DELAWARE CORPORATE LAW BULLETIN

# Delaware Court Summons *Corwin* to Dismiss Breach of Fiduciary Duty Claim Grounded in Allegations of Director Self-Interest in Connection with Merger

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*Also determines that plaintiffs failed to adequately allege that a target company board breached its duty of loyalty or acted in bad faith*

## INTRODUCTION

Since the Delaware Supreme Court issued its now iconic decision in *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"), commentators have lauded the Court's reliance on stockholder ratification to "cleanse" directorial breaches of fiduciary duty.[1] Under *Corwin*, business judgment review attaches to a post-closing damages action alleging directorial breach of fiduciary duties in connection with a transaction approved by a fully informed, uncoerced vote of a majority of disinterested stockholders.[2] Delaware courts have applied this principle "even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors."[3]

In practice, when plaintiffs properly plead that a *majority* of the members of a corporate board breached their duty of loyalty in connection with their approval of a transaction, the standard of review shifts from the default rule for directorial actions—the deferential business judgment rule—to the probing entire fairness standard whereby defendants bear the burden of proving both fair dealing and fair price.[4] And to properly plead a breach of the duty of loyalty,

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1. *See* Steven M. Haas, *The* Corwin *Effect: Stockholder Approval of M&A Transactions*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Feb 21, 2017), https://corpgov.law.harvard.edu /2017/02/21/the-corwin-effect-stockholder-approval-of-ma-transactions/ [https://perma.cc/C4GL-GSBS].

2. *Corwin*, 125 A.3d at *309. *Corwin*'s stockholder approval requirement also can be met when stockholders surrender their shares in a tender offer in the first step of a two-step merger, so long as the disclosures surrounding the offer are adequate. *In re* Volcano Corp. Stockholder Litig., 143 A.3d 727 (Del. Ch. 2016), *aff'd*, 156 A.3d 697 (Del. 2017). For a discussion of the *Volcano* decision, see Robert S. Reder, *Delaware Chancery Court Extends "Cleansing Effect" of Stockholder Approval Under* KKR *Two-Step Acquisition Structure*, 69 VAND. L. REV. EN BANC 227 (2016).

3. *See In re* Merge Healthcare Inc. Stockholders Litig., C.A. No. 11388-VCG, 2017 WL 395981, at *6 (Del. Ch. Jan. 30, 2017) (explaining that *Corwin* is applicable to directorial breach of duty claims arising from transactions not involving "a controlling stockholder that extracted personal benefits"). 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).

4. *See* Golden Cycle, LLC v. Allan, No. Civ.A. 16301, 1998 WL 892631, at *11 (Del. Ch. Dec. 10, 1998) ("[T]he entire fairness of a transaction will be scrutinized by the courts where a *majority* of the directors approving the transaction were interested or where a majority stockholder stands on both sides of the transaction." (quoting *In re* Budget Rent a Car Corp. Shareholders Litig., C.A. No. 10418, slip op. at 6–7 (Del. Ch. Mar. 15, 1991) (emphasis added))); Joseph M. McLaughlin, *Corporate Litigation: Disinterested Directors and "Entire Fairness" Cases*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 25, 2015), https://corpgov.law.harvard.edu/2015/06/25/corporate-litigation-disinterested-directors-and-entire-fairness-cases/ [https://perma.cc/6J78-2VLQ].

plaintiffs must assert facts from which one can reasonably infer that directors (i) were on both sides of a transaction (i.e., self-dealing), (2) were interested in the transaction (i.e., received material benefits from the transaction not shared equally with stockholders), or (3) acted in bad faith.[5]

On the other hand, in the absence of a proper pleading of a breach of the duty of loyalty by a board *majority*, the standard of review *remains* the business judgment rule.[6] In such case, dismissal is appropriate because, presumably, a majority of the uninterested directors approved the transaction.[7] Under such circumstances, it would seem, a *Corwin* analysis is superfluous.[8] And likewise, an analysis whether pleadings properly infer that a corporate board has breached its duty of loyalty should technically be unnecessary if a cleansing *Corwin* vote is present. However, as *In Re Cyan, Inc. Stockholders Litig.*[9] demonstrates, the Delaware Court of Chancery (the "*Chancery Court*") has yet to relinquish the reigns of additional analysis, probing into a duty of loyalty analysis despite finding that *Corwin* applies.[10]

## I. FACTUAL BACKGROUND

Cyan Inc. ("*Cyan*") is a provider of "various carrier-grade networking solutions in North America, Asia, and Europe."[11] Cyan's Board of Directors (the "*Board*") consisted of seven members: two insiders, Cyan's CEO and Chairman of the Board and Cyan's President and co-founder; the senior managing partner and co-CEO of Norwest Venture Partners ("*Norwest*"), which owned 22.71% of Cyan's

5. *See In Re* Cyan, Inc. Stockholders Litig., C.A. No. 11027–CB, 2017 WL 1956955, at *8 (Del. Ch. May 11, 2017). The term "interested directors," as discussed below, means that such directors "expect to derive . . . personal financial benefit from [a transaction in the same] sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

6. Necessarily, this excludes circumstances under which it is alleged that a minority of corporate directors control the rest of the purportedly uninterested directors. *See* Texlon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002).

7. *See* Singh v. Attenborough, 137 A.3d 151, 152 (Del. 2016).

8. *See* Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304, 308–09 (Del. 2015).

9. 2017 WL 1956955.

10. By contrast, in *Sciabacucchi v. Liberty Broadband Corp.*, No. 11418–VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017), the Chancery Court first determined that *Corwin* was inapplicable due to a stockholder vote being "structurally coerced" before requiring the litigants to further brief issues relating to whether the defendant directors acted in breach of their fiduciary duties. For a discussion of the *Sciabacucchi* case, see Robert S. Reder & Victoria L. Romvary, *Delaware Court Determines Corwin Not Available to "Cleanse" Alleged Director Misconduct Due to "Structurally Coercive" Stockholder Vote,* 71 Vand. L. Rev. En Banc 131 (2018).

11. *Cyan*, 2017 WL 1956955, at *2.

outstanding shares and was its largest stockholder; the general partner and managing member of Azure Capital Partners ("*Azure*"), which owned 12.4% of Cyan's outstanding shares and was its second largest stockholder; and three other outside directors (collectively, "*Cyan Directors*"). Beginning early in 2014 and continuing into the following year, the Board faced a series of strategic challenges.[12]

### *A. Strategic Challenge: Securities Litigation*

*First*, a class action was filed against Cyan on April 1, 2014 alleging violations of federal securities laws in connection with its May 2013 initial public offering ("*Securities Litigation*").[13] In addition to Cyan itself and the Cyan Directors, Jefferies LLC ("*Jefferies*") and several other firms who acted as underwriters for the offering were named as defendants.[14] Under certain circumstances, the Cyan Directors and Jefferies were entitled to be indemnified by Cyan for damages resulting from the Securities Litigation.[15]

### *B. Strategic Challenge: Cash Deficiencies and Issuance of Convertible Debt*

*Second*, Cyan management informed the Board on May 22, 2014 that Cyan "only had sufficient cash to survive through the second quarter of 2015."[16] In response, the Board met with Jefferies and Morgan Stanley & Co. LLC ("*Morgan Stanley*") to identify capital-raising opportunities.[17] Though representatives of Morgan Stanley suggested "it would be difficult for Cyan to raise additional capital absent one or more key business developments, such as a major customer win," the Board opted to pursue a convertible debt offering (the "*Convertible Debt*").[18] Because the Board could not obtain satisfactory investment commitments from unaffiliated investors, Cyan's CEO and President, Norwest, and Jefferies agreed to invest $22 million in the aggregate, enabling Cyan to raise a total of $50 million.[19]

Under the terms of the Convertible Debt, note holders (collectively, "*Note Holders*") who converted their notes in connection

12. *See id.* at *2–4.
13. *Id.* at *2.
14. *Id.* at *2.
15. *Id.*
16. *Id.* at *3.
17. *Id.*
18. *Id.*
19. *Id.*

with a sale of Cyan were entitled to "receive the same consideration" as would holders of Cyan common stock unless the acquirer elected to pay them cash.[20] The Convertible Debt provided Note Holders who did not convert with a "make-whole" provision pursuant to which "the [N]ote [H]olders could require [an acquirer] to repurchase their convertible notes at 100% of the principal amount plus accrued and unpaid interest" if the acquisition was structured so as to constitute a "Fundamental Change."[21] A "Fundamental Change" change would occur if the consideration paid for Cyan common stock in the acquisition was a "mix of both cash and stock."[22]

### *C. Strategic Challenge: Consideration of Strategic Alternatives*

*Third*, in the midst of the Securities Litigation and the Convertible Debt offering, the Board conducted an evaluation of its strategic alternatives, culminating in a sales process triggered by receipt of a third-party expression of interest.[23] The Board enlisted Jefferies to serve as a financial advisor for the sale process.[24] As a backdrop to negotiations, Cyan could tout continuous revenue growth in 2014 and the first quarter of 2015; as of March 2015, Cyan's cash and cash equivalents totaled $53.87 million.[25]

Ciena Inc. ("*Ciena*"), a corporation "focused on providing communications networking solutions,"[26] was one of the participants in the sales process.[27] In April 2015, Ciena proposed to purchase Cyan via a merger (the "*Merger*") for a mix of consideration totaling $335 million, consisting of 11% cash and 89% Ciena common stock, thereby triggering a Fundamental Change under the Convertible Notes. Cyan indicated its preference for a cash-out of the Note Holders by structuring the Merger as a Fundamental Change rather than allowing the Note Holders' "security interests in Cyan's assets and the negative covenants in the convertibles notes . . . [to] continue to apply after the closing" of the Merger.[28]

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20. *Id.*
21. *Id.*
22. *Id.* at *4.
23. *Id.*
24. *Id.*
25. *Id.* at *3.
26. *Id.* at *2.
27. *Id.* at *3.
28. *Id.* at *4.

Because Jefferies "would have an interest in the outcome" of the Merger in its dual capacity as a Note Holder and a defendant subject to indemnification by Cyan in the Securities Litigation,[29] the Board decided to retain Houlihan Lokey Capital, Inc. ("*Houlihan*") to render a fairness opinion to the Board in connection with the consideration paid to Cyan stockholders in the Merger. Following receipt of a fairness opinion from Houlihan, the Board unanimously approved the Merger on May 3, 2015.[30] On July 31, 2015, the Merger was approved by a supermajority vote of the holders of Cyan common stock.[31] The Merger closed several days later.[32]

Following public announcement of the Merger, several Cyan stockholders filed a class action in the Chancery Court. These plaintiffs had "identified a host of alleged disclosure deficiencies in Cyan's proxy statement, but they elected not to seek injunctive relief . . . ."[33] Instead, nearly a year later, these plaintiffs amended their complaint, now asserting that "seven members of Cyan's board breached their fiduciary duties in connection with their approval of the Merger."[34] The primary theories underlying the alleged breach were that the Cyan Directors (1) were conflicted because (a) "they were motivated to secure a buyer with deep pockets to ensure they would be indemnified from the high litigation exposure associated with the Cyan Securities Litigation due to the Company's uncertain cash position"[35] ("*Indemnification Conflict*"), and (b) three of the Cyan Directors were Note Holders who were "motivated to ensure a transaction occurred so they could either receive the make-whole payment from the convertible notes in connection with a [F]undamental [C]hange or in the alternative, keep the convertible notes outstanding, but tied to a much more financially secure company"[36] ("*Note Holder Conflict*")[37]; and (2) acted in bad faith

29. *See id.* at *4.
30. *Id.* at *5.
31. *Id.* at *6.
32. *Id.*
33. *Id.* at *1.
34. *Id.* at *6.
35. *Id.* at *8.
36. *Id.* at *10.
37. Plaintiffs also alleged that the two Cyan Directors who were affiliated with Cyan's two largest stockholders (Norwest and Azure) had interests "not aligned with other Cyan stockholders because their holdings are so sizable that the transaction is their only opportunity to cash out without the scrutiny of public markets." *Id.* at *10. Citing Delaware precedent, the Chancellor found that this aspect of the pleadings failed to form a reasonable inference that these two directors were interested directors because "a fiduciary's financial interest in a transaction as a stockholder (such as receiving liquidity value for her shares) does not establish a disabling conflict of interest when [all stockholders receive the same consideration]." *Id.* (quoting *In re* Synthes, Inc. S'holder Litig., 50 A.3d 1022, 1035–36 (Del. Ch. 2012)). Then-Chancellor Strine suggested a disabling conflict could exist if large stockholders had an "immediate need for liquidity" that

by refusing to amend Cyan's proxy materials in connection with the stockholder vote ("Proxy Materials") "after receiving . . . a letter from plaintiffs' counsel asking them to do so shortly before the stockholder meeting to consider the Merger . . . ."[38]

In response, the Cyan Directors moved to dismiss. Chancellor Andre G. Bouchard, siding with the Cyan Directors, granted their motion.

## II. CHANCELLOR BOUCHARD'S ANALYSIS

Chancellor Bouchard found two independent grounds supporting invocation of the business judgment rule, prompting his granting dismissal of plaintiffs' action.[39] *First*, plaintiffs did not "plead sufficient facts to support a reasonable inference that the directors of Cyan breached their duty of loyalty or acted in bad faith in connection with the Merger."[40] *Second*, "a majority of disinterested stockholders of Cyan approved the Merger in a fully informed, uncoerced vote," thus cleansing the transaction under *Corwin* and its progeny.[41] As the Chancellor further explained, in circumstances in which the business judgment rule applies, "the Court will not second-guess a board's decision unless that decision 'cannot be attributed to any rational business purpose.' "[42]

### *A. Failure to Plead Breach of Duty of Loyalty or Bad Faith*

Cyan's certificate of incorporation included a provision exempting (or, "exculpating") Cyan Directors from personal liability for breaches of the duty of care pursuant to section 102(b)(7) of the Delaware General Corporation Law. Therefore, "to survive the motion to dismiss, plaintiffs must [have] state[d] a claim that a majority of defendants acted in bath faith or otherwise breached their duty of loyalty."[43] Underlying the pleading gamesmanship is the standard of review. As a default matter, the business judgment rule applies,

informed their decision to vote in favor of a sale. *Id.* (citing *Synthes*, 50 A.3d at 1035–36). But, no such immediate need for liquidity was implicated here, with Norwest and Azure both receiving the same consideration as other stockholders. *See id.*

38. *Id.* at *11.

39. *Id.* at *7. Preliminarily, Chancellor Bouchard noted that, because the consideration payable to Cyan stockholders in the Merger "primarily consisted of stock in a publicly traded company, enhanced scrutiny under *Revlon* does not apply . . . ." *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at *7 (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).

43. *Id.* at *8.

affording the board in question judicial deference. But if plaintiffs adequately plead a violation of the duty of loyalty or bad faith, the standard of review shifts to the probing entire fairness standard.

To adequately plead a breach of the duty of loyalty where directorial self-dealing[44] is not present, Delaware plaintiffs have two options:[45]

- *First*, plaintiffs may allege facts raising a reasonable inference that any benefits received by *a majority of* the directors not equally shared by stockholders are material to those directors (making them "*Interested Directors*").[46] This pleading requirement is referred to herein as the "*Interested Directors Pleading Requirement*."[47]
- *Second*, plaintiffs may allege facts raising a reasonable inference that the directors acted in bad faith.[48] Bad faith:

  > 'will be found if a fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties'[49] or if 'the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' [50]

  This pleading requirement is referred to herein as the "*Bad Faith Pleading Requirement*."

### 1. Failure to Adequately Allege that a Majority of Cyan Directors Were Interested

*Indemnification Conflict*. Chancellor Bouchard determined that the allegations underlying the Indemnification Conflict failed to establish a reasonable inference that the Cyan Directors were Interested Directors because:

- (1) the Cyan Directors were covered by D&O insurance (indeed, the Merger required Ciena to continue the Cyan Directors' insurance coverage);

44. *See supra* note 5 and accompanying text. Because there was no apparent self-dealing by Cyan Directors, plaintiffs could only plead that the directors either were interested or acted in bad faith, as discussed below.

45. *See Cyan*, 2017 WL 1956955, at *8. (citing Orman v. Cullman, 794 A.2d 5, 23 (Del. Ch. 2002)).

46. *Id.* at *8. (citing *Orman*, 794 A.2d at 23). For this purpose, materiality "means that [any] alleged benefit . . . made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest." *Id.* (quoting *Orman*, 794 A.2d at 23).

47. *See id.* at *10.

48. *Id.* at *8.

49. *Id.* (quoting Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009))

50. *Id.* (quoting Crescent/Mach I P'rs, L.P. v. Turner, 846 A.2d 963, 981 (Del. Ch. 2000)).

- (2) Cyan had $53.87 million in cash or cash equivalents to support its indemnification obligations to the Cyan Directors;[51]
- (3) other defendants, including notably the underwriters, had deep pockets to fund recovery for plaintiffs in the Securities Litigation;
- (4) none of the facts pled suggested that the Cyan Directors were motivated by the possibility of damages arising from the Securities Litigation; and
- (5) none of the facts pled suggested that Ciena had deeper pockets than Cyan.[52]

*Note Holder Conflict*. Chancellor Bouchard was skeptical that the status of three directors as Note Holders created a reasonable inference of a "material" conflict. Each of these directors also was a holder of Cyan common stock "motivated to maximize the exchange ratio in Cyan's favor."[53] Even so, he stopped short of declaring this an immaterial conflict and instead disposed of this assertion on the ground that "this allegation only concerns three of the seven members of Cyan's board and does not show that a majority of Cyan's board" were Interested Directors.[54]

### 2. Failure to Adequately Allege that Cyan Directors Acted in Bad Faith

Chancellor Bouchard determined as a matter of law that plaintiffs' allegations that the Proxy Statement disclosures were deficient had no merit, completely undercutting plaintiffs' claim that Cyan's Directors acted in bad faith.[55] However, Chancellor Bouchard indicated that even if there were a legitimate question regarding the Board's refusal to supplement the Proxy Materials,

> the Complaint contain[ed] no non-conclusory allegation that could support a reasonable inference that the Cyan [Directors] demonstrated 'a conscious disregard for [their duties'[56] or that the decision not to supplement the Proxy was 'so far beyond the bounds

51. In Chancellor Bouchard's estimation, this was sufficient to cover any damages resulting from the Securities Litigation, which it conservatively estimated to total $25.6 million. *Id.* at *9.

52. *Id*. Chancellor Bouchard also pointed out an inconsistency in plaintiffs' argument: "if Cyan truly lacked sufficient capital to satisfy the contractual indemnification obligations it owed to the defendants . . . any consideration its stockholders received in the Merger would amount to a windfall." *Id.*

53. *Id.* at *10.

54. *Id.*

55. *Id.* at *11.

56. *Id.* (quoting Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009)).

of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' [57]

In other words, even if there were a question as to whether the Cyan should have supplemented the Proxy Materials, plaintiffs would *still* have failed to meet the strictures of the Bad Faith Pleading Requirement.[58]

### *B. Application of* Corwin

Chancellor Bouchard's analysis continued with an application of *Corwin*. Because plaintiffs' complaint did not allege the Cyan stockholder vote was coerced,[59] the Chancellor's remaining inquiry focused on whether "the stockholder vote approving the Merger was fully informed."[60]

For stockholders to be fully informed, "directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all *material* information within [a] board's control when it seeks shareholder action."[61] Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[62] Operationally, this means the Cyan Directors were obligated to disclose only information "necessary to make the disclosure of their recommendation materially accurate and complete."[63]

In the interest of judicial economy, Chancellor Bouchard had plaintiffs identify their three strongest disclosure allegations,[64] noting that "plaintiffs tellingly did not believe the deficiencies were serious enough to warrant seeking an injunction to prevent an allegedly uniformed stockholder vote."[65] Plaintiffs' main disclosure allegation was that the Proxy Materials failed to property acknowledge "Jefferies' conflict of interest in giving advice on a strategic transaction" based on

57. *Id.* (quoting Crescent/Mach I P'rs, L.P. v. Turner, 846 A.2d 963, 981 (Del. Ch. 2000)).

58. *See id.*

59. *Id.* at *11.

60. The concept of coercion in the *Corwin* context is fully analyzed by Vice Chancellor Sam Glasscock III in Sciabacucchi v. Liberty Broadband Corp., No. 11418–VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017). *See supra* note 10.

61. *Cyan*, 2017 WL 1956955, at *11 (emphasis added).

62. *Id.* (quoting Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))).

63. *Id.* (quoting Matador Capital Mgmt. Corp. v. BRC Hldgs, Inc., 729 A.2d 280, 295 (Del. Ch. 1998)).

64. This analysis will only focus on one of the disclosure allegations, as all three were found to be without merit essentially on the grounds that the information in question was, in fact, disclosed. *Id.* at *12–17.

65. *Id.* at *12.

the fact that it was a Note Holder and a defendant subject to indemnification by Cyan in the Securities Litigation.[66] Chancellor Bouchard again made a determination as a matter of law, indicating such information, which was already detailed in the Proxy Materials, would not "significantly alter the total mix of information made available to Cyan's stockholders."[67]

## CONCLUSION

There are several takeaways of note from Chancellor Bouchard's *Cyan* analysis:

- First, process continues to be of paramount importance in completing M&A transactions, even with the protection of *Corwin*. If the Chancellor had found that the Board included a majority of Interested Directors, this would have satisfied the Interested Directors Pleading Requirement. And if that were the case, the Board would have had additional disclosure obligations to satisfy *Corwin*'s requirement that a stockholder vote be fully informed. Thus, *Corwin* is not a *carte blanche* for boards of directors to act disloyally or in bad faith, unless they are prepared to disclose the same and risk a negative stockholder vote.
- Related to the first point, pleading requirements like the Interested Directors Pleading Requirement and the *Corwin* doctrine are inextricably intertwined. Defects in boards' actions that will allow plaintiffs to pass the summary disposition stage are the same issues that could lead a purported *Corwin* vote to be deemed invalid.
- Third, Delaware courts are reluctant to use *Corwin* as the sole criterion for dismissal. Chancellor Bouchard's analysis suggests that Delaware courts still expect boards to carry out their fiduciary duties, even if breaches thereof are susceptible to cure by a *Corwin* vote.

66. *Id.*
67. *Id.* at *14.