales that animate Delaware controlling stockholder jurisprudence.”³³ This is because, under Delaware jurisprudence, “stockholder approvals are afforded potency proportionate to their situational legitimacy—burden shifting in the controlling stockholder context, and a restoration of business judgment deference in other contexts that would otherwise implicate entire fairness review.”³⁴ Essentially, the inherently unfair coercion associated with controlling stockholders who buy out the public or receive favorable treatment in a third party-buyout diminishes the potency of a stockholder vote. By contrast, because other alleged breaches of fiduciary duties—such as a conflicted director’s involvement in merger negotiations—“present only board-level conflicts, disinterested stockholders remain equipped to cleanse the challenged transaction by voicing their fully informed, uncoerced approval.”³⁵

29. *Id.* at 28, 33.

30. *Id.* at 33.

31. *Id.* at 30–31.

32. *In re Volcano Corp. Stockholder Litig.*, 2016 Del. Ch. LEXIS 99, at *8 C.A. No. 10485-VCMR (Del. Ch. June 30, 2016).

33. *Larkin*, at 31.

34. *Id.* at 32.

35. *Id.* at 32 n.69.

CONCLUSION

Although both Chancellor Bouchard and Vice Chancellor Slight's grounded their respective decisions in *Comstock* and *Larkin* with reference to *Corwin*, they took notably different approaches to the issues before them. It is clear that *Corwin's* "cleansing effect" *does* operate to insulate directors from breach of duty of care claims (at least where section 102(b)(7) of the Delaware General Corporation is not available to exculpate the directors from personal liability) but *does not* operate to insulate directors from breach of duty claims in connection with controlling stockholder-buyouts of public stockholders or third party-buyouts in which a controlling stockholder receives favorable treatment.

However, it is not yet clear whether the *Corwin* doctrine is available to cleanse duty of loyalty breaches in sales transactions not involving a controlling stockholder, such as transactions where target company directors are alleged to have a disqualifying interest or lack independence, or to have acted in bad faith. Vice Chancellor Slight's opinion in *Larkin* would seem to indicate that it does, but Chancellor Bouchard explicitly did not take this route in *Comstock*. Until either the Delaware Chancery Court or Supreme Court resolves this question, directors cannot assume that a stockholder vote, no matter how disinterested or well-informed, will cleanse breach of loyalty claims brought against them in connection with sales transactions.

POST SCRIPT

On December 6, 2016, Vice Chancellor Laster dismissed yet another post-closing action for damages in a challenged merger under *Chester County Retirement System v. Collins*.³⁶ There, American Securities LLC and Capital Partners (the "Buyers") acquired Blout International, Inc. Of the total outstanding Blout shares entitled to vote, more than seventy-five percent were cast in favor of the merger. After the merger closed, plaintiffs sued Blout's board of directors alleging breach of fiduciary duties in connection with the merger and also alleged that the board's financial advisor, Goldman Sacs & Co., aided and abetted these fiduciary duties.

In dismissing the action, Vice Chancellor Laster found that alleged disclosure violations did not compromise the fully-informed nature of the stockholder vote. He then favorably cited *Larkin*, stating,

36. *Chester County Retirement Sys. v. Collins*, 2016 WL 7117924, No. 12072-VCL (Del.Ch. Dec. 6, 2016) (Trial Order).

“In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.”³⁷ The Vice Chancellor made no mention of *Comstock*. Perhaps this indicates that *Larkin* is progressively gaining traction as the governing standard of whether to invoke *Corwin*’s “cleansing effect.”

37. *Id.* at *2 (quoting *Larkin*, at 1).