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# Director Duties in M&A Transactions: Evolving Standards of Review Under Delaware Law

Application of Business Judgment Standard vs. the Entire Fairness Standard in Evaluating Fiduciary Duty

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# Director Duties in M&A Transactions: Evolving Standards of Review Under Delaware Law

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# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Cummings *on Behalf of New Senior Investment Group, Inc. v. Edens*, 2018 WL 992877 (Del. Ch. Feb. 20, 2018) (V.C. Slights)
- *In re Tesla Motors, Inc. Stockholder Litigation*, 2018 WL 1560293 (Del. Ch. March 28, 2018) (V.C. Slights)
- *In re Oracle Corp. Derivative Litigation*, 2018 WL 1381331 (Del. Ch. March 2018) (V.C. Glasscock)

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- While corporate directors deciding to sell a company face well-known risk of litigation and enhanced judicial scrutiny, recent cases involving Oracle, Tesla and New Senior Investment Group show how directors deciding to buy can be vulnerable if deal involves conflicts of interest

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Common Theme:

  All three cases, plaintiffs claim that the deals were orchestrated for benefit of founder and accused the directors of breaching their fiduciary duty to maximize shareholder value because of conflicts arising from relationships with founder or their own interests in transaction

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Common Lessons:
  - Chancery Court quick to find directors not independent of founder
  - Genuine independent directors are essential to protect conflict transactions from attack
  - Chancery Court requires robust process – a couple of meetings of special committee and fairness opinion will not get job done – Chancery Court expects robust buy-side process in conflict M&A deals

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- New Senior Living Investment (2018 WL 992877)
  - Wesley Edens founded Fortress Investment Group
  - New Senior was publicly traded REIT externally managed by Fortress
  - Holiday Acquisition Holdings LLC, country's second-largest private owner of independent living communities, also managed/sponsored by Fortress
  - Holiday must sell portfolio to pay out investors

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Fortress wants New Senior to purchase portfolio to allegedly continue Fortress management fees/income stream
- Holiday conducts auction but other bidders drop out of process
- Fortress executive negotiates deal on behalf of New Senior
- New Senior special committee of independent directors have a couple of meetings, get banker's fairness opinion and approve deal

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- No smoking gun or shocking bad facts about deal
- V.C. Slights ruled directors not independent and disinterested
  - Director works for nonprofit supported by Fortress founder
  - Director minority owner of Milwaukee Bucks – Fortress founder primary owner
  - Director receives 60% of income from serving on Fortress affiliated boards

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Director breach of loyalty claims not exculpated by 102(b)(7) charter provision
- V.C. Slights ruled viable aiding and abetting claim against Fortress

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Oracle Corp. (2018 WL 1381331)
  - Larry Ellison founded Oracle in 1977 and NetSuite in 1998
  - NetSuite provided cloud-based enterprise resource planning software suites for medium-sized business
  - Oracle moves into NetSuite market and takes significant market share

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- NetSuite stock drops from $107 per share on January 2, 2015 to $53 per share in February 2016
- Oracle pursues acquisition of NetSuite
- Special committee formed with “full and exlcusive power of board”
- Committee meets 13 times

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Financial advisor and management gave separate presentations and recommended acquisition
- Bidding:
  - Oracle offer $100
  - NetSuite counter $125
  - Oracle counter $106
  - NetSuite counter $120
  - NetSuite offer $111
  - Parties settle on $109

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- V.C. Glasscock found complaint did not state claim against 8 outside directors
- V.C. Glasscock permitted lawsuit to proceed against Ellison and Oracle CEO even though both abstained on vote to approve transaction
  - "a corporate fiduciary who abstains from a vote on a transaction may nevertheless face liability if she played a role in negotiating, structuring or approval of the proposal"

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Tesla Motors (2018 WL 1560293)
  - Elon Musk founded Tesla and Solar City, a solar energy system installer
  - Solar City experiences cash crisis – debt and equity markets closed

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Musk gets Tesla to buy Solar City
- Tesla's seven-member board included Musk, his brother and five other directors, all of whom either had substantial investments in Solar city, were highly compensated by Tesla or otherwise alleged to be close friend of Musk

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- History of deal
  - Musk proposes acquisition at three separate Tesla board meetings
  - Board did not form special committee
  - Musk led Tesla board discussions of acquisition
  - Board approved offer with Musk abstaining
  - Merger agreement required approval of Tesla stockholders even though no vote required by Delaware law

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Merger agreement excluded Tesla stockholders who were also directors or executives of Solar City from voting
- V. C. Slights  denied motion to dismiss, finding reasonably conceivable that Musk controlled Tesla
  - Disinterested stockholder approval did not justify business judgment review of plaintiff's breach of duty claim because Musk controlling stockholder
  - All defendants subject to entire fairness review

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Lessons Learned
  - Benefit of majority of directors unquestionably independent of controlling stockholder
  - Directors lack independence when beholden to controlling stockholder
  - Need to adopt process of *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014)

# Conflict M&A Transactions Create Risk for Buy-Side Directors

- Board conditions deal at outset on approval of both special committee and majority of minority stockholder
- Committee is independent
- Empowered to freely select own advisors
- Special committee meets duty of care in negotiating fair price
- Vote of minority informed
- No coercion of minority stockholders

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

*In re Straight Path Communications, Inc. Consolidated Stockholder Litigation*, 2018 WL 3120804 (Del. Ch. June 25, 2018) (V.S. Glasscock)

- In *In re Straight Path*, a controlling stockholder of target risks liability by extracting special benefit from the improper exercise of right to "just say no" to a transaction
  - Controlling stockholder violated fiduciary duty to minority stockholders by conditioning support for merger upon receipt of favorable side deal

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Facts of *Straight Path*
  - Howard Jonas founded IDT Corp., a telecommunications company
  - IDT spun off its wholly owned subsidiary, Straight Path Communications
  - As part of spin-off, IDT indemnifies Straight Path for pre-spin-off liabilities
  - Straight Path owns two assets – wireless spectrum licenses and intellectual property

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Following spin-off, Straight Path maintains dual-class capital structure. Jonas retained majority voting control while holding 18% equity. Jonas held majority voting control and 11% equity of IDT. Jonas family owns additional 10% IDT equity.
- FCC investigates Straight Path misconduct and orders Straight Path to sell wireless spectrum and pay 20% proceeds to FCC as fine

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Straight Path board appoints special committee to oversee sale process
- Committee believes IDT must pay the 20% fine to Straight Path under Indemnification Agreement because misconduct occurred pre-closing
- Special Committee determines that purchaser of wireless spectrum will not recognize value (or pay for) indemnification claim against IDT for 20% fine

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Jonas refuses to approve sale unless indemnification claim resolved prior to closing. Jonas also wants the intellectual property.
- Jonas threat to block deal puts Special Committee in bind

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Straight Path sells IP assets to IDT for $6 million (IP valued at $50 million in FCC settlement)
- Straight Path settles indemnification claim for $10 million plus 22% net proceeds from IP assets
- Straight Path sold to Verizon for $3.1 billion, minus 20% fine paid to FCC. Price represents 486% premium.

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- V.C. Glasscock
  - Stockholder under no duty to sell, even if majority stockholder, merely because the sale would profit the minority
  - Controlling stockholder need not engage in self-sacrifice for benefit of minority stockholders

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- "But that does not mean that the controller or its affiliates are immune from claims for the improper exercise of fiduciary power."
- "If the controller attempts to squeeze out the minority, cause the controlled entity to engage in interested transactions, or other such conduct, the duty of loyalty operates to police the controller's conduct."

# Controlling Stockholder Breaches Duty by Extracting Unique Benefit from Sale of Company

- Controller may not exercise a corporate power in a way that creates an advantage for itself and a disadvantage for the corporation
- "While a controlling stockholder is entitled to act in its own self-interest, that right must yield when a corporate decision impacts a controller's duty of loyalty."
- Entire fairness applied because the transaction was a conflicted transaction

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

*In re Fredrick HSN Living Trust v. ODN Holding Corp.*, 2017 WL 143308 (Del. Ch. April 24, 2017) (V.C. Laster)

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- ODN Holding
  - Minority founder stockholder claimed venture capital firm and its representatives on the portfolio company board sought to maximize the venture capital firm's preferred stock redemption right, instead of value of the company for the long-term benefit of common stockholders through sale of company's assets

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- VC firm invested $150 million in Oversee.net by purchasing preferred stock with mandatory redemption right beginning five years after investment
- VC firm controls Oversee.net board and therefore became controlling stockholder

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- Preferred stock contained contractual covenant that if, on redemption date, the legally available funds were insufficient to redeem the total preferred shares, "the company shall take all reasonable action (as determined by the company's board of directors in good faith and consistent with its fiduciary duties) to generate . . . sufficient legally available funds . . . including by way of . . . sale of assets" (emphasis added)

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- Preferred stock not entitled to cumulative preferred dividend. Therefore the longer the company delayed redemption, the better for common stockholders.
- ODN Holding complaint alleges that roughly three years after the venture firm's investment, the firm concluded that exercising its contractual redemption right was the most effective way to achieve return on its capital and exit the investment

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- Although the company was profitable, the venture firm became disenchanted with the rate of growth
- Venture firm wanted to redeploy its assets and focus on more attractive investments
- As a result of venture firm's decision to exit the investment, the venture firm and its designees to the company board found themselves stuck between fiduciary duty to common stockholders and terms of preferred investment documents

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- The company sold three of its four lines of business in their entirety and divested the principal economic driver for the fourth line of business. In all those sales, the buyer paid less than ODN had paid to acquire the business units.
- V.C. Laster held existence of mandatory redemption right, even one that has ripened, does not convert holders of preferred stock into a creditor

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- A redemption right does not give the holder the absolute, unfettered ability to force corporation to redeem the shares under any circumstances. See, e.g., 8 Del. C. §160(a)(1)
- V.C. Laster found the board does not owe fiduciary duties to preferred stockholders when considering whether to take corporate action that might trigger or circumvent preferred stockholders' contractual rights
- Board must focus on promoting the value of the common shares

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- Board obligated to prefer the interests of common stock over interests of preferred stock
- Board acted disloyally by selling businesses to raise cash to satisfy redemption obligation
- If company lacked surplus or legally available funds, the company could not redeem shares regardless of preferred stock covenant

# Venture Capital Firms and Their Portfolio Company Directors Face Risk of Liability for Conflict of Interest Involving Sale of Company

- Common stockholders have breach of fiduciary duty claim against board for generating surplus and legally available funds to redeem preferred stock
- Note – result could have been different if preferred stock carried cumulative dividend which steadily increases liquidation preferences
- Claim against venture fund for aiding and abetting

RICHARDS LAYTON & FINGER

# Director Duties in M&A Transactions: Evolving Standards of Review Under Delaware Law

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## Overview of Discussion Topics

- *Corwin* Cases
- Controlling Stockholder
- Oversight Claims

*Corwin* Cases

## Standards of Review: *Corwin*

- Under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), absent a controlling stockholder, the business judgment rule applies following fully informed, uncoerced stockholder approval of a transaction.
- Following *Corwin*, in Singh *v. Attenborough*, 137 A.3d 151 (Del. 2016), the Delaware Supreme Court held that fully informed, uncoerced stockholder approval in transactions that do not include a controlling stockholder "irrebuttably" invokes the business judgment rule and precludes judicial review absent extreme allegations sufficient to state a claim for waste.
- Subsequent Court of Chancery decisions have characterized the standard of review under *Singh* as the "irrebuttable business judgment rule." *See, e.g., City of Miami Gen. Emps.' v. Comstock*, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016).

## Standards of Review: *Corwin*

- Subsequent Delaware cases expanded the reach of *Corwin*.
- In *In re Volcano Corp. S'holder Litig.*, 143 A.3d 727 (Del. Ch. 2016), the Court of Chancery held, and in *Lax v. Goldman, Sachs & Co.*, No. 372, 2016 (Del. Feb. 9, 2017) the Delaware Supreme Court affirmed, that the irrebutable business judgment rule established in *Corwin* also applies when a majority of uncoerced, disinterested and fully informed stockholders tender their shares in a two-step merger consummated under Section 251(h) of the DGCL.
- In *The Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958 (Del. Ch. Sept. 29, 2016), the Court rejected a claim that the implementation and adoption of a plan of dissolution was subject to enhanced scrutiny under *Revlon* and *Unocal*. Instead, the Court held that because the plan of dissolution had been approved by a fully informed, non-coerced vote of the stockholders, the irrebuttable business judgment rule under *Corwin* applied.
- Key Take Away: Receipt of disinterested stockholder approval can result in application of the business judgment rule in post-closing litigation resulting in grant of a motion to dismiss.

## Standards of Review: Limits of *Corwin* - Coercion

- *Corwin* will not apply where stockholders are improperly coerced or where relevant disclosures are not sufficient.
  - *In re Saba Software, Inc. Stockholder Litigation*, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017) – Court of Chancery declines to apply *Corwin* where stockholders were coerced due to de-registration of stock and due to material non-disclosures.
  - *Sciabacucchi v. Liberty Broadband Corp.,* 2017 WL 2352152 (Del. Ch. May 31, 2017) – Court of Chancery declines to apply *Corwin* where stockholders were coerced into voting to approve a stock issuance in connection with a merger because the stockholder approval of this matter was a condition to consummation of beneficial merger transaction.

## Standards of Review: Limits of *Corwin* - Disclosure

- In addition to alleging "voter coercion" in certain cases, plaintiffs have begun bringing post-closing disclosure claims in an attempt to prevent the application of *Corwin* and subject change of control transactions to enhanced scrutiny.

- To challenge disclosures in the *Corwin* context, "a plaintiff must first identify a deficiency in the operative disclosure document, at which point the burden would fall to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of the vote." *In re Solera Hldgs., Inc. S'holder Litig.*, 2017 WL 57839, at *8 (Del. Ch. Jan. 5, 2017).

- *van der Fluit v. Yates*, 2017 WL 5953514 (Del. Ch. Nov. 30, 2017) – Court of Chancery holds that the failure to disclose identity of individuals who led sales process and certain post-conversion employment and compensation matters caused *Corwin* not to apply.

## Standards of Review: Limits of *Corwin* - Disclosure

- *Morrison v. Berry*, 2018 WL 3339992 (Del. 2018) – Delaware Supreme Court overturns Court of Chancery dismissal under *Corwin*, finding that disclosure deficiencies related to, among other things, the founder's potential unwillingness to partner with other potential acquirers during auction process prevented stockholder vote from being fully informed under *Corwin*.

- *Appel v. Berkman*, 180 A.3d 1055 (Del. 2018) – Delaware Supreme Court overturns Court of Chancery dismissal under *Corwin*, finding that disclosure deficiencies related to the reasons that a company's Chairman and founder abstained from voting in favor of a merger because of his disappointment with the merger price (and with management for not running the business in a manner that would have commanded a higher price) and his belief that it was an inopportune time to sell the company were material and their omission precluded application of business judgment rule under *Corwin* at the pleading stage.

## Standards of Review: Limits of *Corwin* - Disclosure

- *Fresh Market*: The Delaware Supreme Court determined that the company failed to adequately disclose its founder's (and, together with his son, owners of 9.8% of the company's equity) involvement in negotiations with the acquirer, thus precluding *Corwin's* cleansing effect.
    - The Supreme Court found that because the stockholders had not been provided with all material facts relating to the 14D-9 disclosures, the stockholder vote was not fully informed. Therefore, the claims that the board breached its fiduciary duties could not be cleansed.

## Standards of Review: Limits of *Corwin* – *Massey Energy*

- In *In re Massey Energy Co. Deriv. & Class Action Litig.*, 160 A.3d 484 (Del. Ch. 2017), the Court of Chancery held that *Corwin* did not provide a basis for dismissing director oversight claims that were based on events occurring across several years prior to the company's merger, notwithstanding the fact that (a) such events may have necessitated the sale of the company and (b) a majority of the company's disinterested stockholders approved the merger.

- The Court clarified that in order to invoke *Corwin*, there must be a proximate relationship between the transaction or issue for which stockholder approval is sought and the nature of the claims to be cleansed as a result of a fully-informed vote.

- "The policy underlying *Corwin*, to my mind, was never intended to serve as a massive eraser, exonerating corporate fiduciaries for any and all of their actions or inactions preceding their decision to undertake a transaction for which stockholder approval is obtained."

## Standards of Review: Limits of *Corwin*

- *Lavin v. West Corp.*: Court of Chancery held that the Corwin defense cannot be used to prevent an otherwise properly supported demand for inspection of books and records pursuant to Section 220 of the General Corporation Law of the State of Delaware. The Court found *Corwin* inapplicable in a Section 220 proceeding on both procedural and public policy grounds.
  - Procedural: The Court reasoned that the applicability of a merit-based defense such as Corwin depends on nuanced factual and legal questions (such as whether the stockholder vote was fully informed and uncoerced) that were inappropriate for determination by the Court in a summary Section 220 proceeding.
  - Public Policy: The Court noted that Delaware courts frequently encourage plaintiffs to use Section 220 to fully investigate the merits of their claims prior to filing a complaint.
    - The Court held that applying Corwin in this context would limit the most valuable of plaintiff's "tools at hand" to investigate potential claims and would ultimately deprive the Court of information that could assist it in making an informed decision as to whether a viable breach of fiduciary duty claim exists in the underlying proceeding.

## Standards of Review: Limits of *Corwin*

- Key Take Away:
  - A board will not receive the benefit of *Corwin* for ambiguous, complete or misleading disclosures.
  - As a result of *Corwin,* plaintiffs are increasingly demanding to inspect books and records pursuant to Section 220 of the DGCL post-closing to determine adequacy of disclosure.

# Controlling Stockholders

## Standards of Review: Controlling Stockholder Transactions

- Stockholders owning more than 50% of a Delaware corporation's voting stock or otherwise exercising control over the corporation owe fiduciary duties of loyalty, care, and disclosure to the corporation and its minority stockholders, and in dealing with the corporation must act in good faith and in a manner that does not oppress the corporation and its minority stockholders.

- Where a stockholder is not a majority stockholder, plaintiffs must either show that the minority stockholder actually dominated and controlled the corporation, its board or the deciding committee with respect to the challenged transaction or that the minority stockholder actually dominated and controlled the majority of the board generally.

## Standards of Review: Controlling Stockholder Transactions

- *In re Tesla Motors, Inc. S'holder Litig*., 2018 WL 1560293 (Del. Ch. Mar. 28, 2018), Court of Chancery declined to invoked *Corwin* holding that it was reasonably conceivable that a 22.1% stockholder who was also the chairman of the board, CEO and chief product architect was a controlling stockholder noting, among other things, influence over the stockholders and the board of directors, connections to other members of the board and the fact that a majority of the board was interested in the transaction and public filings acknowledging stockholder's substantial influence.

- *Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC*, 2018 WL 3326693 (Del. Ch. July 6, 2018) Court of Chancery held that minority stockholder exercised actual control over the corporation with respect to a challenged transaction as a result of its contractual rights (including veto rights), efforts to spread misinformation, interference with advisors and members of management and insistent on the challenged transaction supported by threats and combative behavior by its director designees.

## Standards of Review: Controlling Stockholder Transactions – *MFW*

- The entire fairness test is the default standard of review for challenges to conflicted controlling stockholder transactions.

- In *Kahn v. M&F Worldwide Corp*., 88 A.3d 65 (Del. 2014) ("*MFW*"), the Delaware Supreme Court held that the business judgment standard of review applies to a two-sided controlling stockholder merger when it is conditioned, *ab initio*, on:

  - Negotiation and approval by an independent, fully functioning and duly empowered special committee that fulfills its duty of care; and

  - The uncoerced, fully informed vote of a majority of the minority stockholders.

## Standards of Review: Controlling Stockholder Transactions – *Synutra*

- In two recent cases, the Court of Chancery has held that the conditions for *MFW* were satisfied where the initial overture by the controlling stockholder did not expressly condition the transaction on a favorable recommendation from a special committee and approval the majority of the disinterested stockholders.
  - *In re Synutra International, Inc. S'holder Litig.* C.A. No. 2017-0032-VCL (Del. Ch. Feb. 2, 2018) Court of Chancery held that *MFW* applied where "preliminary non-binding proposal" but did not condition a potential transaction on both a favorable special committee recommendation and approval of the majority of the minority, but a follow-up letter sent before the board had substantively evaluated the proposal, reaffirmed its initial offer *and* expressly conditioned the transaction on the approval of the special committee and a majority of the minority stockholders.
  - *Olenik v. Lodzinksi,* 2018 WL 3493092 (Del. Ch. Jul 20, 2018) Court of Chancery explained that the *MFW* protections must be in place at the outset of negotiations (which typically begin when a proposal is made by one party that, if accepted, would constitute a binding agreement); however, such protections may be agreed to after discussions between the parties that are merely "exploratory in nature."

## Standards of Review: Controlling Stockholder Transactions – *Crane*

- In *IRA Trust FBO Bobbie Ahmed v. Crane*, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017), the Court of Chancery dismissed claims alleging that directors of NRG Yield, Inc. ("Yield") breached their fiduciary duties in connection with the approval of a reclassification of Yield's shares that resulted in the issuance of new classes of stock with very limited voting rights to Yield's stockholders.
- The Court held that the reclassifcation was a conflicted controller transaction that would be presumptively subject to the entire fairness standard of review (notwithstanding that it was nominally a pro rata transaction).
- In this regard, the Court held that the reclassification conferred a benefit on the controlling stockholder that was not shared with the minority stockholders, namely the ability to perpetuate its control over Yield by providing Yield with a low vote stock which could be used to, among other things, fund future acquisitions, thereby discontinuing dilution of NRG's voting control.

## Standards of Review: Controlling Stockholder Transactions – *Crane*

- The Court found that the defendants complied with the *MFW* framework, which shifted the standard of review from entire fairness to business judgment.
  - NRG's proposal was conditioned from the beginning on the approval of a majority of the outstanding shares of Yield not affiliated with NRG (i.e., a majority of Yield's outstanding Class A shares). Additionally, Yield's board delegated to its standing conflicts committee the authority to evaluate and negotiate the proposal. The independence of the three members of the conflicts committee was never challenged.
- Because the Court found that the defendants successfully implemented the *MFW* framework, the reclassification was subject to the business judgment rule. As the plaintiff had made no effort to plead facts sufficient to overcome the business judgment rule, the Court granted the defendant's motion to dismiss.
- The Court distinguishes *Williams v. Geier* due to this transaction being before the court on a motion to dismiss and without discovery.

## Standards of Review: Controlling Stockholder Transactions - *CBS*

- In *CBS Corporation, et al. v. National Amusements, Inc., et al.*, C.A. No. 2018-0342-AGB (Del Ch. May 17, 2018), the Court of Chancery denied a temporary restraining order ("TRO") sought by the board of directors of CBS Corporation ("CBS") to prevent its controlling stockholder from amending the company's bylaws prior to a special meeting of the board.
- CBS has two classes of stock: Class A common stock, which has voting power, and Class B common stock, which does not. Shari Redstone, through National Amusements, Inc. ("NAI"), effectively controls about 79% of the voting power CBS. However, Redstone, through NAI, owns only about 10.3% of the economic stake in CBS.
- Beginning in 2016, Redstone began to pursue a combination of CBS and Viacom, which is also controlled by NAI through a dual class structure.
- The deal did not happen at the time due to, among other things, NAI not agreeing that the combined company would be managed as a non-controlled public company with a majority of independent directors.
- During 2016 and 2017, Redstone took other steps in purported conflict with CBS being independently managed.

## Standards of Review: Controlling Stockholder Transactions - *CBS*

- In January 2018, Redstone formally approached the boards of CBS and Viacom and pressed for a combination of the two. After both companies formed special committees to evaluate the potential combination, the CBS special committee determined that a CBS/Viacom combination was not in the best interests of the CBS stockholders, other than NAI.
- The CBS special committee determined that Redstone "present[ed] a significant threat of irreparable and irreversible harm to the Company and its stockholders" and believed that there was a strong likelihood of retributive action by Redstone.
- At the request of the special committee, CBS scheduled a special board meeting where the board would consider, among other things, a special stock dividend of Class A voting shares to all holders of Class A voting and Class B non-voting shares, which would, if approved, effectively dilute NAI's voting power from 81% to 17%.
    - To prevent such dilution, one hour before the TRO hearing, NAI executed and delivered a consent to amend CBS's bylaws to, among other things, require approval of 90% of the directors then in office at two separate meetings held at least 20 days apart to declare a dividend. Such action would make board approval of the dividend impossible without Redstone's consent.

## Standards of Review: Controlling Stockholder Transactions - *CBS*

- The Court balanced the tension between a controlling stockholder's right to protect its control position and the right of independent directors, "empowered under [Section 141(a)]," to respond to a threat posed by a controller, including by diluting the controller.

- The Court cited *Mendel v. Carroll* for the proposition that there could be a scenario where the board may issue a dilutive option to protect minority stockholders from being exploited by a controlling stockholder and that, logically, it would be reasonable for a court to afford a board 'breathing space' to deliberate over such an action by issuing a TRO.

- However, the Court ultimately relied on *Adlerstein v. Wertheimer,* and other precedent, to support the rights of a controlling stockholder to be a "first mover" to protect its control position and suggested that "a truly extraordinary set of circumstances would be necessary to grant" a TRO to thwart a controlling stockholder from preventing a board from diluting the controller.

- However, the court did find that, particularly given CBS's commitment to independent board governance noted in its public disclosures, allegations by CBS as to Redstone's conduct stated a colorable claim for breach of fiduciary duty and advised that the Court has extensive power to provide redress if Redstone takes actions inconsistent with the fiduciary obligations of a controlling stockholder.

# Oversight Claims

## Standards of Review: Oversight Claims

- Directors have a continuing duty to oversee, and, where appropriate, investigate the conduct of corporate employees.
- The Delaware Supreme Court has held that liability for so-called *Caremark* claims could be imposed on directors in connection with this duty of oversight where either:
  - The directors utterly failed to implement any reporting or information systems or controls; or
  - Having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

## Standards of Review: Oversight Claims – *Duke Energy*

- In a 4-1 decision, the Delaware Supreme Court in *City of Birmingham Retirement and Relief System v. Good*, 177 A.3d 47 (Del. 2017) upheld the dismissal of derivative *Caremark* claims against directors of Duke Energy.
  - Complaint alleged that the board consciously disregarded environmental regulations and improperly colluded with regulators, resulting in millions of dollars of criminal fines, restitution and clean-up costs.
- Court of Chancery dismissed under Rule 23.1, holding that complaint did not adequately allege that a majority of the board faced a substantial likelihood of liability.
  - Section 102(b)(7) provision protected against liability for due care; directors faced personal liability risk only for bad faith or disloyalty.
  - Minutes showing board received regular reports on environmental compliance "negated" allegations of "conscious disregard" of oversight duty.
  - Facts pled did not support allegation of illegal "collusion" with regulators.

## Standards of Review: Oversight Claims – *Duke Energy*

- On appeal, majority of the Delaware Supreme Court affirmed, stating:

  "The question before us is not whether Duke Energy should be punished for its actions. That has already happened. What is before us is whether a majority of directors face a substantial likelihood that they will be held personally liable for intentionally causing Duke Energy to violate the law or consciously disregarding the law. We find, as the Court of Chancery did, that Plaintiffs failed to meet this pleading requirement."

## Standards of Review: Oversight Claims – *Duke Energy*

- The majority opinion agreed that complaint unfairly "cherry-picked" from minutes and commented on the distinction between "cooperation with a too-friendly regulator" and "illegal collusion with a corrupt regulator."
- In a strongly worded dissent, Chief Justice Strine disagreed, stating that in his view, the complaint adequately alleged bad faith.

  > "I find the facts pled raise a pleading stage inference that it was the business strategy of Duke Energy, accepted and supported by its board of directors, to run the Company in a manner that purposely skirted, and in many ways consciously violated important environmental laws … [causing] Duke to flout its environmental responsibilities therefore reduc[ing] its costs and increas[ing] profitability. This fiduciaries of a Delaware corporation may not do."

## Standards of Review: Oversight Claims – *Citigroup*

- In *Oklahoma Firefighters Pension & Retirement System v. Corbat*, 2017 WL 6452240 (Del. Ch. Dec. 18, 2017) stockholder plaintiffs brought a derivative action against directors of Citigroup alleging breach of the duty of oversight arising from regulatory violations, fines and fraud losses
- Complaint sought damages relating to:
  - Non-compliance with AML/BSA Consent Orders and fines
  - Foreign exchange manipulations and fines
  - Credit card sales practices violations
  - Fraud losses at Mexican subsidiary
- Complaint sought to excuse demand by alleging that directors faced a substantial likelihood of liability under *Caremark* for failing to implement a system of internal controls and/or consciously failing to oversee its operation.

## Standards of Review: Oversight Claims – *Citigroup*

- The Court of Chancery dismissed the complaint for failure to adequately allege that directors acted in bad faith or with scienter.
- Allegations of conscious "disregard" of oversight duty were insufficient where minutes reflected board attempted to address issues with compliance.
- Red flags of corporate misconduct must be sufficiently similar to events that are subject of suit to demonstrate that board's inaction in response to red flags proximately caused corporate harm.
- Case is on appeal.

## For Additional Information

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