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RECENT DEVELOPMENTS IN THE LAW: DUTIES OF DIRECTORS OF DELAWARE CORPORATIONS

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Court of Chancery Indicates Strong Disapproval of Disclosure-Only Settlements to Resolve M&A Litigation

If you are a director and you have been sued in recent years, odds are it was in M&A litigation. While the rate of filing new securities class actions has not changed much in recent years, with 2015 being a slight exception, lawsuits challenging mergers and acquisitions have become almost ubiquitous. A decade ago less than 40 percent of all major mergers or acquisitions drew a lawsuit. In recent years the total has been well over 90 percent for deals with a nominal value in excess of $100 million. These cases follow a pattern: The target's Board is accused of breaching its fiduciary duties by not getting a good enough deal. The acquiror is accused of aiding and abetting the target's Board in breaching its fiduciary duties, on the theory that the acquiror got too good a deal. And both sides are accused of failing to disclose in the S-4 proxy statement and prospectus something they should have disclosed.

Until very recently, virtually all of these cases settled, and settled early, for what are called disclosure-only settlements. These are settlements in which the target's stockholders get no money but only a supplemental S-4 with a few more disclosures thrown in. Of course, money does change hands, but that money all goes to the plaintiffs' lawyers, who often are the real drivers behind this sort of litigation. And in

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return, the defendants get peace – at least the sort of peace that a broad release can provide. The release becomes sort of an insurance policy against another lawsuit.

But in 2015, this practice began to change. In a series of decisions, the most recent of which was only a month ago, the Delaware Court of Chancery has started to clamp down on these disclosure-only settlements, criticizing them roundly.

In the most recent decision, handed down on January 22, 2016, the Delaware Court of Chancery rejected the proposed settlement of a stockholder class action lawsuit challenging Zillow, Inc.'s acquisition of Trulia, Inc. in a stock-for-stock merger valued at something between $2.5 billion and $3.5 billion.[2] Chancellor Andre Bouchard found that the proposed settlement was neither fair nor reasonable because the company would be providing its stockholders with useless and immaterial supplemental disclosures that did not justify a broad release of claims.[3] Chancellor Bouchard also warned that, moving forward, the Court of Chancery will no longer approve disclosure-only settlements unless (1) the supplemental disclosures satisfy a "plainly material" standard and (2) the proposed release is sufficiently narrow.[4]

The *Trulia* decision follows a series of recent decisions in which the Court of Chancery has signaled its growing unwillingness to approve disclosure-based settlements of merger litigation.

Vice Chancellor Sam Glasscock III examined the agency problems associated with disclosure-only settlements in his September 17, 2015 opinion in *In re Riverbed Technology, Inc. Stockholder Litigation*.[5] He noted the incentives: Plaintiffs' counsel get a quick and certain fee. And defendants avoid future litigation by paying a deal tax to gain a broad release – a release that could displace the interests of stockhold-

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[2] *In re Trulia, Inc. Stockholder Litigation*, C.A. No. 10020-CB, 2016 WL 325008, at *1 (Del. Ch. Jan. 22, 2016). The agreed-upon additional disclosures would have added to the existing 224-page proxy "(1) certain synergy numbers in J.P. Morgan's value creation analysis; (2) selected comparable transaction multiples; (3) selected public trading multiples; and (4) implied terminal EBITDA multiples for a relative discounted cash flow analysis." *Id.* at *11.

[3] The court rejected the settlement even though the parties narrowed the release to exclude unknown claims and antitrust claims. As narrowed, the release still released all claims "arising under federal, state, foreign, statutory, regulatory, common law or other law or rule" held by any member of the proposed class relating in any conceivable way to the transaction. *Id.* at *3-*4.

[4] *Id.* at *10. The Chancellor also encouraged parties to adjudicate disclosure claims outside the context of a settlement – either by a preliminary injunction motion or by a contested fee application. Neither would result in a release.

[5] C.A. No. 10484-VCG, 2015 WL 5458041, at *3-4 (Del. Ch. Sept. 17, 2015).

er class members in diligently pursuing and investigating real claims.[6] Although Vice Chancellor Glasscock narrowly approved the proposed settlement in *Riverbed*, he insisted that the court would approach future proposed settlements with increased scrutiny, particularly with respect to the breadth of claim releases.[7]

Less than a month later, Vice Chancellor Laster rejected a proposed settlement arising from Hewlett-Packard's $2.7 billion acquisition of Aruba Networks, stating that plaintiffs' counsel had inadequately represented the stockholder class members.[8] At the settlement hearing, Vice Chancellor Laster questioned the merits of the case at the time it was initially filed, took note of the weak discovery record of plaintiffs' counsel and expressed concerns over the fact that the proposed release extended far beyond the disclosure claims to cover future, unknown claims. The Court's close scrutiny of the proposed settlement in *Aruba* set the stage for Chancellor Bouchard to issue his stern warning in *Trulia* several months later.

Trulia takeaways:

- **New "plainly material" standard** – *Trulia* established a new standard for evaluating the adequacy of supplemental disclosures offered as part of a proposed settlement. To pass muster, a company's supplemental disclosures must "address a plainly material misrepresentation or omission."[9] In other words, the supplemental disclosure will only support a settlement if the company's previous disclosure was materially incorrect or omitted material information. Relatedly, courts may request supplemental briefing or appoint an *amicus curiae* to help evaluate the alleged benefits of a supplemental disclosure.
- **Narrow releases required** – Only narrow releases that "encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process"[10] will support a settlement. Courts will likely not accept releases that include "unknown claims" or general language referring to "any claims arising under federal, state, statutory, regulatory, common law, or other law or rule," like the release in *Trulia*.[11]
- **Difficulty of negotiation** – The new "plainly material" standard for supplemental disclosures and the narrow release requirement will make it more

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[6] *Id.*

[7] *Id.* at *6.

[8] *In re Aruba Networks, Inc. Stockholder Litigation*, C.A. 10765-VCL, Hr'g Tr. (Del. Ch. Oct. 9, 2015).

[9] *Trulia, Inc.*, 2016 WL 325008, at *10.

[10] *Id.*

[11] *Id.* at *4.

challenging for parties to negotiate settlements in the future. Put simply, plaintiffs will have every incentive to insist upon a monetary settlement.

Practical implications:

- **Decreased filings in Delaware** – The court's increased scrutiny of disclosure-only settlements will likely lead to fewer filings in Delaware of lawsuits traditionally targeted at securing these types of settlements. To the extent that plaintiffs' attorneys do choose to file claims in response to public company M&A deals, the lawsuits will likely be of a higher quality compared to those filed pre-*Trulia*, and will seek money.
- **Forum shopping** – Plaintiffs' counsel may attempt to file merger objection cases in other jurisdictions to avoid increased scrutiny by Delaware courts. The effectiveness of this strategy will depend on whether those jurisdictions choose to follow *Trulia* and whether the corporation has adopted a forum selection bylaw specifying Delaware as its designated forum.
- **No more "deal insurance" for companies and their Boards** – Defendants in stockholder class actions will no longer be able to secure deal certainty by making supplemental disclosures and paying attorneys' fees in exchange for global claim releases. Releases must be much narrower, limited to disclosure issues and deal process issues.
- **Decline in cost of D&O insurance?** – Might rates for directors' and officers' liability insurance fall as a result of a decrease in the volume of frivolous merger opposition lawsuits? Maybe, but it is too early to say.

Expansion of the Business Judgment Rule and New Exceptions to "Entire Fairness" Review

Until very recently, if a corporation entered into a major transaction with a controlling person, the deal would be scrutinized by courts in Delaware under Delaware's "entire fairness" test. In simple terms, that meant the deal had to be fair, both in terms of process and in terms of substance (including price). Also, the burden of proving "entire fairness" was placed on the corporation's directors, not the plaintiffs. That's a tough standard.

There was one escape from this standard. If the directors used an independent and empowered Special Committee to vet and approve the deal, or if an informed majority of the disinterested minority stockholders voted to approve the deal, then the bur-

den of proof shifted from the controlling stockholder over to the plaintiff. But the burden-shift aside, entire fairness review continued to apply.[12]

Such was the law for 20-plus years until 2014, when the Delaware Supreme Court in *Kahn v. M&F Worldwide* ("*MFW*") held that business judgment should be the standard of review for mergers between a controlling stockholder and its subsidiary if, and only if: (i) from the beginning, the controlling stockholder conditions the transaction on the approval of both the Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee has the power to freely select its own advisors and definitively say "no"; (iv) the Special Committee satisfies its duty of care in negotiating a fair price; (v) the minority vote is informed; and (vi) the minority is not subject to coercion.[13] Applying this new standard, the Court ultimately affirmed the Court of Chancery's decision to grant the defendant's motion for summary judgment in a breach of fiduciary duty case arising from a going-private merger.[14]

This occurred in 2014. But several cases decided in 2015 have shed further light on the implications of *MFW*:

- **No business judgment review for superficial compliance with the *MFW* standard**

In its August 27, 2015 *Dole Food* decision, the Court of Chancery held that even where the structure of a going-private transaction technically complied with *MFW* in form, the defendant directors were not entitled to business judgment review because they each took actions to undermine the Special Committee throughout the transaction process.[15] The Court in *Dole Food* found that the defendants' fraudulent actions, which included knowingly providing the Special Committee with "projections that contained falsely low numbers," interfered with the effectiveness of the Special Committee as a bargaining agent for minority stockholders.[16] *Dole Food* highlights the fact that courts will closely scrutinize transactions – even if the transactions appear to follow *MFW* in form – to ensure that each of the six *MFW* requirements is satisfied in substance.

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[12] *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110, 1116 (Del. 1994).

[13] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014).

[14] *Id.* at 654.

[15] *In re Dole Food Co., Inc. Stockholder Litig.*, C.A. No. 8703-VCL (Del. Ch. Aug. 27, 2015), at 1.

[16] *Id.* at 68.

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- ***MFW* applies to private mergers and motions to dismiss at the pleadings stage**

On November 18, 2015, the Delaware Supreme Court affirmed the Court of Chancery's order in *Swombley v. Schlecht*[17] granting a motion to dismiss stockholder class action claims that challenged the fairness of a private-company controlling-stockholder merger.[18] The Court of Chancery had held, and the Supreme Court agreed, that because the merger agreement required approval from both an independent negotiating Special Committee and a majority of unaffiliated minority stockholders, the defendants were entitled to the protection of the business judgment rule under *MFW*. The Supreme Court's decision is significant in several respects:

First, the decision upholds the notion that *MFW* applies to both public and private company freeze-out mergers.

Second, the decision confirms that courts may apply *MFW* at the motion to dismiss stage and grant such motions without allowing discovery, when appropriate. This, in turn, suggests that Boards can structure transactions in a way that seeks to avoid the expenses associated with discovery.

- **Business judgment rule applies to mergers not involving a controlling stockholder if transaction is approved by a fully informed, uncoerced majority of disinterested stockholders**

The Delaware Supreme Court confirmed on October 2, 2015 that that the business judgment rule is the appropriate standard in post-closing damages suits involving mergers that are not subject to the entire fairness standard and that have been approved by a fully informed, uncoerced majority of the disinterested stockholders, even where such approval is statutorily required.[19]

Aiding and Abetting Liability for Deal Advisors in Breaches of Fiduciary Duty and Director Liability for Failure to Properly Inquire about Advisor Conflicts

Several times in recent years directors have escaped liability for breach of fiduciary duty because of exculpatory provisions in the corporation's bylaws,[20] only to see their

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[17] C.A. No. 9355-VCL, 2014 WL 4470947 (Del. Ch. Aug. 27, 2014).

[18] *Swombley v. Schlecht*, No. 180, 2015, 2015 WL 7302260 (Del. Nov. 19, 2015).

[19] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 308-14 (Del. 2015).

[20] Such exculpatory provisions typically are created under Del. Gen. Corp. Law § 102(b)(7). Such provision may "eliminate[e] or limit[] the personal liability of a director to the corpora-

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deal advisors nevertheless be held liable for aiding and abetting the directors' breach of fiduciary duty. While the directors themselves may have escaped liability, it was doubtlessly a nuisance – or worse – for them to remain ensnared as witnesses in the litigation against their deal advisors, and to have the court find that they breached their duty of care.

The most noteworthy of these cases – *Rural/Metro* – was tried in 2014, resulting in a judgment against the bankers for $75.8 million before interest. The judgment against the advisors was affirmed, if narrowed, by the Delaware Supreme Court on November 30, 2015.

The facts of *Rural/Metro* are complicated, but in substance the Court of Chancery found that the Board (i) created a Special Committee that lacked independence, (ii) gave that Committee a very limited charter that did not include negotiating the sale of the company, (iii) failed for months to supervise the Committee, (iv) while the Committee went ahead and hired a financial advisor that (v) never really disclosed that it had a keen interest in, and stood to profit by, using its position as advisor to Rural/Metro to win a contest to provide staple financing to the buyer of Rural/Metro, and (vi) then provided a financial analysis to Rural/Metro based on material false information (vii) which the Rural/Metro Board spent almost no time reviewing before approving the sale of the company. The Court of Chancery found, and the Supreme Court agreed, that the Board had had breached its duty of care under *Revlon*[21] by failing to act within a range of reasonableness in managing the company's sale process. Both courts also agreed that the Board's financial advisors were liable for aiding and abetting the directors' breaches of fiduciary duties.[22] The exculpatory clause saved the Board from monetary liability for its breaches of duty. But the clause did not save the financial advisor from monetary liability for aiding and abetting those breaches – most notably by hiding the advisor's conflict of interest behind some very bland and boilerplate disclosures.[23] Hence the $75.8 million judgment against the advisor.

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tion or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit." 8 Del. Code § 102(b)(7).

[21] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

[22] *RBC Capital Markets, LLC v. Jervis*, No. 140, 2015, 2015 WL 7721882, at *2 (Del. Nov. 30, 2015).

[23] The advisor in *Rural/Metro* is not the only banker to have gotten into trouble recently by hiding its conflicts. The Court of Chancery recently refused to dismiss aiding and abetting

Lessons from *Rural/Metro*:

- **The responsible group – be it the entire Board or a properly empowered Special Committee – should take an active role in the sales process from start to finish** – Rural/Metro created a Special Committee but did not actually empower it to pursue a deal; the Board also appointed to the Special Committee two (of three) directors who had a personal interest in liquidating their investment in Rural/Metro quickly, and thus were not disinterested. Having done this, Board failed to meet for roughly three months, during which the Special Committee pursued an unauthorized and highly flawed sales process almost to completion.[24] In addition, when it finally awoke, the Board did not receive valuations from its financial advisor until hours before it approved the deal.[25] A Board should be cognizant of the company's value on an ongoing basis with respect to both a potential sale and any alternative corporate action.
- **Special Committees with limited charters require monitoring** — Sometimes a Special Committee is delegated all the Board's powers, because the Board, or a majority of its members, have conflicts. But in other instances, where the Special Committees have more limited charters, Boards should monitor their Special Committees to ensure that all of its members remain independent and act within the scope of their delegated duties. The Court of Chancery found that two members of the Special Committee in *Rural/Metro* were conflicted, each having personal incentives to push for a sale of the company.[26] The Special Committee also commenced a sales process without permission from the Board—for months, the Committee acted beyond the scope of its authority, which was limited to hiring an advisor, exploring strategic alternatives and making a recommendation.

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claims against another financial advisor in *In re Zales Corporation Stockholders Litigation*, C.A. No. 9388-VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015). Zales sold itself for $21 a share. Zales' advisor did not tell Zales that a month before seeking to advise Zales, a team from the advisor led by the same senior banker had pitched the buyer, proposing that the buyer acquire Zales for $21 a share. *Id.* at *3, *22. As the court put it, "On the truncated record before me on Defendants' motions to dismiss, I can only speculate as to why the topic of [the advisor's] prior presentation to [the buyer] apparently did not come up in connection with the decision of the [seller's] Board to make a counter offer of $21 per share as opposed to something higher, in response to [the buyer's] all cash offer of $20.50 per share." *Id.* at *22.

[24] *In re Rural Metro Stockholders Litigation*, 88 A.3d 54, 72 (Del. Ch. Mar. 7, 2014), *aff'd sub nom. RBC Capital Markets, LLC., LLC v. Jervis*, – A.3d –, 2015 WL 7721882 (Del. Nov. 30, 2015).

[25] 88 A.3d at 79.

[26] *Id.* at 65.

- **Boards should vet financial advisors carefully as part of engagement process *and beyond*** – Boards and Special Committees should adequately screen potential financial advisors on an ongoing basis to make sure they are aware of any actual and potential conflicts that the advisor, including members of the individual deal team and the advisor firm as an entity, has or may have with any parties to the transaction or other potential bidders. As the Board identifies conflicts, it should evaluate whether or not such conflicts are manageable given the context. A Board must be especially diligent in monitoring conflicted advisors throughout the sales process.
- **Boards may consider using financial advisor engagement letters as a device to screen for potential conflicts –** Boards may consider using their engagement letters with financial advisors as a tool for identifying conflicts. For instance, a Board might include in the terms of the letter (i) representations from an advisor that it has disclosed certain relationships, (ii) a covenant to make additional disclosures if required throughout the process and (iii) a right to terminate the advisor for cause in the event of a breach of any representation or covenant or a change in the advisor's independence.[27]
- **Boards should keep detailed records of their diligence** – Boards should keep detailed records of their ongoing diligence efforts, which include identifying and managing conflicts, holding regular meetings, and overseeing the sales process. To that end, Board minutes should accurately reflect the Board's actions and diligence efforts, and be timely drafted. Creation of minutes should not await the filing of litigation.

[27] *See generally* Klinger-Wilensky, Eric S. and Emeritz, Nathan P., Financial Advisor Engagement Letters: Post-Rural/Metro Thoughts and Observations (April 24, 2015) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2604250) (discussing four contractual provisions that may be used in financial advisor engagement letters to effectively investigate an advisor's potential conflicts).