DELAWARE CORPORATE LAW BULLETIN

Delaware Supreme Court Clarifies Pleading Standard in Post-Closing Damages Action Alleging Breach of "*Revlon* Duties"

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But affirms Chancery Court finding that "side deals" for corporate insiders in connection with a sale of the company did not present a rational inference of bad faith conduct

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** Vanderbilt University Law School, J.D., May 2018. This fall, Victoria will join the Corporate group at Cravath, Swaine & Moore in New York, New York. Many thanks to Professor Reder and the Vanderbilt Law Review for the opportunity to participate in this En Banc series.

INTRODUCTION

Following the Delaware Supreme Court's 2015 decision in *Corwin v. KKR Fin. Hldgs. LLC* ("*Corwin*"),[3] stockholder ratification is available to "cleanse" directorial breaches of fiduciary duty in the M&A context.[4] 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.[5] A *Corwin* "cleansing" vote therefore provides a powerful *ex post* defense to corporate directors who may have erred in conducting a company sale.

Even in circumstances where directors are *not* entitled, for one reason or another, to assert a *Corwin* defense, [6] plaintiffs face no small task in sustaining a damages action. This is particularly true when directors are protected from personal damages for breaching their duty of care by an exculpatory charter provision adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law (a "*§ 102(b)(7) charter provision*"). In those cases, plaintiffs face the difficult burden of establishing a breach of the duty of loyalty. The challenges presented by this burden were illustrated in a recent decision of the Delaware Court of Chancery (the "*Chancery Court*") in *Kahn v. Stern*.[7] In *Kahn v. Stern*, plaintiff claimed (among other things) that corporate insiders extracted side deals in connection with a sale of the company, with the effect of reducing the sales price received by stockholders.[8] After the transaction closed, plaintiff sought damages from the company's directors.

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3. 125 A.3d 304, 308–09 (Del. 2015).

4. For a discussion of *Corwin* and follow-on 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).

5. *Corwin*, 124 A.3d at 309.

6. For instance, *Corwin* "cleansing" is not available when the stockholder vote is (i) not fully informed (*see*, *e.g.*, *In re* Saba Software, Inc. S'holder Litig., No. 10697-VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017)) or (ii) coerced (*see*, *e.g.*, Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017)). For a discussion of the *Saba Software* decision, 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 131 (2018). For a discussion of the *Sciabacucchi* decision, *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 199 (2017).

7. No. 12498-VCG, 2017 WL 3701611 (Del. Ch. Aug. 28, 2017) (hereinafter *Kahn v. Stern I*), *aff'd*, Kahn v. Stern, No. 393, 2018 WL 1341719 (Del. Mar. 15, 2018) (hereinafter *Kahn v. Stern II*).

8. *Kahn v. Stern I*, 2017 WL 3701611 at *1.

Vice Chancellor Sam Glasscock III dismissed plaintiff's action on the basis that the facts pled did not create a reasonable inference of bad faith, thereby defeating the duty of loyalty claim.[9] In a succinct affirmance, the Delaware Supreme Court cautioned against an expansive reading of two aspects of the Vice Chancellor's opinion, reminding M&A practitioners and dealmakers that a failure by corporate directors to satisfy their "*Revlon* duties" may have consequences even after a sale transaction has closed.[10]

I. FACTUAL BACKGROUND

A. The Merger

Kreisler Manufacturing Corporation ("*Kreisler*" or the "*Company*") is a thinly-traded aerospace manufacturing company.[11] In 2016, Kreisler was sold to Arlington Capital Partners ("*Arlington*") for $18.00 per share in a transaction structured as a merger (the "*Merger*").[12] Prior to the Merger, brothers Michael and Edward Stern (the "*Stern Defendants*") and two of their siblings collectively owned 42.6% of the outstanding Company shares.[13] The brothers also served as directors and the sole executive officers of the Company. The other three directors were Joseph P. Daly, John W. Poling, and Jeffrey P. Bacher (together with the Stern Defendants, the "*Board*").[14] The Board was protected from personal damages claims for breaches of their duty of care by a § 102(b)(7) charter provision.[15]

Shortly after prevailing in a proxy contest in early 2015 that exposed fissures within the Stern family, the Board began exploring a sale.[16] The Board formed an independent special committee (the "*Special Committee*"), consisting of directors Poling and Bacher, "to consider strategic alternatives" for the Company.[17] As part of the sale process, dozens of bidders were contacted and the Company entered into nondisclosure agreements with twenty-seven of them.[18] Of these bidders, seven received management presentations and three

9. *Id.* at *6–13.
10. Kahn v. Stern *II*, 2018 WL 1341719 (Del. Mar. 15, 2018).
11. *Kahn v. Stern I*, 2017 WL 3701611 at *2.
12. *Id.* at *4.
13. *Id.* at *2.
14. *Id.*
15. *Id.*
16. *Id.* at *3.
17. *Id.*
18. *Id.* at *4.

eventually submitted bids.[19] Arlington prevailed as the highest bidder at $18.75 per share "subject to adjustments."[20]

As negotiations over the buyout proceeded, the Stern Defendants negotiated personal arrangements with Arlington (collectively, the "*Side Deals*").[21] Michael secured employment as President of the post-Merger entity and the right to rollover a portion of his Kreisler shares into shares of an Arlington subsidiary.[22] Edward secured "better benefits upon his desired termination from the Company."[23] Further, both brothers negotiated a "Sale Bonus Agreement" providing for each to receive up to $105,000 if and when the Merger closed.[24]

Negotiations between Arlington and Kreisler resulted in a final Merger price of $18.00 per share.[25] Included in the Merger agreement was an "Appraisal Out" giving Arlington the right to walk away from the transaction if more than 10% of Kreisler's outstanding shares sought statutory appraisal rights.[26] Kreisler stockholders were provided with an information statement in connection with their decision whether or not to seek appraisal (the "*Information Statement*").[27] Following Special Committee and Board approval, the Merger was approved by stockholders in May 2016 via written consent pursuant to stockholder support agreements signed by stockholders collectively owning 53.2% of outstanding Company shares.[28]

B. The Litigation

Plaintiff brought a class action in Chancery Court in June 2016 on behalf of Kreisler stockholders alleging breach of fiduciary duty by the Board in connection with the Merger. The suit sought damages from the Stern Defendants as well as the other members of the Board to remedy two primary allegations:

(1) *Side Deals*: "Defendants breached their fiduciary duties by knowingly competing for merger consideration or permitting other insiders to compete for merger consideration by securing or approving lucrative deals for Michael Stern and Edward Stern, all of which

19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.* at *1.
28. *Id.* at *5.

resulted in a lower Merger price."[29] The Information Statement did not disclose specifically why Arlington lowered its bid from $18.75 to $18.00, paving the way for plaintiff to assume, and claim, the worst.

(2) *Inadequate Disclosure*: "Defendants breached their fiduciary duties by knowingly withholding and/or [misrepresenting] material information from stockholders. Defendants . . . knew that the Information Statement omitted material information and made material misstatements, and yet approved its dissemination to Kreisler's public stockholders."[30] Plaintiff claimed that these disclosures were calculated to "minimize appraisal activity," with the goal of avoiding a triggering of the "Appraisal Out" that would "thwart the Merger."[31]

Defendants moved to dismiss.

II. Vice Chancellor Glasscock's Analysis

In granting defendants' motion, Vice Chancellor Glasscock explained that because the Board was protected by a §102(b)(7) charter provision, "the Complaint must contain 'sufficient facts to show that *a majority of the Board of directors* breached the fiduciary duty of loyalty . . . .' "[32] As such, "the burden on the Plaintiff is to plead facts from which the Court can reasonably infer that a majority of the Director Defendants were interested in the transaction, or dominated or controlled by an interested party, or that the majority of the Board failed to act in good faith."[33] Because plaintiff did not claim the directors were dominated or controlled by an interested party, the Vice Chancellor turned to the other two elements of plaintiff's pleading burden.

A. Was a Majority of the Board Interested?

To address this prong of the analysis, Vice Chancellor Glasscock explained that "a director is considered interested when she 'will receive a personal financial benefit from a transaction that is not equally shared by the stockholders.' "[34] As direct beneficiaries of the Side Deals,

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29. *Id.* at *6.

30. *Id.*

31. *Id.* at *5.

32. *Id.* at *8 (quoting *In re* NYMEX S'holder Litig., 2009 WL 3206051, at *6 (Del. Ch. Sept. 30, 2009)).

33. *Id.* (citing Orman v. Cullman, 794 A.2d 5, 24–25 (Del. Ch. 2002)).

34. *Id.* at *8 (citing *In re* Alloy, Inc., 2011 WL 4863716, at *7 (Del. Ch. Oct. 13, 2011)) (internal quotation marks omitted).

it was undisputed that the Stern Defendants were interested.[35] On the other hand, there was no dispute that the Special Committee members (Poling and Bacher) were *not* interested.[36] Therefore, the question turned on the independence of the fifth director, Daly.[37]

Plaintiff alleged that Daly was interested due, in large part, to his illiquid block of Company shares representing 19.1% of the outstanding, making him the largest single stockholder.[38] However, because plaintiff offered no evidence beyond "bare" allegations that Daly received any unique consideration, faced a liquidity crisis or similar need to sell, or was unable to objectively make business decisions as a director, the Vice Chancellor determined that Daly was not interested.[39] In fact, since Daly likely would seek to "maximize the value of his investment," his incentives seemed perfectly aligned with those of the other stockholders.[40]

B. Did a Majority of the Board Act in Bad Faith?

Vice Chancellor Glasscock next explained that bad faith will be found if either a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties"[41] or "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."[42]

1. Impact of Side Deals On Merger Price

Plaintiff alleged that the Board acted in bad faith when it favored "the side agreements over the payment of additional consideration to stockholders."[43] According to this reasoning, the Side Deals caused Arlington to adjust its bid price downward (from $18.75 per share to $18.00), thereby siphoning merger consideration from Kreisler stockholders to the Stern Defendants.[44]

35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.* at *9.
39. *Id.*
40. *Id.*
41. *Id.* at *10 (quoting Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009)) (internal quotation marks omitted).
42. *Id.* (quoting *In re* Cyan, Inc. Stockholders Litig., No. CV 11027-CB, 2017 WL 1956955, at *8 (Del. Ch. May 11, 2017)) (internal quotation marks omitted).
43. *Id.*
44. *Id.*

Bare allegations, however, do not suffice to establish bad faith.[45] Rather, the Vice Chancellor explained that "the Complaint must allege the Board's approval of the Merger, in the face of the Side Deals, was so far beyond the bounds of reasonable business judgment that it is inexplicable on the grounds other than bad faith: otherwise, the process allegations must be dismissed."[46]

Compared with previous cases in which the Chancery Court found a breach of fiduciary duties as a result of insiders benefitting at the expense of stockholders, Vice Chancellor Glasscock found plaintiff's conclusory pleadings to be not only lacking, but less extreme on their face.[47] In fact, the Vice Chancellor observed that the sales process that led to the Merger "involv[ed] a lengthy and wide-ranging attempt to generate best price."[48] Further, he recognized a rational business purpose in the potential for the Side Deals "to incentivize proper management of the Company through and after the Merger."[49] Thus, absent more specific or substantial allegations of bad faith, the Vice Chancellor declined to infer that the Board's action relative to the Side Deals was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[50]

2. Alleged Disclosure Omissions and Misstatements

Vice Chancellor Glasscock prefaced this part of his analysis by noting that because the Merger had closed, his analysis would "turn on whether the Defendants … are conceivably liable to the stockholder Plaintiff for damages," as opposed to whether pre-closing equitable relief was available.[51] As such, "plaintiff must allege facts making it reasonably conceivable that there has been *a non-exculpated breach* of fiduciary duty by the board in failing to make a material disclosure."[52] The Vice Chancellor reiterated that a showing of bad faith requires "an 'extreme set of facts to establish that disinterested directors were intentionally disregarding their duties or that the decision . . . [was] so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' "[53]

45. Id. at *9–10.
46. *Id.* at *10.
47. *Id.* at *10–13.
48. *Id.* at *13.
49. *Id.*
50. *Id.* (quoting *In re* Alloy, Inc., 2011 WL 4863716, at *11–12 (Del. Ch. Oct. 13, 2011)) (internal quotation marks omitted).
51. *Id.* at *14 (internal emphasis omitted)
52. *Id.* (quoting Nguyen v. Barrett, 2016 WL 5405095, at *3 (Del. Ch. Sept. 28, 2016)).
53. *Id.* (quoting Nguyen v. Barrett, 2016 WL 5405095, at *3 (Del. Ch. Sept. 28, 2016)).

Plaintiff alleged that the Information Statement (i) contained misrepresentations about stockholder access to the Merger agreement, (ii) failed to include "a fair summary" of financial valuation and projections, and (iii) failed to provide adequate details about the negotiations of the Side Deals.[54] The Vice Chancellor noted that while these alleged disclosure defects may have been sufficient to warrant pre-closing injunctive relief, they were insufficient to "create[ ] an inference that the Defendants deliberately withheld the information or disregarded a manifest duty."[55] Because independent and disinterested directors are presumed to act in good faith, in the absence of any implication of bad faith, the Vice Chancellor found the alleged disclosure defects to be "not actionable."[56]

With regard to the most problematic allegation, that the Information Statement inadequately described the Side Deals, the Vice Chancellor noted the Information Statement "dedicates approximately four single-spaced pages" to explaining the unique interests of the directors and officers and describing the Side Deals in detail.[57] Although the Information Statement did not identify the exact business purpose of the Side Deals, from the Vice Chancellor's point of view, nothing about the disclosures "suggests a cover-up or is otherwise redolent of bad faith on the part of the directors."[58]

III. SUPREME COURT'S ORDER

On March 15, 2018, in a terse, three-page order authored by Chief Justice Leo E. Strine, Jr. (the "*Order*"), the Delaware Supreme Court affirmed Vice Chancellor Glasscock's dismissal of the claims against the Kreisler defendants.[59] The Order supported the Vice Chancellor's conclusion that "the pled facts did not support a rational inference that any of the directors faced a non-exculpated claim for breach of fiduciary duty on the theory that merger consideration was improperly diverted into payments for two management directors."[60] The Order also emphasized that the sale of Kreisler occurred only after a "thorough market check" and was ultimately made to a "buyer without any prior ties to management."[61]

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54. *Id.* at *5–6.
55. *Id.* at *16.
56. *Id.* at *14–15.
57. *Id.* at *15.
58. *Id.* at *16.
59. *Kahn v. Stern II*, 2018 WL 1341719.
60. *Id.* at *1.
61. *Id.*

However, the Order contained two important caveats to the Vice Chancellor's ruling:

First, the Order declared "[t]o the extent . . . the Court of Chancery's decision suggests that it is an invariable requirement that a plaintiff plead facts suggesting that a majority of the board committed a non-exculpated breach of its fiduciary duties in cases where *Revlon*[62] duties are applicable, but the transaction has closed and the plaintiff seeks post-closing damages, we disagree with that statement."[63] Two footnotes included with this statement provide some insight into the Supreme Court's thinking:

The first indicated that "[t]he presence of an exculpatory charter provision does not mean that *Revlon* duties no longer apply [to the Board's actions in connection with the Merger]. Rather, *Revlon* remains applicable as a context-specific articulation of the directors' duties."[64]

The second referred to two well-known Delaware decisions in the *Revlon* line of cases that were critical of (i) in the first case, conflicted management directors who withheld important information concerning a sales process from independent board members, thereby committing "a fraud upon the board,"[65] and (ii) in the second case, independent board members who failed to oversee a sales process run by company management, and thereby "materially contributed to the unprincipled conduct of those upon whom [they] looked with a blind eye."[66]

Such references to *Revlon* in a post-closing action for damages seem, at first blush, to be curious. As recently as 2015, Chief Justice Strine opined in *Corwin* that:

Unocal and *Revlon* are 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. They were not tools designed with post-closing money damages claims in mind, the standards they articulate do not match the gross negligence standard for director due care liability under *Van Gorkom*, and with the prevalence of exculpatory charter provisions, due care liability is rarely even available.[67]

The Order's references to "*Revlon* duties" would seem to indicate, despite the above-quoted language from *Corwin*, that this

62. Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

63. *Kahn v. Stern II*, 2018 WL 1341719 at *1.

64. *Id.* at *2 n.3.

65. *Id.* at *2 n.4 (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283 (Del. 1989)).

66. *Id.* at (quoting *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1002 (Del. Ch. 2005)).

67. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312 (Del. 2015).

important doctrine has continued vitality in the post-closing M&A litigation setting. While plaintiffs still must clear the high bar of pleading a non-exculpated breach on the part of defendant directors, they may look to *Revlon* and its progeny to define the actions required of directors engaged in a sale of their company.

Second, the Order cautioned that Vice Chancellor Glasscock's opinion must not be read "as suggesting that a plaintiff seeking to establish a breach of the duty of loyalty must plead facts that *rule out any possibility other than bad faith*."[68] Rather, plaintiffs are required only to plead "facts that support a *rational inference of bad faith*.[69] Although subtle, this would seem an important distinction. One of the Chancery Court's most common formulations of a bad faith decision is one that "is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[70] To defeat a motion to dismiss, however, the Order instructs that pleadings need only recite facts supporting a *rational inference* of bad faith, for instance, "an inference that [the board] did not reasonably believe that the . . . transaction was in the best interests of the [corporation]."[71] Nevertheless, the Order sustained the Vice Chancellor's conclusion that plaintiff failed to clear even this lower bar.

CONCLUSION

In clarifying Vice Chancellor Glasscock's holding in *Kahn v. Stern*, the Delaware Supreme Court "fe[lt] obliged to affirm on narrow grounds lest the decision below, which came on an unusual set of pled facts and a specific framing of the issues by the parties that itself was unusual, be read too sweepingly."[72] As the Vice Chancellor's opinion demonstrates, the pleading standard for surviving a motion to dismiss in duty of loyalty cases is a high one indeed. The subtle caveats included in the Order clarify that the pleading burden in the *Revlon* context is not quite as high as one might glean from a literal reading of the lower court decision. It will be interesting to see if plaintiffs seek to take advantage of this clarification going forward in situations in which a

68. *Kahn v. Stern II*, 2018 WL 1341719 at *1 (emphasis added).

69. *Id.* (emphasis added).

70. *Kahn v. Stern I*, 2017 WL 3701611 at *10 (quoting *In re* Cyan, Inc. Stockholders Litig., No. CV 11027-CB, 2017 WL 1956955, at *8 (Del. Ch. May 11, 2017)) (internal quotation marks omitted).

71. *Kahn v. Stern II*, 2018 WL 1341719 at *1 n.3 (quoting Brinckerhoff v. Enbridge Energy Co., Inc., 159 A.3d 242, 258–60 (Del. 2017)).

72. *Id.* at *2 n.4.

Corwin “cleansing” stockholder vote is not available to shield defendant directors.