Clients&FriendsMemo

The Delaware Chancery Court's Columbia Pipeline and Saba Software Decisions: Lessons beyond Corwin

April 26, 2017

Two recent decisions from the Delaware Court of Chancery faithfully apply the Delaware Supreme Court's holding in *Corwin v. KKR Financial Holdings LLC*. No surprise there. *Corwin* held that when "a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies." That is so even if, pre-*Corwin*, an all-cash merger otherwise would have been subject to enhanced scrutiny under *Revlon*.

The significance of the two recent lower court decisions – *In re Columbia Pipeline Group, Inc. Stockholder Litigation* and *In re Saba Software, Inc. Stockholder Litigation* – lies not in the fact that they applied *Corwin*, but how each did so on the facts alleged in the complaints. In reaching opposite results (dismissal of the complaint in *Columbia* and denial of a motion to dismiss in *Saba*), the decisions provide important guidance regarding, among other things, the types of disclosures that are material; the appropriate oversight and handling of a sales process by a board and its financial advisor; circumstances that suggest a coerced stockholder vote; and the scope of aiding and abetting liability for the buyer.

Background

In *In re Columbia Pipeline*, Columbia Pipeline Group (CPG) was acquired by TransCanada Corporation for $25.50 per share, which represented a 32% premium over the average closing price for the month preceding announcement of the transaction. The merger agreement was approved by the board of directors, which engaged two financial advisors, Financial Advisor A and Financial Advisor B. The Company's stockholders voted to approve the merger, with more than 95% voting in favor of the deal.

CPG stockholders sued for monetary damages alleging breach of the duty of loyalty on the ground that the defendants "engineer[ed] a spinoff and sale of the Company as part of a self-interested plan to cash in on lucrative change-in-control benefits." Plaintiffs asserted that *Corwin* did not require application of the business judgment rule because there were material omissions in the proxy statement soliciting shareholder approval for the transaction. The Court disagreed, finding that the alleged omission – that defendants' motivation was to generate change-in-control benefits from a spinoff – was not material. Applying *Corwin*, Vice Chancellor Laster found that CPG stockholders had approved the transaction in an informed, uncoerced vote. Therefore, the business judgment rule applied and the Court dismissed the complaint with prejudice.

In contrast, Vice Chancellor Slights in *In re Saba* held that *Revlon*, not the business judgment rule, applied with respect to Vector Capital Management, L.P.'s ("Vector") acquisition of Saba Software, Inc. ("Saba") because the complaint sufficiently pled facts showing "that the stockholder vote approving the transaction was neither fully informed nor uncoerced." Saba was a Delaware corporation whose stock traded on the NASDAQ. In September 2014, the SEC filed a complaint against Saba and two of its former executives alleging that one of Saba's subsidiaries had engaged in a fraudulent scheme to overstate its pretax earnings by $70 million from 2007 to 2011. "Thereafter, Saba repeatedly promised regulators, its stockholders and the market that it would get its financial house in order," including by issuing restated financial statements "by a certain date," but each time "Saba inexplicably failed to deliver the restatement by the promised deadline." In December 2014, Saba announced that it would not be able to meet SEC's final deadline to issue a financial restatement by February 2015, after which the SEC revoked the registration of Saba's common stock. Following this disclosure, Saba's stock price fell from $13.49 to $8.75.

At around the same time, Saba also announced that it was evaluating strategic alternatives, including a sale of the company, and was engaging in preliminary discussions with potential acquirers. On January 15, 2015, Vector submitted "a written indication of interest to acquire Saba at $9 per share." On February 9, 2015, Saba's full board approved the merger with Vector, and the following day, Saba and Vector executed the merger agreement for $9 per share. Five days later, the SEC deregistered Saba's stock. Since the stockholder vote regarding the merger would take place after Saba's stock was deregistered, "Saba was not required to submit its Proxy or GAAP financials for SEC review" and was able to accelerate the approval process. On March 26, 2015, Saba's stockholders voted to approve the merger.

As described by the Court: "When Saba's board of directors ultimately sought stockholder approval of the Merger, after a months-long sales process, the choice presented to stockholders was either to accept $9 per share Merger consideration, well below its average trading price over the past two years, or continue to hold their now-deregistered, illiquid stock. Not surprisingly, the majority of Saba's stockholders voted to approve the Merger." Shortly thereafter, a former Saba stockholder brought suit against Saba's board of directors for breach of fiduciary duty and against Vector for aiding and abetting a fiduciary breach. The defendant directors moved to dismiss, arguing that the business judgment rule applied under *Corwin* since a majority of stockholders approved the transaction. The Court disagreed, holding that the stockholder vote was neither informed nor uncoerced, and that the complaint pled a non-exculpated claim for breach of fiduciary duty.

Disclosure-Related Takeaways:

Delaware requires disclosure of facts, not "self-flagellation": The *CPG* Court found that the proxy statement had sufficiently disclosed relevant facts regarding the transaction, including facts creating differing incentives for fiduciaries, and there is no duty of "self-flagellation" under Delaware law such that an explanation must be provided as to "how those differing incentives could produce a self-interested outcome." Stated differently, Delaware law does not require defendants to disclose "that they acted for selfish and self-interested reasons." The Court added that the "plaintiffs' complaint demonstrates that a reader of the Proxy can readily stitch together the facts to draw the inference that [defendants] used the spinoff to benefit themselves."

Similarly, in *Saba* the complaint asserted that the proxy statement was misleading because it omitted the "justifications for the modifications" to the existing management projections. The Court stated that it "typically is not receptive to these kinds of 'why' or 'tell me more' disclosure claims that criticize the board for failing to explain its motives when making transaction-related decisions." Here, the disclosure was sufficient because the proxy set forth the "changing assumptions that went into the various scenarios," from which a stockholder could "reasonably infer the rationale that went into the changes from one scenario to another." Since plaintiff "d[id] not allege any facts or assumptions regarding the modifications that were omitted or misleading," he failed to plead a disclosure claim.

However, not all "why" disclosures are immaterial. With respect to the *Saba* plaintiff's argument that the board failed to provide information regarding the reasons why Saba was unable to complete the restatement in the proxy materials, the Court agreed with the plaintiff that this omission was material because "[t]his was not a purposeful decision of the Board." Instead, "it was a factual development that spurred the sales process and, if not likely correctible, would materially affect the standalone value of Saba going forward." The Court reasoned that "unless the stockholders were armed with information that would allow them to assess the likelihood that Saba would ever complete a restatement of its financials," they would have no means of determining whether to "accept merger consideration that reflected the depressed value caused by the Company's regulatory non-compliance or stay the course in hopes that the Company might return to the good graces of the SEC."

Financial Advisor Conflicts: The *CPG* plaintiffs alleged that Financial Advisor A was conflicted because it owned $28 million of TransCanada stock. Although Delaware requires "full disclosure of investment banker compensation and potential conflicts," the Court found that in this case, Financial Advisor A's TransCanada stake was disclosed in its then-most recent Section 13F filing, which is "sufficient" under Delaware law, although the Court also indicated that it "personally would favor a disclosure regime that required a proxy statement for a merger to disclose the positions that the sell-side investment advisor and its affiliates held" in any transaction participant. The Court added that, separate and apart from disclosure, Financial Advisor A's ownership interest did not rise to the level of "actual conflict" because this position represented 0.009% of its overall $319 billion portfolio based on the Schedule 13F.

Likewise, the Court in *Saba* rejected plaintiff's assertion that the proxy statement in that case improperly omitted material information regarding the financial advisor conflicts. The complaint alleged that the proxy did not adequately disclose the "specific services" provided by the financial advisor to the buyer and the compensation received for such services. But the proxy disclosed the compensation received in the previous two years, and the Court found that the specific services rendered by the financial advisor were immaterial as a matter of law. "What was material, and disclosed, was the prior working relationship and the amount of fees."

Financial Projections and Analyses: While the Saba proxy disclosed management projections for the years 2015-2019, the complaint alleged that the proxy was misleading because it omitted projections for 2020-2024. The Court found that "management cannot disclose projections that do not exist." Here the Complaint failed to plead facts permitting an inference that such projections existed.

In addition, the *Saba* plaintiff took issue with disclosure surrounding the financial advisor's valuation of the company, including failing to disclose certain discrete financial metrics for each company used in its comparable companies analysis and each transaction in its precedent transaction analysis, and various assumptions utilized by the advisor to derive a discount rate used in its discounted cash flow analysis. The Court found that "stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations for their board as to how to vote on a merger or tender offer rely. A fair summary, however, is a summary," requiring, in general, disclosure of the valuation methods used, key inputs and ultimate values generated by the analyses. The summary need only be "sufficient for the stockholders to usefully comprehend, not recreate, the analysis." Here, according to the Court, the summary did so.

Interest from potential third-party bidders: The *CPG* plaintiffs alleged that the proxy statement was misleading because it omitted disclosure of certain financial analyses concerning a possible bid from a competing bidder. According to the complaint, a party that previously had discussed a possible transaction with the company contacted the seller's CEO days before the merger agreement was signed and represented that a "formal bid was forthcoming" after news of the TransCanada/CPG transaction was reported in the Wall Street Journal. No bid was ever received, but Financial Advisor B presented the board with "preliminary illustrative financial analyses of a potential acquisition" by that third party assuming a mix of cash and stock and various acquisition prices. The Court found that this information did not have to be disclosed because there is no "fiduciary obligation to disclose preliminary discussions, much less an analysis of preliminary discussions." According to the Court, the proxy "disclosed the financial analyses and valuation underlying" Financial Advisor B's fairness opinions, but the third party never made an offer, and therefore, there was no material omission.

Merger Alternatives: The *Saba* Court agreed with the plaintiff that the board's failure to disclose "the post-deregistration options available to Saba" prior to the execution of the merger agreement was material. While acknowledging that Delaware law does not require management "to discuss the panoply of possible alternatives to the course of action it is proposing," the Court determined that Saba's board "needed to take extra care" because the deregistration had "caused a fundamental change to the nature and value of the stockholder's equity stake in Saba" and "dramatically affected the environment in which the Board conducted the sales process." As a result, "[i]n considering whether or not Saba was viable as a going-concern without the Merger, a reasonable stockholder would have needed to understand what alternatives to the Merger existed."

Additional Takeaways:

Coerced Stockholder Vote: The *Saba* Court addressed plaintiff's argument that stockholder vote approving the merger was coerced. Coercion in this context means that "stockholders are induced to vote 'in favor of the proposed transaction for some reason other than the economic merits of that transaction.'" Stated differently, the coercion inquiry "focuses on whether the stockholders have been permitted to exercise their franchise free of undue external pressure created by the fiduciary that distracts them from the merits of the decision under consideration." Here, the Court described a "Hobson's choice" presented to stockholders in voting on the merger: "Saba stockholders were given a choice between keeping their recently-deregistered, illiquid stock or accepting the Merger price of $9 per share." The combination of the "forced timing of the Merger and the Proxy's failure to disclose why the Restatement had not been completed and what financing alternatives might be available to Saba if it remained a standalone company left the Saba stockholders staring into a black box" and "left them with no practical alternative but to vote in favor of the Merger."

Non-Exculpated Fiduciary Duty Claims: Saba's Certificate of Incorporation contained an exculpatory provision enacted pursuant to Delaware General Corporation Law Section 102(b)(7) that eliminated the monetary liability of directors to stockholders other than for breaches of the duty of loyalty or bad faith. The Court found that the complaint pled both. With respect to bad faith, the Court quoted Vice Chancellor Glasscock's description of a finding of bad faith as "a *rara avis*" (a rare bird) in the fiduciary duty context. According to the Court, where "'there is no indication of conflicted interests or lack of independence on the part of the directors,' a finding of bad faith should be reserved for situations where 'the nature of [the director's] action can in no way be understood as in the corporate interest.'" The complaint here met this standard by alleging that "the members of the Board, collectively, rushed the sales process, refused to consider alternatives to a sale, cashed-in significant, otherwise worthless equity awards before the Merger, directed [the financial advisor] to rely upon the most pessimistic projections when considering the fairness of the transaction and then rushed the stockholder vote after supplying inadequate disclosures regarding the circumstances surrounding the failure to complete the Restatement." That sufficed for a "pleading-stage inference of bad faith." And, those same allegations pled a breach of loyalty.

<u>There remains a high bar to plead aiding and abetting liability</u>: The plaintiff in *Saba* also alleged an aiding and abetting claim against the Vector defendants for the individual directors' breaches of fiduciary duty. In considering Vector's motion to dismiss, the Court rejected Vector's first argument that plaintiff failed to plead an underlying breach of fiduciary duty. With respect to Vector's second argument that plaintiff "fail[ed] adequately to plead that Vector knowingly aided the Individual Defendants in any breach they may have committed," the Court agreed. In order to state a claim for aiding and abetting a breach of fiduciary duty, a plaintiff must plead that a defendant knowingly participated in the breach of fiduciary duty, which requires that the defendant "act with the knowledge that the conduct advocated or assisted constituted such a breach." While acknowledging that a buyer "may not knowingly participate in the target board's breach of fiduciary duty by extracting terms which require the opposite party to prefer its interests at the expense of its shareholders," the Court found that plaintiff had not pled any facts to support a reasonable inference that Vector committed such acts. According to the Court, "the receipt of confidential information" or "conclusory allegations that a third party received 'too good of a deal,'" without more, is insufficient to plead a claim for aiding and abetting. Furthermore, the Court rejected plaintiff's newly introduced argument that "Vector used the confidential information it possessed to 'push the Board to end the sales process quickly to assure the Merger Agreement would be executed before Saba's stockholders learned of the Company's favorable prospects,'" determining that plaintiff may not "defeat an argument raised in a motion to dismiss by proffering an after-the-fact theory for this first time in his answering brief."

* * * * *

Jason M. Halper	212 504-6300	jason.halper@cwt.com
Alejandra Contreras	212 504-6017	alejandra.contreras@cwt.com
Hyungjoo Han	212 504-6023	hyungjoo.han@cwt.com