Corporate Governance Litigation & Regulation: A Periodic Review and Predictions for the Remainder of 2019

May 23, 2019

Since the start of 2018, state and, to a lesser extent, federal courts around the country, as well as state legislatures and Congress, have issued decisions or considered legislation having a substantial impact on corporate governance law. In this article, we discuss important judicial and regulatory developments in the following areas:

Mergers and Acquisitions Litigation: For the first time, the Delaware Court of Chancery upheld the termination of a merger agreement based on a material adverse effect. Vice Chancellor Laster's decision in *Akorn* illustrated the high, but not insurmountable, bar a merger party must clear to avoid closing a deal that turns sour. Recently, the Delaware Supreme Court in *Aruba* provided further guidance on when the merger consideration is the best evidence of fair value in appraisal litigation. There also have been notable decisions considering the appropriateness of disclosure-only, non-monetary class action settlements and applying the Delaware Supreme Court's seminal decision in *Corwin*.

Intra-Corporate Disputes: The Delaware Court of Chancery issued decisions touching on a variety of corporate governance issues, including the direct-versus-derivative claim distinction, the question, in the demand-futility context, of whether a decision made by a committee can be imputed to the full board, and the potential for impermissible conflicts between activist hedge funds and "ordinary shareholders." The court also provided guidance on contractual issues pertinent to the governance of unincorporated entities, including related to the proper drafting and interpretation of operating agreements.

Corporate Governance Regulation: The Delaware legislature modified a number of provisions of the Delaware General Corporation Law, including provisions governing defective corporate acts, statutory appraisal rights, and information disclosure requirements for shareholders that dissent from a proposed transaction. And in a push to improve gender equality, both state regulators and major institutional investors took steps to promote and encourage gender diversity on corporate boards. On the executive compensation front, 51 of the Russell 3000 companies (2.6%) failed their "say on pay" votes in 2018, which was the highest failure rate among Russell 3000 companies

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since 2015 and 1.1% higher than 2017. As of April, 2019, 1.9% of the Russell 3000 Companies have failed their "say on pay" votes, which is 1.3% lower than at this time last year.[1]

Delaware Judiciary Developments: Delaware responded to the growing burden on the Court of Chancery by expanding the court from five to seven members, welcoming new Vice Chancellors Morgan Zurn and Kathleen McCormick.

I. MERGERS AND ACQUISITIONS

A. Chancery Allows Termination of Merger Agreement Based on Material Adverse Change for the First Time in *Akorn*

In a landmark ruling, the Delaware Court of Chancery held that Fresenius Kabi AG was within its contractual rights to terminate a merger agreement with Akorn Inc. because: (i) Akorn suffered, prior to closing, a material adverse effect ("MAE"); (ii) Akorn breached its representations and warranties related to regulatory compliance in a manner that would reasonably be expected to have an MAE; and (iii) Akorn did not comply in all material respects with its covenant to use commercially reasonable efforts to operate in the ordinary course of business following signing of the merger agreement.[2] In a 247-page opinion thought to be the longest in the Court of Chancery's history, Vice Chancellor Laster found that an MAE had occurred for the first time in Delaware, a decision that recently was upheld by the Delaware Supreme Court.[3] The sprawling opinion details the disastrous market performance of Akorn following a hard-bargained agreement to be acquired by the German pharmaceutical company Fresenius. After signing, in addition to Akorn's market performance falling to well below the forecasts it had presented to Fresenius, the company faced serious regulatory challenges with respect to its data-integrity practices. Under these circumstances, Vice Chancellor Laster found that Akorn had suffered an MAE under the parties' agreement and upheld Fresenius's decision to terminate the merger agreement.

Fresenius and Akorn had entered into the merger agreement in 2017, soon after the announcement of strong first-quarter results for Akorn. Then "Akorn's business fell off a cliff,"[4] including second-quarter performance well below guidance and the failure of performance to recover during the remainder of 2017. In the fall of 2017, Fresenius received anonymous whistleblower letters

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1 Semler Brossy, *2019 Say on Pay & Proxy Results*, Semler Brossy (Apr. 18, 2018) https://www.semlerbrossy.com/wp-content/uploads/SBCG-2019-SOP-Report-2019-04-18.pdf.

2 *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018). For an extended analysis of the Court of Chancery's decision, see Joshua Apfelroth *et al.*, *M&A Update: Akorn Falls Far from the Tree: Delaware Chancery Court Finds a "Material Adverse Effect" for the First Time in Akron, Inc. v. Fresenius Kabi AG, et al.,* Cadwalader Wickersham & Taft LLP (Oct. 25, 2018), https://www.cadwalader.com/resources/clients-friends-memos/ma-update-akorn-falls-far-from-the-tree-delaware-chancery-court-finds-a-material-adverse-effect-for-the-first-time-in-akorn-inc-v-fresenius-kabi-ag-et-al.

3 *Akorn Inc. v. Fresenius Kabi AG*, ___ A.3d ___, 2018 WL 6427137 (Del. Dec. 7, 2018) (unpublished table decision).

4 2018 WL 4719347 at *1.

alleging that Akorn's product development processes failed to comply with regulatory requirements. Fresenius responded by launching an investigation pursuant to reasonable access covenants in the merger agreement. The investigation uncovered "serious and pervasive data integrity problems that rendered Akorn's representations about its regulatory compliance sufficiently inaccurate."[5] Making matters worse, Akorn oversold its remediation efforts in a presentation to the FDA, cancelled regular audits of certain of its facilities, failed to maintain its data integrity systems in compliance with FDA requirements, and submitted filings to the FDA based on fabricated data. Accordingly, Fresenius notified Akorn on April 22, 2018 that it was terminating the merger agreement, and Akorn filed an action in the Court of Chancery seeking to invalidate the termination notice and requesting specific performance compelling Fresenius to consummate the merger.

In finding an MAE, the court hewed to longstanding Delaware principles providing that an MAE will have occurred if its effect would "substantially threaten the overall earnings potential of the target in a durationally-significant manner . . . which one would expect to be measured in years rather than months."[6] Vice Chancellor Laster observed that Akorn's year-over-year declines in revenue, operating income and earnings per share were 34%, 292% and 300%, respectively, and that these dramatic declines had commenced after the execution of the merger agreement. The court found that the underlying causes of performance deterioration were durationally-significant because Akorn's poor performance had continued for over one year with no signs of improvement and Akorn's stated reasons for the decline — including new competition and the loss of a significant contract – were not short-term phenomena.

The court also held that the determination of whether an issue would reasonably be expected to result in an MAE is an objective determination that must take into account "quantitative and qualitative aspects." Vice Chancellor Laster was convinced that the pervasive regulatory violations and compliance issues at Akorn would be material to a long-term acquirer, and was also persuaded by expert testimony that the compliance issues would result in a $900 million decrease in Akorn's value, a decline of over 20% of the value implied by the merger agreement.

Finally, the court held that Akorn breached its covenant to use "commercially reasonable efforts" to operate its business "in all material respects" in the ordinary course of business post-signing and pre-closing because of its ineffectual data integrity procedures and insufficient response to allegations of regulatory non-compliance. In so holding, the court found that "in all material respects" is not equivalent to a material breach, as Akorn argued, but was subject to a lower standard of whether the issues are "significant in the context of the parties' contract, even if the

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5 *Id.* at *2.

6 *Id.* at *53.

breaches are not severe enough to excuse a counterparty's performance under a common law analysis."[7]

The Delaware Supreme Court, in an opinion written by Chief Justice Leo E. Strine, affirmed the decision in a three-page order—a conspicuously terse treatment that may have been meant to signal to the State's corporate residents and deal lawyers that the court does not intend for *Akorn* to mark a sea-change in Delaware deal jurisprudence.

While the *Akorn* decision is momentous, it should not cause sellers' pulses to quicken out of fear of a new emerging trend consisting of courts finding MAEs in surprising circumstances. As the court made clear, it was influenced by Akorn's drastic performance decline and significant regulatory issues related to its core business. The *Akorn* decision thus confirms that determining whether an MAE has occurred will be a fact-dependent exercise grounded in whether there is substantial and "durationally-significant" performance deterioration or other significant effects on the merger party.

B. ***Trulia*'s Impact**

The Delaware Court of Chancery's 2016 decision in *In re Trulia, Inc. Stockholder Litigation*[8] changed the landscape for "disclosure-only" settlements in class action suits. Recognizing a trend that had been building in the Court of Chancery, in *Trulia* Chancellor Bouchard declared his intent to reject disclosure-only settlements unless the resulting supplemental disclosures are "plainly material" and any releases are "narrowly circumscribed."[9] Based on the most recent data, this has led to a spike in the number of M&A transactions that have been challenged in federal courts. While there were only 34 cases filed in federal court in 2015 before *Trulia*, this number increased by fivefold in 2018 with 182 cases filed. Of these challenges, approximately one-third were brought in district courts in the Third Circuit.[10]

Trulia appears to have inspired plaintiffs' firms to bring challenges to merger transactions in federal and state courts outside of Delaware in the hopes of escaping its effect.[11] But other jurisdictions are divided about whether to follow the *Trulia* approach. This continuing jurisdictional split is likely to encourage plaintiffs to keep forum shopping in the hopes of striking a quick disclosure-only

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7 *Id.* at *86.

8 129 A.3d 884 (Del. Ch. 2016).

9 *Id.* at 888.

10 Cornerstone Research, *Securities Class Action Filings—2018 Year in Review*, Cornerstone Research (Jan. 30, 2019) https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2018-Year-in-Review.

11 *2017 Year in Review: Corporate Governance Litigation & Regulation*, Cadwalader Wickersham & Taft LLP (Jan. 9, 2018), https://www.cadwalader.com/resources/clients-friends-memos/2017-year-in-review-corporate-governance-litigation--regulation. "Only 9% of merger transactions valued at over $100 million were challenged in Delaware in the first 10 months of 2017, compared to 34% in 2016 and 60% in 2015."

settlement, and thereby receiving a fee from the target company as part of the settlement while expending relatively little effort.

1. **Florida Reverses Course and Follows *Trulia***

In *Griffith v. Quality Distribution, Inc.*,[12] the Florida Second District Court of Appeal reversed a lower court,[13] and held that "the *In re Trulia* standard is applicable" in Florida. In *Griffith*, the plaintiff objected to a settlement agreement that required the defendant, Quality Distribution, Inc., to supplement the disclosures in a proxy statement issued in connection with a merger in exchange for a release of all claims. As we observed last year,[14] the trial court approved the disclosure-only settlement without assessing the value of the supplemental disclosures, holding that "[e]ven if the court assumes the incremental disclosure is immaterial, it can still approve the settlement because that is the better choice among the alternatives."[15] The appeals court held that this was error, emphasizing the same concern that motivated the Court of Chancery in *Trulia*: plaintiffs' attorneys can score a fee for relatively little effort or benefit to the class while the defendants receive broad class-wide releases. Thus, the appeals court held, "when a Florida trial court is asked to approve a disclosure settlement in a class action merger lawsuit, in order for a disclosure settlement to pass muster, the supplemental disclosures must address and correct a plainly material misrepresentation or omission."[16] The court also held that "the subject matter of the proposed release must be narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process."[17]

2. **New York Continues to Decline to Follow *Trulia***

In *City Trading Fund v. Nye*,[18] the New York Supreme Court for New York County—bound by the Appellate Division, First Department's 2017 decision in *Gordon v. Verizon Communications, Inc.*[19]—declined to apply *Trulia* to a disclosure-only settlement, but expressed significant reservations about *Gordon*'s approach. The *Gordon* court declined to follow *Trulia* and instead approved a more relaxed standard for disclosure-only settlements that permits judicial approval, as

12 2018 WL 3403537 (Fla. Dist. Ct. App. Jul. 13, 2018).

13 *Griffith v. Quality Distribution, Inc.*, 2018 WL 3403537 (Fla. Dist. Ct. App. 2018).

14 *2017 Year in Review: Corporate Governance Litigation & Regulation*, Cadwalader Wickersham & Taft LLP (Jan. 9, 2018), https://www.cadwalader.com/resources/clients-friends-memos/2017-year-in-review-corporate-governance-litigation--regulation.

15 *Delman v Quality Distribution, Inc.*, 2017 WL 2694490, at *1 (Fla. Cir. Ct. 2017).

16 *Supra* note 5, at *6.

17 *Id.* at *6.

18 59 Misc. 3d 477 (N.Y. Sup. Ct. 2018).

19 148 A.D.3d 146 (N.Y. App. Div. 2017).

long as “some additional benefit” is obtained for stockholders.[20] In *Nye*, a stockholder sought to enjoin a merger between Texas Industries, Inc. and Martin Marietta Materials, Inc. on the grounds that Martin Marietta “breached its fiduciary duties to its shareholders by making material misstatements and omissions in the definitive proxy provided to the shareholders” in advance of the proposed merger.[21] The parties eventually settled, with Martin Marietta agreeing to provide additional supplemental disclosures and pay the plaintiffs’ attorneys a fee. The court noted that the parties settled for what was essentially a “peppercorn and a fee” and expressed concern that the Appellate Division’s refusal to adopt the *Trulia* standard would encourage litigants to forum-shop, observing that “the federal courts have embraced *Trulia* and deterred such a ‘race to the bottom,’ [but] New York has not.”[22] In the court’s view, “unless the Court of Appeals reverses [the *Gordon* standard], New York will become celebrated as the jurisdiction of the judicial rubber stamp.”[23]

3. North Carolina Has Cited *Trulia* Favorably without Formally Adopting Its Standard

The North Carolina Business Court has cited *Trulia* favorably in analyzing disclosure-only settlements, but has stopped short of explicitly adopting its standard. In *In re Krispy Kreme Doughnuts, Inc.*, court stated that it “is fully in accord with *Trulia*'s enhanced scrutiny to determine whether the release is narrowly circumscribed.”[24] Accordingly, the court should conduct “a careful examination of the ‘give’ and the ‘get’ of the class settlement” to “satisfy itself that the supplemental disclosures are ‘material.’” But the court also held that it must resist “a reflexive rejection of a class settlement on grounds of immateriality or insufficient consideration.” The court cautioned that “[u]nless the value of the supplemental disclosures are plainly disproportionate to the scope of the proffered release,” the trial court is “less well-equipped to measure a disclosure's worth than are competent and experienced counsel.”[25] The court did find, however, that it is “generally well-equipped to conduct a reasoned inquiry into” the reasonableness of a fee award.[26] Using this

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20 *Id.* at 159.

21 *Supra* note 18, at 481.

22 *Id.* at 515.

23 *Id.* at 482.

24 No. 16-CVS-3101, 2018 WL 264537, at *6 (N.C. Super. Jan. 2, 2018).

25 *Id.* at *7.

26 *Id.*

framework, the court approved the requested attorneys' fees, but denied the request for expenses.[27]

4. Using Forum Selection Bylaws to Counteract *Trulia* Forum Shopping

One tool corporations have used to avoid forum shopping for jurisdictions that have not followed *Trulia* is to adopt forum selection bylaws that name Delaware as the exclusive forum for internal corporate disputes. These bylaws may help to cut down on forum shopping, but they cannot end it entirely.[28] First, the provisions are "not automatically executing"[29] and must instead be brought "to the attention of the presiding court" by a defendant corporation.[30] This effectively "creates a defense-side *option*" where the corporation can opt to require that the litigation proceed in Delaware *or* settle in an alternative jurisdiction that is not receptive to *Trulia*, depending on what is most advantageous to the defendant.[31] Second, the provisions can be sidestepped by plaintiffs' attorneys if they "append a state merger claim" to a federal claim that is subject to mandatory federal jurisdiction, like a proxy disclosure claim under Sections 10(b) and/or 14(a) of the Exchange Act.[32] While some federal courts have grafted *Trulia*'s standard onto Federal Rule of Civil Procedure 23,[33] most have yet to consider the question.

C. Post-*Corwin*, the Delaware Supreme Court Has Focused on whether the Shareholder Vote Was "Informed"

A pair of 2018 decisions from the Delaware Supreme Court hammered home the importance of accurately disclosing all material information to stockholders in advance of a vote on a merger or other transaction in order to insulate the directors from post-closing damages actions. In 2015, the Delaware Supreme Court held in *Corwin v. KKR Financial Holdings*[34] that a transaction that is not subject to entire fairness review, and that is approved by a majority of fully informed and uncoerced stockholders, is entitled to review under the deferential business judgment rule and will be upheld absent evidence of corporate waste. Stated differently, a vote by stockholders can "cleanse" any

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27 *In re Krispy Kreme Doughnuts, Inc. S'holder Litig.*, No. 16-CVS-3101, 2018 WL 3062205, at *12 (N.C. Super. Jun. 20, 2018).

28 Emma Weiss, In Re Trulia*: Revisited and Revitalized*, 52 Rich. L. Rev. 529, 538 (2017).

29 *Id.* at 540.

30 Kevin M. LaCroix, *More about Litigation Reform Bylaws: Will "NO Pay" Provisions Succeed Where Forum Selection Bylaws Have Failed?,* THE D&O DIARY (Jan. 22, 2017), https://www.dandodiary.com/2017/01/articles/securities-laws/litigation-reform-bylaws-will-no-pay-provisions-succeed-forum-selection-bylaws-failed/.

31 Sean Griffith, *Corporate Atty Picked for New Chancery Seats*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Dec. 17, 2018), https://corpgov.law.harvard.edu/2017/01/17/private-ordering-post-trulia/.

32 *Supra* note 28, at 540.

33 *In re Walgreen Co. Stockholder Litig.*, 832 F.3d 718, 723 (7th Cir. 2016) (Posner, J.).

34 125 A. 3d 304 (Del. 2015).

supposed breaches of fiduciary duties by directors in connection with the approval of a transaction, provided the voting stockholders were fully informed and uncoerced. Of late, on a number of occasions the Delaware Supreme Court has refused to accord *Corwin* "cleansing" to a challenged transaction upon finding material omissions in proxy materials.

1. *Appel v. Berkman*

In *Appel v. Berkman*,[35] a former stockholder of Diamond Resorts brought a post-closing breach of fiduciary duty action against the former Diamond Resorts directors in connection with its sale to Apollo Global Management in a two-step merger (*i.e.*, a tender offer followed by a merger). In his complaint, Plaintiff alleged that Stephen Cloobeck, the company's founder, largest shareholder, and Chairman at the time, informed the Board that he opposed the transaction because "mismanagement [at Diamond] had negatively affected the sale price" and, thus, "it was not the right time to sell the company." While Cloobeck's abstention from the vote was disclosed in Diamond's Schedule 14D-9, the specific concerns he raised were not. The Court of Chancery granted the defendants' motion to dismiss, finding that the stockholders were fully informed and uncoerced despite the non-disclosure of Cloobeck's reasons for abstaining from the board vote.

The Supreme Court reversed. *First*, the court found unpersuasive defendants' contention that Cloobeck's reasons for not supporting the transaction were immaterial because they were his opinions, rather than facts. Given that the Schedule 14D-9 was replete with opinions, including "all the many reasons" the directors believed the transaction was in the company's best interests, "it creates confidence that a disclosure that Cloobeck expressed to the board that he believed the company had been managed sub-optimally and that this mismanagement negatively affected the sale price would catch a reasonable stockholder's attention." *Second,* while acknowledging that Delaware courts have held that a director's reason for abstaining from a vote is not material information, the court soundly rejected the notion that there is a per se rule in Delaware that such information is never material. Instead, the court directed a "contextual approach . . . which requires an examination of whether a fact . . . would materially affect the mix of information." *Third*, the court disagreed with the idea that stockholders could have guessed, from what the company did disclose (Cloobeck's abstention), that Cloobeck did not support the transaction. According to the court, stockholders should not be expected to speculate about material facts, and "although stockholders are assumed to be skilled readers, proxy statements are not intended to be mysteries to be solved by their audience."

[35] 180 A.3d 1055 (Del. 2018).

2. *Morrison v. Berry*

The Delaware Supreme Court again emphasized the importance of a fully informed stockholder vote in *Morrison v. Berry*.[36] There, the court reversed the Court of Chancery's decision to apply *Corwin* and held that stockholders who voted in favor of a going-private transaction were not fully informed because the company's public filings omitted key facts that could have helped stockholders more accurately assess the value of the deal. The plaintiff, a former stockholder of The Fresh Market, had challenged the company's acquisition in a transaction much like the one challenged in *Appel*, *i.e.*, a two-step merger with Apollo Global Management, arguing that the board failed to disclose numerous "troubling facts" related to the transaction: (i) the board failed to disclose the portion of a November email from Fresh Market's founder in which he "agreed, as he did in October" to roll over his equity in any deal with Apollo, which should have alerted the board to the fallacy of previous denials of an agreement with Apollo; (ii) the Schedule 14D-9 gave the impression that the founder was willing to partner with non-Apollo acquirers while omitting statements he made to the contrary; and (iii) the Schedule 14D-9 omitted threatening statements from the founder that he would consider selling his shares if the board failed to initiate a sales process. The Court of Chancery granted the defendants' motion to dismiss, finding that it was an "exemplary case" for *Corwin* protection. The Delaware Supreme Court reversed, finding that the case "offers a cautionary reminder to directors and the attorneys who help them craft their disclosures" that "'partial and elliptical disclosures' cannot facilitate the protection of the business judgment rule under the *Corwin* doctrine."[37]

In reversing, the Supreme Court analyzed each of the purported disclosure deficiencies to determine whether stockholders were fully informed. *First*, the court was persuaded that the company's omission of a portion of the founder's November email was material because it would have informed stockholders that he had previously lied to the board. According to the court, a reasonable stockholder "would want to know the facts showing that [the founder] had not been forthcoming with the Board about his agreement with Apollo . . . as directors have 'an unremitting obligation to deal candidly with their fellow directors.'" *Second*, the court found the Schedule 14D-9 materially misleading because it included statements that implied the founder's openness to bidders other than Apollo while omitting other statements in which the founder suggested he would consider rolling over his equity only in connection with a transaction with Apollo. The latter disclosures, according to the court, would allow a stockholder to "infer that [the founder's] expression of a clear preference for Apollo and reluctance to engage with other bidders hindered the openness of the sales process." *Finally*, the court found material The Fresh Market's omission of the fact that its founder told the board he would sell his shares unless the directors pursued a sale at that time. In the court's view, while this was not a threat, it was economically relevant

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36 191 A.3d 268 (Del. 2018).

37 *Id.* at 272.

information because a reasonable stockholder "would want to know the rationale that [the founder] gave the Board in encouraging it to pursue a sale."

Appel and *Morrison* underscore a reality that public companies and their boards must confront when assessing how to evaluate potential or actual damages actions challenging mergers or other extraordinary transactions, particularly in a post-*Trulia* world where inexpensive disclosure-only settlements by and large are not available. With the resulting increase in post-closing damages cases, it is imperative that directors and their advisors carefully assess the adequacy of disclosure to stockholders in connection with votes on merger or comparable transactions.

D. **Transactions with Controllers**

There have been several notable decisions from the Delaware courts concerning transactions with controlling stockholders. *First*, in a pair of cases, the Delaware Supreme Court provided clarity regarding when a transaction with a controlling stockholder will be entitled to deferential business judgment rule review. *Second*, the Court of Chancery's decision in *In re Tesla Motors, Inc. Stockholder Litigation*[38] underscored that a minority (22%) stockholder—Tesla Inc.'s co-founder and CEO, Elon Musk—can be found to have such a high degree of control over the board as to qualify as a controller. Finally, in *CBS Corp. v. National Amusements, Inc.*,[39] the Court of Chancery was called upon to resolve a showdown between a board and a controlling group—the Redstone family—and struck a blow in favor of the right of controllers to protect their controlling interests from dilution.

1. ***Flood v. Synutra* and *Olenik v. Lodzinski***

In *Flood v. Synutra*,[40] the Delaware Supreme Court endorsed a practical approach that grants a transaction business judgment rule review as long as the conditions set forth in *Kahn v. M & F Worldwide Corp.* ("MFW") are in place before any substantive economic negotiations begin. In *MFW*, the court held that the business judgment rule — rather than the exacting entire fairness standard — applies to controlling stockholder transactions if the transaction is conditioned *ab initio*, or from the beginning, "upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care . . . and the uncoerced, informed vote of a majority of the minority stockholders" (the "*MFW* Conditions").[41] At issue in *Synutra* was the question of what the *MFW* decision meant by the term "*ab initio*."

[38] 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).

[39] 2018 WL 2263385 (Del. Ch. May 17, 2018).

[40] 195 A.3d 754 (Del. 2018).

[41] *Kahn v. M & F Worldwide*, 88 A.3d 635 (Del. 2014).

Synutra involved a going-private transaction proposed by Liang Zhang, who controlled 63.5% of Synutra's stock. He initially proposed to take Synutra private by acquiring the remaining stock for $5.91 per share by way of a letter to the company's board that made no mention of conditioning the transaction on the *MFW* Conditions. The board set a meeting for one week later, but the directors agreed in advance that they would not use the meeting to "substantively evaluate" the proposal.[42] Instead, they formed a special committee to evaluate the proposal and negotiate with Zhang. One week after that—before the newly formed special committee had convened its first meeting—Zhang sent a second letter, reaffirming his interest and, this time, stipulating that he was willing to condition consummation of the transaction on the *MFW* Conditions. After a period of negotiations, the special committee and the controller struck a deal for $6.05 per share, which was approved by a majority-of-the-minority vote.

Minority stockholders filed class actions challenging the transaction, arguing that the transaction price was unfair and alleging breach of fiduciary duty by the board. The controller and the directors contended that the deal was subject to business judgment rule review given that the controller, in his second letter, agreed to condition the transaction on the *MFW* Conditions before any substantive economic negotiations had begun. The plaintiff, seeking an entire fairness review, argued for a strict reading of *MFW*'s "*ab initio*" requirement that would withhold business judgment rule review unless the controller indicated a willingness to submit to those conditions in the controller's "first approach."[43] The Court of Chancery granted defendants' motion to dismiss and the plaintiffs appealed to the Delaware Supreme Court.

In affirming, the Supreme Court held that the term "*ab initio*" should not be read to impose "the brightest of lines" and require that a controller include the *MFW* Conditions in her or his very first proposal.[44] Instead, the court adopted a standard whereby the conditions must be in place before any substantive economic negotiations have taken place, or "before there has been any economic horse trading."[45] The court was persuaded that this standard achieves the main objective of the *MFW* Conditions, which is to ensure that the controller cannot use the conditions as a bargaining chip and "both the controller and Special Committee bargain under the pressures exerted on both of them by these protections."[46] That way, the *MFW* Conditions "cannot be dangled in front of the Special Committee, when negotiations to obtain a better price from the controller have commenced, as a substitution for a bare-knuckled contest over price."[47] Thus, as long as the

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42 *Flood*, 195 A.3d at 757.

43 *Id.* at 760.

44 *Id.*

45 *Id.* at 756.

46 *Id.* at 763.

47 *Id.*

conditions are put in place "at the germination stage of the Special Committee process, when it is selecting its advisors, establishing its method of proceeding, beginning its due diligence, and has not commenced substantive economic negotiations with the controller," the "*ab initio*" requirement is met.[48]

The court also rejected plaintiffs' assertion that they could avoid business judgment review by pleading that the special committee violated its duty of care because it allegedly lacked negotiating skill and achieved an inadequate price. The court reaffirmed that where the *MFW* Conditions are validly in place, plaintiffs cannot avoid business judgment rule review absent well-pled allegations that the special committee acted with gross negligence—the standard by which a duty of care claim is measured—which requires more than mere disagreement with a special committee's tactics or the price the committee achieved. The allegations in *Synutra* revealed that the special committee had engaged in extensive negotiations over seven months, sought extensive advice from legal and financial advisors, and negotiated for (and achieved) an increase in consideration—all of which, the court held, failed to support a pleading-stage inference of gross negligence.

The court's decision in *Synutra* reflects an appreciation for economic reality: it is not uncommon for a controller's initial expression of interest to be made informally, and by eschewing a formalistic approach to the "*ab initio*" requirement, the court ensured that a controller's failure to invoke the *MFW* Conditions at the very first contact will not needlessly deprive a transaction that is structured as an arm's-length deal of an appropriately deferential standard of review.

In contrast, in *Olenik v. Lodzinski*,[49] decided shortly after *Synutra*, the Delaware Supreme Court concluded that the *MFW* Conditions were put in place too late to trigger business judgment rule review of a controller transaction. In *Olenik*, the court looked to where the institution of the *MFW* Conditions fell on the "negotiating continuum"—from the first expression of interest to the consummation of the transaction—and concluded that "substantial economic negotiations" had already taken place "well before" the controller sent the target a formal offer letter that made reference to the *MFW* Conditions.

The transaction in *Olenik* involved a merger between two subsidiaries of a common controlling parent. The court observed that prior to the acquiring subsidiary's transmission of a formal offer letter, the parent—which deal documents described as a "financial partner" to the acquirer in the transaction[50]—had provided the acquiring subsidiary with confidential information about the target subsidiary. Moreover, the acquiring subsidiary and the parent engaged in "multiple substantive economic communications," during which the acquiring subsidiary floated two specific valuation

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48 *Id.*

49 ___ A.3d ___, 2019 WL 1497167 (Del. Apr. 5, 2019).

50 *Id.* at *9.

proposals for the target subsidiary (one at $305 million, and a later one at $335 million)—discussions that, in the court's view, effectively "set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made."[51] As it turned out, the final deal price—approximately $333 million—fell within that range. Aside from those discussions between the parent and the acquiring subsidiary, representatives from all three entities attended "numerous meetings," which included "meaningful on-site due diligence," all before any proposal was made to apply the *MFW* Conditions. Together, those interactions led the court to conclude that the three companies had already "engaged in substantive economic discussions" before the acquiring subsidiary presented its formal offer containing the *MFW* Conditions. As a result, the transaction was subject to an entire fairness review.

2. ***In re Tesla Motors, Inc.***

Addressing an issue that has arisen repeatedly over the last few years, the Court of Chancery in *In re Tesla Motors*[52] had to determine whether a minority stockholder was a controller for purposes of deciding the appropriate standard of review with respect to a challenged merger. The plaintiffs sued in connection with the Tesla Motors, Inc. ("Tesla") $2.6 billion acquisition by of SolarCity, alleging that the Tesla board, as well as its Chairman and CEO, Elon Musk, breached their fiduciary duties by agreeing to a transaction that benefitted SolarCity's stockholders to the detriment of Tesla stockholders. The plaintiffs' theory of the case was that Musk—who was SolarCity's Chairman and a 21.9% stockholder—used his control over the Tesla board to push through an acquisition that effectively bailed out SolarCity at Tesla's expense. In moving to dismiss the lawsuit, defendants argued that Musk—who owned 22.1% of Tesla's outstanding stock—was not a controlling stockholder of Tesla and that the transaction, which was approved by a majority of Tesla's stockholders, was eligible for *Corwin* protection and thus business judgment rule review.

The Court of Chancery denied the motion to dismiss, holding that the stockholders' allegations, if proved, made it reasonably conceivable that Musk was a controlling shareholder. The court identified four primary indicia of control: (1) Musk's ability to influence stockholders' votes, (2) his "domination of the Board during the process leading up to the Acquisition against the backdrop of his extraordinary influence within the Company generally," (3) certain "Board-level conflicts that diminished the Board's resistance to Musk's influence," and (4) "the Company's and Musk's own acknowledgements of his outsized influence."[53]

Regarding Musk's voting influence, the court found that, while his 22.1% stake was "relatively low," other case-specific factors suggested that he potentially had the "ability to exercise the equivalent

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51 *Id.*

52 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).

53 *Id.* at *19.

of majority voting control." These included supermajority voting provisions in Tesla's bylaws that made it easier for Musk to block board proposals even with a minority stake, his unique potential to "rally other stockholders" to his voting position, and the fact that "public investments in Tesla," according to the stockholders, "actually reflect investments in Musk and his vision."[54]

With respect to Musk's alleged domination of the board's decision-making, the stockholders alleged that "there were practically no steps taken to separate Musk from the Board's consideration of the Acquisition," even though Musk allegedly proposed the acquisition three separate times before the board finally acquiesced, "led the Board's discussions" of the acquisition and "was responsible for engaging the Board's advisors."[55] More generally, the court took note of the allegation that the board viewed Musk as having a "singularly important role in sustaining Tesla in hard times and providing the vision for the Company's success" and was aware that Musk had historically "infused his own capital into the Company to keep it afloat."[56]

Also supporting an inference of control was the fact that, of the five members of the board who approved the transaction, two were, according to Tesla's own SEC filings, not independent directors, and a third had substantial business ties to Musk. Finally, both Musk and Tesla had made public comments suggesting that Musk had a "powerful influence" over the company.[57] Tesla's SEC filings stated, among other things, that the company is "highly dependent on [his] services," and, separately, Musk had stated that "Tesla, SolarCity and SpaceX form a 'pyramid' on top of which he sits" and that Tesla is "his company."[58]

All told, these allegations were sufficient, in the court's view, to permit a reasonable inference that Musk had a level of influence equivalent to a controlling stockholder. The *Tesla* decision also provides helpful guidance for minority controllers in the future, including that the Delaware courts will consider circumstantial evidence, including transaction terms, in determining whether a minority stockholder is a controller. The *Tesla* court credited plaintiffs' allegations that the transaction was so one-sided in SolarCity's favor that it constituted a "bail-out." The Delaware courts also will take into account a stockholder's past behavior and current status at the company. The *Tesla* court cited allegations that Musk had ousted senior management in the past, had a "singularly important role in sustaining Tesla in hard times and providing the vision for the Company's success," and had publicly supported the SolarCity transaction on numerous occasions. Finally, while a minority stockholder must actually exercise control with respect to the challenged transaction in order to be deemed a controller for purposes of triggering entire fairness review, here, Musk actively pursued a

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54 *Id.* at *15.

55 *Id.* at *16.

56 *Id.*

57 *Id.* at *18.

58 *Id.* at *18–19.

SolarCity transaction, pursued no alternative transactions, chose Tesla's legal and financial advisors in connection with the transaction, and led the board's deliberations.

3. *CBS Corp. v. National Amusements, Inc.*

In *CBS Corp. v. National Amusements, Inc.*,[59] the Court of Chancery was called upon to wade into a dispute between CBS and its controlling stockholder, National Amusements, the media holding company controlled by Sumner Redstone, his daughter, Shari, and their family. Because of a dual class structure in place at CBS, National Amusements controlled 80% of CBS's voting power but only 10% of its total equity. The action touched upon, but did not resolve, a tension in Delaware law about whether a controlling stockholder's preemptive action to protect its voting power trumps a board's action to limit the controller, or vice versa, which Chancellor Bouchard called a "first mover advantage."

According to the CBS board, Shari Redstone posed an existential threat. In the past, Ms. Redstone had unilaterally removed directors of Viacom, another company controlled by National Amusements, when she was unhappy with them, and the board worried she would recycle this strategy with the CBS board in retaliation for a CBS Special Committee's rejection of Ms. Redstone's prior proposals that CBS and Viacom merge. To protect the company and its stockholders, the CBS board scheduled a special board meeting to vote on issuance of a dividend of Class A voting stock to all Class A and B holders, which would not affect any stockholder's economic interest, but would have diluted National Amusement's voting power from 80% to 17%.

Three days before the meeting, the board filed a complaint in the Court of Chancery, seeking an injunction to restrain the Redstone group from interfering either with the board's composition or its authority to declare dividends under the CBS bylaws until the board could consider the dividend proposal at the scheduled meeting. National Amusements opposed the injunction, arguing that allegations that it intended to remove directors were speculative, any harm from such an action was not irreparable because relief would be available under 8 *Del. C.* § 225 (improper removal of directors), and the proposed dividend was a breach of fiduciary duty and impermissible under Delaware authority, allowing controllers to preemptively remove directors who want to dilute the controller's voting power.

The court promptly scheduled a hearing on plaintiffs' motion, but, one hour before the hearing was to begin, the Redstone group notified the court that it had executed and delivered consents to amend the CBS bylaws to require 90% supermajority board approval—at two consecutive board meetings—before the board could issue any dividend. Given that "act of self-help," the court

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[59] 2018 WL 2263385 (Del. Ch. May 17, 2018).

temporarily restrained the Redstone Group from taking this action until it ruled on the CBS board's motion.[60]

Ultimately, Chancellor Bouchard denied the motion, although he found that the directors' allegations were sufficient to state a colorable claim for breach of fiduciary duty against National Amusements. The Chancellor stated that the key premise of the complaint was that National Amusements' attempts to bend the board to its will undermined CBS's longstanding representations to its shareholders that it was committed to independent governance, which, according to the board, were carefully designed to "assuage stockholder concerns about investing in a company controlled by the Redstones."[61] The court agreed with the board that—if true—National Amusements' efforts to undermine that commitment (including by reportedly preparing to replace board members in order to force through a Viacom merger, interfering with a board committee, undermining management, and dissuading potential acquirers from making offers for the company) would run afoul of their fiduciary duties as a controlling stockholder.

However, the court held that such anticipated harms were not irreparable because the directors could bring an action under 8 Del. C. § 225 for improper removal of a director or, if National Amusements attempted to compel a merger, an action for breach of fiduciary duties at that time. According to Chancellor Bouchard, the board's proposed dividend was "an extraordinary measure," and he saw no precedent for the board's request to, in advance of National Amusement's doing so, restrain it from exercising its voting power to alter the board or the company's governing documents.[62]

Of particular interest for future cases is the court's conclusion that the balance of equities in this action—"between a controlling stockholder's right to protect its control position and the right of independent directors . . . to manage 'the business and affairs of the corporation'"—"weigh[ed] heavily" in favor of National Amusements.[63] Chancellor Bouchard recognized, on the one hand, a line of cases, including *Adlerstein v. Wertheimer*,[64] that stand for the proposition a controller is "fully entitled" to take action to protect dilution of its control interests; and, on the other, a line of cases, including *Mendel v. Carroll*,[65] that suggest a board might, consistent with its fiduciary duties, "issue a dilutive option in order to protect the corporation or its minority shareholders from exploitation by

60 *Id.* at *3.

61 *Id.*

62 *Id.* at *2.

63 *Id.* at *6.

64 2002 WL 205684 (Del. Ch. Jan. 25, 2002).

65 651 A.2d 297, 306 (Del. Ch. 1994).

a controlling shareholder."[66] While observing that the exigency of plaintiffs' motion precluded the court from definitively resolving the tension between these two theories, it found that *Adlerstein* was more on point, that the CBS board cited no precedent allowing a board to preemptively restrain a controller from exercising his or her voting power to protect against dilution, and that only a "truly extraordinary set of circumstances" would justify that kind of restraint.[67]

E. Section 220 — Books and Records Claims

1. *California State Teachers' Retirement System v. Alvarez*

In a decision with significant implications for shareholders seeking to abide the Delaware courts' instructions to use the "tools at hand" to gather information from a corporation before filing a derivative suit, the Delaware Supreme Court held, in *California State Teachers' Retirement System v. Alvarez*,[68] that it does not violate due process principles for one shareholder's failure to adequately plead demand futility to bind all other shareholders.

The issue at the heart of *Alvarez* was whether federal constitutional due process concerns preclude a finding under state law that one shareholder's failure to adequately plead demand futility has a preclusive effect on all other shareholders, thereby blocking a subsequent shareholder from making an attempt to establish demand futility. In a unanimous decision, the Delaware Supreme Court found in favor of precluding all other shareholders as long as the first shareholder was not a "grossly deficient" representative of the other shareholders.[69]

The plaintiffs in *Alvarez*—who lost the race to be the first to plead and argue that demand was futile—were stockholders of Walmart. They argued that earlier stockholders were grossly deficient representatives because they filed their complaint alleging demand futility without first taking advantage of Section 220 of the Delaware General Corporation Law to access the company's books and records. The court acknowledged that it and the Court of Chancery had "repeatedly urged parties to use Section 220 to seek relevant books and records before filing derivative complaints," but nonetheless concluded that the shareholder's "tactical error" to forgo a books-and-records request did not, "in this instance," mean that the earlier shareholders' efforts had been grossly deficient.[70]

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66 *Id.* at 306.

67 *Id.*

68 *CBS*, 2018 WL 2263385, at *6.

69 *Id.* at 852.

70 *Id.* at 853–54.

The court was careful not to foreclose the possibility that a first-filing shareholder's failure to utilize Section 220 before launching a derivative suit may, in the right circumstances, mean that other shareholders should be allowed to make a second, better-prepared attempt to establish demand futility. As the court observed, the first-filing shareholders in *Alvarez* did have some company documents available to them when they drafted their derivative complaint by virtue of disclosure in the press of relevant internal company memoranda, so their decision not to seek additional books and records through a 220 demand had some legitimacy.

But the upshot of *Alvarez* is that shareholders who heed the Delaware courts' advice to use the "tools at hand" to obtain company books and records before filing a derivative suit may find themselves precluded from arguing that demand is futile because of a shareholder who files a derivative suit without conducting that pre-suit diligence. The possibility of losing the race to be the first to plead demand futility has infused the Section 220 process with a new degree of urgency and has already begun to alter the way that disputes over Section 220 demands are playing out.

For example, in *In re UnitedHealth Group Inc.*,[71] a group of shareholders served a Section 220 demand in anticipation of filing a derivative suit. After the company resisted the demand, the shareholders sued to enforce their Section 220 rights, and the Court of Chancery granted them access to certain books and records. The company appealed the decision and, as is common in Section 220 cases, moved to stay its obligation to turn over its books and records pending a decision on its appeal.

Delaware courts have regularly granted such stay applications given that disclosure "cannot be reversed" if the company prevails.[72] But the shareholders argued that in light of *Alvarez*, they should be granted immediate access to the information they sought, lest they be beaten to a ruling on demand futility by shareholders who had initiated a derivative suit in another forum without first seeking access to company books and records. The Court of Chancery still granted the company's request for a stay, but suggested to the shareholders that they "seek[] an expedited schedule with the Delaware Supreme Court" to accelerate a decision on the company's appeal.[73]

2. ***Corwin's*** **Effect on Section 220 Litigation**

Section 220 demands have taken on new importance in the wake of the Delaware Supreme Court's 2015 *Corwin* decision. As observed earlier, shareholders have, in response to *Corwin*, focused their efforts on challenging the assumptions upon which *Corwin*'s "cleansing" effect rests: whether stockholder approval of a challenged transaction truly was "fully informed" and

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71 2018 WL 2110958 (Del. Ch. Apr. 27, 2018).

72 *Id.* at *2.

73 *Id.*

"uncoerced." In both *Morrison v. Berry* and *Appel v. Berkman*, stockholders' efforts to avoid *Corwin* were bolstered by information gleaned from Section 220 demands.

In *Morrison*, stockholders were able to stave off, at the pleading stage, application of the business judgment rule based on *Corwin* by pointing to "board minutes and a crucial e-mail" they obtained through a Section 220 demand to demonstrate material inconsistencies between the company's public disclosures and information known to the directors.[74] And in *Appel*, stockholders were able to reveal, through board minutes they obtained via a Section 220 demand, that the company had omitted from its public disclosures the fact that its founder and chairman had abstained from a board vote on a proposed sale of the company because he believed that "mismanagement of [the company] had negatively affected the sale price and it was therefore not the right time to sell the company."[75]

As these two cases demonstrate, one of *Corwin*'s collateral effects is to give Section 220 demands greater prominence in M&A litigation as shareholders seek ways to avoid business judgment rule review.

3. The Delaware Supreme Court Expressly Approves of Demands for Emails in Section 220 Proceedings

In *KT4 Partners LLC v. Palantir Technologies Inc.*,[76] the Delaware Supreme Court put to rest any lingering doubt that demands for books and records under Section 220 can reach emails. As Chief Justice Strine observed, the court had in the past implicitly approved of the practice, and the Court of Chancery has "explicitly" approved of it on a number of occasions.[77] Were it otherwise, Section 220 would not keep pace with "companies' actual and evolving record-keeping and communication practices," and bringing emails within the scope of Section 220, the Chief Justice said, flows logically from earlier decisions that permitted stockholders "the right to inspect a variety of corporate 'papers,' often including letters and memoranda among officers and directors."[78]

In recent years, the Court of Chancery had begun to flesh out a framework for determining when emails must be produced, and the court opted to endorse what it viewed as the general principle that has emerged from those decisions: emails should not be produced "when other materials (*e.g.*, traditional board-level materials, such as meeting minutes) would accomplish the petitioner's proper purpose, but if non-email books and records are insufficient, then the court should order that

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74 *Morrison*, 191 A.3d at 273.

75 *Appel*, 180 A.3d at 1058.

76 203 A.3d 738 (Del. 2019).

77 *Id.* at 753.

78 *Id.*

emails be produced."[79] While a stockholder need not offer "compelling evidence" that emails are essential, the stockholder must present "some evidence" that they "are indeed necessary,"[80] and "if a company observes traditional formalities, such as documenting its actions through board minutes, resolutions, and official letters, it will likely be able to satisfy a § 220 petitioner's needs solely by producing those books and records."[81]

By effectively adopting the consensus position staked out in recent years by the Court of Chancery, *KT4* does not work a significant change to Section 220 jurisprudence. Nonetheless, by putting to rest lingering doubts about the propriety of demands for emails, *KT4* should reduce the frequency of the threshold disputes that commonly occur when a stockholder makes an explicit demand for them. *KT4* also reinforces the importance of following corporate formalities and maintaining appropriate written records of corporate action to reduce the risk of having to engage in a potentially expensive—and expansive—production of emails in response to a Section 220 demand.

F. Appraisal Litigation Post-*DFC* and *Dell*

In high-profile 2017 decisions in *DFC Global Corp. v. Muirfield Value Partners L.P.*[82] and *Dell Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*,[83] the Delaware Supreme Court stressed the potential importance of market-based factors in determining fair value, including the company's pre-merger announcement share price and the merger consideration paid to stockholders.[84] While the Delaware Supreme Court declined to establish a presumption equating fair value to deal price, those decisions suggested that plaintiffs must offer strong evidence concerning material flaws in the sales process or an inefficient market in order to demonstrate an entitlement to a price higher than the merger consideration.

Following *DFC* and *Dell*, the Court of Chancery has continued to grapple with this issue, with some cases underscoring the prominence of market-based evidence of fair value, and others ultimately eschewing market-based indicators after identifying merger-related synergies (which must be subtracted from the fair value conclusion) or flaws in the sales process (which would render merger consideration unreliable evidence of fair value). But the Delaware Supreme Court's recent decision in *Aruba* further emphasized the importance of the agreed-upon merger consideration in

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79 *Id.* at 753–54 (footnotes omitted).

80 *Id.* at 755.

81 *Id.* at 742.

82 172 A.3d 346 (Del. Aug. 1, 2017).

83 2017 WL 6375829 (Del. Dec. 14, 2017).

84 For an extended analysis of *DFC* and *Dell*, see Jason Halper, *et al.*, *2017 Year in Review: Corporate Governance Litigation & Regulation*, Cadwalader Wickersham & Taft LLP (Jan. 9, 2018), https://www.cadwalader.com/resources/clients-friends-memos/2017-year-in-review-corporate-governance-litigation--regulation.

determining a company's fair value. Given this decision, appraisal arbitrage in Delaware—which depends on a finding of fair value in excess of the merger consideration—is likely to remain at reduced levels.

1. *Verition Partners v. Aruba*

The Delaware Supreme Court, in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, [85] reversed a decision of the Delaware Court of Chancery in a statutory appraisal proceeding. The lower court had relied on the 30-day unaffected stock price to determine that $17.13 per share was the fair value of Aruba Networks, Inc. at the time of its 2015 acquisition by Hewlett Packard Companies. This determination was approximately 30.6% less than the merger consideration of $24.67 per share, despite Aruba's status as a widely held, publicly traded company that was sold in an arm's-length transaction.

In the Court of Chancery decision, Vice Chancellor Laster first calculated his own "deal-price-less-synergies" estimate of $18.10 per share after finding that the transaction consideration provided "reliable evidence of fair value."[86] However, noting that a "deal-price-less-synergies" calculation that he performed on his own "could have errors at multiple levels," and that the calculation of fair market value would also need to exclude "reduced agency costs" (*i.e.*, costs associated with competing interests of shareholders and management), Vice Chancellor Laster arrived at a fair value of $17.13 per share by averaging the unaffected market price of Aruba's shares in the 30 days before the merger was publicly disclosed.[87] Vice Chancellor Laster was satisfied that this calculation struck the proper balance between *DFC Global* and *Dell*'s directive that courts consider '"the collective judgement of the many'" in determining fair value and mitigating the prejudice derived from the court's "own fallible determination[.]"[88]

In a unanimous *per curiam* ruling, the Delaware Supreme court reversed the decision and held that Aruba's fair value per share was $19.10, representing the consideration paid by HP in the merger less merger-specific synergies. In so holding, the Supreme Court remarked that the decision by the trial judge to rely exclusively on the unaffected market price—even though neither party advanced that argument until the judge broached the subject in connection with post-trial briefing—"could be seen" as a "results-oriented move to generate an odd result compelled by his personal frustration at being reversed in *Dell*."[89] The Supreme Court also reaffirmed its recognition of merger

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[85] 2019 WL 1614026 (Del. Apr. 16, 2019).

[86] 2018 WL 922139 at *2, 44 (Del Ch. Feb. 15, 2018).

[87] *Id.* at *54.

[88] *Id.* (quoting *DFC*, 172 A.3d at 369-70).

[89] 2019 WL 1614026 at *7 (Del. Apr. 16, 2019).

consideration as strong evidence of fair value in statutory appraisal actions involving transactions resulting from a fair and competitive sale process.

The Supreme Court's decision provides a number of important takeaways for appraisal litigation. *First*, transaction consideration can be strong evidence of fair value even in the absence of multiple bids for the target. The Supreme Court explained that "*DFC* and *Dell* recognized that when a public company with a deep trading market is sold at a substantial premium to the preannouncement price, after a process in which all interested buyers had access to confidential information and a fair and viable opportunity to bid, the deal price is a strong indicator of fair value."[90] In *Aruba*, the fact that the logical strategic buyers that Aruba approached both before and after signing a merger agreement with HP were not interested does not "signal[] a market failure simply because buyers do not believe the asset on sale is sufficiently valuable." In the view of the court, "[i]f that were the jurisprudential conclusion, then the judiciary would itself infuse assets with extra value by virtue of the fact that no actual market participants saw enough value to pay a higher price. That sort of alchemy has no rational basis in economics."[91]

Second, a bidder's access to non-public information regarding the target supports the reliability of merger consideration as evidence of fair value. The Supreme Court again affirmed its acceptance of the efficient capital markets hypothesis, whereby when a "market was informationally efficient in the sense that 'the market's digestion and assessment of all publicly available information concerning [the Company] [is] quickly impounded into the Company's stock price, the market price is likely to be more informative of fundamental value."[92] Thus, according to the court, the unaffected market price can be "a proxy for fair value" but should not be exclusively relied upon in determining a company's fair value in an appraisal or fundamental value in economic terms. Rather, "when that market price is further informed by the efforts of arm's-length buyers of the entire company to learn more through due diligence, involving confidential non-public information, and with the keener incentives of someone considering taking the non-diversifiable risk of buying the entire entity, the price that results from that process is even more likely to be indicative of so-called fundamental value."[93]

Third, due process and fairness concerns are important in appraisal litigation. By raising the idea of using the unaffected stock price as an appropriate measure of fair value for the first time during the parties' post-trial supplemental briefing, the Court of Chancery in *Aruba* did not provide the parties with an opportunity to develop a full factual record during pretrial discovery and at trial as to whether the stock price was, in fact, reliable evidence of fair value. According to the Supreme

90 *Id.* at *5.

91 *Id.* at *6.

92 *Id.* at *6.

93 *Id.*

Court, "the extent to which the market price approximated fair value was never subjected to the crucible of pretrial discovery, expert depositions, cross-expert rebuttal, expert testimony at trial and cross examination at trial."[94] These issues impacted the substantive rights of the parties because "[t]he reason for pretrial discovery and trial is for parties to have a chance to test each other's evidence and to give the fact-finder a reliable basis to make an ultimate determination after each side has a fair chance to develop a record and to comment upon it."[95]

Fourth, litigants need to carefully consider which arguments to raise regarding appropriate evidence of fair value before trial or risk abandoning them. The Supreme Court observed that neither party requested supplemental briefing after it issued *Dell*, nor did any party advocate relying on the unaffected market price as evidence of fair value. Rather, after the lower court requested supplemental briefing on "the market attributes of Aruba's stock," "Aruba pivoted from its previous reliance on its expert's discounted cash-flow model and the deal price minus synergies to ask for the first time that the court set fair value at the unaffected thirty-day average market price."[96] The court was obviously skeptical of Aruba's "pivot" at that late stage: "We chalk up this about-face to a litigant receiving a more favorable outcome than they argued for and trying to cement that unexpected victory on appeal."[97]

Finally, agency costs are encompassed by a calculation of synergies when two public companies merge. The Supreme Court held that the Court of Chancery's reliance on unaffected market price was erroneous for the additional reason that the Vice Chancellor did so "on the inapt theory" that he "needed to make an additional deduction from the deal price for unspecified 'reduced agency costs.'"[98] Such a reduction had "no basis in the record" or in "corporate finance literature given that all the cost reductions HP expected as a widely held, strategic buyer were likely to be fully accounted for by its expected synergies."[99] The court further noted that "agency costs" are more likely to arise in connection with an acquisition by a private equity buyer by replacing "a dispersed group of owners with a concentrated group of owners," which could, theoretically, "add value because the new owners are more capable of making sure management isn't shirking or diverting the company's profits."[100]

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94 *Id.* at *7.

95 *Id.* at *8.

96 *Id.* at *7 n. 59.

97 *Id.* at *9 n. 63.

98 *Id.* at *4.

99 *Id.* at *5.

100 *Id.* at *4.

2. ***Merlin Partners v. SWS Group***

In *Merlin Partners, L.P. v. SWS Group, Inc.*,[101] the Delaware Supreme Court affirmed the Court of Chancery's determination of fair value below the transaction price in a synergy-driven transaction. The plaintiffs filed an appraisal action in connection with Hilltop Holdings, Inc.'s 2015 acquisition of SWS Group, Inc. for $6.92 per share in cash and stock. Vice Chancellor Glasscock applied a DCF analysis to determine a fair value of $6.38 per share, significantly below the merger consideration. The court assigned no weight to the merger consideration because neither party relied on it for its fair value calculations and the court found the merger consideration to be unreliable due to a "problematic process," including by virtue of a credit agreement that in certain circumstances granted Hilltop a veto over competing offers.[102] Instead, the court considered DCF analyses offered by both parties' experts. The court employed its own DCF analysis to exclude merger-related synergies and held that the fair value was $6.38 per share. According to the court, that sub-deal-price figure was "not surprising" because the deal was a "synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."[103]

3. ***In re Appraisal of AOL***

In *In re Appraisal of AOL, Inc.*,[104] Vice Chancellor Glasscock issued a post-trial decision in an appraisal proceeding that arose out of Verizon Communications Inc.'s June 2015 acquisition of AOL Inc. for $50 a share. The court interpreted *DFC* and *Dell* as providing, "in distilled form," that "where a petitioner is entitled to a determination of the fair value of her stock, the trial judge must consider 'all relevant factors,' and that no presumption in favor of transaction price obtains."[105] On the other hand, where "the transaction price represents an unhindered, informed, and competitive market valuation, the trial judge must give particular and serious consideration to transaction price as evidence of fair value."[106]

In determining whether the deal price should be accorded weight in the calculation of fair value, Vice Chancellor Glasscock first evaluated whether the deal was "*Dell* Compliant." According to the court, a transaction is "*Dell* Compliant" where "(i) information was sufficiently disseminated to potential bidders, so that (ii) an informed sale could take place, (iii) without undue impediments

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101 181 A.3d 153 (Del. Feb. 23, 2018) (unpublished table decision). For an extended analysis of the Court of Chancery's decision, see Jason Halper, *et al.*, *2017 Year in Review: Corporate Governance Litigation & Regulation*, Cadwalader Wickersham & Taft LLP (Jan. 9, 2018), https://www.cadwalader.com/resources/clients-friends-memos/2017-year-in-review-corporate-governance-litigation--regulation.

102 *In re Appraisal of SWS Grp. Inc.*, 2017 WL 2334852, at *10 (Del. Ch. May 30, 2017).

103 *Id.* at *5.

104 2018 WL 1037450 (Del. Ch. Feb. 23, 2018).

105 *Id.* at *1.

106 *Id.*

imposed by the deal structure itself." Vice Chancellor Glasscock observed that "before [the court] may consider the deal price as persuasive evidence of statutory fair value, [it] must find that the deal process developed fair market value."[107] Although the court found the matter of whether the transaction was "*Dell* Compliant" to be a "close question," the court held that the AOL CEO's "declared intent" to "consummate a deal with Verizon," combined with other post-agreement factors, created a "considerable risk of informational and structural disadvantages dissuading any prospective bidder."[108] Accordingly, the court held that the transaction price was not the best evidence of fair value and determined to use the merger consideration only as "'a check' on [its] analysis, while granting it zero explicit weight."[109] The court instead conducted a DCF analysis to determine a fair value of $48.70. After both parties moved for re-argument, the court made an adjustment to its DCF analysis and revised the fair value from $48.70 to $47.08 per share, 5% below the deal price.[110]

4. ***Bluebade Capital v. Norcraft***

In *Bluebade Capital Opportunities LLC v. Norcraft Cos.*,[111] Vice Chancellor Slights emphasized the importance of a high-quality sales process in appraisal determinations. He concluded that the transaction price from a May 2015 transaction, in which Fortune Brands Home & Security Inc. acquired a cabinet manufacturer, Norcraft Companies, did not reflect Norcraft's fair value because there were "significant flaws" in the sales process, including: the absence of a pre-signing market check, the failure to consider other potential merger partners, the inclusion of deal-protection measures that rendered the post-signing go-shop ineffective as a price discovery tool, and a lead negotiator for Norcraft who was at least as focused on securing benefits for himself as he was on securing the best price available for Norcraft.[112] Consequently, the court "borrowed the most credible components of each expert's analysis" to conduct its own DCF valuation.[113] The court did not rely on any precedent transactions or comparable company data and concluded that no parties identified truly comparable companies. Instead, the court evaluated DCF inputs and assumptions step by step, making determinations about which expert's testimony was more credible for each disputed input. Finally, the court conducted a "reality check" by comparing its own DCF valuation

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107 *Id.* at *8.

108 *Id.* at *9.

109 *Id.* at *21.

110 *In re Appraisal of AOL Inc.*, 2018 WL 3913775, at *2 (Del. Ch. Aug. 15, 2018).

111 2018 WL 3602940 (Del. Ch. July 27, 2018). For an extended analysis of the court's decision, see Jason Halper, *et al.*, *M&A Update: The Importance of a High-Quality Sales Process in Determining the Outcome of an Appraisal Proceeding*, Cadwalader Wickersham & Taft LLP (Aug. 8, 2018), https://www.cadwalader.com/resources/clients-friends-memos/ma-update-the-importance-of-a-high-quality-sales-process-in-determining-the-outcome-of-an-appraisal-proceeding#_ftn5.

112 *Id.* at *2.

113 *Id.*

to the market price. The court's valuation of $26.16 per share represented 2.59% more than the deal price of $25.50.[114]

5. *In re Appraisal of Solera*

Finally, *In re Appraisal of Solera Holdings, Inc.*[115] provides a prime example of a quality sales process—against a backdrop of an efficient market—such that the transaction price was a reliable measure of fair value. In that case, Chancellor Bouchard held that the fair value of Solera Holdings at the time of a March 2016 transaction, in which the company was acquired by Vista Equity Partners, was the transaction price less estimated synergies, which amounted to $1.90 less than the merger consideration. The court found that Solera was sold in an open process that "was characterized by many objective indicia of reliability."[116] The process included two months of outreach to private equity firms, a six-week auction conducted by an independent and fully empowered special committee of the board, and public disclosure that the company was for sale. The court found no reason to question the reliability of the trading price of the company's stock given the context for the transaction negotiations, stating that "the sales process was conducted against the backdrop of an efficient and well-functioning market for Solera's stock."[117] That the merger consideration represented a significant premium to Solera's unaffected market price was strong evidence that stockholders received fair value in the transaction.

II. OTHER DEVELOPMENTS IN CORPORATE GOVERNANCE LITIGATION

A. Corporate Overpayment Claims and the Business Judgment Rule

In *Sciabacucchi v. Charter Communications Corporation,*[118] the Delaware Court of Chancery discussed, in the context of a corporate overpayment claim, two important issues of Delaware law: the direct-versus-derivative claim distinction and whether, in the context of demand futility, the focus should be on the members of a six-person special committee that approved the challenged transactions or the entire ten-member board. The plaintiff in *Sciabacucchi* alleged that defendant directors breached their fiduciary duties in approving certain transactions between Charter

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[114] *Id.* at *3.

[115] 2018 WL 3625644 (Del. Ch. Jul. 30, 2018).

[116] *Id.* at *1.

[117] *Id.* at *20.

[118] 2018 WL 3599997, at *1 (Del. Ch. Jul. 26, 2018). For an extended analysis of this case, see Jason Halper, *et al.*, *Delaware Chancery Court Finds Absence of Controlling Stockholder Does Not Eliminate Possibility for Adequately Pled Corporate Overpayment Claims*, Cadwalader Wickersham & Taft LLP (Aug. 2, 2018), https://www.cadwalader.com/resources/clients-friends-memos/delaware-chancery-court-finds-absence-of-controlling-stockholder-does-not-eliminate-possibility-for-adequately-pled-corporate-overpayment-claims.

Communications, Inc. and its largest stockholder, Liberty Broadband Corporation, which had the right to designate four of ten directors on Charter's Board.

Plaintiff brought both derivative and individual claims, but the court found that the claims were derivative. Under the Delaware Supreme Court's decision in *Gentile v. Rossette*,[119] a corporate overpayment claim may be both direct and derivative where: (1) a stockholder having majority or effective control causes the corporation to issue excessive shares of its stock in exchange for assets of the controlling stockholder holding a lesser value, and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder and a corresponding decrease in the share percentage owned by the minority shareholders.[120] In an earlier decision, the court had concluded that two shareholders were not controllers and, on the basis of that decision, the court dismissed the direct claims.

The court then held that the independence of the full ten-person board—not a six-member committee that voted on the challenged transactions—determined whether the business judgment rule would apply. The defendant directors argued that the transactions were approved only by the committee of six non-Liberty designees and that a majority of these directors were independent. The court disagreed. It found the transactions were "presented to both the remaining directors and the stockholders in a structurally coercive manner," and since "all ten Charter directors played a role in securing the approval of the challenged transactions, it is the full board whose independence counts." The court further found that the four Liberty designees, along with the rest of the board, "approved the acquisitions of Time Warner and Bright House, and the structure whereby those deals would not close unless the challenged transactions received stockholder approval. Thus, by signing off on the structurally coercive terms of the acquisitions, the Liberty designees helped 'strong arm' the stockholders into voting for the [challenged] transaction[s] 'for reasons outside of the economic merit' of the decision."[121] Accordingly, the plaintiff needed only to call into question the independence of five members of the ten-person board, rather than four of the six non-Liberty designees.

B. Conflicts between Short-Term-Gain-Seeking Hedge Funds and "Ordinary" Shareholders

The Court of Chancery took aim at "activist pressure" in *In re PLX Technology Inc. Stockholder Litigation*,[122] holding that a director nominated by an activist hedge fund breached his fiduciary duties (and caused the other directors to breach their duties) by pushing for a prompt sale to satisfy

[119] 906 A.2d 91 (Del. 2006).

[120] *Id.*

[121] *Id.* at *16.

[122] 2018 WL 5018535 (Del. Ch. Oct. 16, 2018).

his and his fund's desire to "pursu[e] short-term performance at the expense of long-term wealth."[123]

The events in question began in 2011, when PLX engaged in merger discussions with Integrated Device Technology, Inc. ("IDT"). After lengthy preliminary discussions, IDT made a bid for PLX, which included an opportunity for PLX to conduct a post-signing go-shop. The PLX board accepted and, during the post-signing canvass, one additional bidder—Avago Wireless (U.S.A.) Manufacturing Inc.—submitted a competing proposal. PLX elected to continue with IDT over Avago, but the IDT transaction later fell through in the face of antitrust concerns, and PLX's share price plummeted.

These events attracted the attention of Potomac Capital Partners II, L.P., an activist hedge fund, which took a sizeable stake in PLX. The fund's investment thesis was that PLX should be promptly sold, with Avago—whose identity, at that time, had not been made public—the top prospective suitor. PLX's board, however, did not believe that a sale was in the company's best interests. Potomac waged a proxy contest and succeeded in replacing three of the company's eight directors with its slate of nominees—one of whom was the fund's co-managing member Eric Singer. The day after the PLX election, an Avago executive contacted its financial advisor—which, at the time, was also serving as financial advisor to PLX—to convey that Avago was interested in acquiring PLX in about three months for $300 million. The financial advisor relayed that information directly to Singer, but Singer did not inform the rest of the board. After assuming his seat on the board, Singer was chosen to be the chair of the special committee overseeing a potential sale of PLX. After three months had passed, PLX and Avago commenced negotiations and announced a proposed transaction within a month. PLX's stockholders later approved the PLX-Avago transaction.

A number of stockholders sued the PLX directors and Potomac (along with Avago and the parties' financial advisor), alleging that the directors' approval of the merger was a breach of their fiduciary duties and that the other entities had aided and abetted the breach. All parties except Potomac ultimately settled or were dismissed, and the shareholders' claims against Potomac for aiding and abetting a breach of fiduciary duty by the directors were tried before Vice Chancellor Laster.

As a threshold matter, the court denied the transaction the benefit of *Corwin* "cleansing" because the recommendation statement the board sent to stockholders failed to disclose the tip from the Avago executive that had been passed along to Singer, which, the court held, amounted to a material omission that deprived the stockholders of a fully informed vote on the sale proposal. The

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123 *Id.* at *41.

court then considered whether Singer and the other directors breached their *Revlon* duties, and concluded that they had.

The court first observed that the basic structure of the sale process the special committee followed—a "narrow, pre-signing canvass with a post-signing market check"—was a "reasonable approach" that would ordinarily have satisfied *Revlon*.[124] But the court held that a different result was warranted because Singer's interest in securing a "short-term sale [of PLX] to the other bidder who had emerged during the go-shop period for the [earlier, failed merger] transaction" was in conflict with the interest of stockholders as a whole in maximizing the company's "long-term wealth."[125] As Vice Chancellor Laster saw it, "[a]ctivist hedge funds . . . are impatient shareholders, who look for value and want it realized in the near or intermediate term," and he found that in this case, that interest caused Singer to focus myopically on a quick sale instead of evaluating other "ideas for generating value at PLX."[126]

The court also found that the other directors ultimately "deferred to Singer when he sought to position himself to best achieve a sale" and "permitted [him] to take control of the sale process."[127] Once in control, Singer and the special committee made a number of decisions aimed at pushing through a quick deal with Avago at near the price that Avago had suggested upon tipping Singer.[128] The court found that "as a whole . . . Potomac and Singer undermined the Board's process and led the Board into a deal that it otherwise would not have approved," with Singer's failure to inform the rest of the board about that tip "fatally undermin[ing] the sale process."[129] As for Potomac, the court found it liable for knowingly participating in the breach.

The court's emphasis on the conflict between Singer's perceived interest in short-term gains and the interest of other stockholders in maximizing the company's long-term value serves as a cautionary note for activist investors and their board nominees to avoid engaging in conduct that appears to elevate their investment priorities above that of the company's other stockholders. *In re PLX*'s unusual facts—including the undisclosed, backchannel tip of the buyer's purchase strategy, the use of the same financial advisor by the buyer and seller, and the contentious relationship Singer had with the other directors—may limit its reach, but the case serves as an important

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124 *Id.* at *44.

125 *Id.* at *41.

126 *Id.*

127 *Id.* at *45.

128 *Id.*

129 *Id.* at *47.

reminder to activist investors to guard against conduct that appears to put them at odds with other shareholders.

C. Operating and Merger Agreement Construction

1. Court of Chancery Looks to Statutes Governing Analogous Business Forms in *Domain Associates v. Shah*

In a post-trial opinion in *Domain Associates v. Shah*,[130] Vice Chancellor Laster ordered venture capital firm Domain Associates, LLC to pay an ousted former member, Nimesh Shah, the fair value of his 12.1% membership interest, which according to the Final Order and Judgment was worth $3,763,000,[131] rather than the far smaller capital account balance that Domain contended was the appropriate amount. Vice Chancellor Laster also found that the individual members of Domain were jointly and severally liable for breaching the Domain LLC Agreement when they forced Shah out but did not pay him the fair value for his interest.

The dispute arose after members of Domain expelled Shah and contended that he was entitled to a payment equal to the amount in his capital account, $438,353, rather than the fair value of his membership interest. Notably, while the Domain LLC Agreement addressed the payout for a voluntarily retiring member, it was silent on the amount a member would be entitled to receive in the event of forced withdrawal.

Because the Domain LLC Agreement did not address the payout for a forced-out member, the court examined the default provisions of Delaware's Limited Liability Company Act. After concluding that the LLC Act did not provide guidance, the court looked to Section 15-701 of the Delaware Revised Uniform Partnership Act, which provides that an expelled partner should receive "an amount equal to the fair value of such partner's economic interest as of the date of dissociation. . ." In holding that Shah should thus receive the fair value of his 12.1% membership interest, the court observed that the Partnership Act's guidance "is all the more apt because the Company was a member-managed entity whose governance structures resembled a partnership." The court further stated that "[t]he choices that the drafters make have consequences," and if "the drafters have embraced the statutory default rule of a member-managed governance arrangement, which has strong functional and historical ties to the general partnership (albeit with limited liability for the members), then the parties should expect a court to draw on analogies to partnership law." The court distinguished a member-managed entity from, for example, an entity with a single managing

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130 *Domain Associates, LLC v. Shah*, 2018 WL 3853531 (Del. Ch. Aug. 13, 2018). For an extended analysis of the Court of Chancery's decision, see Jason Halper, *et al.*, *Delaware Chancery Court Orders Venture Capital Firm to Increase Terminated LLC Member's Payout in Post-Trial Opinion*, Cadwalader Wickersham & Taft LLP (Aug. 28, 2018), https://www.cadwalader.com/resources/clients-friends-memos/delaware-chancery-court-orders-venture-capital-firm-to-increase-terminated-llc-members-payout-in-post-trial-opinion.

131 *Domain Associates, LLC v. Shah*, 2018 WL 4676380 (Del. Ch. Sep. 27, 2018).

member and passive non-managing members (for which parties to the agreement should expect a court to look to limited partnership law by way of analogy) and a manager-managed entity with corporate features (for which the parties to the agreement should expect a court to look to corporate law).

The court also held that Domain's members individually breached the LLC Agreement, and were jointly and severally liable for monetary damages to Shah. In its analysis, the court found it significant that "the LLC Agreement does not create an obligation on the part of the Company to pay Shah." Instead, the court found, "[t]he LLC Agreement is silent, and the breach arises under the default provisions of the LLC Act." The court also took account of equitable reasons supporting this outcome, including that "the remaining members were not passive actors or so uninvolved in the Company's management such that holding them liable for breach of contract is unwarranted."

Shah underscores the importance of careful drafting of operating agreements for Delaware entities. Because the operative agreement was silent as to the issue for the payout amount due to an expelled member, the court looked for guidance from not only the default rules of Delaware's LLC Act but also its Partnership Act. In addition, LLC Agreement's silence about who would bear the responsibility for breach of contract contributed to the court's holding that a rational reading of the contract as well as equitable considerations supported joint and several liability on the part of individual members.

2. Delaware Declines Application of the Implied Covenant of Good Faith and Fair Dealing in *Miller v. HCP & Co.*

In *Miller v. HCP & Co.*,[132] Vice Chancellor Glasscock rejected an invitation to apply the implied covenant of good faith and fair dealing to a dispute where the defendants' operating agreements contained provisions waiving fiduciary duties and a waterfall provision allocating the bulk of the first $30 million received in a sale to the controlling shareholder. On appeal, the Delaware Supreme Court agreed with the Court of Chancery's decision not to apply the implied covenant as to the issues in dispute, though it noted that language in Trumpet's operating agreements did not relieve Trumpet of its duty to act consistently with the implied covenant in other respects.[133]

The dispute arose when minority shareholders challenged the sale of Trumpet Search LLC. Defendants HCP & Co. and its affiliates were the largest holders of membership units in Trumpet and had the right, under Trumpet's operating agreement, to appoint four of the seven managers on

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[132] *Miller v. HCP & Co.*, 2018 WL 656378 (Del. Ch. Feb. 1, 2018). For an extended analysis of this case, see Jason Halper & James Fee, *Contracting Party Beware: The Implied Covenant Will Not Save You from Your Agreement if You Negotiated Away Your Rights*, Cadwalader Wickersham & Taft LLP (Feb. 12, 2018), https://www.cadwalader.com/resources/clients-friends-memos/contracting-party-beware--the-implied-covenant-will-not-save-you-from-your-agreement-if-you-negotiated-away-your-rights.

[133] *Miller v. HCP & Co.*, 194 A. 3d 908 (Del. Sep. 20, 2018).

Trumpet's corporate board. In the event of a sale, Trumpet's operating agreement explicitly waived fiduciary duties and contained a waterfall provision that provided that HCP entities would receive 90% of the first $30 million of returns. Following a transaction in which the HCP-dominated board sold Trumpet to a buyer for $43 million without an open-market sales process, plaintiffs sued, arguing that the implied covenant required defendants to pursue an open-market sale or auction to maximize value for all stockholders, and that the waterfall provision provided the HCP board members with a "perverse" disincentive to negotiate for a price above $30 million.

Vice Chancellor Glasscock found no basis to apply the implied covenant because to do so would impermissibly "rewrite a contract simply because a party now wishes it had gotten a better deal."[134] The court stated that the agreement expressly addressed the challenged transaction, and thus there was "no gap in the parties' agreement to which the implied covenant may apply." According to the court, "[t]he implied covenant, like the rest of our contracts jurisprudence, is meant to enforce the intent of the parties, and not to modify that expressed intent where remorse has set in."

The decision reinforces the importance of careful drafting of operating agreements and dispels any false sense of security that the implied covenant will effectively substitute for fiduciary duties. To the contrary, the implied covenant is a contractual concept that seeks in limited circumstances to effectuate the intent of the parties to the contract "had they considered the issue in their original bargaining positions at the time of contracting." The court observed, for instance, that if the parties "had chosen to employ the corporate form here, with its common-law fiduciary duties, then this matter would be subject to entire fairness review" given the existence of a controlling stockholder. In that event, the court would have assessed whether the sale transaction resulted from a fair process and yielded a fair price. Here, as noted, the HPC-dominated board had virtually complete discretion regarding the sales process pursuant to the governing agreements.

3. Delaware Court of Chancery Strictly Interprets Merger Agreement in Upholding Termination of Merger in *Vintage Rodeo v. Rent-A-Center*

In *Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc.*,[135] the Delaware Court of Chancery found that Rent-A-Center, Inc. properly terminated its merger agreement with Vintage Capital Management LLC after Vintage failed to submit a notice to extend the drop-dead date for its pending $1.37 billion buyout of Rent-A-Center. In so holding, Vice Chancellor Glasscock strictly interpreted the express language of the merger agreement and permitted Rent-A-Center to terminate the merger unilaterally by delivering a termination notice only hours after the extension deadline passed.

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[134] *Miller*, *supra* at *9.

[135] No. 2018-0928-SG (Del. Ch. Mar. 14, 2019).

The merger agreement provided that each party had the unilateral right to extend the outside date for the merger to close from December 17, 2018 to March 17, 2019, by giving the other party written notice of its election to extend on or before December 17, 2018. If neither party elected to extend the end date, then the parties would still be bound by the merger agreement, but either party could terminate the merger agreement by delivering a written notice to the other party. The merger agreement provided that, upon termination, Vintage would be obligated to pay to Rent-A-Center a reverse breakup fee equal to 15.75% of the transaction's equity value. In light of the prolonged Federal Trade Commission approval process, it was clear to each party that the merger would not be completed by December 17. Shortly before the deadline, the Rent-A-Center board determined that it would not unilaterally extend the end date, and that, if Vintage did not extend, Rent-A-Center would elect to terminate the merger agreement. While Rent-A-Center anticipated that Vintage would elect to extend, to Rent-A-Center's surprise, Vintage did not extend the end date by the prescribed deadline. On the morning of December 18, 2018 (only a few hours after the deadline had passed), Rent-A-Center delivered a termination notice to Vintage and demanded that Vintage pay the breakup fee.

Despite Vintage's arguments that an extension notice was constructively delivered or waived, the court came to the "startling conclusion" that Vintage "simply forgot" to deliver the extension notice. Seeking a declaratory judgment, Vintage filed suit against Rent-A-Center, seeking to invalidate Rent-A-Center's termination notice on the basis that the extension deadline had been extended by the conduct of the parties and that Rent-A-Center breached its implied covenant of good faith and fair dealing. Rent-A-Center asserted a counterclaim for breach of contract, seeking payment of the breakup fee. Following a two-day trial, the court found that Rent-A-Center's termination was valid and effective. In so finding, the court rejected Vintage's arguments that (1) its failure to provide written notice to extend the end date was obviated by the parties' conduct; (2) Rent-A-Center breached its obligation to use commercially reasonable efforts to close the transaction by failing to remind Vintage of its obligation to deliver an extension notice or inform Vintage of its intention to terminate if Vintage failed to deliver an extension notice; and (3) Rent-A-Center fraudulently induced Vintage to believe that Rent-A-Center still wanted to consummate the merger.

Vintage Rodeo highlights that Delaware courts generally will strictly enforce the clear and unambiguous terms of a merger agreement. The court emphasized that, when the terms of a contract are clear and unambiguous, judicial review of such terms generally stops, unless a party "justif[ies] its deviation, by, for instance, showing that it has acted reasonably, in light of the circumstances, to substantially comply in a way that preserves the benefits of the contract to the counterparty."[136] The court found that the facts of this case did not warrant such an exception. Instead, the court held that the end date and the extension thereof were "matters of

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[136] *Id.* at *14.

importance" and were "heavily negotiated," and as such, the parties are "bound to their contractual bargain."[137]

The decision also underscores that reasonable efforts do not require reminding a counterparty of its contractual rights. Vintage argued that Rent-A-Center, by not disclosing in advance its intent to terminate the merger if Vintage elected not to extend the end date, failed to use commercially reasonable efforts to consummate the merger and, therefore, breached the agreement, rendering its termination of the transaction invalid. But the court found that Rent-A-Center did not sabotage satisfaction of a condition precedent, and that Vintage simply lacked an understanding of its explicit rights under the merger agreement. In so holding, the court acknowledged that, under Delaware law, "parties are assumed to have knowledge of their own contractual rights."[138] And because there was no evidence that Rent-A-Center was aware of Vintage's misunderstanding, the court found that Rent-A-Center's failure to remind Vintage of its notice obligations did not result in a breach of the merger agreement. Likewise, the court found that Rent-A-Center had no duty to warn Vintage of an impending termination. If the parties in fact had agreed to include an advance notice provision in the merger agreement, they would have done so expressly.

III. DEVELOPMENTS IN CORPORATE GOVERNANCE REGULATION

A. DGCL Amendments

On August 1, 2018, certain amendments to the Delaware General Corporation Law went into effect, including modifications to Sections 102, 204, and 262.[139]

In particular, the legislature clarified under what circumstances a corporation may use Section 204 to ratify defective corporate acts.[140] The amendments clarified that a board may vote to ratify a corporate act pursuant to Section 204 even when there is no valid stock outstanding, notwithstanding that ratification normally would have required shareholder approval under the statute if shares had been issued.[141] Additionally, the new rules provide that when a stockholder

137 *Id.* at *3.

138 *Id.* at *19.

139 S.B. 180, 149th Gen. Assemb. (Del. 2018).

140 *Id.*

141 Del. Code. Ann. tit 8 § 204(c) (West).

vote is scheduled to ratify a defective corporate act, the required notice must be sent to all record holders of stock as of the date of the defective corporate act.[142]

The legislature amended the appraisal statute, Section 262,[143] to extend the "market out" exception to the availability of statutory appraisal rights to exchange offers followed by a back-end merger consummated without a vote of stockholders pursuant to Section 251(h). The legislature thereby reconciled the discrepancy that had existed permitting the "market-out" exception for a long-form stock-for-stock merger with a stockholder vote but not for a two-step merger.[144] Section 262(e) was also amended to clarify that the surviving corporation is required to provide dissenting shareholders with information regarding the number of shares that were not tendered or exchanges, as applicable.[145]

The amendments to Section 102 added the requirement that a corporation's name must be different from the name or reserved name of any registered series of a limited liability company. LLCs were thus added to the list of entities from which a corporation's name must be distinguished. This amendment will not take effect until August 1, 2019.[146]

The Corporate Council of the Corporation Law Section of the Delaware Bar Association released proposed legislation that, if adopted by Delaware, would comprehensively address the effect of electronic signatures and delivery through electronic transmission. In addition, the proposal will reverse the statutory default for notice to stockholders. Under the proposed rules, notices to stockholders will be permitted by e-mail *unless* the stockholders have notified the corporation of an objection to receiving notices through electronic means.[147]

B. **Board Diversity**

In the past several years there has been a push from regulators and large institutional investors to encourage diversity on corporate boards. In June 2018, the New York City Comptroller and New York City Retirement Systems sent letters to the nominating and governing chairs of 151 companies encouraging them to disclose race, gender and other demographic information in

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142 Matthew M. Greenberg, *New Amendments to Delaware General Corporation Law*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Aug. 16, 2018), https://corpgov.law.harvard.edu/2018/08/16/new-amendments-to-delaware-general-corporation-law/.

143 *Supra* note 145.

144 *Supra* note 148.

145 *Supra* note 145.

146 *Id.*

147 John Mark Zeberkiewicz, *2019 Proposed Amendments to DGCL*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Apr. 13, 2019), https://corpgov.law.harvard.edu/2019/04/13/2019-proposed-amendments-to-dgcl/.

addition to skills, experience and other qualifications.[148] In response, more than 35 companies have agreed to disclose the qualifications and demographic information of their board members.[149] There is some evidence of gradually increasing board diversity. Since the beginning of the initiative, 49 companies, including eBay Inc., and Wells Fargo & Co., have "elected 59 new female or minority directors," and a total of 24 companies have committed to including women and minority candidates in future board searches.[150]

Also in 2018, in California—which is home to 377 Russell 3000 companies with all-male boards[151]— Governor Jerry Brown signed a bill requiring that any publicly held domestic or foreign corporation with principal executive offices in California must have at least one female director on its board.[152] According to one study, at least an additional 684 women would need to be added to corporate boards to comply with the law's requirements.[153] Currently, just 20% of S&P 500 board seats are occupied by women. Some European countries have already passed similar laws, with Norway requiring that at least 40% of director seats must be occupied by women.[154] In addition, a New York State pension fund as well as State Street Global Advisors, each announced that it would vote against exclusively-male slates of directors.[155]

Multiple states are debating bills similar to California's legislation to promote gender diversity on corporate boards. A bill that has passed the Illinois House and is currently under consideration in the Senate would require that any "publicly held domestic or foreign corporation whose principal executive offices . . . are located in Illinois shall have a minimum of one female director and one African American director on its board of directors."[156] A similar bill currently in debate in the New

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[148] Meghan Kilroy, *NYC Comptroller Engages With More Than Half of Companies in Board Diversity Campaign*, Pensions & Investments (Jun. 27, 2018), https://www.pionline.com/article/20180627/ONLINE/180629856/nyc-comptroller-engages-with-more-than-half-of-companies-in-board-diversity-campaign.

[149] *Id.*

[150] *Id.*

[151] Patrick McGreevy, *Gov. Jerry Brown Signs Bill Requiring California Corporate Boards to Include Women,* Los Angeles Times (Sep. 30, 2018), https://www.latimes.com/politics/la-pol-ca-governor-women-corporate-boards-20180930-story.html.

[152] Cal Corp. Code § 301.3.

[153] Emily Stewart, *California Just Passed a Law Requiring More Women on Boards. It Matters, Even if It Fails.,* Vox (Oct. 3, 2018), https://www.vox.com/2018/10/3/17924014/california-women-corporate-boards-jerry-brown.

[154] *Id.*

[155] Joanna S. Lublin, *New York State Fund Snubs All-Male Boards*, Wall Street Journal (Mar. 20, 2018), https://www.wsj.com/articles/new-york-state-fund-snubs-all-male-boards-1521538321; Cyrus Taraporevala, *Fearless Girl Helps to Re-Write the Rulebook*, State Street (Oct. 23, 2018), https://www.ssga.com/blog/2018/10/fearless-girl-helps-to-re-write-the-rulebook.html.

[156] H.B. 3394, 101st Gen. Assemb., Reg. Sess. (Ill. 2019).

Jersey legislature would require that by December 31, 2019, any publicly held corporation with its principal office in New Jersey must have at least one female director on its board.[157]

Despite such efforts, boardroom diversity remains elusive. From 2012 to 2018, the number of Fortune 500 companies with a board consisting of more than 40% diverse directors (defined as women and minority groups) more than doubled from 69 companies to 145 companies, still less than one-third of the companies in that index. Of the 1,033 board seats filled between 2016 and 2018, nearly 60% were filled by non-diverse candidates. Of the board seats held at Fortune 100 companies in 2018, 25% were filled by women and 19.5% were filled by minorities.[158]

IV. DELAWARE JUDICIARY DEVELOPMENTS

In 2017, Delaware Supreme Court Chief Justice Leo E. Strine, Jr. requested the creation of two additional seats on the Court of Chancery to address the court's increasing workload—by some measures, it had increased 64% in the prior decade.[159] The Delaware General Assembly responded in 2018 by expanding the court for the first time since 1989, adding two seats that have since been filled by new Vice Chancellors Morgan Zurn and Kathleen McCormick.[160]

V. LOOKING AHEAD: CORPORATE GOVERNANCE LITIGATION AND REGULATION FOR THE REMAINDER OF 2019

We expect the remainder of 2019 to be eventful. In particular, we will be watching for noteworthy developments in the following areas:

- **Will Delaware soon see another "material adverse effect"?** The Delaware Supreme Court's conspicuously-terse order affirming the Court of Chancery's finding of a material adverse effect in *Akorn* seems designed to signal to the Delaware bench and bar that the finding of a material adverse effect in that case is not a transformation in Delaware deal jurisprudence. But it remains to be seen how other cases raising this issue will be handled in the Court of Chancery or whether the decision may lead M&A lawyers to take a fresh look at

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[157] A4726, 218th Gen. Assemb., Reg Sess. (N.J. 2019).

[158] *Missing pieces report: The 2018 board diversity census of women and minorities on Fortune 500 boards,* Deloitte (2019), https://www2.deloitte.com/us/en/pages/center-for-board-effectiveness/articles/missing-pieces-fortune-500-board-diversity-study-2018.html.

[159] *2017 Year in Review: Corporate Governance Litigation & Regulation*, Cadwalader Wickersham & Taft LLP (Dec. 13, 2018), https://www.cadwalader.com/resources/clients-friends-memos/2017-year-in-review-corporate-governance-litigation--regulation.

[160] Tom McParland, *Del. Gov. Names 2 Women for New Chancery Seats as Business Court Expands*, Delaware Law Weekly (Sep. 21, 2018), https://www.law.com/delawarelawweekly/2018/09/21/del-gov-names-2-women-named-for-new-chancery-seats-as-business-court-expands/.

drafting material adverse effect clauses. Any significant drafting changes could produce a new crop of deal provisions to be tested in future cases.

- **The *Trulia* standard will continue to be litigated in new jurisdictions.** Since *Trulia* was issued in 2016, there has been a split among jurisdictions outside Delaware regarding whether to adopt the rule it articulated. Going forward, it seems likely that that plaintiffs will continue to seek out jurisdictions that have not adopted or considered *Trulia*, in the hopes of finding a favorable forum for achieving a quick fee via a disclosure-only settlement.

- **Has the Delaware Supreme Court struck an appropriate balance in *Corwin* cases?** The decisions in *Appel v. Berkman* and *Morrison v. Berry* potentially mitigated the practical impact of *Corwin* by finding it inapplicable due to material omissions or misstatements in connection with shareholder votes. It remains to be seen whether corporations heed the warnings in those cases by ensuring adequate disclosure or, alternatively, risk forfeiting business judgment rule review as a result of disclosure issues.

- **Has *Synutra* established a workable standard for determining how early in negotiations a controller must self-disable for the transaction to be entitled to business-judgment-rule review?** As discussed above, the Delaware Supreme Court held in *Flood v. Synutra* that a controller must condition a proposed transaction on the twin MFW Conditions—approval by an independent, empowered special committee and the informed, uncoerced vote of a majority of the minority stockholders—before any "substantive economic negotiations" have taken place in order for a controller transaction to be entitled to deferential business-judgment-rule review. The court largely left the question of just when "substantial economic negotiations" have occurred to fact-bound determinations in particular cases, over the dissent of Justice Valihura, who favored "more of a bright line" test that would alleviate the need for difficult factual inquiries at the pleadings stage.[161] *Olenik v. Lodzinski*, as mentioned above, provided the court with the first opportunity to conduct just that sort of inquiry. After taking stock of the transaction at issue in that case—and numerous facts pled about the course of negotiations—the court concluded that the controller in that case invoked the MFW Conditions too late, after substantial negotiations were underway. *Synutra* has yet to be applied by the Court of Chancery, and it remains to be seen how the fact-bound inquiry it requires will affect the already substantial burdens the Court of Chancery shoulders to resolve complex pleadings-stage motions. And because the *Synutra* inquiry requires a fact-specific determination to be made based on only the allegations in the complaint, *Synutra* raises the specter of having to litigate the standard of review twice: one at

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[161] *Flood*, 195 A.3d at 768.

the pleadings stage and again at summary judgment (or trial) if the facts developed during discovery about the course and timing of negotiations differ from the complaint.

- **How will the levels of appraisal arbitrage be affected by the Delaware Supreme Court's decision in *Aruba*?** Appraisal arbitrage refers to situations where stockholders, often hedge funds, purchase shares of a target after a transaction is publicly announced and commence an appraisal proceeding in the hope that the court will find fair value to be in excess of the merger consideration. In addition, a stockholder seeking appraisal is entitled under Section 262 to receive interest on the court's fair value award at the rate of 5% above the federal funds rate, compounded quarterly, for the period the lawsuit was pending. This above-market rate could provide an additional incentive for stockholders to engage in appraisal arbitrage (although 2016 amendments to Section 262(h) provide corporations the option to prepay appraisal claimants an amount of their choosing to cut off or reduce the accrual of interest payments). However, the Supreme Court's trilogy of decisions relying on merger consideration less synergies as evidence of fair value, in *Dell*, *DFC*, and now *Aruba*, may continue to provide a strong deterrent to commencing such litigation absent persuasive reasons to believe that the merger consideration is not reliable evidence of value. That would be the case, for instance, where conflicts of interest on the part of directors, officers, financial advisors, or significant stockholders undermine the quality of a company's sales process or where all logical bidders are not given access to accurate confidential information or a fair opportunity to participate in a sale process. But absent such facts, it appears that Delaware courts are likely to rely on the transaction price negotiated at arm's-length by motivated buyers and sellers, with fewer merger-related synergies proven to be included in the transaction price.

- **How will the role of the implied covenant of good faith and fair dealing develop in merger litigation?** In *Vintage Rodeo*, the Court of Chancery held that Rent-A-Center's right to terminate was not limited by the implied covenant of good faith and fair dealing. In so holding, the court noted that the implied covenant of good faith and fair dealing serves as a "gap filler" that applies only when parties expressly failed to include terms that are "so obvious." But the court left open the question of whether Vintage should be responsible to pay to Rent-A-Center the reverse breakup fee based on the implied covenant of good faith and fair dealing. In particular, the court questioned whether the parties intended for the breakup fee to apply in a situation where the buyer is ready and willing to close, but inadvertently failed to notify the other party of its election to extend. As such, the court requested supplemental briefing on the applicability of the implied covenant to payment of the breakup fee before rendering a decision on whether the breakup fee must be paid. The court's ruling on that issue could impact how M&A practitioners account for the covenant of good faith and fair dealing going forward.

- **Expect increasing costs of Section 220 demands.** We expect the combination of the Delaware Supreme Court's decisions in *KT4*, which expressly recognized that emails are fair game for Section 220 demands, and *Alvarez*, which promotes a race-to-the-courthouse in derivative actions to avoid a stockholder-wide preclusive ruling on demand futility, will cause the burdens of responding to Section 220 demands to climb. In *KT4*, Chief Justice Strine chastised the company for spending "more time arguing over the form of the books and records that had to be produced rather than the substantive nature of those books and records," and encouraged future parties to focus on the "substance" of a document and whether it is responsive to a 220 demand rather than on whether that document is an email or a paper record.[162] But that elides the substantial difference in burden that an email search entails—with the need to develop protocols and search terms and, often, retain third-party vendors—compared to the traditional gathering of a discrete set of responsive documents, like "board minutes, resolutions, and official letters."[163] Conducting an email search in response to a 220 demand can impose discovery-like burdens, despite the court's oft-repeated refrain that "§ 220 inspections are not tantamount to 'comprehensive discovery.'"[164] If email searches become the norm, it remains to be seen how the Delaware courts will police the scope of 220 demands to prevent them from fully transforming into pre-litigation discovery. Applying further pressure are *Alvarez* and *Corwin*, with the former adding new time pressure to Section 220 demand served in the context of a potential derivative suit, and the latter making Section 220 demands nearly indispensable for plaintiffs hoping to avoid the *Corwin* bar by uncovering evidence that a stockholder vote was not fully informed. Together, we expect that Section 220 demands will become greater in number, advanced with greater urgency, and increasingly burdensome to answer.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Jason M. Halper	+1 212 504 6300	jason.halper@cwt.com
Nathan Bull	+1 212 504 5752	nathan.bull@cwt.com
Ellen Holloman	+1 212 504 6200	ellen.holloman@cwt.com
Jared Stanisci	+1 212 504 6075	jared.stanisci@cwt.com

162 *KT4*, 203 A.3d at 757.

163 *Id.* at 742.

164 *Id.* at 751.

Alex Owings	+1 212 504 6124	alex.owings@cwt.com
Victor Bieger	+1 212 504 6088	victor.bieger@cwt.com
Monica Martin	+1 212 504 6145	monica.martin@cwt.com
Zack Schrieber	+1 212 504 6166	zack.schrieber@cwt.com