Insights:
The Delaware Edition

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If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

This issue focuses on important, developing areas of Delaware corporation law and deal litigation, including recent trends in Delaware corporate disclosure law, the Delaware Supreme Court's important ruling in *Marchand v. Barnhill*, three Court of Chancery appraisal decisions following *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, and rulings focused on disclosure of attorney-client privileged communications.

Corwin, MFW and Beyond: Developing Trends in Delaware Disclosure Law

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Over the last several years, Delaware corporate law practitioners have traced numerous legal developments that dramatically reduced the injunction practice that dominated M&A litigation in Delaware for nearly three decades,[1] changing the development of Delaware disclosure law jurisprudence. Corporate law practitioners formerly benefited from a near-constant stream of judicial rulings resolving motions for expedited proceedings, expedited discovery and preliminary injunctions that focused, in part, on disclosures issued to stockholders in connection with mergers and other transactions. Those decisions generated a quick-paced, iterative body of case law that continually updated practitioners and transaction participants on the court's current thinking on disclosures, and enabled the court to address disclosures to stockholders on a "real-time" basis.

As injunction practice has declined, corporate disclosure law in Delaware is evolving at a slower pace, primarily through application of the Delaware Supreme Court's decisions in *Corwin v. KKR Financial Holdings LLC* (*Corwin*), in the absence of a controlling stockholder, and *Kahn v. M & F Worldwide Corporation* (*MFW*), when a controlling stockholder is present. These decisions, typically issued months or even years after a transaction has closed, affect the relevant standard of review but do not afford transaction participants the opportunity to correct disclosure deficiencies before a stockholder vote.

In the absence of a conflicted controller, under *Corwin*, a fully informed vote of disinterested, uncoerced stockholders will extinguish breach of fiduciary duty claims, leaving only claims for waste. As a result, in cases that do not involve controlling stockholders, the litigation often

[1] *See, e.g.*, our July 18, 2018, client alert "M&A Litigation Developments: Where Do We Go From Here?"; Jan. 23, 2018, client alert "Key Developments in Delaware Corporation Law in 2017"; Nov. 21, 2017, client alert "Continuing Trends in M&A Disclosure Litigation"; Nov. 17, 2016, client alert "Forward Momentum: Trulia Continues To Impact Resolution of Deal Litigation in Delaware and Beyond"; May 19, 2016, client alert "Court of Chancery Continues Clarify Views of Disclosure-Based Deal Litigation Settlements"; and Nov. 16, 2015, article "Del. Scrutiny of M&A Settlements Leads to Varying Decisions," (*Law360*).

focuses on whether a stockholder vote was truly "fully informed." Where a controlling stockholder is present, under *MFW*, a merger may nevertheless be subject to review under the deferential business judgment rule when it has been approved by an independent, disinterested and properly empowered special committee and a nonwaivable, fully informed and uncoerced vote of a majority of the minority stockholders. In that context, one focus in litigation is whether the unaffiliated stockholder vote was "fully informed." As a result, the Court of Chancery continues to opine on stockholder plaintiffs' long-favored disclosure topics — such as financial projections, management conflicts and financial advisor conflicts — but now does so through the lens of *Corwin* and *MFW*, on a much slower, less frequent basis.

In addition, although requests to enjoin mergers are now exceedingly uncommon, the rare preliminary injunction decision may complement the development of disclosure law in Delaware. Moreover, as more defendants begin to contest applications for "mootness" fees made by stockholder plaintiffs in federal securities merger litigation, courts outside of Delaware are starting to weigh in on disclosure issues.

Delaware Courts Continue To Test the Adequacy of Disclosures Under *Corwin*

As noted above, a critical element of the *Corwin* test is a "fully informed" stockholder vote. In two recent cases applying *Corwin*, the Delaware Court of Chancery opined on the adequacy of disclosures issued in connection with mergers involving financial projections, management conflicts and financial advisor conflicts, with differing outcomes.

In *English v. Narang*, C.A. No. 2018-0221-AGB (Del. Ch. Mar. 20, 2019), the Court of Chancery applied the *Corwin* doctrine to dismiss a fiduciary challenge to a merger following what the court ultimately held to be a fully informed stockholder vote. In that case, stockholder plaintiffs challenged a transaction whereby NCI, Inc. (NCI) was acquired by a third party for cash through a tender offer followed by a merger. NCI's founder and retired CEO, who held 83.5% of the company's voting power, received the same per-share consideration as NCI's minority stockholders. Following the stockholder vote on the transaction, the defendants moved to dismiss the action under *Corwin*. The stockholder plaintiffs opposed the motion, arguing that NCI's founder was conflicted with respect to the transaction because he faced a liquidity need as part of his estate planning and wealth management strategy, and the stockholder vote was not fully informed.

The court rejected the argument that NCI's founder was conflicted, finding the liquidity theory insufficiently pled. The court also rejected each of the disclosure challenges raised by the plaintiffs, including allegations that the board materially misrepresented NCI's financial outlook by disclosing financial projections that "understated the Company's upside and overstated certain risk factors;" failed to disclose "when, and the extent to which, discussions occurred regarding post-close employment opportunities for NCI management;" and failed to disclose "potential conflicts of interest affecting NCI's financial advisors," including that each financial advisor had previously performed work for the company.

By contrast, in *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, C.A. No. 2017-0421-KSJM (Del. Ch. June 21, 2019), the Court of Chancery denied motions to dismiss claims challenging Virtu Financial Inc.'s (Virtu) acquisition of KCG Holdings, Inc. (KCG), finding that alleged disclosure deficiencies defeated application of the *Corwin* defense. The stockholder plaintiffs' 96-page complaint, which was bolstered by documents obtained in discovery in connection with the plaintiffs' motion for a preliminary injunction in June 2017, alleged, among other things, that in the months leading

up to the transaction, KCG's long-time financial advisor had provided Virtu with confidential information about KCG's bond-trading platform, BondPoint, which KCG planned to divest, and simultaneously advised KCG on an alternative restructuring plan while "pressur[ing] the Board to pursue a transaction with Virtu." The plaintiffs also alleged that once Virtu made its best and final offer of $20 per share, KCG's CEO indicated that he believed the price was "too low" but would support the merger if he could negotiate a satisfactory compensation and retention pool for himself and his management team, which the board authorized. Additionally, according to the complaint, the night before the board approved the $20 per-share price, KCG's CEO and management team revised the company's financial projections to be more pessimistic, and after the board approved those revisions over email, KCG's new financial advisor based its fairness opinion on the more pessimistic projections, which fell in the middle of the new discounted cash flow analysis.

The court held that the defendants could not invoke a defense under *Corwin* because the plaintiffs had identified "significant deficiencies" in the proxy statement that rendered the stockholder vote uninformed. Those "deficiencies" included a failure to disclose detailed information about the BondPoint divestiture strategy; that the CEO initially indicated that the $20.21 per-share counteroffer was "too low," but later supported the $20 per-share deal price while negotiating a compensation pool for himself and his management team; and "the more optimistic, earlier projections presented during the merger negotiations and the circumstances surrounding the creation of the later revised projections."

Disclosures Continue To Play a Key Role in Cases Involving Controlling Stockholders

Disclosure law has developed in the context of *MFW* as well. In one decision earlier this year, *Olenik v. Lodzinski*, No. 392, 2018 (Del. Apr. 5, 2019), the Delaware Supreme Court reversed the Court of Chancery's application of *MFW* to dismiss claims, holding that the challenged transaction was not premised on *MFW*'s dual procedural protections "ab initio," but affirmed the Court of Chancery's dismissal of disclosure claims in connection with its *MFW* analysis. The dismissed claims included a failure to disclose that the financial advisor's initial contribution analysis did not support the ownership split for the transaction; that the financial advisor was "pressured" to revise its analysis to support the final ownership split; and that the company was "motivated to sell" due to its "dire need for cash." As to the first category of disclosures, the court explained that although the proxy did not discuss changes in the analysis, it stated both the analysis methodology and the company's annual projections, and thus "[i]nvestors were free to place the emphasis where warranted." With respect to the second category, the court reasoned that the company need not adopt "plaintiff's characterization of the facts." And as to the third category, the company's motivation for selling, the court found that "the Board was not obliged to characterize [the company's] position, particularly when the facts were disclosed and neither the Special Committee nor the Board actually concluded that [the company] was distressed and needed to sell."

In addition, the court has expanded *MFW*'s scope beyond "transformative" transactions to apply to other corporate decisions. In *Tornetta v. Musk*, C.A. No. 2018-0408-JRS (Del. Ch. Sept. 20, 2019), the Court of Chancery denied a motion to dismiss breach of fiduciary duty claims against Elon Musk and Tesla's board of directors arising from the board's and stockholders' approvals of an incentive-based compensation plan for Musk that the plaintiff alleged had a maximum potential value of $55.8 billion. However, in its ruling, the court advised future transaction participants that, by following the procedures set forth in *MFW*, non-extraordinary transactions too could be subject to business judgment review, opening the door to a broader application of the doctrine. Of course, as with merger cases, for *MFW*

to apply, the corporate decision must be approved by a *fully informed* vote of unaffiliated stockholders, once again spotlighting the importance of robust disclosures.

In Rare Cases, Injunctions Continue To Develop the Law on Disclosures

Although merger injunction applications in Delaware are rare, in one case this year, the Court of Chancery had the opportunity to opine on disclosure claims in real time, prior to a stockholder vote.

In *FrontFour Capital Group LLC v. Taube*, C.A. No. 2019-0100-KSJM (Del. Ch. Mar. 11, 2019), following an expedited trial, the Court of Chancery enjoined two cross-conditioned mergers pending the issuance of corrective disclosures, but denied the plaintiffs' request for a "curative shopping process." The case involved a challenge to a combination of three affiliated entities — Medley Management, Inc., Medley Capital Corporation and Sierra Income Corporation. Because the proposed transaction posed "significant conflicts," each of the three entities formed a special committee in an effort to simulate arm's-length dealings. Ultimately, a deal was reached whereby Sierra would first acquire Medley Capital and then Medley Management in two cross-conditioned mergers, with Sierra as the surviving combined entity. After Medley Capital issued the proxy statement relating to the proposed mergers, multiple third parties expressed interest in an alternative deal with Medley Capital. The special committee considered these expressions of interest and ultimately determined not to engage or pursue them.

The plaintiffs, stockholders of Medley Capital, sought to enjoin the merger. The court held that the entire fairness standard of review applied and that the defendants failed to prove that the mergers were entirely fair, concluding that "a deeply flawed process obscure[d] the fair value of [the company]." The court further held that certain deal protections failed under enhanced scrutiny and also concluded that Medley Capital's directors violated their duty of disclosure because the proxy statement created "the misleading impression that the Special Committee process at Medley Capital was effective," "replicated arm's-length negotiations amid the conflicts tainting the Proposed Transactions," and failed to disclose other third-party indications of interest. As a result, the court enjoined the defendants from holding a stockholder vote or from consummating the merger until corrective disclosures were made, stopping short of ordering a "curative shopping process" that would have "strip[ped] an innocent third party of its contractual rights."

Contested Mootness Fee Applications May Contribute to the Development of Disclosure Law Going Forward

Another area in which corporate disclosure law may develop is in the context of contested mootness fee applications in federal securities actions challenging disclosures issued in connection with mergers.

In one recent decision, *Scott v. DST Systems, Inc.*, C.A. No. 1:18-cv-00286-RGA (D. Del. Aug. 23, 2019), the United States District Court for the District of Delaware denied contested mootness fee applications in two lawsuits challenging the disclosures issued in connection with SS&C Technologies Holdings, Inc.'s (SS&C) acquisition of DST Systems, Inc. (DST). After DST announced its planned merger with SS&C and issued its preliminary proxy statement, three DST stockholders (two in the District of Delaware and one in the Western District of Missouri) filed suit, alleging that the proxy contained material misstatements or omissions in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934. Several months after DST issued supplemental disclosures mooting the disclosure claims, the plaintiffs filed mootness fee applications, claiming that the supplemental disclosures provided a "substantial benefit" to DST's stockholders. The supplemental disclosures fell into three categories: projections of

unlevered free cash flow, inputs and assumptions underlying the financial advisor's discounted cash flow analysis, and multiples used for the financial advisor's comparable companies and selected precedent transaction analyses. In denying the fee application, the court held that the plaintiffs failed to carry their burden of showing that any of the alleged omissions (and supplemental disclosures) were material as a factual matter.

Although contested fee applications are not yet common, they may appear with more frequency in the coming months, especially as courts continue to issue case law favorable to corporate defendants.

Takeaways

- Over the past year, Delaware fiduciary duty disclosure law has continued to develop at a measured pace under *Corwin* (in cases where no controlling stockholder is present) and *MFW* (in cases where a controlling stockholder is involved in the transaction).
- Under either the *Corwin* or *MFW* frameworks, a fully informed stockholder vote — meaning that stockholders have the material information necessary to make an informed decision about a particular proposed transaction — remains the key element.
- Recent cases addressing a variety of disclosure claims — including, among other things, financial projections, management conflicts and financial advisor conflicts — demonstrate how, through the lens of *Corwin* and *MFW*, the Court of Chancery continues to develop Delaware's disclosure law jurisprudence, still carefully analyzing the alleged misstatements or omissions to determine whether information is material given the particular facts of the case.
- Other than in connection with an exceedingly rare attempt to stop a stockholder vote based on inadequate disclosures, Delaware courts are evaluating disclosure claims post-closing to determine whether or not *Corwin* or *MFW* should apply to a board's decision to enter into a transaction (and thus whether business judgment review should apply to protect such a decision). As a result, Delaware courts are typically addressing disclosure claims months or years after a stockholder vote and the closing of a transaction, at a time when disclosure violations can no longer be remedied by supplemental or clarifying disclosures. Accordingly, consulting with legal advisers in advance of a stockholder vote about the best way to position the company and the board to defend themselves post-closing is paramount.
- Outside of the *Corwin* and *MFW* contexts, Delaware disclosure issues arise less frequently, but the rare decision involving a preliminary injunction or a contested federal securities mootness fee application also complements the development of Delaware corporate disclosure law.

Delaware Supreme Court Reinforces Director Oversight Obligation

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On June 18, 2019, in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), the Delaware Supreme Court issued an important decision reaffirming the obligation that directors of Delaware corporations make good faith efforts to implement and monitor a risk oversight system. In *Marchand*, the Supreme Court reversed the Court of Chancery's dismissal of a stockholder derivative suit seeking damages pursuant to alleged *Caremark* claims, which are difficult to plead and prove.[1] Specifically, the Supreme Court held that, at the pleading stage, the plaintiffs had alleged facts sufficient to satisfy the high *Caremark* standard for establishing that a board breached its duty of loyalty by failing to make a good faith effort to oversee a material risk area, thus demonstrating bad faith.

The decision in *Marchand* is already impacting several cases pending in the Court of Chancery.

Summary of Supreme Court's *Caremark* Analysis in *Marchand*

In *Marchand*, the plaintiffs asserted a claim against the directors for lack of oversight under the standards developed in *Caremark* and *Stone ex rel. AmSouth Bancorporation v. Ritter*,[2] which recognize an obligation to attempt in good faith to assure that a corporate information and reporting system exists, such that appropriate information will come to the board's attention in a timely manner. The elements for director liability on an oversight claim are well settled: (i) the directors must have utterly failed to implement any reporting or information system or controls; or (ii) having implemented appropriate compliance controls, the directors consciously failed to monitor or oversee the operation of that system.

The case arose out of a listeria outbreak from ice cream made by Blue Bell Creamery USA Inc. that sickened many consumers, caused three deaths and resulted in a total product recall. The Delaware Supreme Court held that the complaint stated a claim for lack of board oversight because the Blue Bell board allegedly failed to implement any system to monitor Blue Bell's food safety performance or compliance. The Supreme Court explained that "[a]s with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches," but "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort — *i.e.*, try — to put in place a reasonable board-level system of monitoring and compliance."[3] The Supreme Court noted that testing reports received by management had identified listeria contamination in certain of Blue Bell's plants, but the board meeting minutes reflected "no board-level discussion" of these negative reports.[4] The Supreme Court indicated that "the fact that Blue Bell nominally complied with FDA regulations does not imply that the *board* implemented a system to monitor food safety *at the board level*."[5] Additionally, the court rejected the directors' argument that because Blue Bell management discussed general operations with the board, a *Caremark* claim was not stated. In doing so, the Supreme Court explained "if that were the case, then *Caremark* would be a chimera," because "[a]t every board

[1] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (*Caremark*).

[2] 911 A.2d 362 (Del. 2006).

[3] 212 A.3d at 821.

[4] *Id.* at 812.

[5] *Id.* at 823 (emphasis in original).

meeting of any company, it is likely that management will touch on some operational issue."[6] According to the opinion, despite management's knowledge of the problem, "this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem" regarding "what has to be one of the most central issues at the company: whether it is ensuring that the only product it makes — ice cream — is safe to eat."[7] The court was particularly concerned that reports containing "what could be considered red, or at least yellow, flags" were not disclosed to the board.[8] As Chief Justice Leo E. Strine observed: "If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty."[9]

[6] *Id.* at 824.

[7] *Id.* at 812, 822.

[8] *Id.*

[9] *Id.* at 824. Another notable aspect of the Supreme Court's *Marchand* decision involved the reversal of the Court of Chancery's dismissal of the action for failure to make a presuit demand on the board. Specifically, the Supreme Court held that the complaint adequately pled that a director — previously viewed by the Court of Chancery as independent — could not impartially consider a demand due to his alleged "warm and thick personal ties of respect, loyalty, and affection between [the director] and the [company's founding family]," including business relationships allegedly facilitated by the family over many years. As a result, the court found that a majority of the board was not independent and disinterested for purposes of the board's consideration of a stockholder demand to file a lawsuit against directors and officers. This aspect of the *Marchand* decision is also having an immediate impact on recent Chancery decisions. *See, e.g.*, *In re BGC Partners, Inc. Derivative Litigation*, Consol. C.A. 2019-0722-ABG (Del. Ch. Sept. 30, 2019) (TRANSCRIPT) (relying in part on *Marchand*, finding three of four directors on a special committee were not independent because, in part, they were among the alleged controller's "go-to" choices for board appointments on companies he controlled, they received substantial compensation from their service on those boards, and they had significant social ties to the controller).

Caremark Decisions Post-*Marchand*

The *Marchand* opinion had an almost immediate ripple effect in a number of cases pending in the Court of Chancery, although two of these cases focused their analysis on the second prong of *Caremark*, which requires directors to monitor and oversee reporting systems already in place.

In *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. July 29, 2019), the Court of Chancery refused to find that the allegations stated a *Caremark* claim. A stockholder of J.C. Penney Company asserted that the company's directors breached their fiduciary duty of loyalty by consciously disregarding their responsibility to oversee the company's compliance with California laws governing price-comparison advertising.[10] The complaint alleged that the board failed to ensure that the company abided by the terms of its settlement in a class action (the *Spann* action) related to claims of false reference pricing.[11] The independence of J.C. Penney's directors was "unquestioned;" instead, the plaintiff argued that a majority of the board faced a substantial likelihood of liability with respect to the alleged oversight claims.[12]

Referencing the Supreme Court's guidance in *Marchand*, the court found that the complaint and documents incorporated therein indicated that the company had a board-level reporting system in place at the time of the *Spann* action to monitor compliance with laws and regulations.[13] The court acknowledged that the audit committee of the board was charged with regulatory compliance, and that both the audit committee and the board reviewed the memorandum of settlement in the *Spann* action. As a result, the court held "it cannot be said that J.C. Penney's

[10] 2019 WL 3408812, at *1.

[11] *Id.* at *1, *3.

[12] *Id.*

[13] *Id.* at *9.

directors 'utterly failed to implement any reporting or information system or controls' relevant to complying with price-comparison advertising laws or, in the more recent words of *Marchand*, that they made no good faith effort to 'try.'"[14]

The court held that the plaintiff's allegations similarly failed to support an inference that the directors consciously failed to monitor or oversee the company's operations. The plaintiff argued that "settlements and warnings" constitute red flags to demonstrate directors knew or should have known of violations of the law, but the court concluded that "[w]hen such events become a 'red flag' depends on the circumstances."[15] The court held that plaintiff did not allege "particularized *facts* from which it reasonably can be inferred that the *Spann* settlement put the directors on notice of any ongoing violations of law."[16] The court observed that, to the contrary, when the *Spann* action was discussed with the board, it was in terms of a settlement to resolve the class action without any admission of liability and with an express acknowledgement that the company was not then violating any laws.[17] Further, when the settlement was approved, the company represented to the court that it implemented a new price-comparison advertising policy in response to the *Spann* action, created a pricing governance committee, instituted regular training sessions, and created a new director of pricing compliance position to monitor and ensure compliance with the new pricing policy.[18] As a result, the court held that the plaintiff failed to allege facts from which the court could infer that any of the directors consciously allowed the company to violate any price-comparison advertising laws to demonstrate bad faith, and dismissed the complaint with prejudice.[19]

[14] *Id.*

[15] *Id.* at *11.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.* at *14.

More recently, in *In re Clovis Oncology, Inc. Derivative Litigation*, Consol. C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019) (TRANSCRIPT), the Court of Chancery upheld *Caremark* claims that the director defendants breached their fiduciary duties by failing to oversee a clinical trial of a drug under development and allowing the company to mislead the market regarding the drug's efficacy. Clovis, a biopharmaceutical firm, develops and commercializes cancer treatments, and was in the process of developing its first drug, Roci, to hit the market.

As a company with no products on the market and no sales revenue, Clovis relied heavily on investor capital for its operations, and the company's prospects were dependent upon the success and FDA approval of one of the company's developmental drugs.[20] As a result, the court observed that, in the company's "race for FDA approval" against a competing drug, the board was "hyper-focused" on Roci's development and clinical trial.[21] The plaintiffs alleged that the defendants spent hours at board meetings discussing the drug and its progress, and that the board was "laser-focused" on the drug's response rate, which was the criteria that defined its success in the clinical trial.[22] The court observed that as the trial progressed, the board knew that neither investors nor the FDA would accept unconfirmed responses.[23] Yet, despite reports received by the board (including management presentations) indicating that Roci's response rate was being calculated based on unconfirmed responses, "the Board did nothing."[24] The court observed that the board "relied heavily on the market's positive reaction" to the publicly reported response rate "to make its case for further investment in the Company."[25] Despite the drug's trial results, Clovis' public statements

[20] C.A. No. 2017-0222-JRS, Tr. at 10.

[21] *Id.*

[22] *Id.* at 11-13.

[23] *Id.* at 13.

[24] *Id.* at 14-15.

[25] *Id.* at 16.

"remained upbeat," and "[w]ith hands on their ears to muffle the alarms," the defendants signed the company's annual report reaffirming the inflated reports that relied upon unconfirmed responses.[26] Not only did the company fail to properly report response rates, but the board was advised that Roci had serious, undisclosed side effects and that there were clinical trial violations due to management reports on protocol deviations and the drug's side effects, and notice letters from the FDA.[27]

The court found that the plaintiffs alleged particularized facts to support reasonable inferences that the board knew the drug's testing protocol required "confirmed" responses, both industry practice and FDA guidance required reporting of "confirmed" responses, and management was incorrectly reporting responses. The court held that "[a]s *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised."[28] Acknowledging that "even in this context, *Caremark* does not demand omniscience," the court found that given the degree to which Clovis relied upon the response rate when raising capital and the defendants' personal backgrounds in the industry, "it is reasonable to infer the Board would have understood the concept and would have appreciated the distinction between confirmed and unconfirmed responses."[29]

[26] *Id.* at 16-17.

[27] *Id.* at 22-24.

[28] *Id.* at 36.

[29] *Id.* at 36, 40.

Takeaways

Although *Marchand* does not signal any change in Delaware law, it reaffirms the obligation on directors to demonstrate their good faith efforts to implement and monitor a risk oversight system. To do so, directors should focus on (i) their companies having in place, continually monitoring and updating (as necessary), and periodically reporting to the board about, systems reasonably designed to identify, monitor and mitigate material risks to their companies; and (ii) acknowledging information that comes to the board's attention. Boards also should take care to document their compliance efforts in minutes and other meeting materials.

The recent decisions highlight the importance of director oversight when a company operates in an environment subject to external regulations that govern its "mission critical" operations, noting that in such circumstances, director oversight "must be more rigorously exercised." This suggests that the courts might be inclined to more aggressively monitor directors' *Caremark* efforts at the pleading stage in those circumstances.

The recent guidance from the Delaware courts suggests that effective board-level monitoring and compliance procedures may include a board committee that addresses (i) risk and compliance, (ii) regular processes and protocols that require management to keep the board apprised of compliance and risks, (iii) regularly scheduled board meetings to consider key risks (iv) and protocols for disclosing to the board adverse information received by management. The guidance further highlights the importance of a board-level response to violations of positive law or adverse reports received by the board.

Delaware Appraisal Decisions Chart Separate Courses From *Aruba*

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> See page 14 for implications

The Delaware Supreme Court's April 2019 decision in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc*. reversed the Delaware Court of Chancery's finding that unaffected market price was fair value, holding instead that deal price minus synergies was the more reliable indicator of fair value. *Aruba* underscores the importance of deal price as an indicator of fair value "absent deficiencies in the deal process." The ruling also marks the third time in three years that the Supreme Court has reversed a Court of Chancery decision for underweighting deal price (*Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd* and *DFC Global Corp. v. Muirfield Value Partners, L.P.* are the other two cases).[1]

Three appraisal decisions have since been issued by the Court of Chancery interpreting *Aruba*: (1) *In re Appraisal of Jarden Corporation*, July 19, 2019, in which the court found that the unaffected market price was the most reliable indicator of fair value, and the deal price was not reliable because the "sale process left much to be desired"; and (2) *In re Appraisal of Columbia Pipeline Group, Inc*., August 12, 2019, and (3) *In re Stillwater Mining Company*, August 23, 2019, both in which the court ruled that the respective deal prices were fair value, even though market evidence in both cases indicated that trading prices could be persuasive indicators of value. While the first Court of Chancery appraisal decision following *Aruba* relied on the unaffected market price because of deficiencies in the deal process, the two appraisal decisions since have found that the deal price was the most reliable indicator of fair value. Moreover, none of the Court of Chancery's appraisal decisions since *Aruba* have meaningfully relied on traditional valuation analyses, such as discounted cash flow analyses.

Aruba Underscores Preference for Deal Price Over Market Evidence

The Court of Chancery's opinion in *Aruba* gave exclusive weight to the "unaffected market price," defined as the average market price during the 30-day period predating the merger announcement. The court explained that the unaffected market price ($17.13 per share) was a more reliable indicator of fair value than the deal price minus the buyer's estimated synergies ($19.10 per share).

The Supreme Court reversed, holding instead that the deal price minus the buyer's estimated synergies constituted fair value, and stating that the trial court's interpretation of *Dell* and *DFC* suggested that trading prices should be treated as exclusive indicators of fair value, but that interpretation is "not supported by any reasonable reading of those decisions." The Supreme Court also held that its decisions in *Dell* and *DFC* recognized that when a public company trades in an efficient market, its market price is an important indicator of its economic value. However, when that public company is sold at a substantial premium to the preannouncement market price, after a process in which interested buyers all had a fair and viable opportunity to bid, the deal price likely is strong evidence of fair value. Likewise, when the deal price is further informed by the efforts of arm's-length buyers of the entire company to learn more through due diligence, involving confidential nonpublic information, and with the keener incentives of someone considering taking the non-diversifiable risk of buying the entire entity, the resulting price is even more

[1] See our client alerts concerning *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, "Dell and Fair Value in Statutory Appraisal Actions," (May 29, 2018) and *DFC Global Corp. v. Muirfield Value Partners, L.P.*, "Delaware Courts Continue to Define Appropriate Valuation Methodologies for Statutory Appraisal," (November 21, 2017).

likely to be indicative of fair value. In other words, "HP [the buyer] had more incentive to study Aruba closely than ordinary traders in small blocks of Aruba shares, and also had material, nonpublic information that, by definition, could not have been baked into the public trading price."

Moreover, the Supreme Court held that its decisions in *Dell* and *DFC* did not discount the importance of competition, but rather recognized that a single-bidder sale process that provides an open opportunity for many potential buyers is not necessarily a "failure of competition." As the Supreme Court explained, "[i]t cannot be that an open chance for buyers to bid signals a market failure simply because buyers do not believe the asset on sale is sufficiently valuable for them to engage in a bidding contest against each other." Accordingly, the Supreme Court ordered that final judgment be entered in the amount of $19.10 per share plus any interest, which was the deal price minus Aruba's estimate of synergies.

Jarden Still Relies on Unaffected Market Price Post-*Aruba*

In its first post-*Aruba* appraisal decision, the Court of Chancery issued its post-trial opinion in *Jarden* on July 19, 2019, ruling that the "unaffected market price" was fair value.[2] The court found that the unaffected market price ($48.31 per share) was a more reliable indicator of fair value than the deal price ($59.21 per share) and the respondent's calculation of deal price minus synergies ($46.21 per share). Thus, *Jarden* demonstrates that market price still has a role in the appraisal function, especially when deficiencies are found in the sale process that render the deal price unreliable.

In *Jarden*, the unaffected market price, on the one hand, was a reliable indicator of fair value corroborated by "market evidence," including "unrebutted expert testimony" coupled with an event study of the market's response to Jarden's material announcements, Jarden's public float of 93.9%, its heavy trading volume, its coverage by "numerous professional stock analysts," its "narrow bid-ask spread" and its decision "to finance a sizeable acquisition just prior to the Merger (in the midst of negotiations) with an equity offering valued at $49.00 per share." Moreover, the court found "no credible evidence that material information bearing on Jarden's fair value was withheld from the market as of the Merger" and the unaffected market price was not stale by the time the merger closed.

The deal price, on the other hand, was not a reliable indicator of fair value, with or without synergies backed out. The court explained that the deal price was unreliable because the "sale process left much to be desired." In particular, Jarden's lead negotiator acted with "little to no oversight by the Board" and suggested "a price range the Board would accept to sell the Company before negotiations began in earnest." The sale process lacked a "pre-signing or post-signing market check." The parties agreed that attempting to back out synergies "was especially difficult in this case." Nevertheless, the court considered, as a reality check, the deal price less synergies value ($46.21 per share) as proffered by the respondent.

As to the traditional valuation methodologies, the court found unreliable the petitioners' "comparable company/market multiples analysis," which resulted in a value of $71.35 per share. The court noted that petitioners' analysis would imply that "the market mispriced Jarden by over $5 billion." Similarly, the court disagreed with both the petitioners' and respondent's discounted cash flow analyses. Instead, the court performed its own discounted cash flow analysis that resulted in a valuation of $48.13 per share, which was adjusted to $48.23 per share in the court's September 16, 2019, order on petitioners' motion for reargument. The court found that its own discounted cash flow analysis merely corroborated its determination that the unaffected market price of $48.31 per share was fair value.

[2] In *Jarden*, the "unaffected market price" was the closing price on the day prior to the merger announcement, as opposed to the 30-day average used in *Aruba*.

Columbia, Stillwater Defer to Deal Price

In the Court of Chancery's August 2019 appraisal decisions in both *Columbia* and *Stillwater*, the court deferred to the deal price after determining that the sale process in each case involved "objective indicia of deal-price fairness." Likewise, in both decisions, the court rejected adjustments to the deal price for lack of concrete, quantifiable amounts and accorded no weight to market prices or discounted cash flow analyses because in the presence of a reliable deal price, other less reliable indicators would inject error into the fair value determination. Thus, both *Columbia* and *Stillwater* underscore the continuing trend to defer to deal prices that result from sale processes with objective indicia of fairness.

Columbia

In *Columbia*, the Court of Chancery ruled that the deal price of $25.50 per share was fair value. After extensively reviewing the Supreme Court's three recent decisions in *DFC*, *Dell* and *Aruba*, the court explained that each of these decisions endorsed using deal price in an arm's-length transaction as evidence of fair value. However, the court noted that each decision weighed in on aspects of the sale process that made the deal price a reliable indicator of fair value.

The court's analysis in *Columbia* began by identifying six "objective indicia of deal-price fairness": (1) the merger in *Columbia* was an arm's-length transaction with a third party, (2) the board had no conflicts of interest, (3) the buyer conducted due diligence that included confidential insights into Columbia's value, (4) the pre-signing market check included outreach to potential buyers providing them a free chance to pursue a merger, (5) the seller extracted multiple price increases from the buyer and (6) the post-signing market check permitted superior bids, and none emerged. In sum, the court found that the sale process bore enough objective indicia of deal-price fairness to render the deal price a persuasive and reliable indicator of fair value.

The *Columbia* opinion proceeded to address, in turn, the petitioners' several challenges to the sale process, including that:

- management possessed conflicts of interest that resulted in "a fire sale of Columbia to obtain personal benefits";
- "Columbia favored TransCanada over opportunities with other buyers";
- standstill arrangements with potential suitors distinguished Columbia from past precedent;
- management created an information vacuum insulating Columbia's board during the sale process;
- the stockholders' vote was uninformed; and
- the deal protection devices undermined the validity of the deal price.

However, the court did not find any of these challenges to be persuasive evidence of an unreliable sale process because the petitioners failed to show that the deal price "left a portion of Columbia's fundamental value on the table," and "any other serious bidders were precluded from coming forward, yet none did."

The court in *Columbia* also rejected the respondent's request for a downward adjustment to the deal price to account for synergies and eliminate elements of value arising from the merger. The court explained that the respondent had not carried their burden to prove that any downward adjustment was warranted, and the court noted the irony that the respondent's expert used a discounted cash flow analysis to show synergies valued at $4.64 per share, while also rejecting the use of a discounted cash flow analysis to show fair value.

The court in *Columbia* concluded with a summary analysis of the market price and the parties' respective discounted cash flow analyses. The court held that it need not determine the reliability of the market price because it found that the deal price was a reliable and persuasive indicator of fair value. Nevertheless, the court indicates

that it has considered the market price and determined that the deal price is a more reliable indicator, noting that "[r]elying on trading price would only inject error into the fair value determination." The court similarly dispatched the parties' discounted cash flow analyses, explaining that there is no need to "call the balls and strikes of the valuation inputs" because "a DCF valuation is [not] likely to provide a reliable indication of fair value" when a company is "publicly traded, widely held, and sold in a process that began with pre-signing outreach and finished with an open, albeit passive, post-signing market check."

Stillwater

In *Stillwater*, the Court of Chancery determined that the deal price of $18.00 was fair value. The petitioners argued that fair value was $25.91 based on their expert's discounted cash flow model. The respondent contended that fair value was $17.63, based on a combination of the deal price, adjusted trading price and their expert's discounted cash flow model. The court concluded that the deal price was "the most persuasive indicator of fair value," and "[r]elying on any of the other valuation metrics would introduce error."

The court's opinion in *Stillwater* bears many similarities to the opinion in *Columbia*. Like in *Columbia*, the *Stillwater* opinion begins by identifying "objective indicia" that "suggest that the deal price was a fair price": (1) the merger was "an arm's length transaction with a third party," (2) "the Board did not labor under any conflicts of interest," (3) the buyer "received confidential information about Stillwater's value" in due diligence, (4) the company "extracted multiple price increases " and (5) "no bidders emerged during the post-signing phase." The court concluded that, while fewer than the indicia in *DFC*, *Dell* or *Aruba*, "the objective indicia that were present provide a cogent foundation for relying on the deal price as a persuasive indicator of fair value."

Also like in *Columbia*, the court in *Stillwater* proceeded to address the petitioners' several challenges to the reliability of the sale process, including that:

- Stillwater engaged in "a single bidder strategy in which it only interacted with [the buyer] before signing the Merger Agreement" and performed "no pre-signing outreach";
- the CEO pursued the buyer's indication of interest without board authorization;
- the CEO had personal interests in the transaction based on his desire to leave Stillwater;
- the board failed to exercise meaningful oversight;
- the financial advisor did not have time to run a meaningful presigning market check;
- the buyer pressured Stillwater to sign a merger agreement while the price of Stillwater's primary product, palladium, was rising;
- the deal protection devices prevented stockholders from capturing the value of an increasing market price; and
- the stockholders' vote was uninformed.

In response to the petitioners' challenges to the presigning phase, the court explained that even "if Stillwater had pursued a single-bidder strategy," the deal price would still provide persuasive evidence of fair value because there was "a meaningful post-singing market check." Relying on the Delaware Supreme Court's opinion in *C & J Energy Services, Inc. v. City of Miami General Employees and Sanitation Employees Retirement Trust* and other precedent involving "enhanced scrutiny" in breach of fiduciary duty cases, the court held that the sale process satisfied "enhanced scrutiny jurisprudence" and "the deal price will provide persuasive evidence of fair value in an appraisal proceeding involving a publicly traded firm if the sale process would satisfy enhanced scrutiny in a breach of fiduciary duty case." Likewise, in response to the challenges concerning the rising price of palladium, the court reasoned that the merger agreement "was not attempting to give the stockholder the benefit of a transaction that included the potential upside or downside

that would result from changes in the price of palladium after signing"; rather, the merger agreement "was trying to provide stockholders with the ability to opt for the comparative certainty of deal consideration." Furthermore, the court declined to adjust the deal price for any changes in value between signing and closing because the petitioners failed to carry their burden by "identifying a persuasive reason for the change and proving the amount." In sum, the court determined that the sale process was reliable "given the arm's-length nature of the Merger, the premium over market, and the substance of what took place during the sale process."

The court also rejected the respondent's argument that a downward adjustment was appropriate because the respondent failed to prove "a quantifiable amount that the court should deduct from the deal price." Likewise, after considering the parties' respective positions concerning the adjusted market price, including their arguments about the factors of market efficiency and their respective experts' event studies, the court accorded no weight to the market price because there was "sufficient reason for concern," and the deal price provided an available alternative "market-tested indicator." The court also did not accord any weight to the parties' respective discounted cash flow analyses because these analyses were undercut by the legitimate debates among their respective experts concerning the inputs, and the deal price provided an alternative "market-based metric."

Implications

Directors and officers of corporations considering a transaction that may give rise to appraisal rights should evaluate the following implications of recent decisions:

- *Aruba* and the Court of Chancery's subsequent appraisal decisions make clear that, while there is no judicial presumption in favor of deal price, Delaware courts continue to rely on the deal price to determine fair value so long as the sale process has objective indicia of deal-price fairness.
    - When the sale process leaves much to be desired, however, *Jarden* demonstrates that unaffected market price may still provide a reliable indicator of fair value even after *Aruba*, and a finding that the deal price is unreliable does not necessarily mean that the fair value will be greater than the deal price.
    - When the sale process contains objective indicia of deal-price fairness, *Columbia* and *Stillwater* show that a respondent must prove synergies to reduce fair value below the deal price, and Delaware courts are weary to accord any weight to traditional valuation analyses if there is a legitimate debate among competing experts concerning the inputs.
- The consistent flow of Delaware opinions finding fair value at or below deal price likely has a deterrent effect on stockholders considering seeking appraisal in public company transactions.

Court of Chancery Rules on Attorney-Client Privilege During Intra-Board and Post-Transaction Disputes

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Two recent Delaware rulings have refused to compel disclosure of attorney-client privileged communications despite facially appealing arguments from the party seeking the materials. These decisions provide guidance to directors and target companies looking to preserve the integrity of attorney-client privileged communications.

Gilmore v. Turvo[1] provides guidance to directors facing complex circumstances involving differing director interests. The court was presented with a slight twist on the typical circumstances giving rise to board-level attorney-client privilege disputes — whether an excluded director was entitled to access communications between the other directors and counsel that took place while the plaintiff was still a member of the board. In *Gilmore*, the plaintiff was the co-founder, majority common stockholder, CEO and a director of Turvo, Inc. Turvo's board (the board) consisted of the plaintiff and three preferred stockholder designees (the preferred directors). As alleged (and denied by the plaintiff), in May 2019, Turvo's CFO discovered that the plaintiff had expensed "at least $125,000 in entertainment charges," including more than $76,000 to "adult entertainment venues." The CFO alerted one of the preferred directors, who sought the advice of law firm Latham & Watkins, rather than the board's longtime counsel. Latham previously had served as counsel for one of Turvo's preferred stockholders, but never had represented Turvo or the board. From May 10-21, 2019, Latham investigated and assessed the impact of the information on Turvo's business. Additionally, two of the preferred directors had their own personal attorneys advising them. On May 21, 2019, the directors convened a meeting to discuss the plaintiff's alleged misconduct and then asked plaintiff to recuse himself. Thereafter, the preferred directors purported to remove the plaintiff as CEO and to adopt a resolution retaining Latham "as counsel for the Board 'effective as of May 10, 2019.'"[2] According to Turvo, "the resolution's retroactive language was meant to allow Turvo to pay the legal fees incurred by the Preferred Directors prior to the May 21 meeting."

In the ensuing litigation, the plaintiff argued that he was entitled to receive privileged communications between Latham and the preferred directors from May 10-21, 2019, because he was a board member during that time, and Latham had "functionally served as counsel to the Board by advising the Preferred Directors." The Court of Chancery disagreed. While acknowledging the general rule providing directors full access to privileged communications between the board and its counsel, the court concluded that the communications between Latham and the preferred directors were not communications "furnished to the board" and that the plaintiff had failed to show that he "had a reasonable expectation that the attorney(s) in question were representing all members of the board." The court noted that there was "no act by the Board to hire Latham as Board counsel prior to the May 21 meeting" nor "any indication that Latham had agreed to represent the Board prior to that meeting." The court rejected "[o]ffhand comments" made by a preferred director after removing the plaintiff as CEO, in which he stated that "[t]he board" worked continuously to "fix" the situation. The court also rejected the plaintiff's argument that the resolution to backdate Latham's representation to May 10, 2019 provided a basis to conclude that Latham served as the board's counsel prior to May 21, 2019. The court found that the board "was entirely within its business judgment to determine that the company should pay the Preferred Directors' fees by deeming Latham to have been working on behalf of the company prior to May 21." The court noted that Latham's preexisting relationship with a Turvo preferred stockholder gave it

[1] 2019 WL 3937606, at *1 (Del. Ch. Aug. 19, 2019).

[2] The Turvo board would formally establish a special committee on May 23, 2019. The court, however, offers no discussion about the establishment of a special committee prior to May 21, 2019.

"some comfort that the Preferred Directors did not set out to establish a backdoor to hiring Latham as Board counsel while shielding their communications from Mr. Gilmore." Accordingly, the court refused to compel Turvo to turn over the privileged communications.

In *Shareholder Representative Services LLC v. RSI Holdco, LLC*,[3] the court refused a buyer's request to compel the seller to turn over all of its preclosing privileged communications because the seller expressly contracted to maintain the privilege. In 2016, RSI Holdco, LLC acquired Radixx Solutions International, Inc. As part of the acquisition, RSI Holdco obtained possession of Radixx's computers and email servers, which contained approximately 1,200 pre-merger emails between Radixx and its counsel. During post-closing litigation, RSI Holdco requested access to the emails, arguing that the attorney-client privilege had been waived by the target because Radixx took no steps to "excise" or "segregate" the privileged communications from the computers and email servers before transferring them to the buyer.

The court found that Radixx had not waived privilege. In deciding the dispute, the court looked at *Great Hill Equity Partners IV, LP v. SIG Growth Equity Funds I, LLP*,[4] which provided guidance for drafting continued privilege protections. There, the court found that privilege was waived when pre-merger privileged communications between the target and its counsel were transferred to the surviving company because the target took no affirmative steps to prevent the transfer or preserve the privilege. The court advised that, in the future, sellers should "use their contractual freedom" to "exclude from the transferred assets the attorney-client communications they wish to retain as their own" and, thus, avoid waiver.

By contrast, in *RSI Holdco*, Radixx contracted in "plain and broad language" to preserve its ability to assert privilege over pre-merger attorney-client communications. The merger agreement also (i) contained a "no-use" clause preventing the buyer from using or relying on those privileged communications in post-closing litigation against the target; (ii) expressly assigned control over the privilege to a third party, Shareholder Representative Services; and (iii) required both the seller and the buyer to take "steps necessary to ensure that the privileges remain in effect." Together, these provisions prevented the buyer from using the privileged communications in post-closing litigation with the seller and, notably, did not require the seller to take additional steps to "excise" or "segregate" the privileged communications from the computers and email servers before transferring them to the buyer.

As *Gilmore* and *RSI Holdco* demonstrate, directors seeking to comply with their fiduciary duties in the face of potentially conflicting interests among board members, as well as directors negotiating intricate transactions, face a complex and nuanced question regarding the privilege of any advice they receive. Preserving the attorney-client privilege is possible, but can require careful analysis and planning. Directors should consult counsel on the best path forward to protect the company, its stockholders and its directors.

[3] 2019 WL 2290916, at *1 (Del. Ch. May 29, 2019) (RSI Holdco).

[4] 80 A.3d 155 (Del. Ch. 2013).

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