DELAWARE CORPORATE LAW BULLETIN

Delaware Supreme Court Reverses Dismissal of Fiduciary Breach Claims Against Target Company Directors

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Determines that Corwin did not warrant early dismissal because tendering stockholders were not "fully informed" of the reasons underlying Board Chairman's abstention

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INTRODUCTION

The now-iconic 2015 decision of the Delaware Supreme Court ("*Supreme Court*") in *Corwin v. KKR Financial Holdings* ("*Corwin*")[1] has presented target company directors with a new *ex post* defense to challenges of their actions undertaken in connection with M&A transactions. Under *Corwin*, the deferential business judgement rule attaches to post-closing damages actions alleging directorial breach of fiduciary duties where the transaction "is approved by a fully informed, uncoerced vote of the disinterested stockholders . . . ."[2] If it can be established that the stockholder vote approving the merger was both (1) fully informed and (2) uncoerced, the vote in effect "cleanses" the directorial fiduciary breach, absent a sufficient pleading of waste (no easy feat), the action will be dismissed at the pleading stage.[3]

The Supreme Court extended *Corwin* to two-step acquisitions (i.e., a tender offer followed by a cash-out merger) in *In re Volcano Corp. Stockholder Litig*. ("*Volcano*").[4] The *Volcano* Court found that "the same policy reasons dictate that 'the acceptance of a first-step tender offer followed by fully-informed, disinterested, uncoerced stockholders representing a majority of a corporation's outstanding shares in a two-step merger . . . has the same cleansing effect under *Corwin*.' "[5]

Subsequent Delaware Court of Chancery ("*Chancery Court*") decisions have clarified the boundaries of *Corwin*:

- *In re Merge Healthcare Inc. Stockholders Litig*.[6] indicated that *Corwin* cleansing will apply "even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors."[7]

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1. 125 A.3d 304 (Del. 2015).

2. Appel v. Berkman, C.A. No. 12844-VCMR, 2017 WL 6016571, at *1 (Del Ch. July 13, 2017) (citing *Corwin*, 125 A.3d at 309).

3. *See id*. at *2.

4. *Id*. at *1 (citing *In re* Volcano Corp. Stockholder Litig., 143 A.3d 727, 747 (Del. Ch. 2016)). For a discussion 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).

5. *Appel*, at *1 (citing *Volcano*, 143 A.3d at 747).

6. C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017); For a discussion of this and related decisions, see Robert S. Reder & Tiffany M. Burba, *Delaware Courts Confront Question Whether "Cleansing Effect" of* Corwin *Applies to Duty of Loyalty Claims,* 70 VAND. L. REV. EN BANC 187 (2017).

7. *Merge Healthcare*, at *6 (citing Larkin v. Shah, C.A. No. 10918-VCS, 2016 WL 4485447, at *1 (Del. Ch. Aug. 25, 2016)).

- *In re Saba Software, Inc. Stockholder Litig.*[8] refused to apply *Corwin* because "the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction . . . created a 'circumstance[] [that was] impermissibly coercive.' "[9]
- *In re Massey Energy Co. Deriv. and Class Action Litig.*[10] ruled that "there logically must be a far more proximate relationship than exists here between the transaction or issue for which stockholder approval is sought and the nature of the claims to be 'cleansed' as a result of a fully-informed vote."[11]

In a July 2017 order in *Appel v. Berkman* ("*Appel*"),[12] Vice Chancellor Tamika Montgomery-Reeves determined that the target company's disclosures were adequate to fully inform tendering stockholders under the *Corwin* rubric. Accordingly, the Vice Chancellor granted defendant directors' motions to dismiss. However, in February 2018, the Supreme Court reversed and remanded, declaring that omissions from disclosures provided to the tendering stockholders "are material and their omission precludes the invocation of the business judgment rule standard at the pleading stage."[13]

I. FACTUAL BACKGROUND

Diamond Resorts International ("Diamond") was acquired by the giant private equity firm Apollo Global Management LLC ("Apollo") in a transaction that closed on September 2, 2016.[14] Diamond's board of

8. C.A. No. 10697–VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017). For a discussion of *Saba Software*, see Robert S. Reder, *Delaware Court Refuses to Invoke* Corwin *to "Cleanse" Alleged Director Misconduct Despite Stockholder Vote Approving Merger*, 70 VAND. L. REV. EN BANC 199 (2017).

9. *Saba Software*, at *16. The Vice Chancellor found that the Saba stockholders faced a "Hobson's choice" of either voting in favor of the transactions in question or retaining their stock "in the midst of . . . regulatory chaos," leaving them "with no practical alternative but to vote in favor of the Merger." *Id.* at *15. But compare *In re Paramount Gold and Silver Corp. Stockholders Litig.*, C.A. No. 10499-CB, 2017 WL 1372659 (Del. Ch. Apr. 13, 2017), in which Chancellor Bouchard found none of the disclosure issues raised by plaintiffs to be material and therefore dismissed the related complaint "under the Corwin doctrine." *Id.* at *14. For a discussion of *Paramount Gold*, see Robert S. Reder, *Delaware Chancellor Again Invokes* Corwin *in Granting Directors' Motion to Dismiss Breach of Fiduciary Duty Claim*, 70 VAND. L. REV. EN BANC 209 (2017).

10. 160 A.3d 484 (Del. Ch. May 4, 2017).

11. *Id.* at *508.

12. Appel v. Berkman, C.A. No. 12844-VCMR, 2017 WL 6016571, at *5 (Del Ch. July 13, 2017).

13. Appel v. Berkman, No. 316, 2017, 2018 WL 947893, at *8 (Del. Feb. 20, 2018).

14. *Appel*, 2017 WL 6016571, at *1.

directors hired Centerview Partners LLC ("Centerview") as the financial advisor to its strategic review committee. The acquisition was structured as a two-step transaction under Section 251(h) of the Delaware General Corporation Law.[15] In the first-step tender offer (the "*Tender Offer*"), more than 81% of Diamond's outstanding shares were tendered by the expiration date.[16] The next day, the second-step was consummated *via* a merger, with all untendered shares being converted into the same $30.25 per share payable in the Tender Offer.[17]

Plaintiff, a Diamond stockholder, sued the board of directors and its chairman, founder, and largest stockholder, Stephen Cloobeck ("*Cloobeck*") in Chancery Court claiming that defendants breached their fiduciary duties to Diamond stockholders by approving an unfair transaction. The lawsuit challenged various aspects of the process undertaken by the Diamond board in effecting the transaction. Among other claims, plaintiff pointed out that disclosure materials provided by the board to the tendering stockholders merely recited that Cloobeck abstained from board votes approving the transaction and "has not yet determined whether to tender . . . his shares,"[18] while failing to set forth the reasons for the abstentions. Although Cloobeck ultimately did tender his shares, he abstained from the board votes "because mismanagement of Diamond . . . had negatively affected the sale price and it was therefore not the right time to sell the company."[19] The defendants moved to dismiss.[20]

II. THE VICE CHANCELLOR'S ANALYSIS

Setting the stage for granting defendants' motions to dismiss, Vice Chancellor Montgomery-Reeves analyzed plaintiff's claim that *Corwin* was not available to cleanse the alleged directorial misconduct because the Diamond stockholders were not fully informed when they tendered their shares into the Tender Offer.[21] Specifically, plaintiff alleged that Diamond's Schedule 14D-9 (the "14D-9") filed with the Securities and Exchange Commission and distributed to Diamond

15. *Id.*
16. *Id.* at *2.
17. *Id.* at *1.
18. *Id.* at *2.
19. Appel v. Berkman, No. 316, 2017, 2018 WL 947893, at *2 (Del. Feb. 20, 2018).
20. *Appel*, 2017 WL 6016571, at *1.
21. *Id.* at *2.

stockholders under the tender offer rules failed to provide adequate disclosure in three respects.[22]

A. The Board Vote

First, plaintiff argued that the 14D-9 "fails to disclose . . . Cloobeck's 'disappointment' with the price and timing of the merger, as well as with 'the Company's management for not having run the business in a manner that would command a higher price.' "[23] The Vice Chancellor rejected this argument, highlighting that "Delaware law does not require 'that individual directors state (or the corporation state for them) the grounds of their judgment for or against a proposed shareholder action.' "[24] Moreover, "this principle applies equally to an abstention."[25] Here, "[t]he 14D-9 expressly states that Cloobeck abstained from the vote on the merger three times."[26] In addition, "the 14D-9 states: 'To the Company's knowledge, [Cloobeck] has not yet determined whether to tender or cause to be tendered all of his Shares."[27] "Under the significant weight of twenty-five years of Delaware authority on this point," the Vice Chancellor rejected this claim.[28]

B. Centerview's Conflicts

Next, plaintiff claimed that the 14D-9's "disclosure regarding Centerview's conflicts of interest" were misleading in light of Centerview's "history of providing financial services to Apollo."[29] Although the 14D-9 specifically disclosed services provided by Centerview to one Apollo portfolio company, it failed to "identify any of Centerview's other Apollo engagements . . . or the compensation Centerview had received or would receive in connection therewith."[30]

The Vice Chancellor concluded that the description of Centerview's potential conflicts was adequate. The 14D-9 disclosed

22. A fourth claim alleging aiding and abetting on the part of Centerview also failed because plaintiff "fails to state a claim for breach of fiduciary duty against the [Diamond directors], and because plaintiff has failed to plead facts necessary to overcome the 'high burden' from which 'a court could reasonably infer that a financial advisor acted with the requisite scienter.' " *Id.* at 4; *see also* Singh v. Attenborough, 137 A.3d 151, 152 (Del. 2016); *Volcano*, 143 A.3d at 750.

23. *Appel*, 2017 WL 6016571, at *2.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.* at *3.

30. *Id.* Specifically, this was Caesars Entertainment Corporation. *Id.*

"that Centerview has provided 'and is currently providing' services to Apollo-affiliated entities and has been and will be receiving compensation from Apollo."[31] Distinguishing the facts before her with those of two precedents cited by plaintiff, the Vice Chancellor observed that "[p]laintiff has not alleged that the amount of Centerview's compensation would 'significantly alter the total mix' of information already provided regarding Centerview's disclosed relationships with Apollo"[32] or "any specific allegations of materiality."[33]

C. One Director's Relationship with Apollo

Finally, plaintiff complained that the 14D-9 failed to adequately disclose "allegedly conflicting relationships" between one of the Diamond directors and Apollo."[34] However, the 14D-9 did disclose that during a strategic review committee meeting, "'it was noted that [the director] served on the boards of entities owned by certain investment funds managed by affiliates of Apollo . . . ."[35] Furthermore, Diamond's proxy statement listed twelve Apollo-related entities on whose boards this director served.[36] And importantly, the director recused herself from strategic review committee meetings that deliberated on the transaction with Apollo.[37] On this basis, the Vice Chancellor concluded that plaintiff "does not convince me that additional information regarding [the director's] length of service or compensation from these various entities would 'significantly alter the total mix' of information available to stockholders regarding [the director's] already-disclosed potential conflicts."[38] Plaintiff appealed this decision to the Supreme Court.

III. THE SUPREME COURT'S REVERSAL

In reversing the Vice Chancellor's dismissal at the pleading stage, the Supreme Court focused on the materiality of the alleged

31. *Id*.

32. *Id*. at *3. In fact, the Vice Chancellor noted that the amounts Centerview received in retainer and advisory fees were "immaterial to Centerview relative to its total annual revenue." *Id*.

33. *Id*. Nevertheless, the Vice Chancellor cautioned that "prudence would counsel in favor of disclosing the amount of compensation Centerview received from Apollo." *Id*.

34. *Id*. at *4.

35. *Id*.

36. *Id*.

37. *Id*.

38. *Id*.

omissions relating to the reasons for Cloobeck's abstention. Defendants made "much of the distinction between opinion and fact, arguing that because Cloobeck's belief that it was the wrong time to sell was just his opinion, his expression of that opinion to the board cannot be a material fact that requires disclosure."[39] The Supreme Court rejected the relevance of the fact *vs.* opinion distinction in this context, noting that "[i]t is inherent in the very idea of a fiduciary relationship that the stockholders that directors serve are entitled to give weight to their fiduciaries' opinions about important business matters."[40] In fact, "when . . . a board expresses its reasons for voting in favor of a transaction, the contrary view of an individual board member may be material to a stockholder wrestling with whether to accept the board's recommendation."[41]

In so ruling, the Supreme Court declined to apply "a number of Court of Chancery decisions . . . in which a director's stated reason for abstaining or dissenting was held to be immaterial."[42] The Supreme Court continued:

> Contrary to the stark *per se* approach the defendants advance, our decision in no way implies that the reason for a particular director's dissent or abstention will always be material. Rather, we adhere to the contextual approach that has long been Delaware law, which requires an examination of whether a fact—which can include the fact that a director shared with the board particular reasons for his position on an important transaction—would materially affect the mix of information, or whether the disclosure is required to make sure that other disclosures do not present a materially misleading picture.[43]

Turning to the particular facts before them, the Supreme Court explained that "the omission here was in the context of a high-stakes transaction: a sale for cash."[44] Further, Cloobeck was a " 'key board member' if ever there was one . . . ."[45] Though the Supreme Court suggested a different outcome may obtain following discovery upon a summary judgment decision, it concluded by indicating that "the sole basis for the Court of Chancery's dismissal was without merit" and thus it "revers[ed] and remand[ed] the plaintiffs' claims against all of the directors for proceedings consistent with this decision."[46]

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39. Appel v. Berkman, No. 316, 2017, 2018 WL 947893, at *4 (Del. Feb. 20, 2018).
40. *Id.* at *5.
41. *Id.* at *6.
42. *Id.*
43. *Id.*
44. *Id.* at *7.
45. *Id.*
46. *Id.* at *8.

CONCLUSION

The Supreme Court's reversal of Vice Chancellor Montgomery-Reeves ruling in *Appel* demonstrates once again that, despite the concerns of some commentators, defendant directors' invocation of *Corwin* following a favorable stockholder vote will not automatically cleanse fiduciary breaches on the part of those directors in approving an M&A transaction. Although stockholders admittedly face a high bar when challenging corporate disclosures in the *Corwin* context, the Delaware courts will nonetheless parse those disclosures closely to ensure stockholders are apprised of all material facts. *Appel* also serves as a reminder that Delaware courts tend to disfavor establishing bright lines that predetermine the outcomes of challenges to directorial action. Quite the contrary, context is key, giving deal planners and their counsel an opportunity to take actions that make sense and justify those actions in the related disclosures.