

# DELAWARE LAW REVIEW

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*Kathaleen S. McCormick and Daniel M. Kirshenbaum*

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# DELAWARE LAW REVIEW

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## KEY DECISIONS OF 2015 IN DELAWARE CORPORATE LAW

Kathaleen S. McCormick and Daniel M. Kirshenbaum\*

### I. DEAL LITIGATION

#### **A. *Corwin V. KKR Financial Holdings LLC: The Effect Of An Uncoerced And Fully Informed Disinterested Stockholder Vote On The Standard Of Review In A Merger Without A Controlling Stockholder***

In *Corwin v. KKR Financial Holdings LLC*,<sup>1</sup> the Delaware Supreme Court held that the business judgment rule is the appropriate standard of review in post-closing damages suits involving mergers that are not subject to the entire fairness standard, and which have been approved by a fully informed, uncoerced majority of the disinterested stockholders.

*KKR* involved the acquisition of KKR Financial Holdings LLC (“Holdings”) by KKR & Co. L.P.’s (“KKR”) in a stock-for-stock merger.<sup>2</sup> The stockholder plaintiffs filed suit challenging the merger, alleging, among other things, that KKR was a controlling stockholder of Holdings and that it breached its duty of loyalty to other stockholders by causing Holdings to enter into the merger agreement.<sup>3</sup> Although KKR owned less than 1% of Holdings’ shares, the plaintiffs argued that KKR actually controlled Holdings’ corporate conduct through a management agreement between Holdings and an affiliate of KKR, KKR Financial Advisors LLC (“Advisors”) and, as such, the entire fairness standard of review should apply.<sup>4</sup>

The Court of Chancery dismissed the complaint, holding that a minority stockholder will not be considered a controlling stockholder “unless it exercises such formidable voting and managerial power that it, as a practical matter, is no differently situated than if it had majority voting control.”<sup>5</sup> The Court of Chancery concluded that although the management agreement demonstrated that KKR controlled the day-to-day operations of Holdings, the complaint did not contain facts sufficient to support a reasonable inference that KKR controlled the Holdings board and was able to prevent the Holdings board from exercising its independent judgment when deciding whether or not to approve the merger agreement.<sup>6</sup>

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\* Ms. McCormick is a partner in Mr. Kirshenbaum is associated with the Corporate Counseling and Litigation Section of Young Conaway Stargatt & Taylor, LLP. The authors express their gratitude to members of their firm who assisted with this article, including Emily V. Burton, James M. Yoch, and Meryem Y. Dede.

1. 125 A.3d 304 (Del. 2015).
2. *Id.* at 306.
3. In re KKR Fin. Hldgs. LLC S’holder Litig., 101 A.3d 980, 990 (Del. Ch. 2014) (Bouchard, C.), *aff’d sub nom.* *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304 (Del. Ch. 2015).
4. *Id.*
5. *Id.* at 993.
6. *Id.* at 995.

On appeal, the plaintiffs challenged the Court of Chancery's ruling that KKR was not a controlling stockholder.<sup>7</sup> The plaintiffs further contended that even if KKR was not a controlling stockholder and thus the entire fairness standard did not apply, the Court erred in not applying enhanced scrutiny review under *Revlon* to the actions of the target directors.<sup>8</sup>

The Supreme Court affirmed. Respecting the Court of Chancery's ruling that KKR was not a controlling stockholder, the Supreme Court adopted the Court of Chancery's "well-reasoned opinion," and observed that "the Chancellor correctly applied the law and we see no reason to repeat his lucid analysis of the question."<sup>9</sup>

In rejecting the plaintiffs' argument that the Court of Chancery erred in not evaluating the actions of the target's board under *Revlon* and *Unocal*, the Court observed that *Revlon* and *Unocal* doctrines were intended to allow for pre-closing injunctive relief in merger transactions, not post-closing monetary relief.<sup>10</sup> In reaching this conclusion, the Supreme Court focused on the effect of a fully informed, uncoerced stockholder vote, explaining that where the entire fairness standard does not apply, it is the "long-standing policy" of Delaware law "to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic measures of a transaction for themselves."<sup>11</sup> The Court reasoned that "there is little utility to having [judges] second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders)."<sup>12</sup> The Supreme Court concluded that in such cases "the business judgment standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form."<sup>13</sup> The Supreme Court also agreed with the Court of Chancery's view that *Gantler v. Stevens*,<sup>14</sup> a case in which the Supreme Court held that a stockholder vote can ratify certain transactions only when the vote is not statutorily required, stands for the limited question of whether the doctrine of "ratification" applies only to a voluntary stockholder vote.<sup>15</sup> *Gantler*, the Court observed, was not intended to overrule Delaware law giving "standard of review-invoking effect to a fully informed vote of the disinterested stockholders."<sup>16</sup>

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7. *Corwin*, 125 A.3d at 308.

8. *Id.*

9. *Id.*

10. *Id.* at 312.

11. *Id.* at 312-13.

12. *Id.* at 313-14.

13. *Id.* at 313.

14. 965 A.2d 695 (Del. 2009).

15. 125 A.3d 304, 309-311 & n.20 (citing J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 20 WM. MITCHELL L. REV. 1443 (2014)).

16. *Corwin*, 125 A.3d at 309 n.19.

## B. Controlling Stockholder Liability

In *In re Dole Food Co., Inc. Stockholder Litigation*,<sup>17</sup> the Court of Chancery held that a merger conditioned on both the approval of an independent special committee and the vote of the majority of minority stockholders was not entirely fair because the controlling stockholder undermined the special committee process.

*Dole* involved a controlling stockholder transaction in which David H. Murdock, the owner of approximately 40% of the common stock of Dole Food Company Inc. (“Dole”), purchased Dole’s outstanding common stock for \$13.50 per share.<sup>18</sup> Aspects of the process leading to the transaction led the Court to conclude that Murdock and Dole officers engaged in fraud that culminated in the \$13.50 per share deal. For example, the Court held that, while Deutsche Bank AG (“Deutsche Bank”) was acting as Dole’s financial advisor in the strategic review process, it also held private discussions with Murdock about a freeze-out transaction in which Murdock would acquire Dole’s outstanding common shares.<sup>19</sup> The Court observed that “Deutsche Bank should not have been secretly helping Murdock plan to acquire Dole” while it was simultaneously advising the board.<sup>20</sup> The Court also held that Dole’s management publicly announced downward revisions to Dole’s earnings estimates to depress the trading price of Dole’s stock,<sup>21</sup> and opposed and ultimately thwarted an open-market share repurchase program that could result in a price appreciation potentially detrimental to a take-private transaction.<sup>22</sup> Notably, although the board formed an independent committee to consider Murdock’s offer,<sup>23</sup> the Court held that Dole’s controller and management were involved in the committee’s affairs, by, among other measures, attempting to limit the scope of the committee’s authority, retaining control over the terms of nondisclosure agreements with other potential bidders, and objecting to the committee’s choice of advisors.<sup>24</sup> The Court also found that management provided false financial information to the committee, which left the committee uninformed when agreeing to the \$13.50 per share price.<sup>25</sup>

Ultimately, the Court held that the merger was not entirely fair because it was not a product of fair dealing.<sup>26</sup> The Court explained that fraud by Dole’s controlling stockholder and management “rendered useless and ineffective the highly commendable efforts of the [c]ommittee and its advisors to negotiate a fair transaction that they subjectively believed was

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17. 2015 Del. Ch. LEXIS 223 (Del. Ch. Aug. 27, 2015) (Laster, V.C.).

18. *Id.* at \*2.

19. *Id.* at \*27.

20. *Id.* at \*27.

21. *Id.* at \*34-35.

22. *Id.* at \*40.

23. *Id.*

24. *Id.* at \*53-55.

25. *Id.* at \*80.

26. *Id.* at \*85.

in the best interests of Dole's stockholders."<sup>27</sup> The Court also raised an issue with the merger price, explaining that while \$13.50 per share was within the range of reasonableness it was likely within the lower end of the range when accounting for management's fraud.<sup>28</sup> The Court therefore concluded that the plaintiffs were entitled under the circumstances "to a 'fairer' price."<sup>29</sup>

In addressing the issue of damages, the Court held that the controller and a Dole officer were personally liable to the plaintiffs for breaching their duty of loyalty.<sup>30</sup> The Court concluded that the resulting damages from their efforts to drive down the market price and their fraud during negotiations reduced the ultimate deal price by 16.9%, or \$2.74 per share.<sup>31</sup>

In addition, as a combined entire fairness and appraisal proceeding, *Dole* also involved appraisal claimants seeking the fair value of their shares. But in its post-trial opinion, the Court declined to independently assess fair value, concluding that "the damages award potentially renders the appraisal claim moot."<sup>32</sup>

On February 10, 2016, the Court of Chancery approved a settlement agreement under which Murdock paid to the class plaintiffs and appraisal petitioners a sum equivalent to the damages (including interest) for which the Court of Chancery found the defendants liable in its post-trial opinion.<sup>33</sup>

### C. Financial Advisor Liability

In *RBC Capital Markets, LLC v. Jervis*,<sup>34</sup> the Delaware Supreme Court affirmed several post-trial decisions by the Delaware Court of Chancery involving the liability of a banker for aiding and abetting breaches of the duty of care by a board of directors. Most significantly, the Supreme Court confirmed that RBC Capital Markets, LLC ("RBC") was liable to the shareholders of Rural Metro Corp. ("Rural") for nearly \$76 million because RBC had aided and abetted

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27. *Id.* at \*85-86.

28. *Id.* at \*112.

29. *Id.* at \*124.

30. *Id.* at \*127-29.

31. *Id.* at \*155.

32. *Id.* at \*156-57. The decision by the Court to forgo an independent analysis of fair value was premised on the petitioners' ability to obtain damages from the controller and management defendants. In concluding that the appraisal claims are "potentially ... moot," the Court reasoned: "The appraisal proceeding could regain its relevance ... if the appraisal claimants did not receive complete relief from Murdock, Carter, and DFC Holdings, at which point they would have reason to proceed against Dole. But because Dole is owned indirectly by Murdock through DFC Holdings, a separate remedy against Dole may not have incremental utility." *Id.* at \*157. The Court further reasoned that the issue might be academic because the merger subsidiary is liable to the same degree as the controller under *In re Emerging Communications, Inc. Shareholders Litigation*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004). This aspect of the Court's opinion—and the implicit message that the statutory right to demand appraisal could be left unresolved as moot—invites commentary beyond the scope of this article.

33. *In re Dole Food Co., Inc. S'holder Litig.*, C.A. No. 8703-VCL (Del. Ch. Feb. 10, 2016) (ORDER) (Laster, V.C.).

34. 2015 Del. LEXIS 629 (Del. Nov. 30, 2015), *aff'g* *In re Rural Metro Corp. S'holder Litig.*, 88 A.3d 54 (Del. Ch. 2014) (post-trial opinion concerning liability), 102 A.3d 205 (Del. Ch. 2014) (damages opinion).

the Rural board of directors' breach of fiduciary duty by interfering with and exploiting RBC's own interests in a 2011 sales process.<sup>35</sup> In so holding, the Supreme Court affirmed that the Rural board's *Revlon* duties had been triggered by the special committee's unauthorized decision to hire RBC to sell the company and that RBC knowingly aided and abetted the board's breach under *Revlon*.<sup>36</sup> The Delaware Supreme Court also affirmed the Court of Chancery's decision to reject RBC's efforts to claim settlement contribution from the defendants' adjudicated joint tortfeasors, who qualified for protection under Rural's 102(b)(7) exculpation from liability.<sup>37</sup>

*RBC Capital* arose from Rural's June 2011 merger with an affiliate of Warburg Pincus LLC ("Warburg").<sup>38</sup> Dissenting stockholders of Rural filed suit, alleging that the Rural board breached its fiduciary duties by (i) failing to conduct a reasonable sales process, and (ii) failing to disclose material information in Rural's definitive proxy statement.<sup>39</sup> The plaintiffs also alleged that the Rural board's financial advisors, RBC and Moelis & Company LLC ("Moelis"), aided and abetted the Rural board's breaches of fiduciary duties. The Rural directors and Moelis settled before trial.<sup>40</sup> Thus, RBC was the sole defendant at trial.

At trial, the plaintiffs proved the following: In December 2010, RBC was aware that both Rural and Emergency Medical Services Corporation ("EMS"), Rural's largest competitor, were interested in being acquired.<sup>41</sup> RBC saw an opportunity to use its position as a sell-side advisor for Rural to secure a buy-side role with other firms bidding for EMS. RBC pursued this opportunity and became Rural's sell-side financial advisor, but did not disclose its plans to use this position to procure financing work from the bidders for EMS.<sup>42</sup> RBC commenced the sales process on the instructions of one Rural director and without the full Rural board's approval. Soon after the sales process began, problems arose.<sup>43</sup> Because RBC had timed the Rural sales process to run in parallel with the EMS sales process, many of the financial sponsors who participated in the EMS process were conflicted from considering Rural due to confidentiality restrictions.<sup>44</sup> These conflicts ultimately resulted in Warburg being the only bidder for Rural. Based on these facts, the Court of Chancery held that the Rural board had breached its duty of care and that RBC had knowingly participated in such a breach.<sup>45</sup> On October 10, 2014, the Court of Chancery issued its opinion on damages.<sup>46</sup> In that opinion the Court determined that Rural was

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35. 2015 Del. LEXIS 629, at \*129-130.

36. *Id.* at \*75-98.

37. *Id.* at \*139-146.

38. *Id.* at \*1.

39. *Id.* at \*4.

40. *Id.* at \*6.

41. *Id.* at \*17.

42. *Id.* at \*18-23.

43. *Id.* at \*79.

44. *Id.* at \*25.

45. *Id.* at \*38-39.

46. 102 A.3d 205 (Del. Ch. 2014).

worth \$21.42 per share at the time of its sale to Warburg.<sup>47</sup> As such, the plaintiffs were entitled to total damages of \$91.3 million.<sup>48</sup> The Court allocated \$75.8 million of liability to RBC, representing 83% of the total damages award.<sup>49</sup>

RBC appealed the decisions below on several grounds.<sup>50</sup> RBC challenged the Court of Chancery's determination that Rural's board breached its duty of care under *Revlon* scrutiny and violated their fiduciary duty of disclosure by making material misstatements and omissions in Rural's proxy statement.<sup>51</sup> RBC also challenged the Court of Chancery's imposition of aiding and abetting liability on RBC for the board's alleged breaches of fiduciary duties. RBC disputed the Court of Chancery's assessment of proximate cause on damages, the general calculation of damages, and appealed the Court of Chancery's application of the Delaware Uniform Contributions Among Tortfeasors Act ("DUCATA").<sup>52</sup>

The Delaware Supreme Court affirmed and held that the board breached their duty of care under enhanced *Revlon* scrutiny.<sup>53</sup> Since both parties agreed that *Revlon* applied at some point, the dispute only centered on when *Revlon* was triggered, either in December 2010 or a later time.<sup>54</sup> RBC's argument that business judgment review should apply to a search for strategic alternatives in December 2010 was rejected based on the Court of Chancery's finding that no exploration of strategic alternatives actually took place.<sup>55</sup> Communications within RBC indicated that RBC believed it had been hired to sell Rural in the December 2010 timeframe.<sup>56</sup> Even in light of some evidence that the board had not "completely abandoned" other alternatives, the record contained sufficient facts showing one director (Shackleton) and RBC "expanded their mandate into a sale" to support the Court of Chancery's holding, making reversal inappropriate.<sup>57</sup> The Court found that Shackleton, RBC, and "ostensibly the Special Committee" initiated a sale process in December 2010 that was later ratified by the Board in March 2011.<sup>58</sup> The Court invoked a policy argument for applying *Revlon*, arguing that applying business judgment review would give the Board the benefit of a deferential standard of review during the time when their lack of oversight allowed the Special Committee and RBC to engage in a "flawed and conflict-ridden sale process."<sup>59</sup>

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47. 102 A.3d at 226.

48. *Id.* at 263.

49. *Id.*

50. 2015 Del. LEXIS 629, at \*4.

51. *Id.*

52. *Id.*

53. *Id.* at \*4-5.

54. *Id.* at \*76.

55. *Id.* at \*79.

56. *Id.* at \*78-79.

57. *Id.* at \*79.

58. *Id.* at \*83.

59. *Id.*

The Court rejected all of RBC's arguments. Third parties can be held liable for aiding and abetting breaches of fiduciary duties only upon a showing of *scienter*. Therefore, in order to impose liability, the plaintiff must convince the trial court as a factual determination that the aider and abettor had "actual or constructive knowledge that their conduct was legally improper."<sup>60</sup> The Court noted that there was ample evidence that RBC had the requisite knowledge, explaining that "RBC knowingly induced the breach by exploiting its own conflicted interests to the detriment of Rural and by creating an informational vacuum."<sup>61</sup> Specifically, RBC failed to disclose to Rural's board that it was actively trying to leverage its engagement as Rural's advisor into a buy-side financing role for EMS.<sup>62</sup> RBC was found to have been aware of the board's lack of knowledge on valuation and financial analysis, and used that informational disadvantage for their own benefit. These failures by RBC resulted in a "poorly-timed sale at a price that was not the product of appropriate efforts to obtain the best value reasonably available[.]"<sup>63</sup> Rural's board was unaware of RBC's modifications to the relevant valuation analysis, their "back channel" communications with the buyer and an "eleventh-hour" attempt to secure some role in the buy-side financing business.<sup>64</sup> RBC's internal communications demonstrated "manifest intentionality" and evidenced their knowledge that Rural's board was operating with fragmented and misleading information.<sup>65</sup> Because there was ample evidence of RBC's knowledge, the *scienter* requirement was met, and the imposition of liability was appropriate.<sup>66</sup>

One of the most publicized aspects of the Court of Chancery's liability holding involved the characterization of the role of a financial advisor as that of a "gatekeeper."<sup>67</sup> While affirming the conclusions of the Court of Chancery, however, the Court explicitly rejected the "dictum" regarding the gatekeeper concept in a lengthy footnote.<sup>68</sup> The Court recognized that the financial advisor relationship is often contractual in nature, based upon an engagement letter negotiated at arms-length between sophisticated parties.<sup>69</sup> The Court held that absent substantial factual findings of *scienter*, a failure by a financial advisor to *prevent* a breach of the fiduciary duty of care by directors would not automatically give rise to an aiding and abetting claim.<sup>70</sup>

The Supreme Court also rejected RBC's challenge to the Court of Chancery's conclusion that Rural's exculpatory charter provision precluded contribution from the directors who breached their fiduciary duty.<sup>71</sup> Exculpation under

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60. *Id.* at \*110.

61. *Id.* at \*111.

62. *Id.*

63. *Id.* at \*112.

64. *Id.* at \*68, \*111.

65. *Id.* at \*112-113.

66. *Id.*

67. *Id.* at \*118-119 n.191.

68. *Id.* at \*119.

69. *Id.*

70. *Id.*

71. *Id.* at \*139-146.

102(b)(7) is inapplicable to third parties, the Supreme Court affirmed.<sup>72</sup> Application of an opposite rule could, according to the Court, “create a perverse incentive system wherein trusted advisors to directors could, for their own selfish motives, intentionally mislead a board only to hide behind their victim’s liability shield when stockholders or the corporation seeks retribution for the wrongdoing.”<sup>73</sup> Further, the Court of Chancery held that to lower their proportionate liability, third parties facing joint tortfeasor liability under DUCATA are required to prove that the directors would not have been exculpated. RBC challenged the effect of the interplay between 102(b)(7) and DUCATA. They argued that stockholders who voted for exculpation clauses should not be permitted to, effectively, shift monetary liability from fiduciaries who were “primarily liable” (though statutorily immunized under 102(b)(7)) to third parties who are neither fiduciaries nor immunized from liability.<sup>74</sup> This interpretation of DUCATA, they argued, caused financial advisors to shoulder a disproportionate risk of liability.<sup>75</sup> The Supreme Court held there was no error committed by the Court of Chancery in determining that RBC bore the burden of proving that Rural’s directors would not have been exculpated, and but for the settlement of their claims, would have shared a common liability to the stockholder class.<sup>76</sup> Further, the two directors who were not exculpated were allocated liability under DUCATA.<sup>77</sup> The holding below did not violate principles of equity because the Court of Chancery found that RBC was responsible for a disproportionate amount of fault.<sup>78</sup> Moreover, even if RBC had acted in a grossly negligent way, they would not have been held liable as an aider and abettor.<sup>79</sup> Rather, the imposition of liability required *scienter*, a significantly difficult state of mind to prove.<sup>80</sup>

#### **D. Pre-Trial Dismissal Of Independent Directors On The Basis Of Exculpatory Charter Provisions**

As discussed in *Key Decisions of 2014 in Delaware Corporate and Alternative Entity Law*,<sup>81</sup> in 2015, the Delaware Supreme Court overruled the Court of Chancery’s decision in *In re Cornerstone Therapeutics, Inc. Shareholder Litig.*, holding that even when the challenged transaction is subject to entire fairness review, exculpated claims against directors protected by exculpatory charter provisions may be resolved before trial, saving the directors the burden of litigation.<sup>82</sup>

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72. *Id.* at \*143.

73. *Id.*

74. *Id.* at \*143-144.

75. *Id.* at \*144.

76. *Id.*

77. *Id.* at \*145.

78. *Id.*

79. *Id.*

80. *Id.*

81. 16 DEL. L. REV. 1, 65-68 (2016).

82. 115 A.3d 1173, 1176 (Del. 2015), *overruling* 2014 Del. Ch. LEXIS 170 (Del. Ch. Sept. 10, 2014) (Glasscock, V.C.).

## E. Appraisal Under 8 DEL. C. § 262

### 1. Statutory Requirements For Pursuing Appraisal Concerning Continuous Stock Ownership And Share-Tracing

In *In re Appraisal of Dell Inc.*,<sup>83</sup> the Court of Chancery clarified the continuous ownership requirement of 8 *Del. C.* § 262(a) with respect to beneficial owners of stock.

*Dell* involved the going-private merger of Dell Inc. (“Dell”) in which each publically held share of Dell would be converted into the right to receive \$13.75 in cash.<sup>84</sup> Five institutions who were Dell stockholders (the “Funds”) sought appraisal of their stock.<sup>85</sup> The Funds did not hold legal title to their stock but instead owned the stock indirectly through accounts at custodial banks.<sup>86</sup> The custodial banks were participating members of The Depository Trust Company (“DTC”), commonly known as Cede & Co. (“Cede”), which was the record owner of the stock.<sup>87</sup>

Under Section 262, the word “stockholder” means the record holders of stock—here, Cede—and one of the statutory requirements is that the stockholder pursuing appraisal must “continuously hold[] such shares through the effective date of the merger.”<sup>88</sup> Thus, the statute required Cede to continuously hold its stock through the date of the merger in order for the Funds to pursue appraisal.

By operation of the custodial bank’s internal protocol, however, and through no fault of the Funds, this did not occur. After the Funds caused Cede to demand appraisal, DTC moved a corresponding number of shares out of a fast automated securities transfer account, an electronic book entry system that tracks the number of shares of stock that each participant owns, by directing Dell’s transfer agent to issue uniquely numbered certificates.<sup>89</sup> The transfer agent issued paper stock certificates in Cede’s name for the shares owned beneficially by the Funds.<sup>90</sup> Because DTC does not act as a custodian of paper stock certificates for its participating members, however, DTC made arrangements to deliver the certificates to the custodial banks.<sup>91</sup> Pursuant to their internal procedures that required any certificates to be re-registered in the names of their own nominees, the custodial banks instructed Cede to authorize the shares to be re-titled in the names of their nominees.<sup>92</sup>

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83. 2015 Del. Ch. LEXIS 184 (Del. Ch. July 13, 2015) (Laster, V.C.).

84. *Id.* at \*9.

85. *Id.*

86. *Id.* at \*10.

87. *Id.*

88. 8 DEL. C. § 262(a).

89. *Id.*

90. *Id.* at \*21.

91. *Id.*

92. *Id.* at \*22.

Dell moved for summary judgment pursuant to 8 *Del. C.* § 262(a), arguing that the record holder (Cede) did not hold their shares continuously through the effective merger date so as to enable the Funds to continue to pursue appraisal, because the stock certificates were reissued in the name of the Funds, which therefore lost their rights to appraisal.

The Court granted Dell's motion. The Court observed that Delaware precedent is clear that "it is the record holder—not the beneficial owner—that is subject to the statutory requirements for showing entitlement to appraisal and demonstrating perfection of appraisal rights" under the statute.<sup>93</sup> As a result, the Court explained that the "re-titling of a certificated share after the demand but before the effective date [of the merger] violates the Continuous Holder Requirement by causing record ownership to change."<sup>94</sup> The Court held that the "record holder" of a company's shares is the party who is listed as the owner of those shares in the stock ledger maintained by the company or its transfer agent.<sup>95</sup> As such, the Court concluded that because the legal ownership of the Funds' shares changed from Cede to the custodial banks' nominees on Dell's records as maintained by the Transfer Agent, the Funds lost their appraisal rights.<sup>96</sup> The Court held inapposite the fact that the Funds were unaware of these transfers, explaining that the Funds "assumed the risk that [their] intermediaries might act contrary to their interests."<sup>97</sup>

While the Court bemoaned this result—commenting that "[w]ere it up to me, I would hold that the concept of a 'stockholder of record' includes the custodial banks and brokers on the DTC participant list"—it was bound by Delaware precedent, which as the Court noted, could only be changed by the Delaware Supreme Court.<sup>98</sup>

In another opinion clarifying the statutory requirements for demanding appraisal under 8 *DEL. C.* § 262, *In re Appraisal of Ancestry.com, Inc.*,<sup>99</sup> the Court of Chancery explained that Section 262 does not require a stockholder who purchases shares of an acquired company after the record date of the transaction to demonstrate that the previous owners of the shares also refrained from voting in favor of the transaction.

*Ancestry* involved a cash-out transaction through which Permira Advisors ("Permira"), a private equity firm, acquired Ancestry.com ("Ancestry") for \$32 per share.<sup>100</sup> The definitive proxy for the transaction was filed on November 30, 2012, indicating a record date of November 30 and a meeting date of December 27, 2012.<sup>101</sup> Merion Capital L.P. ("Merion") began purchasing shares of Ancestry on December 4, 2012, four days after the record date, and continued purchasing shares through December 17, 2012.<sup>102</sup> On December 12, 2012, Merion's portfolio manager notified Cede &

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93. *Id.* at \*28.

94. *Id.*

95. *Id.* at \*27.

96. *Id.* at \*28.

97. *Id.* at \*32.

98. *Id.* at \*78.

99. 2015 Del. Ch. LEXIS 2 (Del. Ch. Jan. 5, 2015) (Glasscock, V.C.).

100. *Id.* at \*4.

101. *Id.*

102. *Id.* at \*5.

Co. (“Cede”), the record owner of the shares, that it would be exercising its appraisal rights.<sup>103</sup> On December 18, 2012, Cede notified Ancestry that it was asserting appraisal rights with respect to the 1,255,000 shares beneficially owned by Merion.<sup>104</sup> Merion asserted in its petition that “it did not vote in favor of the merger.”<sup>105</sup> Merion also asserted that “none of the petitioner’s shares were voted in favor of the merger,” but did not put forth any evidence to verify that those shares were not voted in favor of the merger by previous owners.<sup>106</sup>

Ancestry filed a motion for summary judgment asserting that Merion lacked standing to file a petition for appraisal. Ancestry argued that, pursuant to the 2007 amendment to Section 262(e), which allows a beneficial owner to file an appraisal petition in its own name, Merion was required to prove that it did not vote in favor of the merger.<sup>107</sup> Ancestry further argued that because Merion purchased its stock after the record date, Merion was required to prove that the previous owners of the shares did not vote in favor of the merger, which Merion was unable to prove.<sup>108</sup>

The Court rejected Ancestry’s argument. The Court explained that while the 2007 amendment to Section 262(e) allowed beneficial owners of stock to file an appraisal petition in their own name, it did not amend the standing requirement of Section 262(a).<sup>109</sup> Pursuant to Section 262(a), a petitioner need only show that the *record holder* of the stock for which appraisal is sought: (1) held those shares on the date it filed a petition for appraisal; (2) continuously held those shares through the effective date of the merger; and (3) did not vote in favor of the merger with respect to those shares.<sup>110</sup> The Court added that even if the 2007 amendment to Section 262(a) extended the requirement that an appraisal petitioner not vote in favor of the merger to the *beneficial owner*, Merion met that requirement.<sup>111</sup> The Court held that it was irrelevant that Merion could not prove that the shares were not voted in favor of the merger by the previous owner, explaining that 262(a) “focuses on the actions of the *stockholder*, not on the shares.”<sup>112</sup> The Court therefore denied Ancestry’s summary judgment motion and held that Merion had standing to bring a petition for appraisal.

The Court of Chancery reached a similar conclusion in *Merion Capital LP v. BMC Software, Inc.*<sup>113</sup> In *Merion*, the petitioners, who were beneficial owners of BMC Software, Inc. (“BMC”) shares, attempted to direct the record owner of those shares, Cede & Co. (“Cede”), to demand an appraisal.<sup>114</sup> When Cede refused, the petitioners withdrew their shares

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103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.* at \*2.

108. *Id.* at \*3.

109. *Id.* at \*21.

110. 8 DEL. C. § 262(a).

111. *Id.* at \*24.

112. *Id.*

113. 2015 Del. Ch. LEXIS 3 (Del. Ch. Jan. 5, 2015) (Glasscock, V.C).

114. *Id.* at \*4.

from the fungible mass at Cede and registered the shares with Computershare, BMC's transfer agent.<sup>115</sup> BMC argued that because the petitioners' shares were transferred from the fungible mass at Cede the petitioners were not able to say how those specific shares were voted in the merger and therefore the petitioners did not have standing to seek an appraisal.<sup>116</sup> The Court concluded that there is no such requirement under 8 DEL. C. § 262.

## 2. Cases Addressing When Merger Price As Opposed To A Discounted Cash Flow Analysis Is A More Reliable Indicator Of Fair Value

*Merion Capital v. BMC Software*<sup>117</sup> capped a series of Court of Chancery opinions that looked to the merger price, resulting from an arm's-length, thorough and informed sales process, to determine the fair value in appraisal actions. *Merion Capital* followed similar rulings in *In re Appraisal of Ancestry.com, Inc.*,<sup>118</sup> *Merlin Partners LP v. AutoInfo, Inc.*,<sup>119</sup> and *LongPath Capital, LLC v. Ramtron International Corporation*.<sup>120</sup>

As discussed above, *Ancestry* involved a cash-out transaction in which Ancestry was acquired by Permira, a private equity firm, for \$32 per share. Ancestry's board, consisting of six independent directors and three non-independent directors, began exploring strategic options in 2012.<sup>121</sup> Following a board presentation by Ancestry's financial advisory, Qatalyst Partners ("Qatalyst"), concerning Ancestry's growth prospects, the board authorized Qatalyst to engage in an auction process.<sup>122</sup> Ultimately, seven potential bidders submitted non-binding indications of interest, with the bids ranging from \$30-\$38 per share, and Ancestry invited the three highest bidders to engage in an extensive diligence process.<sup>123</sup> After conducting full diligence, Permira submitted a bid for \$31 per share, eventually raising its bid to \$32 per share.<sup>124</sup> Upon receiving a fairness opinion from Qatalyst, Ancestry's board approved the merger with Permira at \$32 per share, which represented a 41% premium over the stock price.<sup>125</sup> No topping bids emerged during the two-month period between the announcement of the merger and the closing date, despite there being a fiduciary out clause in the merger agreement.<sup>126</sup>

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115. *Id.* at \*5.

116. *Id.* at \*10 n.21.

117. 2015 Del. Ch. LEXIS 268 (Del. Ch. Oct. 21, 2015) (Glasscock, V.C.).

118. 2015 Del. Ch. LEXIS 21 (Del. Ch. Jan. 30, 2015) (Glasscock, V.C.).

119. 2015 Del. Ch. LEXIS 128 (Del. Ch. Apr. 30, 2015) (Noble, V.C.).

120. 2015 Del. Ch. LEXIS 177 (Del. Ch. June 30, 2015) (Parsons, V.C.).

121. *Ancestry*, 2015 Del. Ch. LEXIS 21, at \*8.

122. *Id.* at \*10.

123. *Id.* at \*11.

124. *Id.* at \*14.

125. *Id.* at \*16.

126. *Id.* at \*17.

The petitioners, who were beneficial owners of 1,415,000 Ancestry shares at the time of the merger date, filed an appraisal demand. Both parties' experts relied exclusively on a discounted cash flow ("DCF") analysis in reaching their respective conclusions about the fair value at the time of the merger.<sup>127</sup> The petitioners' expert relied on the average of two sets of management projections prepared in connection with the auction process in concluding that the fair value of Ancestry's stock was "at least" \$42.81 per share.<sup>128</sup> In contrast, Ancestry's expert only relied on the more recent of the two sets of management projections, which he held were more accurate because they incorporated bidder feedback.<sup>129</sup> Based on that set of projections, Ancestry's expert concluded that the fair value of Ancestry's stock was \$30.63 per share.<sup>130</sup>

The Court found each of the experts' approaches "less than fully persuasive," explaining that their approaches appeared to be "result-oriented riffs on the market price."<sup>131</sup> The Court therefore performed its own DCF analysis and arrived at a fair value of \$31.79 per share.<sup>132</sup> The Court concluded, however, that because the reliability of the inputs and management projections were questionable and because Ancestry engaged in a robust sales process, the fair value of Ancestry's stock "was best represented by the market price."<sup>133</sup> The fact that the Court's DCF valuation was close to the market price gave the Court comfort that "no undetected factor skewed the sales process."<sup>134</sup>

*Merlin* involved the sale of AutoInfo, Inc. ("AutoInfo") to Comvest Partners ("Comvest"). AutoInfo was a non-asset based transportation services company that provided brokerage and contract carrier services through a network of independent sales agents.<sup>135</sup> In 2011, believing that its stock price was depressed, AutoInfo's board, a majority of whom were independent directors, retained Stephens, Inc. ("Stephens") to reach out to potential purchasers and run a sales process.<sup>136</sup>

In early 2012, Stephens contacted 164 potential acquirers.<sup>137</sup> Approximately seventy of those bidders signed non-disclosure agreements.<sup>138</sup> Ten bidders had submitted an indication of interest, with bids ranging from \$.90-\$1.36 per share.<sup>139</sup> Of those, three bidders submitted letters of intent and two others presented verbal valuation ranges.<sup>140</sup> The

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127. *Id.* at \*26.

128. *Id.* at \*31.

129. *Id.* at \*33.

130. *Id.* at \*28.

131. *Id.* at \*57.

132. *Id.* at \*61.

133. *Id.* at \*74.

134. *Id.*

135. *Merlin*, 2015 Del. Ch. LEXIS 128, at \*1.

136. *Id.*

137. *Id.* at \*9.

138. *Id.* at \*9.

139. *Id.* at \*10.

140. *Id.*

board formed a special committee to evaluate the bids.<sup>141</sup> The special committee consisted of three outside directors and proceeded to review the bids with the assistance of a legal advisor and a financial advisor.<sup>142</sup> Initially, the special committee recommended that the board pursue the \$1.30 per share offer from HIG Capital (“HIG”),<sup>143</sup> but HIG eventually decided not to proceed with the transaction,<sup>144</sup> and the parties terminated their letter of intent and Stephens continued contacting potential acquirers.<sup>145</sup> By October 2012, four other parties submitted letters of intent or verbally indicated their interest.<sup>146</sup> Of the four, the highest offer of \$1.26 per share came from Comvest Partners (“Comvest”).<sup>147</sup> The special committee recommended to the board to pursue the Comvest offer and the board unanimously agreed.<sup>148</sup> The parties executed a letter of intent at \$1.26 per share with a thirty-day exclusivity period.<sup>149</sup>

While conducting due diligence, Comvest discovered several potential issues with AutoInfo’s business.<sup>150</sup> It also discovered the poor quality of AutoInfo’s financials. Accordingly, Comvest lowered its bid to \$0.96 per share.<sup>151</sup> The parties eventually reached an agreement at \$1.05 per share.<sup>152</sup> On April 25, 2013, AutoInfo’s stockholders approved the deal and the transaction closed on that day.<sup>153</sup> There were no topping bids between the deal’s announcement and its closing.<sup>154</sup>

The petitioners, former stockholders of AutoInfo, demanded an appraisal of their shares. The petitioners’ expert opined that AutoInfo’s fair value was \$2.60 per share.<sup>155</sup> In doing so, he placed equal weight on a DCF analysis based on AutoInfo management’s projections and two comparable companies analyses in reaching his conclusion.<sup>156</sup> On the other

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141. *Id.*

142. *Id.*

143. *Id.* at \*11.

144. *Id.* at \* 12.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at \*13.

151. *Id.*

152. *Id.* at \*16.

153. *Id.* at \*18.

154. *Id.*

155. *Id.* at \*19.

156. *Id.*

hand, AutoInfo's expert opined that AutoInfo's fair value was \$0.967 per share.<sup>157</sup> He rejected the idea that a DCF and comparable company analyses were accurate indicators of fair value based on the available data and instead concluded that the deal price, minus cost savings arising from the deal, was the best evidence of AutoInfo's fair value.<sup>158</sup>

The Court rejected the petitioners' expert's reliance on a DCF analysis.<sup>159</sup> The Court explained that while it will often give weight to management projections made in the ordinary course of business, such predictions "may be disregarded where the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, or where the projections were created for the purpose of obtaining benefits outside the company's normal course of business."<sup>160</sup> The Court observed that AutoInfo's management had never prepared projections in the normal course of business and only did so when prompted by Stephens in an effort to market the company to potential bidders.<sup>161</sup> The Court also noted that AutoInfo's management itself had doubts about its ability to accurately forecast the company's future performance, and that their projections were "indisputably optimistic."<sup>162</sup> The Court therefore concluded that if AutoInfo's management "could not have been trusted to produce credible projections in the ordinary course of business, the projections it created during the sales process deserve little deference."<sup>163</sup>

The Court also rejected the petitioners' expert's comparable analyses. The Court explained that "the utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison."<sup>164</sup> The Court held that the petitioners failed to show that the selected "comparables are truly comparable."<sup>165</sup> In so holding, the Court relied on the facts that "(i) all of the bids received by AutoInfo during the sales process implied market multiples well below [the petitioners' expert's], and (ii) AutoInfo ultimately sold, through a thorough sales process, at a price less than half of AutoInfo's comparable companies valuations."<sup>166</sup>

The Court agreed with AutoInfo's expert and held that the deal price was a reliable indication of AutoInfo's fair value at the time of the merger. The Court explained that "[w]here no comparable companies, comparable transactions, or reliable cash flow projections exist ... the merger price may be the most reliable indicator of value."<sup>167</sup> The Court added, however, that "[t]he dependability of a transaction price is only as strong as the process by which it was negotiated."<sup>168</sup>

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157. *Id.*

158. *Id.*

159. *Id.* at \*22.

160. *Id.*

161. *Id.*

162. *Id.* at \*23.

163. *Id.* at \*23-24.

164. *Id.* at \*25.

165. *Id.* at \*32.

166. *Id.*

167. *Id.*

168. *Id.*

After thoroughly analyzing the sale process, the Court determined that “AutoInfo’s process was comprehensive and nothing in the record suggests that the outcome would have been a merger price drastically below fair value.”<sup>169</sup> As such, the Court concluded that “[p]lacing heavy weight on the [deal] price is justified in light of the absence of any other reliable valuation analysis.”<sup>170</sup>

The Court did not agree with AutoInfo’s expert, however, that the deal price should be adjusted downward to account for the portion of the price that was attributable to the actual consummation of the deal. The Court agreed that “in any appraisal action, the Court must value [the petitioners’] shares exclusive of any element of value arising from the accomplishment or expectation of the merger ....”<sup>171</sup> The Court held, however, that the cost savings AutoInfo’s expert attributed to the deal were speculative and that “the record did not establish that [Comvest] had based its bid on cost savings that [AutoInfo] could not have itself realized had it continued as a going concern.”<sup>172</sup> The Court also supported its holding by explaining that “[a]llowing a near automatic reduction in price would reverse the burden that is on the party arguing that adjustments are warranted.”<sup>173</sup> The Court therefore concluded that AutoInfo’s fair value at the time of the merger was \$1.05 per share, which was the deal price.<sup>174</sup>

*LongPath Capital* involved a hostile tender offer by Cypress Semiconductor Corporation (“Cypress”) to acquire Ramtron International Corporation (“Ramtron”). After Ramtron’s board rejected Cypress’s offer of \$2.48 per share, Cypress initiated a hostile tender offer at \$2.68 per share.<sup>175</sup> Ramtron’s board recommended that Ramtron’s stockholders not tender their shares and reached out to over twenty potential buyers, without any success.<sup>176</sup> The parties eventually agreed on a transaction price of \$3.10 per share and the merger was approved by a stockholder vote.<sup>177</sup>

The stockholder petitioner, LongPath Capital LLC (“LongPath”) is an investment vehicle that began acquiring its shares in Ramtron approximately one month after the announcement of the merger.<sup>178</sup>

Both parties presented expert testimony regarding the fair value of Ramtron’s stock at the time of the merger. The petitioner’s expert opined that the fair value of Ramtron’s stock was \$4.96.<sup>179</sup> He reached this conclusion on a combination of a DCF analysis based on Ramtron management’s projections, which he weighted at 80%, and a comparable transactions analysis of two comparable transactions, which he weighted at 20%.<sup>180</sup> Ramtron’s expert opined that the fair

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169. *Id.* at \*41.

170. *Id.*

171. *Id.* at \*49.

172. *Id.* at \*51.

173. *Id.*

174. *Id.* at \*53.

175. *LongPath*, 2015 Del. Ch. LEXIS 177, at \*4.

176. *Id.* at \*24.

177. *Id.* at \*25.

178. *Id.* at \*3.

179. *Id.* at \*26.

180. *Id.*

value of Ramtron's stock at the time of the merger was \$2.76 per share.<sup>181</sup> He used the deal price to arrive at his conclusion, reasoning that the merger was a result of a fair and competitive auction process and Ramtron management's projections were overly optimistic and unreliable.<sup>182</sup>

The Court agreed that in this instance a DCF analysis was an unreliable method to determine the fair value of Ramtron's stock. The Court explained that while the law favors valuations based on management projections "because management ordinarily has the best first-hand knowledge of a company's operations," those projections can be rejected entirely when they were prepared: "(1) outside of the ordinary course of business; (2) by a management team that never before had created long-term projections; (3) by a management team with a motive to alter the projections ... and (4) when the possibility of litigation ... probably affected the neutrality of the projections."<sup>183</sup> The Court held that Ramtron management's projections suffered from each one of these issues.<sup>184</sup> The Court supported its conclusion by noting that the projections relied upon by the petitioner's expert were created by relatively new employees who utilized new methodologies as a basis for their projections.<sup>185</sup> The Court also observed that the projections were only created after Cypress issued its initial offer and not in the ordinary course of business.<sup>186</sup> Finally, the Court pointed out that the projections suggested a dramatic turnaround in the company without an explanation of the underlying changes that would justify such an improvement, which according to the Court was a "red flag."<sup>187</sup>

The Court also rejected Ramtron's expert's comparable transactions approach. The Court explained that "[r]eliance on a comparable companies or comparable transactions approach is improper where the purported 'comparables' involve significantly different products or services than the company whose appraisal is at issue, or vastly different multiples."<sup>188</sup> The Court found that Clarke's analysis suffered from this flaw.<sup>189</sup> Additionally, the Court noted that the "dearth of data points" in Clarke's comparable transaction analyses "undermines reliability of the methodology."<sup>190</sup>

The Court therefore concluded that the merger price provided the best evidence of the fair value of Ramtron's stock at the time of the merger. The Court explained that "in the situation of a proper transactional process likely to have resulted in an accurate valuation of an acquired corporation, this Court has looked to the merger price as evidence of fair value and, on occasion, given that metric one-hundred percent weight."<sup>191</sup> The Court rejected the argument that a

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181. *Id.*

182. *Id.* at \*26-27.

183. *Id.* at \*32-33.

184. *Id.* at \*33.

185. *Id.* at \*35.

186. *Id.*

187. *Id.* at \*53.

188. *Id.* at \*63-64.

189. *Id.* at \*65.

190. *Id.*

191. *Id.* at \*69.

multi-bidder auction is a prerequisite to finding that the merger price is a reliable indicator of fair value.<sup>192</sup> Instead, the Court held that “the process by which [Ramtron] was marketed to potential buyers was thorough, effective, and free from any spectre of self-interest or disloyalty” and therefore the price received from Cypress provided a reliable indication of fair value.<sup>193</sup> The Court likewise rejected the “real world” evidence asserted by the petitioner that it contended undermined the merger price as a reliable indicator of fair value, such as speculative remarks by Ramtron’s CEO during negotiations with Cypress regarding what he believed to be the true value of Ramtron and an analyst price target that was admittedly based upon inconclusive models.<sup>194</sup>

Finally, because “it is inappropriate to include merger-specific value” in an appraisal action, the Court analyzed the portion of the merger price that was attributable to Cypress-specific synergies as opposed to Ramtron’s value as a going concern.<sup>195</sup> The Court held that the net synergies were \$0.03 per share.<sup>196</sup> The Court therefore concluded that the fair value of Ramtron’s stock at the time of the merger was \$3.07 per share.<sup>197</sup>

*Merion Capital* involved a going-private transaction in which BMC Software, Inc. (“BMC”), one of the world’s largest software companies specializing in information technology management, was taken private by a consortium of investment firms, including Bain Capital, LLC, Golden Gate Private Equity, Inc., and Insight Venture Management, LLC (together, the “Buyer Group”) for \$46.25 per share.<sup>198</sup> In May 2012, Elliot Associates, L.P. and Elliot International, L.P. (together, “Elliot”) took a 5.5% stake in BMC with the intent to urge the company to pursue a sale.<sup>199</sup> Elliot commenced a proxy contest in which it proposed a slate of four directors to be elected to BMC’s board.<sup>200</sup> As part of a settlement with Elliot, BMC’s board formed a strategic committee to explore all options that would create stockholder value, including a sale.<sup>201</sup>

After months of exploring different options and contacting potential strategic buyers, BMC received expressions of interest from three buyers, among them the Buyer Group.<sup>202</sup> While the Buyer Group had not submitted the highest bid, the board accepted the Buyer Group’s offer, which included a 30-day go-shop period, after receiving a fairness opinion from its financial advisors, and recommended that BMC’s stockholders approve the merger.<sup>203</sup> During the 30-day

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192. *Id.* at \*70.

193. *Id.* at \*71.

194. *Id.* at \*88.

195. *Id.* at \*83.

196. *Id.* at \*86.

197. *Id.* at \*89.

198. 2015 Del. Ch. LEXIS 268, at \*2.

199. *Id.* at \*23.

200. *Id.*

201. *Id.* at \*24.

202. *Id.* at \*27.

203. *Id.* at \*29.

go-shop period, the board contacted both financial and strategic entities and waived any provisions pursuant to standstill agreements that would have prohibited a potential bidder from reengaging with BMC.<sup>204</sup> No alternative proposals were submitted, however, and the stockholders voted to approve the merger with the Buyer Group.<sup>205</sup>

The petitioners' expert witness relied exclusively on a DCF analysis based on BMC management's projections to reach the conclusion that the fair value of BMC's stock at the time of the merger was \$67.08 per share.<sup>206</sup> He concluded that other methodologies, such as comparable companies and comparable transaction analyses, were not appropriate given the specific facts of the case.<sup>207</sup> BMC's expert witness also relied on the same DCF analysis but concluded that the fair value of BMC's stock was \$37.88 per share.<sup>208</sup> BMC's expert held that management's projections were overly optimistic and therefore reduced the projections by 5%.<sup>209</sup> He supported this conclusion by performing a DCF analysis using projections derived from a collection of Wall Street analysts who followed BMC and a comparable companies analysis using trading multiples from selected publically-traded software companies.<sup>210</sup> The experts also used different discount rates, different long-term growth rates, and different excess cash values, among other things.<sup>211</sup>

In evaluating the issue, the Court undertook its own DCF analysis based on management projections without a 5% reduction.<sup>212</sup> The Court also used a supply side equity risk premium to calculate the discount rate, as was used by the petitioners' expert, instead of a historical equity risk premium.<sup>213</sup> After making other inputs and assumptions, the Court's DCF analysis resulted in a fair value per share price for BMC of \$48.00.<sup>214</sup>

The Court also analyzed the sales process and concluded that BMC had conducted a robust, arm's-length sales process that was sufficiently structured to develop fair value of BMC.<sup>215</sup> The Court therefore held that the merger price of \$46.25 per share was a relevant factor in determining the fair value of BMC at the time of the merger.<sup>216</sup>

The Court held that the merger price did not require any reduction for synergies in calculating fair value. The Court explained that a two-step analysis is required in determining whether to adjust the merger price to calculate fair

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204. *Id.* at \*30.

205. *Id.*

206. *Id.* at \*31.

207. *Id.*

208. *Id.*

209. *Id.* at \*34.

210. *Id.* at \*32

211. *Id.* at \*34-37.

212. *Id.* at \*42.

213. *Id.* at \*43.

214. *Id.* at \*49.

215. *Id.* at \*50.

216. *Id.* at \*57.

value: “first, were synergies realized from the deal; and if so, were they captured by sellers in the deal price?”<sup>217</sup> The Court concluded that there was no evidence that either of these factors were present in the merger.<sup>218</sup>

In weighing all relevant factors, the Court concluded that the merger price of \$46.25 per share was the best indicator of fair value of BMC’s stock at the time of the merger.<sup>219</sup> In so concluding, the Court explained that it was concerned with the reliability of its DCF valuation because of the possibility that management’s projections were overly optimistic.<sup>220</sup> The Court was also concerned about the discount rate used in its DCF analysis, “in light of a meaningful debate on the issue of using a supply side versus historical equity risk premium.”<sup>221</sup>

In contrast to the trend of relying on merger consideration as an indicator of fair price, in *Owen v. Cannon*,<sup>222</sup> the Court awarded an appraisal petitioner approximately \$16 million in post-trial damages, on management projections created in the ordinary course of business.

*Owen* involved a conflicted cash-out merger in which Nathan Owen (“Nathan”), formerly the largest stockholder of Energy Services Group (“ESG”), was cashed out for \$19.95 per share by ESG’s two other largest stockholders, Bryn Owen (“Bryn”) and Lynn Cannon. The cash-out merger was the result of significant disagreements between Nathan, on the one hand, and Bryn and Cannon, on the other hand, regarding ESG’s operations.<sup>223</sup> The merger was presented to Nathan at a specially noticed board meeting in May 2013.<sup>224</sup> At the special meeting, Bryn and Cannon voted in favor of the merger while Owen voted against it.<sup>225</sup> Bryn, Cannon, and Nathan were the only three board members.

The \$19.95 per share price was determined by Grant Thornton, whom Bryn and Cannon engaged to prepare a set of five-year financial projections for the purpose of obtaining a credit facility to consummate the buy-out.<sup>226</sup>

After the May 2013 board meeting, Nathan brought claims in the Court of Chancery against Bryn and Cannon for breach of fiduciary duty in their capacities as directors and in their capacities as controlling stockholders and simultaneously sought an appraisal of his stock.<sup>227</sup>

Both parties’ experts used a DCF analysis to arrive at their conclusions regarding the fair value of Nathan’s shares at the time of the merger.<sup>228</sup> The dispute between the parties concerned which projections should be used as a basis for

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217. *Id.* at \*63.

218. *Id.*

219. *Id.* at \*64-65.

220. *Id.* at \*64.

221. *Id.* at \*64-65.

222. 2015 Del. Ch. LEXIS 165 (Del. Ch. June 17, 2015) (Bouchard, C.).

223. *Id.* at \*18-20.

224. *Id.* at \*40.

225. *Id.* at \*42.

226. *Id.* at \*33.

227. *Id.* at \*44.

228. *Id.* at \*48-50.

the DCF analysis and what is the appropriate tax rate that should be used in the DCF analysis. Nathan's expert based her DCF analysis on the 2013 five-year projections prepared by Grant Thornton.<sup>229</sup> Nathan's expert also opined that it was appropriate to use a tax rate of 21.5% in any DCF analysis, which reflected ESG's Subchapter S status.<sup>230</sup> Nathan's expert concluded that the fair value of Nathan's stock at the time of the merger was \$39.89 per share. ESG's expert, on the other hand, created his own set of ten-year projections, which were considerably lower than the 2013 projections prepared by Grant Thornton.<sup>231</sup> ESG's expert also argued that ESG's earnings should not be tax affected due to its status as a Subchapter S corporation.<sup>232</sup>

The Court agreed that a DCF analysis was the proper methodology to determine the fair value of Nathan's shares at the time of the merger, noting that the DCF methodology "has featured prominently in this Court because it 'is the approach that merits the greatest confidence' within the financial community."<sup>233</sup> Specifically, the Court sided with the opinion of Nathan's expert that the 2013 projections were the appropriate basis for a DCF analysis. The Court held that those projections were the product of a "deliberate, iterative process over a period of three years to create, update and revise multi-year projections" for ESG.<sup>234</sup> The Court was satisfied that the 2013 projections were properly adjusted to account for contemporaneous and anticipated business developments.<sup>235</sup> The Court also found fault with the ten-year projections created by ESG's expert, explaining that they were "not reflective of management's best estimates of future performance as of the [m]erger."<sup>236</sup> The Court added that "Delaware courts are generally skeptical of projections created by an expert during litigation," and that the projections created by ESG's expert were "tainted by hindsight bias."

In addressing the appropriate tax rate to use in the DCF analysis, the Court held that Nathan "was entitled to be paid for that which has been taken from him," which, the Court explained, included the tax advantage of being a stockholder in a Subchapter S corporation.<sup>237</sup> The Court therefore agreed with Nathan's expert that ESG's earnings should be tax affected to compensate Nathan's for his being deprived of his Subchapter S taxholder status.<sup>238</sup>

Based on these assumptions, the Court concluded that the fair value of Nathan's stock at the time of the merger was \$31.94 per share.<sup>239</sup> The Court used this valuation in analyzing the entire fairness of the merger. The Court held

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229. *Id.* at \*48.

230. *Id.*

231. *Id.* at \*50.

232. *Id.* at \*51.

233. *Id.* at \*47.

234. *Id.* at \*53.

235. *Id.* at \*55.

236. *Id.* at \*61.

237. *Id.* at \*67.

238. *Id.*

239. *Id.* at \*85.

that the merger was not at a fair price nor was it the product of fair dealing.<sup>240</sup> The Court therefore awarded Nathan compensatory damages equal to the difference between the fair value of his stock at the time of the merger—\$31.94 per share—less the price per share he actually received in the merger.<sup>241</sup>

### 3. Settlement Of Appraisal Demands With Non-Appearing Stockholders

In *Mannix v. PlasmaNet, Inc.*,<sup>242</sup> the Court of Chancery addressed whether it is appropriate for a surviving corporation to settle the appraisal demands of certain stockholders on terms that are not available to other stockholders who sought appraisal.

*PlasmaNet* involved the merger of PlasmaNet, Inc. (“PlasmaNet”) and Free Lotto, Inc., with PlasmaNet being the surviving corporation. The petitioner sought appraisal of his 1,700 PlasmaNet shares.<sup>243</sup> Pursuant to 8 DEL. C. § 262(f), PlasmaNet filed a verified list of forty-eight PlasmaNet stockholders who purported to exercise their appraisal rights.<sup>244</sup> However, several of those PlasmaNet stockholders failed to file an appraisal proceeding (the “Non-Appearing Dissenters”).<sup>245</sup>

PlasmaNet entered into a settlement with the Non-Appearing Dissenters of all demands for appraisal.<sup>246</sup> Under the terms of the settlement, the Non-Appearing Dissenters were scheduled to receive a certain amount of equity in the surviving corporation.<sup>247</sup> Also pursuant to the settlement, the Non-Appearing Dissenters attested to their status as “accredited investors” as defined in the Securities Act of 1933.<sup>248</sup> PlasmaNet extended the same settlement offer to the petitioner, who rejected it, and also to all other PlasmaNet stockholders who properly demanded appraisal and who could attest to being an accredited investor.<sup>249</sup>

PlasmaNet moved to dismiss the Non-Appearing Dissenters from the proceeding. The petitioner argued, however, that the motion to dismiss should be rejected for two reasons. The petitioner first argued that the settlement with the Non-Appearing Dissenters was invalid because it was not available to all stockholders who demanded appraisal, namely, the ones who could not qualify as accredited investors.<sup>250</sup> The petitioner also argued that a settlement with only some of

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240. *Id.* at \*88-92.

241. *Id.* at \*93.

242. 2015 Del. Ch. LEXIS 190 (Del. Ch. July 21, 2015) (Bouchard, C.).

243. *Id.* at \*3.

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.* at \*4

248. *Id.*

249. *Id.*

250. *Id.* at \*6.

the PlasmaNet investors who demanded an appraisal “undermines the bedrock and fundamental principles of the appraisal statute by undercutting the economics of this appraisal proceeding.”<sup>251</sup>

The Court rejected the petitioner’s arguments. The Court explained that the concerns expressed in previous Delaware case law regarding the settlement of representative litigation do not apply in a case where the surviving corporation attempts to settle the appraisal demands of those stockholders who did not join the proceeding.<sup>252</sup> The Court compared this situation to a putative class action—where the defendant is readily permitted under the law to settle a class claim with non-representative class members—and held that “it logically follows that the surviving corporation after a merger may seek to settle the appraisal demands of non-appearing dissenters.”<sup>253</sup> The Court also commented that the fact that the proposed settlement would undercut the economics of the appraisal proceeding does not make the settlement unjust.<sup>254</sup> The Court noted that to conclude otherwise “effectively would give the [p]etitioner a settlement hold-up right not envisioned by 8 DEL. C. § 262(k), which is to be strictly construed, and would be contrary to the purpose of the Court-approval requirement of the appraisal statute.”<sup>255</sup>

## F. “Disclosure-Only” Settlements

“Disclosure-only” settlements refer to settlements of class action lawsuits challenging transactions involving public companies—typically mergers, acquisitions, recapitalizations, or other significant transactions—where the sole or primary benefit to the class achieved by the settlement is supplemental or corrected public disclosures. In addition to the agreement to provide supplemental or corrective disclosures, these settlements typically involve broad releases, extinguishing all claims against anyone involved in the challenged transaction (referred to as “intergalactic” releases by some Delaware judges),<sup>256</sup> and substantial fee awards to the plaintiffs, but no cash compensation for the class members. “Disclosure-only” settlements increased in popularity in the last decade.<sup>257</sup> Historically, the Court of Chancery has approved disclosure-only

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251. *Id.*

252. *Id.* at \*13.

253. *Id.* at \*14.

254. *Id.* at \*16.

255. *Id.*

256. *Acevedo v. Aeroflex Holding Corp.*, C.A. No. 9730-VCL, at 62:17-63:6 (Del. Ch. July 8, 2015) (Laster, V.C.) (TRANSCRIPT) (“*Acevedo* 7/8/15 Tr.”) (“The main component of these settlements are the following: First, the defendants, defined broadly to encompass anyone having anything to do with the transaction, get a broad class-wide release that extinguishes all claims against them. Not only all claims that were asserted in the litigation but all claims arising out of or relating to any of the facts an issues that were in the litigation or in the complaint or in the documents referenced in it. And it usually goes on much further than that. Since the complaint is based on a proxy statement ant the public filings related to the deal, that is a truly expansive scope of relief. Our Chief Justice has appropriately described those types of releases as ‘intergalactic.’”).

257. *In re Trulia, Inc. S’holder Litig.*, 2016 Del. Ch. LEXIS 8, at \*24 (Del. Ch. Jan. 22, 2016) (Bouchard, C.) (“In Delaware, the percentage of such cases settled solely on the basis of supplemental disclosures grew significant from 45.4% in 2005 to a high of 76% in 2012, and only recently has seen some decline.” (citing Matthew D. Cain & Steven Davidoff Solomon, *Takeover Litigation in 2014* 2 (Jan. 14, 2016))). Many scholars and Delaware judges view the proliferation of “disclosure only” settlements as a symptom of a problem: the fast-filing of hastily prepare complaints challenging public transactions for the purpose of generating attorneys’ fees.

settlements, even where the additional information provided is not material or of significant value to the stockholders.<sup>258</sup> Some have concluded, however, that this historical practice in fact has a deleterious effect on the stockholder franchise.<sup>259</sup> In particular, some courts have addressed the agency conflict in these types of suits—whereby the motivations of counsel for a plaintiff class may be different from the interests of the class itself, as counsel has incentive to seek quick settlement, and thus quick profit.<sup>260</sup> In 2015, the Court diverged from its historical practice, rejecting numerous disclosure-only settlements, and signaling an intent to impose a more rigorous standard on such settlements moving forward.

The first 2015 decision rejecting a class action settlement was issued in *Acevedo v. Aeroflex Holding Corp.*<sup>261</sup> In *Acevedo*, the plaintiffs challenged a cash deal subject to enhanced scrutiny where it appeared that a potentially higher bidder was being excluded from the process.<sup>262</sup> The Court observed that the complaint stated colorable claims sufficient to warrant expedited proceedings. After expedited discovery, however, the Court found that there were no conflicts tainting the process that led to the ultimate deal, and that all incentives aligned with achieving the highest deal price.<sup>263</sup> The Court thus concluded that the additional disclosures revealing the lack of conflicts were insufficient to support the broad settlement release.<sup>264</sup> The plaintiffs' counsel had also negotiated for a reduction in some of the deal protections in the challenged merger agreement, which the Court concluded were not actual impediments to a competing bid, and thus was also of little value.<sup>265</sup>

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*See, e.g., Trulia*, 2016 Del. Ch. LEXIS 8, at \*16. Defendants in such lawsuits are incentivized to settle to “achieve closing certainty” and minimize the expense and distraction of litigation, *id.* at \*16, and thus settlements seem like a “necessary evil,” *Acevedo* 7/8/15 Tr. at 64:304. Supplemental or corrective disclosures are the easiest “give” to be provided by defense groups, and thus a common way to settle such suits, *Trulia*, 2016 Del. Ch. LEXIS 8, at \*18-19, though many question whether they provide “any identifiable much less quantifiable benefit to stockholders,” *Acevedo* 7/8/15 Tr. at 65:2-4. The Court of Chancery is positioned to alleviate the perceived problems underlying disclosure-only settlements, because it has the obligation to review these settlements exercising its independent judgment to assure that the settlement is fair to absent class members. *Trulia*, 2016 Del. Ch. LEXIS 8, at \*3.

258. *Trulia*, 2016 Del. Ch. LEXIS 8, at \*23 (citing cases). *See also Acevedo* 7/8/15 Tr. at 62:12-15.

259. *Acevedo* 7/8/15 Tr. at 64:7-66:20 (observing that disclosure-only settlements contributed to the proliferation of M&A Litigation, fail to convey meaningful benefits to stockholders, undercut the credibility of the Litigation process, create disincentives for litigating meritorious claims, create blanket protections against potentially meaningful recovery, and undermine Delaware's reputation as the “honest broker in the legal realm”).

260. *See e.g., In re Riverbed Technology, Inc. S'holders Litig.*, 2015 Del. Ch. LEXIS 241 (Sept. 17, 2015).

261. C.A. No. 9730-VCL (Del. Ch. July 8, 2015) (Laster, V.C.) (TRANSCRIPT).

262. *Acevedo* 7/8/15 Tr. at 78:15-19.

263. *Id.* at 73:19-22.

264. *Id.* at 73:7-16.

265. *Id.* at 71:8-72:10.

Given the deficiencies in the settlement, the Court refused to approve the settlement as presented by the parties, but offered alternative options. As one option, the Court invited the plaintiffs to reframe their motion as a mootness dismissal, as opposed to a settlement under Court of Chancery Rule 23 achieving mutual releases of the parties, but in which the plaintiffs' counsel could argue for (and likely obtain)<sup>266</sup> fees.<sup>267</sup> Alternatively, the Court recommended that the parties revise the proposed release to tailor it more pointedly to the claims investigated through the litigation.<sup>268</sup> As a final alternative, the Court welcomed the defendants to move to dismiss the action.<sup>269</sup> Ultimately the Court granted the defendants' motion to dismiss but retained jurisdiction to consider an application for attorneys' fees by plaintiff's counsel.<sup>270</sup>

In *In re Riverbed Technologies Stockholders Litigation*, the Court of Chancery approved a disclosure-only settlement, but decreased the attorney's fees sought by the plaintiffs' counsel.<sup>271</sup> In *Riverbed*, former stockholders of a corporation challenged a cash-out merger through a class action suit, initially seeking to enjoin the merger.<sup>272</sup> The Court expedited claims challenging the disclosure of potential conflicts of interest of a financial advisor to the corporation. Ten days later, the parties agreed to proposed settlement terms.<sup>273</sup>

Although it is rare for proposed settlements like that in *Riverbed* to draw objections, after the settlement was publicly disclosed, Sean J. Griffith, a law school professor who has written about the difficulty of disclosure-only settlements bought stock in the company specifically to raise an objection.<sup>274</sup> Because the objector bought stock after the challenged transaction was announced, the plaintiffs argued that the objector lacked standing.<sup>275</sup> The Court rejected the argument, finding that despite having bought stock after the transaction and the settlement were announced, the professor nonetheless was a member of the class and therefore entitled to object.<sup>276</sup> In finding that the objector had standing, the Court dismissed concerns raised by the plaintiffs—that the Court's ruling would engender “‘professional’ objectors with nefarious strike-suit motives”—as something the Court can address by applying doctrines like unclean hands should the need arise.<sup>277</sup>

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266. *Id.* at 75:18-21.

267. *Id.* at 74:5-17.

268. *Id.* at 74:18-75:2.

269. *Id.* at 75:3-17.

270. *Acevedo v. Aeroflex Hldg. Corp.*, C.A. No. 9730-VCL (Del. Ch. Aug. 10, 2015) (ORDER).

271. *In re Riverbed Tech., Inc. Stockholders Litig.*, 2015 Del. Ch. LEXIS 241 (Del. Ch. Sept. 17, 2015) (Glasscock, V.C.).

272. *Id.* at \*3.

273. *Id.*

274. *Id.* at \*5-6.

275. *Id.*

276. *Id.* The objector was Sean J. Griffith, one of the authors of *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557 (2015).

277. 2015 Del. Ch. LEXIS 241, at \*8.

Before evaluating the fairness of the settlement, the Court canvassed agency problems inherent in the settlement process, including the interests of class representatives and class counsel,<sup>278</sup> the interests of defendants,<sup>279</sup> and the lack of an adversary at the settlement approval phase.<sup>280</sup> The Court reiterated the need to balance “the value of all claims being compromised against the value of the benefit to be conferred on the Class by the settlement.”<sup>281</sup> The Court approved the settlement, observing that the disclosures obtained—including that one of the financial advisors had existing engagements with the purchasers and their affiliates of a substantial nature—was “a positive result of small therapeutic value” but “not of great importance.”<sup>282</sup> The Court noted: “the Plaintiffs have achieved for the class a peppercorn, a positive result of small therapeutic value to the Class which can support, in my view, a settlement, *but only where what is given up is of minimal value.*”<sup>283</sup>

The Court also warned of how similar suits may be treated in the future:

I note first that, given the past practice of this Court in examining settlements of this type, the parties in good faith negotiated a remedy ... with the reasonable expectation that the very broad, but hardly unprecedented, release negotiated in return would be approved by this Court. I note that this factor, while it bears some equitable weight here, will be diminished or eliminated going forward in light of this Memorandum Opinion and other decisions of this Court.<sup>284</sup>

The Court denied the plaintiffs’ counsel’s fee request of \$500,000, although the defendants did not oppose the request, and instead awarded fees and costs of \$330,000.<sup>285</sup> The plaintiffs’ counsel argued that a number of mooted disclosures should be considered along with the disclosure by the financial institution.<sup>286</sup> The Court found the mooted disclosures to be evidence of “modest benefit,” but noted that the mooted disclosures were the result of the company’s

278. *Id.* at \*9-10 (“A plaintiff’s attorney may favor a quick settlement where the additional effort required to fully develop valuable claims on behalf of the class may not generate an additional fee as lucrative to the plaintiff’s attorney as accepting a quick and moderate fee, then pursuing other interests.”).

279. *Id.* at \*9 (“the defendants’ interest is largely subsumed within that of the successor entities’ interests, which is commonly in the consummation of the deal and the termination of any further litigation threat ... there is little incentive for the defendants to engage in further litigation threat even if the claims are weak ... and every reason to go forward to obtain via settlement ... the broadest release possible”).

280. *Id.* at \*13-14 (“In the class action arena, it falls on the Court to consider the fairness of [the settlement] exchange. The interests of the individual litigants and their counsel may not be fully aligned with the class ....”).

281. *Id.* at \*3 (quoting *In re MCA, Inc. S’holders Litig.*, 598 A.2d 687, 691 (Del. Ch.1991)).

282. *Id.* at \*18.

283. *Id.* (emphasis added).

284. *Id.* at \*6 (citing *In re Susser Hldgs. Corp. S’holder Litig.*, C.A. No. 9613-VCG (Del. Ch. Sept. 15, 2015) (Glasscock, V.C.) (TRANSCRIPT); *Acevedo 7/8/15 Tr.*; *In re Intermune, Inc., S’holder Litig.*, C.A. No. 10086-VCN (Del. Ch. Jul. 8, 2015) (Noble, V.C.) (TRANSCRIPT)).

285. 2015 Del. Ch. LEXIS 241, at \*22.

286. *Id.* at \*6-7.

definitive proxy on the merger, and that the plaintiffs had filed their suit before even a preliminary proxy had been filed.<sup>287</sup> Ultimately, the Court awarded attorneys' fees of \$200,000 for the supplemental disclosures as a direct result of litigation, \$100,000 for the mooted disclosures, and almost \$30,000 in costs.<sup>288</sup>

In *In re Aruba Networks, Inc. Stockholder Litigation*, the Court rejected a proposed settlement and dismissed the entire case with prejudice for inadequate representation by counsel.<sup>289</sup> *Aruba* involved a challenge to the acquisition of Aruba Networks by Hewlett-Packard Company.<sup>290</sup> The Court expressed doubts about the strength of the plaintiffs' claims early in the case, stating in the suit's scheduling order that plaintiffs' counsel should be prepared to explain "at oral argument why this matter should not be approached in the same manner as the Aeroflex case[.]" (thus referencing *Acevedo* discussed *supra*). The Court found several problems with the proposed settlement, and the litigation's process generally. First, the Court questioned whether the case had been meritorious when filed.<sup>291</sup> The suit was commenced before any proxy statement was filed, and thus the suit's only basis for relief was inadequate price, rather than any allegations of an ineffective process.<sup>292</sup> Second, although the plaintiffs had obtained discovery reflecting that the defendants' disclosures were materially inaccurate when made, the plaintiffs did not actively pursue remedies other than supplemental disclosures.<sup>293</sup> Third, and most importantly, the Court disapproved of the disparity between the broad release, although it carved out federal securities claims, and the benefit gained for the class.<sup>294</sup> The Court suggested that it would have supported a release of limited future claims, but could not agree to enter a settlement that had mild disclosure-only gains to the stockholder class, while giving the defendants a broad release from liability for all future derivative claims arising from the transaction.<sup>295</sup> Citing the same agency problems that earlier opinions discussed, the Court noted: "One thing we know is when people have a path to getting paid, behavior starts to reflect how one gets paid .... I am not saying anybody is consciously corrupt. The point is ... we are all imperfect and subjectively limited humans."<sup>296</sup>

In early 2016, the Court of Chancery provided its clearest guidance yet as to the Court's changing reception of disclosure-only settlements. In *In re Trulia, Inc. Stockholder Litigation*, a stockholder class challenged the merger of Zillow, Inc. and Trulia, Inc., alleging breaches of fiduciary duties of Trulia's board in approving the proposed merger at an

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287. *Id.*

288. *Id.* at \*8.

289. C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015) (Laster, V.C.) (TRANSCRIPT).

290. *Id.* at 6-8.

291. *Id.* at 59.

292. *Id.*

293. *Id.* at 60:19-62:22.

294. *Id.* at 65:1-67:10.

295. *Id.*

296. *Id.* at 69:6, 69:18-23.

unfair exchange ratio.<sup>297</sup> After four months of discovery, the parties reached an agreement-in-principle to settle, detailed in a memorandum of understanding, and sought court approval of their proposed settlement.<sup>298</sup>

The Court rejected the settlement and, in doing so, signaled the Court's commitment to a harsher approach in evaluating disclosure-only settlements, affirming a new-found stance:

[P]racticitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a *plainly material* misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently.<sup>299</sup>

The Court further defined "plainly material," stating that "it should not be a close call that the supplemental information is material[.]"<sup>300</sup> In sum, after *Trulia*, practitioners should expect any settlements involving disclosure-only benefits to shareholders to be unsuccessful unless they both, 1) contain "narrowly circumscribed" releases, tailored to specific claims investigated in the litigation; and 2) the disclosures, themselves address "plainly material" misrepresentations or omissions.

The *Trulia* settlement did not meet this standard, the Court concluded. The Court held that Trulia's disclosures provided a "more-than-fair summary" of the information contained in its releases, and from the perspective of the Trulia's stockholders, "the 'get' in the form of the Supplemental Disclosures does not provide adequate consideration to warrant the 'give' of providing a release of claims to defendants and their affiliates in the form submitted or otherwise."<sup>301</sup> Importantly, the proposed settlement would release all "unknown 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."<sup>302</sup> The Court denied the settlement, holding that the supplemental disclosures had not been "material or even helpful to Trulia's stockholders."<sup>303</sup>

The Court also discussed the history and proliferation of disclosure-only suits at length, finding that "far too often such litigation serves no useful purpose for stockholders. Instead, it serves only to generate fees for certain lawyers

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297. 2016 Del. Ch. LEXIS 8 (Del. Ch. Jan. 22, 2016) (Bouchard, C.). For earlier statements by Chancellor Bouchard on disclosure-only suits, see *In re TW Telecom, Inc. S'holders Litig.*, C.A. No. 9845-CB (Del. Ch. Aug. 20, 2015) (TRANSCRIPT), where the Chancellor questioned, but ultimately approved, a settlement containing broad releases of unknown claims for supplemental disclosures and a reduced matching rights period. The Chancellor stated, "So any time any member of the plaintiffs' bar walks in here to make one of these settlements, you better be ready to explain why things really matter in the real world. Not just some abstract 'more information is always better,' but why something really matters in the real world. Because I have a high degree of skepticism." The Chancellor reduced the requested fees to \$150,00 (less than 40% of plaintiff's request).

298. *Id.* at \*2.

299. *Id.* at \*35 (emphasis added).

300. *Id.* at \*35-36.

301. *Id.* at \*59-60.

302. *Id.* at \*10 (emphasis added).

303. *Id.* at \*3.

who are regular players in the enterprise[.]”<sup>304</sup> Touching on agency concerns once again, the Court described how after striking an agreement-in-principle to settle, both plaintiffs and defendants “share the same interest in obtaining the Court’s approval of the settlement[.]” and thus the litigation becomes “non-adversarial[.]”<sup>305</sup>

## II. DERIVATIVE LITIGATION

### A. Creditor Standing To Bring Derivative Claims

In *Quadrant Structured Products Company, LTD v. Vertin*,<sup>306</sup> the Court of Chancery provided further guidance concerning creditor standing to bring derivative claims on behalf of insolvent corporations.

*Quadrant* involved a motion for summary judgment filed by the board of Athilon Capital Corp. (“Athilon”) seeking dismissal of derivative claims brought against them by the holder of Athilon’s senior debt securities, Quadrant Structured Products Company, Ltd. (“Quadrant”).<sup>307</sup> The board argued that Quadrant lacked standing to bring derivative claims on behalf of Athilon, contending that for a creditor to have derivative standing, the company on whose behalf the creditor sues must be insolvent at the time of suit and continuously thereafter.<sup>308</sup>

Acknowledging that the issue was one of “first impression,” the Court denied the motion and held that there is no continuous insolvency requirement for creditors to have standing to bring derivative claims.<sup>309</sup> If a creditor can show that the company was insolvent at the date the suit was brought, a creditor has standing, so long as it remains a creditor, even if the company regains solvency during the pendency of the lawsuit.<sup>310</sup> In addition, the Court affirmed the use of the balance sheet test for determining whether a company is insolvent for the purpose of determining creditor standing.<sup>311</sup> In doing so, it rejected the argument that the “irretrievable insolvency” test (which is required for the appointment of a receiver) should be used to determine creditor standing to bring a derivative claim.<sup>312</sup>

The Court also provided guidance on the often murky issue of creditor standing to bring derivative claims.<sup>313</sup> In a thorough and clear review of the creditor derivative cases of the last decade,<sup>314</sup> the Court suggested that the actual

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304. *Id.* at \*16.

305. *Id.* at \*19.

306. 115 A.3d 535 (Del. Ch. 2015) (Laster, V.C.).

307. *Id.* at 539.

308. *Id.*

309. *Id.* at 544, 548-556.

310. *Id.* at 548-556.

311. *Id.* at 556-561.

312. *Id.*

313. 102 A.3d 155, 177 (Del. Ch. 2014) (Laster, V.C.).

314. 115 A.3d at 545-556 (discussing the Delaware law concerning creditor standing to pursue derivative claims before and after *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007)).

claims that creditors can successfully pursue are, as a practical matter, quite narrow—in essence breaches of the duty of loyalty through self-interested transactions and waste claims.<sup>315</sup>

## B. Pleading Demand Futility

In *Delaware County Employees Retirement Fund v. Sanchez*,<sup>316</sup> the Delaware Supreme Court articulated the standard a plaintiff must meet when pleading demand excusal under *Aronson v. Lewis*<sup>317</sup> on the basis that the directors are not disinterested and independent. In reversing the Court of Chancery, the Supreme Court held that a trial court must consider all facts pled by the plaintiff regarding the directors' lack of disinterestedness and independence in their totality and draw all reasonable references in favor of the plaintiff.

*Sanchez* involved a transaction in which Sanchez Energy Corporation (“Sanchez Energy”) purchased a partial working interest in 40,000 acres of undeveloped land from Sanchez Resources, LLC (“Sanchez Resources”), a private company whose equity was wholly owned by the family of A.R. Sanchez, Jr.<sup>318</sup> Members of the Sanchez family stood on both sides of the transaction—owning Sanchez Resources outright, and having a significant 21.5% stake in Sanchez Energy. Two Sanchez family members also sat on the Sanchez Energy board.<sup>319</sup> The other three board members acted as the audit committee, which was created for the purpose of evaluating and approving interested-party transactions between Sanchez Energy and Sanchez family members.<sup>320</sup> The independent audit committee members, assisted by a financial advisor, approved the transaction with Sanchez Resources.<sup>321</sup>

Stockholder plaintiffs filed a derivative action alleging a breach of fiduciary duty claim against all of the directors for approving the transaction. The plaintiffs did not make a pre-suit demand, arguing that such a demand was futile under the first prong of the *Aronson* test because two of the three members of the audit committee lacked independence from the Sanchez family.<sup>322</sup> In *Aronson*, the Supreme Court held that a plaintiff who has not made a demand on the board must plead allegations raising a reasonable doubt that “(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”<sup>323</sup> The plaintiff primarily based their argument on allegations that one of the audit committee members, Jackson, had donated to a Sanchez family member’s political campaign and maintained a close friendship with the Sanchez patriarch “for more than five decades.”<sup>324</sup> The plaintiff also noted that Jackson had several other business relationships with the Sanchez family.

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315. 115 A.3d at 554.

316. 124 A.3d 1017 (Del. 2015), *aff'g* 2014 Del. Ch. LEXIS 239 (Del. Ch. Nov. 25, 2014) (Glasscock, V.C.).

317. 473 A.2d 805 (Del. 1984).

318. 2014 Del. Ch. LEXIS 239, at \*6.

319. *Id.* at \*3.

320. *Id.* at \*7.

321. *Id.*

322. *Sanchez*, 2014 Del. Ch. LEXIS 239, at \*8.

323. *Aronson*, 473 A.2d at 814.

324. *Sanchez*, 2014 Del. Ch. LEXIS 239, at \*16.

The Court of Chancery dismissed the complaint, finding the plaintiffs' allegations wholly insufficient bases upon which to reasonably infer that either Jackson or Garcia lacked independence from the Sanchez family.<sup>325</sup> In doing so, the Court of Chancery analyzed Jackson's friendship with the Sanchez family and his business relationships with the Sanchez family as two distinct issues, ultimately concluding that each one on its own did not support the inference that Jackson could not act independently of the Sanchez board members for the purpose of demand excusal.<sup>326</sup>

The Supreme Court disagreed with the Court of Chancery's approach. The Supreme Court explained that Delaware law "requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence."<sup>327</sup> The Supreme Court added that the court is required to draw all inferences from those facts in favor of the plaintiff at the pleading stage.<sup>328</sup>

In applying that standard, the Supreme Court held that the plaintiffs had pled sufficient facts to show "that there is a reasonable doubt that Jackson can act impartially in a matter of economic importance to Sanchez personally."<sup>329</sup> The Supreme Court distinguished the facts of the case from the facts in *Beam v. Stewart*,<sup>330</sup>—a seminal case in which the Supreme Court held that allegations that the directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,'" were insufficient to plead demand excusal—explaining that the plaintiffs "did not plead the kind of thin social-circle relationship" that was at issue in that case.<sup>331</sup> Instead, the Supreme Court concluded that the plaintiffs had pled facts regarding the economic relationship between Jackson and Sanchez "that buttress their contention that they are confidantes."<sup>332</sup>

### C. Collateral Estoppel And *Res Judicata* Effect Of Dismissal Due To A Failure To Plead Demand Excusal

In *City of Providence v. Dimon*,<sup>333</sup> and *Asbestos Workers Local 42 Pension Fund v. Bammann*,<sup>334</sup> the Court of Chancery applied the full faith and credit doctrine and holding of *Pyott v. La. Municipal Police Employees' Retirement System*,<sup>335</sup> to dismiss claims previously dismissed in a prior New York actions for failure to plead demand futility.

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325. *Id.* at \*21.

326. *Id.*

327. 124 A.3d at 1022.

328. *Id.*

329. *Id.*

330. 845 A.2d 1040.

331. *Sanchez*, 124 A.3d at 1022.

332. *Id.*

333. 2015 Del. Ch. LEXIS 195 (Del. Ch. July 29, 2015) (Parsons, V.C.), *aff'd* 2016 Del. LEXIS 98 (Del. Feb. 25, 2016).

334. 2015 Del. Ch. LEXIS 142 (Del. Ch. May 21, 2015) (Glasscock, V.C.), *aff'd* 2016 Del. LEXIS 40 (Del. Jan. 28, 2016).

335. 74 A.3d 612, 615 (Del. 2013).

In *City of Providence*, the plaintiffs filed suit derivatively on behalf of JPMorgan Chase & Co. (“JPMorgan”) seeking to hold the company’s board and officers liable for over \$2 billion lost through a series of settlements and consent orders relating to alleged violations of federal anti-money laundering statutes and regulations, some of which arose from the Maddoff Ponzi schemes.<sup>336</sup> In *Asbestos Workers*, the plaintiffs sued derivatively on behalf of JPMorgan, seeking to hold the company’s board accountable for approximately \$6.3 billion in damages caused in 2012 as a result of complex, high-risk trading by the Chief Investment Officer, nicknamed the “London whale.”<sup>337</sup>

In both cases, the defendants moved to dismiss the lawsuit, arguing that principles of collateral estoppel and *res judicata* barred the claims because a prior lawsuit in New York federal and state courts arising out of the same series of transactions was dismissed for failure to plead demand futility.<sup>338</sup> In both cases, the Court of Chancery granted the defendants’ dismissal motion, albeit under different theories. In *City of Providence*, the Court concluded that because *res judicata* barred the Delaware litigation from proceeding forward, the Court need not analyze whether collateral estoppel likewise precluded the lawsuit.<sup>339</sup> In *Asbestos Workers*, the opposite result was reached—the Court dismissed the case under theories of collateral estoppel, and reasoned that the Court need not analyze whether *res judicata* precluded the lawsuit.<sup>340</sup>

In *City of Providence*, the Court observed that under Delaware law applying the *Full Faith and Credit Clause of the United States Constitution* and the Full Faith and Credit Act, “once a court of competent jurisdiction has issued a final judgment, a successive case is governed, under the full faith and credit doctrine, by the principles of collateral estoppel and *res judicata* rather than by demand futility law.”<sup>341</sup> The Court applied New York law to analyze the *res judicata* argument. Under New York *res judicata* law, a party may not re-litigate a claim from a prior action between the same parties involving the same subject matter.<sup>342</sup> The Court also observed that, under New York law, “a later stockholder asserting derivative claims on behalf of a corporation is considered to be the ‘same plaintiff’ as a different stockholder asserting those claims on behalf of the corporation in a separate action.”<sup>343</sup> Thus, the critical question in *City of Providence* was whether the prior action involved the same subject matter. New York applies a transactional analysis to this question, such that “once a claim is brought to a final conclusion, all other claims arising out of the same transaction or series of transactions are barred, even if based upon different theories or if seeking a different remedy.”<sup>344</sup> The Court concluded that because the deferred prosecution agreement that was the focal point of the prior action was also the centerpiece of the settlements and consent orders challenged in the Delaware lawsuit, the transactional analysis was satisfied.<sup>345</sup> In reaching this conclusion,

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336. 2015 Del. Ch. LEXIS 195, at \*2.

337. 2015 Del. Ch. LEXIS 142, at \*4-5.

338. *Id.*

339. 2015 Del. Ch. LEXIS 195, at \*2-3.

340. 2015 Del. Ch. LEXIS 142, at \*3-4.

341. *Id.* at \*21 (citing *Pyott v. La. Mun. Polic Emps.’ Ret. Sys.*, 74 A.3d 612, 615 (Del. 2013)).

342. 2015 Del. Ch. LEXIS 195, at \*23. (citing *In re Hunter*, 826 N.E.2d 269, 274 (N.Y. 2005)).

343. *Id.*

344. *Id.* at \*25 (citing *Hunter*, 827 N.E.2d at 274).

345. *Id.* at \*25-30.

the Court rejected the plaintiff's argument that for *res judicata* to bar subsequent litigation, the "same evidence" must be needed to "support both claims," and the "facts essential to the second" must be "present in the first."<sup>346</sup>

In *Asbestos Workers*, the Court applied New York law in considering the elements of collateral estoppel. Under New York law, two requirements must be met before a party is barred from relitigating an issue on the basis of collateral estoppel: (1) "the party seeking the benefit of collateral estoppel must prove that the identical issue was necessarily decided in the prior actions and is decisive in the present action"; and (2) "the party to be precluded from relitigating an issue must have had a full and fair opportunity to contest the prior determination."<sup>347</sup> The Court also noted that under New York law "it is well-settled that collateral estoppel may be applied in the shareholder derivative context."<sup>348</sup> Because the plaintiffs had not argued that they lacked the opportunity to fully and fairly litigate the issues in the New York action, the "sole question" was whether the identical issues had been necessarily decided.<sup>349</sup> The Court held that collateral estoppel barred the plaintiffs' claims because the issue under consideration in the Delaware action was the "precise question" presented by the plaintiffs in the New York action.<sup>350</sup> In so concluding, the Court rejected the plaintiffs' argument that collateral estoppel did not apply because the controlling facts were more developed and pleaded more compellingly in the Delaware action than in the New York action.<sup>351</sup> The Court explained that this argument misapprehended the standard; rather "the underlying conduct is what is at issue, not whether the [c]omplaint raises additional facts, or a more compelling characterization of those facts, regarding the same conduct previously at large."<sup>352</sup>

The Delaware Supreme Court summarily affirmed both decisions.<sup>353</sup>

#### **D. Common Law Defense Of Stockholder Ratification In Challenges To Non-Employee Director Compensation**

Two 2015 decisions in derivative lawsuits challenging non-employee director compensation—*Calma v. Templeton*<sup>354</sup> and *Espinoza v. Zuckerberg*<sup>355</sup>—addressed whether particular stockholder conduct accomplishes ratification so as to shift the standard of review.

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346. *Id.* at \*34.

347. *Id.* at \*47.

348. *Id.*

349. *Id.* at \*49.

350. *Id.*

351. *Id.* at \*53.

352. *Id.*

353. *Asbestos Workers*, 2016 Del. LEXIS 40 (Del. Jan. 28, 2016); *City of Providence*, 1026 Del. LEXIS 98 (Del. Feb. 25, 2016).

354. 114 A.3d 563 (Del. Ch. 2015) (Bouchard, C.).

355. 124 A.3d 47 (Del. Ch. 2015) (Bouchard, C.)

In *Calma*, the director defendants argued that stockholder approval of the compensation plan pursuant to which the challenged decisions were made constituted ratification sufficient to shift the standard of review.<sup>356</sup> The Court disagreed, concluding that “in obtaining omnibus approval of a Plan covering multiple and varied classes of beneficiaries, the Company did not seek or obtain stockholder approval of any action *bearing specifically on the magnitude of compensation to be paid to its non-employee directors*.”<sup>357</sup> In reaching this conclusion, the Court contrasted the plan at issue in *Calma* with plans that placed meaningful limits on director compensation, and emphasized that a stockholder vote must approve the “specific decision of the board of directors” under scrutiny to have a standard-shifting effect.<sup>358</sup> The *Calma* decision is consistent with the Court of Chancery’s 2012 decision in *Seinfeld v. Slager*,<sup>359</sup> and signaled that *Seinfeld* was not an aberration.

Whereas in *Calma*, the defendants argued that a stockholder vote of a compensation plan should be sufficient to ratify or provide insulating effect to issuances made pursuant to such a plan, in *Zuckerberg*, the defendants argued that the assent of a controlling stockholder to the compensation decisions at issue should suffice to invoke the business judgment rule. In rejecting this argument, the Delaware Court of Chancery resolved an issue of first impression, holding that a controlling stockholder’s informal expression of assent was insufficient to ratify a board action so as to shift the standard of review from entire fairness to the business judgment rule.<sup>360</sup>

*Zuckerberg* involved derivative claims challenging the Facebook board’s 2013 approval of compensation to its outside directors.<sup>361</sup> Given that a majority of the board were outside directors and were therefore conflicted regarding the compensation decision, the parties agreed that the entire-fairness standard would apply to the decision unless the defendants could successfully demonstrate that stockholder ratification entitled the board to the presumption of the business judgment rule.<sup>362</sup> The defendants, including Facebook’s controlling stockholder and board chairman, Mark Zuckerberg, argued such ratification had occurred because Zuckerberg (in his capacity as Facebook’s controlling stockholder) expressed his approval of the decision through his deposition and in an affidavit.<sup>363</sup> The plaintiff countered that Zuckerberg’s informal expressions of assent were insufficient to constitute stockholder ratification under Delaware law, and that to have a standard-shifting impact, ratification must be accomplished pursuant to Section 228 of the Delaware General Corporation Law (the “DGCL”) by a stockholder vote at a meeting or by written stockholder consent.<sup>364</sup>

On the defendants’ motion for summary judgment, the Court ruled in favor of the plaintiff, concluding that a controlling stockholder may accomplish standard-shifting ratification only through formal stockholder action at a meeting or by written consent, and thus that the entire-fairness standard would be applied to the 2013 compensation decision.<sup>365</sup>

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356. 114 A.3d at 569.

357. *Id.* (emphasis in original).

358. *Id.* at 586.

359. 2012 Del. Ch. LEXIS 139 (Del. Ch. June 29, 2012) (Glasscock, V.C.).

360. 124 A.3d at 49.

361. *Id.*

362. *Id.* at 49, 54.

363. *Id.* at 50, 54.

364. *Id.* at 54-55.

365. *Id.* at 49.

Among other grounds for its ruling, the Court cited policy goals that would be advanced by a rule requiring ratification to comply with the “formal mechanisms” set forth in the DGCL.<sup>366</sup> Specifically, the Court noted that requiring adherence to corporate formalities would promote transparency, enable minority stockholders to stay abreast of decision making, and limit the potential for ambiguity and misinterpretation of an act by which ratification is later claimed to have been accomplished.<sup>367</sup>

The Court also observed that the presence of a single controlling stockholder like Zuckerberg, as opposed to a control group, did not change the analysis.<sup>368</sup> Even though Zuckerberg “can outvote all other stockholders and thus has the power to effect any stockholder action he chooses,” the Court explained, “he still must adhere to corporate formalities (and his fiduciary obligations) when doing so, because his rights as a stockholder are no greater than the rights of any other stockholder—he simply holds more voting power.”<sup>369</sup>

### III. CASES INVOLVING STOCKHOLDER RIGHTS

#### A. Removal Of Directors “Without Cause” Under 8 DEL. C. § 141

In *In re VAALCO Energy, Inc. Consolidated Stockholder Litigation*,<sup>370</sup> the Court of Chancery held that a company without a classified board may not eliminate a stockholders’ ability to remove directors without cause by operation of 8 Del. C. § 141(k).

In 2009, VAALCO Energy Inc. (“VAALCO”) amended its corporate charter to de-classify its staggered board and establish a board elected annually, but left in place other charter and bylaw provisions limiting the removal of directors to “only for cause.”<sup>371</sup> In 2015, in response to an activist investor’s consent solicitation to remove members of VAALCO’s board, VAALCO responded that its charter and bylaws precluded removal of directors without cause in between annual elections.<sup>372</sup> Stockholder plaintiffs filed a class action contending that under Section 141(k) of the Delaware General Corporation Law, stockholders have the right to remove directors without cause unless the company has a classified board or cumulative voting.<sup>373</sup> In a December 21, 2015 bench ruling, the Court of Chancery invalidated the removal for-cause limitations of VAALCO’s charter and bylaws.<sup>374</sup>

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366. *Id.* at 61.

367. *Id.* at 50, 55, 57, 64, 65.

368. *Id.* at 65.

369. *Id.*

370. C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT) (“12/21/15 VAALCO Tr.”).

371. Op. Br. in Opp. to Pls.’ Mot. for Summary Judgment and in Support of Defs.’ Mot. for Summary Judgment, *In re VAALCO Energy, Inc. Cons. S’holder Litig.*, C.A. No. 11775-VCL, Dkt. No. 9 (Del. Ch. Dec. 14, 2015), at pp.1, 6-9.

372. *Id.* at pp. 10-13.

373. *Id.* at 1; Ver. Compl. for Breaches of Fiduciary Duties, *In re VAALCO Energy, Inc. Cons. S’holder Litig.*, C.A. No. 11775-VCL, Dkt. No. 1 (Del. Ch. Dec. 7, 2015).

374. 12/21/15 VAALCO Tr. at 3:12-18.

This ruling is likely to be of interest to the many companies (at least 175)<sup>375</sup> with similar charter and bylaw provisions as those deemed invalid in *VAALCO*.

## B. Inspection Of Books And Records Under 8 DEL. C. § 220

### 1. The Proper Purpose Requirement

Under Section 220 of the Delaware General Corporation Law, to inspect books and records, a stockholder must state a “proper purpose,”<sup>376</sup> and is required to demonstrate that proper purpose, in any enforcement action, by a preponderance of the evidence.<sup>377</sup> A proper purpose is defined as one “reasonably related to such person’s interest as a stockholder.”<sup>378</sup> In two 2015 decisions—*Fuchs Family Trust v. Parker Drilling Co.*<sup>379</sup> and *Southpaw Credit Opportunity Master Fund LP v. Advanced Battery Techs.*<sup>380</sup>—the Court of Chancery clarified the proper purpose requirement and denied inspection demand where the plaintiff failed to state a proper purpose.

In *Fuchs*,<sup>381</sup> the Court denied a demand to inspect documents to investigate mismanagement where a federal court had dismissed with prejudice an action challenging the same allegedly wrongful acts. As in *City of Providence* and *Asbestos Workers*, discussed *supra* § I.B.3, the Court concluded that as a consequence of the Court’s dismissal with prejudice of the prior federal action, collateral estoppel barred prosecution of the claims that the plaintiffs sought to investigate.

*Fuchs* arose from the 2010 disclosure by Parker Drilling Co. (“Parker”) that the DOJ and SEC had requested information about the company’s operations in Kazakhstan and Nigeria to investigate potential violations of the Foreign Corrupt Practices Act (“FCPA”), which prohibits the bribing of foreign officials.<sup>382</sup> Parker further disclosed that an internal investigation had revealed potential non-compliance with the FCPA.<sup>383</sup>

In response to the disclosures, stockholders filed derivative actions in Texas state and federal courts alleging that Parker’s directors and executives had breached their fiduciary duties by failing to implement and maintain internal controls to ensure Parker remained legally compliant.<sup>384</sup> The Texas state courts dismissed the plaintiffs’ petition (and an

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375. *Id.* at 11:8-12.

376. 8 DEL. C. § 220(b)(1).

377. *Seinfeld v. Verixon Commc’ns, Inc.*, 909 A.2d 117, 121 (Del. 2006).

378. 8 DEL. C. § 220(b).

379. 2015 Del. Ch. LEXIS 55 (Del. Ch. Mar. 4, 2015) (Noble, V.C.).

380. 2015 Del. Ch. LEXIS 54 (Del. Ch. Feb. 26, 2015) (Legrow, M.).

381. 2015 Del. Ch. LEXIS 55.

382. *Id.* at \*2.

383. *Id.*

384. *Id.* at \*3-4.

amended petition) without prejudice on the grounds that the plaintiffs failed to adequately plead demand futility.<sup>385</sup> The federal court dismissed the complaint with prejudice, a decision affirmed by the Fifth Circuit.<sup>386</sup>

Parker later entered into a deferred prosecution agreement with the DOJ and a civil settlement with the SEC (the “Settlement”).<sup>387</sup> In its settlement papers, which were made public, Parker admitted that two Parker executives had used a lawyer obtained by Parker to channel \$1.25 million in bribes to Nigerian officials.<sup>388</sup>

After the Settlement, the plaintiff sent a Section 220 inspection demand to the Parker board. Parker rejected the demand and asserted that the plaintiff had failed to state a proper purpose or credible basis for inspection.<sup>389</sup> The plaintiff subsequently narrowed its demand to include only documents sufficient to allow identification of two Parker executives, the outside law firm, and the lawyer involved for the stated purpose of assessing potential litigation or to demand Parker take action.<sup>390</sup> The action was tried on a paper record.<sup>391</sup>

The Court of Chancery ruled that the plaintiff’s stated purpose of assessing potential litigation was not proper because any future derivative action brought by the plaintiff on this issue would be barred by collateral estoppel.<sup>392</sup> The Court held that the Texas federal court’s dismissal with prejudice barred future action by this plaintiff because (1) in a derivative action, all stockholders are in privity with a shareholder plaintiff, making the Delaware 220 plaintiff in privity with the plaintiffs in the federal action; (2) both plaintiffs in the Delaware 220 action and the federal action alleged breaches of fiduciaries duties based on the same underlying actions by Parker and both advanced largely the same legal theories; and (3) the fact Parker had not publically admitted the bribery scheme prior to the federal court’s ruling did not defeat the application of collateral estoppel because Parker’s public admission was not material to the federal court’s decision.<sup>393</sup> Given that collateral estoppel would bar all future derivative actions brought by the plaintiff in this context, the Court of Chancery held that investigating a claim was not a proper purpose for the plaintiff to demand inspection.<sup>394</sup>

In *Southpaw*,<sup>395</sup> the Court of Chancery concluded that the plaintiff’s desire to conduct a risk assessment concerning the purchase of additional stock was not a proper purpose.

*Southpaw* involved a corporate defendant that was delisted from the NASDAQ in 2011.<sup>396</sup> The plaintiff, a hedge fund, purchased shares of the defendant’s stock in March 2014, aware that the defendant was delisted but believing the

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385. *Id.* at \*4.

386. *Id.*

387. *Id.* at \*5-6.

388. *Id.* at \*6.

389. *Id.* at \*7.

390. *Id.*

391. *Id.*

392. *Id.* at \*16-24.

393. *Id.* at \*17-19.

394. *Id.* at \*23.

395. 2015 Del. Ch. LEXIS 54.

396. *Id.* at \*1.

stock was undervalued.<sup>397</sup> Thereafter, the plaintiff demanded to inspect records for the stated purposes of (1) assessing the risk of buying more shares of the defendant's stock and of maintaining its current holdings, and (2) to determine the actual value of its purchased shares.<sup>398</sup> When the parties could not settle the terms of the document inspection, the plaintiff filed a books and records action.<sup>399</sup>

The Court concluded that the plaintiff's risk assessment purpose was not a proper purpose, because the risk assessment purpose appeared to be an attempt by the plaintiff to obtain the information it would receive if the defendant was compliant with SEC regulations.<sup>400</sup> The Court concluded that because Section 220 is not to be used to give stockholders the power to enforce SEC regulations, the plaintiff's risk assessment purpose was not proper insofar as it aimed to achieve that end.<sup>401</sup>

The Court further concluded, however, that the plaintiff's valuation purpose was proper, regardless of the fact the plaintiff had purchased stock without knowledge of the stock's value or the defendant's financial health at the time.<sup>402</sup> The Court therefore decided that the plaintiff was entitled to inspect the books and records necessary and essential to valuing its stock with the defendant.<sup>403</sup>

## 2. The Credible Basis Standard

Where the stated purpose of an inspection demand is to investigate mismanagement, the stockholder must provide some evidence that suggests a credible basis from which such mismanagement can be inferred.<sup>404</sup> The credible basis standard is the lowest possible burden of proof under Delaware law, and "falls far short of requiring a stockholder to prove by a preponderance of the evidence that mismanagement or wrongdoing actually has occurred."<sup>405</sup> Two 2015 Section 220 decisions—*Oklahoma Firefighters Pension & Retirement System v. Citigroup Inc.*<sup>406</sup> and *Southeastern Pennsylvania*

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397. *Id.* at \*4-5.

398. *Id.* at \*5.

399. *Id.* at \*6.

400. *Id.* at \*14-16.

401. *Id.* at \*16-17, \*31-33.

402. *Id.* at \*17-20.

403. *Id.*

404. *Southeastern Pa. Trans. Auth. v. AbbVie, Inc.*, 2015 Del. Ch. LEXIS 110, at \*42 (Del. Ch. Apr. 15, 2015) (Glasscock, V.C.), *aff'd* No. 239, 2015 (Del. Jan. 20, 2016) (ORDER).

405. *Okl. Firefighters Pension & Ret. Sys. v. Citigroup Inc.*, 2014 Del. Ch. LEXIS 189, at \*18 (Del. Ch. Sept. 30, 2014) (LeGrow, M.), *aff'd* 2015 Del. Ch. LEXIS 199 (Apr. 24, 2015) (Noble, V.C.).

406. 2014 Del. Ch. LEXIS 189 (Del. Ch. Sept. 30, 2014) (LeGrow, M.), *aff'd* 2015 Del. Ch. LEXIS 119 (Del. Ch. Apr. 24, 2015) (Noble, V.C.).

*Transportation Authority v. AbbVie, Inc.*<sup>407</sup>—addressed whether a plaintiff had established a credible basis to infer mismanagement for the purpose of obtaining inspection.

In *Citigroup*, the plaintiff sought to inspect books and records for the purpose of investigating mismanagement and possible breaches of fiduciary duty in connection with fraud at Banamex, one of Citigroup's indirect wholly-owned foreign subsidiaries, and Citigroup's internal investigation of that fraud.<sup>408</sup> The plaintiff also demanded information concerning whether pre-suit demand would be excused in any action related to the events at Banamex.<sup>409</sup> In response to the plaintiff's demand, Citigroup asserted that no proper purpose had been stated because the plaintiff failed to meet the credible basis standard.<sup>410</sup>

The Court found that the plaintiff had established a credible basis for a possible breach of fiduciary duty in connection with the fraud at Banamex. The Court recognized that “the mere fact that wrongdoing occurred at a subsidiary is not a credible basis to infer mismanagement by the board or senior management of a parent company.”<sup>411</sup> In this case, however, the Court found that a credible basis had been established with respect to the fraud at Banamex because of “[t]he scope of the fraud at the subsidiary [i.e., Banamex], the significance of the subsidiary to the parent company's profits, the public reports indicating that investigations uncovered deficiencies in internal controls, and the fact that one of the parent company's senior executives oversees the subsidiary and the parent company's board and its committees are responsible for overseeing the controls in question.”<sup>412</sup> The finding of a credible basis fell well short of demonstrating that any wrongdoing actually occurred, but provided a basis for inspection of the company's books and records.<sup>413</sup> To that end, the Court observed that a stockholder is *not* required to provide specific and concrete evidence of wrongdoing to sustain a Section 220 demand.<sup>414</sup>

The Court also found that the plaintiff had established a credible basis to infer mismanagement in connection with the investigation into Banamex's regulatory compliance.<sup>415</sup> Although the Court observed that the consent orders alone would not have formed a credible basis, the Court cited in combination (1) the findings of various regulators underlying the consent orders; (2) the consent orders by which Citigroup undertook to improve its Bank Secrecy Act and anti-money laundering compliance and controls; and (3) the subpoenas issued in the wake of the regulators' findings and the consent orders.<sup>416</sup> The Court further noted that it would be improper to infer wrongdoing by Citigroup's directors simply because

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407. 2015 Del. Ch. LEXIS 110 (Del. Ch. Apr. 15, 2015) (Glasscock, V.C.), *aff'd* No. 239, 2015 (Del. Jan. 20, 2016) (ORDER).

408. 2015 Del. Ch. LEXIS 189, at \*2-9.

409. *Id.* at \*3.

410. *Id.* at \*13.

411. *Id.* at \*18.

412. *Id.* at \*19-20.

413. *Id.* at \*20.

414. *Id.*

415. *Id.* at \*21-22.

416. *Id.*

they had oversight over Banamex at the time the fraud occurred. However, the Court concluded that there was a credible basis to infer wrongdoing given that Banamex generates 10% of Citigroup's annual profits, the fraud was extensive enough to require Citigroup to restate its financials, Citigroup's CEO admitted there were multiple "telltale" signs that employees should have recognized and relayed to supervisors, Citigroup did not review its credit exposure after Standard & Poor's stopped rating an important company involved in the fraud, and the fraud involved a central component of Citigroup's business.<sup>417</sup>

In affirming the Master's report, the Court of Chancery focused on the fact the government-issued subpoenas were sent out quickly after Citigroup entered its consent orders, indicating to the Court that the government investigation was related, at least in part, to the events that occurred at Banamex.<sup>418</sup> The plaintiff therefore had a proper purpose to investigate the controls and compliance programs the board agreed to under the consent orders.<sup>419</sup>

In contrast, in *AbbVie*,<sup>420</sup> the Court denied the stockholders' inspection demand for failure to establish a credible basis to infer corporate wrongdoing in a rescinded corporate inversion.

In July 2014, AbbVie, Inc. ("AbbVie") entered into a formal agreement with the foreign entity Shire plc ("Shire") to undergo a corporate inversion that would significantly reduce AbbVie's corporate tax obligations.<sup>421</sup> In September 2014, the United States Treasury and Internal Revenue Service announced their intent to issue retroactive regulations to eliminate the tax benefits available from merger-based inversions.<sup>422</sup> In light of the regulatory changes, the AbbVie board reversed its favorable recommendation of the inversion agreement and terminated the proposed agreement.<sup>423</sup> AbbVie then paid Shire the break-up fee provided for in the proposed agreement.<sup>424</sup>

The stockholder plaintiffs sought ten categories of documents for the stated purposes of investigating potential breaches of fiduciary duties, mismanagement, wrongdoing, and corporate waste by the AbbVie board and officers, demand futility,<sup>425</sup> and potential aiding and abetting by AbbVie's financial advisor in the inversion, J.P. Morgan.<sup>426</sup> AbbVie rejected the plaintiffs' demands for failure to state a proper purpose on the grounds that the plaintiffs failed to establish a credible basis.<sup>427</sup> AbbVie also argued that because its Certificate of Incorporation exculpated directors from liability for a

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417. *Id.* at \*7.

418. 2015 Del. Ch. LEXIS 119, at \*17-19.

419. *Id.* at \*19.

420. 2015 Del. Ch. LEXIS 110.

421. *Id.* at \*4-6.

422. *Id.* at \*27-28.

423. *Id.* at \*30.

424. *Id.* at \*31.

425. *Id.*

426. *Id.* at \*31-32.

427. *Id.* at \*33.

breach of duty of care pursuant to Section 102(b)(7) of the DGCL, investigating any such breach was futile and did not constitute a proper purpose.<sup>428</sup>

The Court of Chancery held, after a coordinated one-day trial,<sup>429</sup> that a plaintiff whose sole purpose is to assess a derivative action can only investigate non-exculpated corporate wrongdoing—i.e., breaches of the duty of loyalty, actions in bad faith, or corporate waste.<sup>430</sup> The Court held that a failed merger, without more, does not create a credible basis to infer corporate wrongdoing under *U.S. Die Casting & Developing Company v. Security First Corporation*.<sup>431</sup> The Court distinguished the facts of *U.S. Die-Casting*, which involved a suspicious failed merger and subsequent generous, gratuitous payments by the board, from AbbVie's payment of the break-up fee.<sup>432</sup> Likewise, contrary to the plaintiffs' suggestion, the amount of the break-up fee, on its own, could not establish a credible basis to infer bad faith.<sup>433</sup> Instead, the plaintiffs had to show that the risk of termination was so clear that the board's agreement to the break-up fee in the first place amounted to a willful and wrongful disregard of the corporation's interest.<sup>434</sup> Based upon the record before it, the Court determined that was not the case.<sup>435</sup> Given that the board had considered the political environment, which was hostile to inversion but appeared thoroughly gridlocked, in making its decision to go forward, there was no credible basis to infer bad faith.<sup>436</sup> The Court further held that because the deal would have created substantial value but for the changes in tax regulations, there was no credible basis to infer that paying the break-up fee constituted corporate waste.<sup>437</sup>

The Court also concluded that investigating the corporation's potential claims against a third party is not a proper purpose for a Section 220 demand in the absence of a credible basis to believe the directors could not adequately decide whether to pursue the company's claims.<sup>438</sup> The Court began by noting its holding in *Saito v. McKesson HBOC, Inc.*, that investigating potential claims against a defendant's third-party advisors was not a proper purpose.<sup>439</sup> The Court adopted that holding, though not categorically.<sup>440</sup> The Court held that any potential claims against J.P. Morgan were

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428. *Id.* at \*40.

429. *Id.* at \*33.

430. *Id.* at \*40.

431. *Id.* at \*48.

432. *Id.*

433. *Id.* at \*50.

434. *Id.* at \*52.

435. *Id.* at \*53-54.

436. *Id.* at \*53.

437. *Id.* at \*53-54.

438. *Id.* at \*62-63.

439. *Id.* at \*61 (citing *Saito*, 2001 Del. Ch. LEXIS 96, at \*21 (Del. Ch. July 10, 2001), *aff'd in relevant part*, 806 A.2d 113 (Del. 2002)).

440. *Id.* at \*62-63.

AbbVie's to vindicate, and that because the plaintiffs had failed to establish a credible basis to infer that the directors, who would be exculpated from personal liability for any underlying breach, could not make an informed decision whether or not to pursue claims against J.P. Morgan, the plaintiff had no proper purpose to investigate any aiding and abetting of a third-party advisor.<sup>441</sup>

### 3. The Necessary And Essential Requirement

In the context of a Section 220 action, once a stockholder has demonstrated a proper purpose, the stockholder is entitled only to “documents in the corporation’s possession, custody or control, that are necessary to satisfy that proper purpose.”<sup>442</sup> This restriction as to the scope of inspection, sometimes referred to as the “necessary and essential” requirement, was at issue in multiple 2015 decisions, including *In re Lululemon Athletica Inc. 220 Litigation*,<sup>443</sup> *Southpaw*,<sup>444</sup> and *Fuchs*.<sup>445</sup>

In *Lululemon*, the Court of Chancery denied the plaintiffs’ request to inspect the personal e-mail accounts of the board members of lululemon athletica, inc. (“lululemon”), but granted inspection of necessary though privileged documents under Section 220 (*see discussion infra*). *Lululemon* arose from a motion to enforce an order from the Court of Chancery directing the defendant to produce documents related to potential mismanagement claims.<sup>446</sup> The defendant had already produced 195 documents, but the plaintiffs argued that the defendant should be required to search for and produce responsive emails from board members’ non-company, personal e-mail accounts.<sup>447</sup>

In denying inspection of the board members’ personal e-mail accounts, the Court observed that the plaintiffs had failed to show by a preponderance of the evidence that the non-company emails were necessary and essential to their proper purpose and therefore denied expanding of the scope of investigation.<sup>448</sup> The Court determined that the “crux” of the plaintiffs’ proper purpose was to investigate whether any director had contacted lululemon to investigate possible insider trading.<sup>449</sup> However, any inquiries to that end would have ended up on the company’s email server, which was

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441. *Id.*

442. *Saito*, 806 A.2d at 115.

443. 2015 Del. Ch. LEXIS 127 (Del. Ch. Apr. 30, 2015) (Parsons, V.C.).

444. 2015 Del. Ch. LEXIS 54 (Del. Ch. Feb. 26, 2015) (Legrow, M.).

445. 2015 Del. Ch. LEXIS 55 (Del. Ch. Mar. 4, 2015) (Noble, V.C.).

446. 2015 Del. Ch. LEXIS 127, at \*1. The plaintiffs alleged that, in December 2012, lululemon’s then-Chairman of the Board of Directors, Dennis Wilson, entered into a trading plan (the “Trading Plan”) wherein his broker was allowed to sell a capped number of his shares of common stock per month. On June 5, 2013, Wilson learned that lululemon’s then-CEO planned to leave the company. On June 7, 2013, the entire board was informed of the news. On that same day, Wilson’s broker sold over 600,000 shares of Wilson’s stock, maxing out the monthly limit. A few days later, lululemon publically announced the then-CEO’s resignation and the price of shares dropped. The *Wall Street Journal* emailed lululemon to confirm facts for a story on the June 7 sale. Individuals from Wilson’s personal investment office and lululemon emailed one another to craft a coordinated response to the *Wall Street Journal* (the “WSJ Email Chain”). Later, lululemon’s corporate secretary and in-house counsel responded to an email from one of lululemon’s directors asking if the sale had conformed to the terms of the Trading Plan (the “Nicholas Email”).

447. *Id.* at \*7.

448. *Id.* at \*21-22.

449. *Id.* at \*23.

included in the original inspection order.<sup>450</sup> The Court held that though emails sent by directors on their personal email accounts might be “interesting” or “helpful” to the plaintiffs, they were not necessary and essential to the stated proper purpose, and therefore expanding the scope of investigation was unwarranted.<sup>451</sup>

Moreover, the Court noted that even if the documents were to fall within the plaintiffs’ inspection right, it remained unclear whether the Court had the power to compel defendants to produce emails from non-company or personal email accounts under Section 220.<sup>452</sup> The Court reasoned that if the Court were to order production, it would require a careful review of the facts and circumstances of the case, with a particular focus on whether the documents were within the defendants’ “possession, custody, or control.”<sup>453</sup> However, because the Court found that the sought-after emails did not fall within the plaintiffs’ inspection right, the Court did not need to resolve the issue and declined to undertake the necessary factual analysis on the record before it.<sup>454</sup>

In *Southpaw*, discussed *supra*, the Court rejected the defendant’s argument that Chinese law precluded the removal of accounting records for a Chinese company’s recordkeeping system.<sup>455</sup> The defendant’s evidence of supposed illegality consisted solely of an uncertified translation of the Chinese law at issue and a law firm client alert, and thus failed to demonstrate that Chinese law precluded the defendant from complying with the inspection demand.<sup>456</sup> Further, the Court held that even if Chinese law did prohibit some means of inspection, the defendant had failed to show that all

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450. *Id.*

451. *Id.* at \*24.

452. *Id.* at \*17.

453. *Id.* at \*17.

454. *Id.* at \*17-18. This issue came to a head in two 2016 cases which, though not the focus of this canvas of key 2015 decisions, nevertheless warrant mention. In *Chammas v. Navlink, Inc.*, 2016 Del. Ch. LEXIS 22, at \*24 (Del. Ch. Feb. 1, 2016) (Noble, V.C.), the Court denied a board member’s demand to inspect the private communications among directors, observing that “[w]hile directors’ access to company books and records is broader than that of stockholders, the requested information itself must qualify as a book or record of the company before the Court will order its production.” The Court observed that “subjecting Section 220 proceedings to such broad requests, even by directors, runs contrary to the ‘summary nature of a Section 220 proceeding.’ As such, any request for communications among corporate directors and officers must (1) state a proper purpose, (2) encompass communications constituting books and records of the corporation, i.e., those that affect the corporation’s rights, duties, and obligations, and (3) be sufficiently tailored to direct the Court to the specific essential to the demand futility inquiry,” and assuming that such documents constitute books and records of the corporation.” *Id.* at \*26. In *Navlink*, the Court concluded that the plaintiff failed to establish the second or third requirement so as to be entitled to inspect private director communications. The Court nevertheless declined to impose a “blanket prohibition” on inspection of such communications. *Id.* The Court favorably cited the reasoning of *lululemon* in its analysis. *Id.* at \*23-24 n.91. One day after the *Navlink* opinion, the Court of Chancery reached an opposite conclusion in *Amalgamated Bank v. Yahoo! Inc.*, 2015 Del. Ch. LEXIS 314 (Del. Ch. Feb. 2, 2016) (Laster, V.C.), permitting inspection of private communications among board members which might not be located on the company’s server, and reasoning that “[t]hrough its jurisdiction over a corporation, a court can compel production of documents in the possession of officers, directors, and managing agents of the firm.” *Id.* at \*87 n.43 (citing cases). The *Yahoo* decision was vacated by stipulation of the parties on cross-appeal. *See* Stip. of Dismissal, No. 83, 2016, Docket No. 18 (Del. June 6, 2016).

455. 2015 Del. Ch. LEXIS 54, at \*21-29.

456. *Id.* at \*26.

means of inspection were prohibited.<sup>457</sup> Because the documents could legally be made available for inspection, even if only through unconventional and potentially inconvenient means, the Court concluded that the defendant was not excused from its Section 220 obligations.<sup>458</sup>

In *Fuchs*, discussed *supra*, the Court noted that the plaintiff had stated a proper purpose in seeking to assess its options with respect to making a demand that the board take action.<sup>459</sup> However, the Court determined that Parker's publicly available settlement papers gave the plaintiff enough information about the Nigerian bribery scheme to pursue its contemplated course of action, without the plaintiff needing to learn the identities of the two executives accused of engaged in bribery, the law firm they used, and the implicated lawyer.<sup>460</sup> Because the requested information was not necessary and essential to the plaintiff making a demand on the Parker board, the Court denied the plaintiff's request and entered judgment for Parker.<sup>461</sup>

#### 4. Inspection Of Privileged Documents

In a 2014 decision by the Delaware Supreme Court, *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW* ("Wal-Mart II"),<sup>462</sup> the Supreme Court clarified that the standard set forth in *Garner v. Wolfenbarger*<sup>463</sup> for requiring production of privileged company information to company stockholders applied under Delaware law and in the Section 220 context. Applying the holdings of *Garner* and *Wal-Mart II*, in possibly one of the most publicized Section 220 issues of 2015, the Court of Chancery in *Lululemon* (*see discussion supra*),<sup>464</sup> granted inspection of necessary though privileged documents.

As discussed above, *Lululemon* arose from a motion to enforce an order from the Court of Chancery directing the defendant to produce documents related to potential mismanagement claims. The plaintiffs argued that in addition to the documents already produced by the defendant, the Court should order the defendant to produce two emails that had been withheld as privileged.<sup>465</sup>

The Court permitted inspection of the two emails, which the Court determined were privileged, but nonetheless must be produced because the plaintiffs had shown "good cause" to set aside privilege under the fiduciary exception to privilege established by *Garner* and *Wal-Mart II*.<sup>466</sup> The Court began by noting that the fiduciary exception to attorney-

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457. *Id.* at \*27-28.

458. *Id.* at \*28-29.

459. 2015 Del. Ch. LEXIS 55, at \*24-25.

460. *Id.* at \* 24.

461. *Id.* at \*24-26.

462. 95 A.3d 1264 (Del. 2014).

463. 430 F.2d 1093 (5th Cir. 1970).

464. 2015 Del. Ch. LEXIS 127 (Del. Ch. Apr. 30, 2015) (Parsons, V.C.).

465. *Id.* at \*7, 11.

466. *Id.* at \*25-51.

client privilege is “narrow, exacting, and intended to be very difficult to satisfy.”<sup>467</sup> In determining that the plaintiffs had shown good cause to set aside privilege, the Court analyzed and balanced the six factors set forth in *Garner*.<sup>468</sup> The Court concluded that the factors weighed in favor of setting aside privilege because the plaintiffs were seeking a limited number of documents, the plaintiffs were substantial stockholders, the emails did not involve trade secrets, and the alleged wrongdoing was a criminal act.<sup>469</sup> Moreover, the Court concluded that the plaintiffs’ claims were obviously colorable, and the emails related to the underlying events giving rise to the litigation, rather than the litigation itself, making it more appropriate to set aside privilege.<sup>470</sup> The Court further concluded that the documents were essential to the plaintiffs’ proper purpose in investigating potential *Brophy* and mismanagement claims and were unavailable from other sources.<sup>471</sup> Taken together, the Court concluded that the plaintiffs had carried their burden in showing good cause to set aside privilege and ordered the defendant to produce the WSJ Email Chain and Nicholas Email for inspection.<sup>472</sup>

## 5. Conditions On Inspection

Section 220 vests the Court of Chancery with the discretion to prescribe “limitations or conditions” to inspection, including requiring the inspecting party to sign a confidentiality agreement as a condition to inspection.<sup>473</sup> The Court of Chancery’s exercise of this discretion was been heavily litigated in and around 2015.<sup>474</sup>

The Court of Chancery explored this issue in *Southpaw*, discussed *supra*, determining that because the defendant, though a public company, was not compliant with SEC information reporting requirements, it should be considered a private company for the purposes of assessing the necessity of a confidentiality agreement as a condition to plaintiff’s

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467. *Id.* at \*37 (quoting *Wal-Mart II*, 95 A.3d at 1278).

468. *Id.* at \*37-49.

469. *Id.* at \*49-50.

470. *Id.* at \*39.

471. *Id.* at \*42-43.

472. *Id.* at \*49-51.

473. 8 *Del. C.* § 220 (c).

474. *See, e.g.*, *United Techs. Corp. v. Treppel*, 109 A.3d 553 (Del. 2014) (Strine, C.J.) (remanding Court of Chancery decision and directing court to exercise care in determining whether to condition inspection on the imposition of a forum selection clause); *Quantum Tech. P’rs IV, L.P. v. Ploom, Inc.*, 2014 Del. Ch. LEXIS 78 (Del. Ch. May 14, 2014) (FINAL REPORT) (Legrow, M.) (adjudicating disputes over the appropriate confidentiality restrictions to govern inspection); *Ravenswood Inv. Co., L.P. v. Winmill & Co. Inc.*, 2014 Del. Ch. LEXIS 93 (Del. Ch. May 30, 2014) (Noble, V.C.) (holding that a company may not condition access to its books and records on an agreement forbidding the recipient from trading in its stock); *Ravenswood Inv. Co., L.P. v. Winmill & Co. Inc.*, 2014 Del. Ch. LEXIS 272 (Del. Ch. Dec. 31, 2014) (Noble, V.C.) (requiring documents produced to the plaintiff to be maintained as confidential for a period of one or three years, depending on the information, and rejecting the defendants’ arguments to lengthen that period of time); *Amalgamated Bank v. Yahoo! Inc.*, 2016 Del. Ch. LEXIS 314, at \*95 (Del. Ch. Feb. 2, 2016) (Laster, V.C.) (imposing condition to inspection that all documents produced as for inspection be incorporated by reference in any complaint concerning the same alleged wrongdoing the plaintiffs sought to investigate in the inspection).

inspection of the defendant's books and records.<sup>475</sup> The Court, noting that there is good reason to err on the side of imposing confidentiality agreements, concluded that the nature of the defendant's records, which it considers confidential, made a confidentiality agreement appropriate.<sup>476</sup>

However, the Court in *Southpaw* declined to include in the confidentiality agreement a restriction on the plaintiff's ability to trade shares of the defendant's stock on the basis of the books and records it inspects. The Court adopted in *Southpaw* a position similar to that taken in *Ravenswood Investment Co., L.P. v. Winnmill & Co.*,<sup>477</sup> that for a "corporation to condition access" to stock valuation information "on an agreement not to trade—would inappropriately frustrate this fundamental stockholder right."<sup>478</sup> The Court also declined to require the defendant to publically disclose the books and records it provided through inspection so as to avoid potential implicit trading restrictions on the Plaintiff under SEC Regulation FD, holding that the potential federal legal obligations of the parties resulting from a Section 220 inspection are for the parties, not Delaware courts, to discern and resolve.<sup>479</sup>

## 6. Procedural Considerations

In *Fuchs*, discussed *supra*, the Court of Chancery discussed the procedural impropriety of expanding inspection demands on the eve of trial.<sup>480</sup> There, eight days prior to trial, the plaintiff attempted to broaden the scope of its inspection request.<sup>481</sup> The plaintiff issued a supplemental inspection demand requesting any report prepared by Parker's board or any Parker committee related to Parker's legal violations in Nigeria, as well as all the documents relied on by the Parker board and committees regarding Parker's FCPA non-compliance.<sup>482</sup>

The Court of Chancery held that allowing the plaintiff to broaden its inspection request eight days prior to trial would substantially impair Parker's right to receive and properly consider an inspection demand prior to litigation, and thus rejected the plaintiff's attempt to do so.<sup>483</sup> The plaintiff's inspection demands were thus limited to the documents it sought in its original complaint.<sup>484</sup>

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475. 2015 Del. Ch. LEXIS 54, at \*29-38.

476. *Id.* at \*29-33.

477. 2014 Del. Ch. LEXIS 93 (Del. Ch. May 30, 2014) (Noble, V.C.).

478. *Id.* at \*35 (quoting *Ravenswood*, 2014 Del. Ch. LEXIS 93, at \*12).

479. *Id.* at \*37 (citing *Ravenswood*, 2014 Del. Ch. LEXIS 93, at \*12-13. Although 2016 decisions are not the focus of this article, in the first quarter of 2016, the Court of Chancery imposed a condition at the request of a corporate defendant that it described as an "issue of first impression" in *Amalgamated Bank v. Yahoo! Inc.*, 2016 Del. Ch. LEXIS 314, at \*95 (Del. Ch. Feb. 2, 2016) (Laster, V.C.). Specifically, the Court conditioned "any further production on [the plaintiff] incorporating by reference into any derivative action complaint that it files the full scope of the documents that Yahoo has produced or will produce in response to the Demand (the 'Incorporation Condition')." *Id.*

480. 2015 Del. Ch. LEXIS 55, at \*12-16.

481. *Id.*

482. *Id.*

483. *Id.*

484. *Id.*

#### IV. ADVANCEMENT UNDER 8 DEL. C. § 145

##### A. Issues Of First Impression—Claims For Equitable Contribution For Advancement From Third-Parties And The Status Of Advancement Claims In The Context Of A Delaware Receivership

The Court of Chancery decided a significant number of advancement cases in 2015, two of which—*Konstantino v. AngioScore, Inc.*<sup>485</sup> and *Andrikopoulos v. Silicon Valley Innovation Company, LLC*<sup>486</sup>—resolved issues of first impression.

In *Konstantino*, the Court of Chancery entered judgment for the defendant on its third-party claim of equitable contribution for advancement. There, the Court of Chancery had granted advancement to the plaintiff from a former employer, AngioScore, Inc. (“AngioScore”), in connection with claims for usurpation of a corporate opportunity brought against him by AngioScore.<sup>487</sup> AngioScore then sought equitable contribution from the plaintiff’s then-current employers, the “third-party defendants,” who benefited from the acts of fiduciary breach and who also owed the plaintiff advancement obligations.<sup>488</sup> On the third-party defendants’ motion to dismiss, the Court recognized that the standard for equitable contribution set forth in *Chamison v. HealthTrust, Inc.* applied in the advancement context.<sup>489</sup> *Chamison* held that “[t]o seek contribution from another insurer, the one seeking contribution must show that the other insurer’s liability is concurrent, benefits the same insured, and insures the same risk.”<sup>490</sup> *Chamison*, and a later case applying this standard, *Levy v. HLI Operating Co., Inc.*,<sup>491</sup> both involved indemnification. Although the Court had previously applied the *Chamison* standard in determining allocation among related entities in the context of advancement claims,<sup>492</sup> the Court’s decision denying dismissal in *Konstantino* was the first time the Court squarely addressed the viability of an equitable contribution claim in the advancement context between unrelated third-parties.

In a later bench ruling in *Konstantino*, the Court granted AngioScore summary judgment on its claims for equitable contribution from the third-party defendants, holding that the third-party defendants were 50% liable for advancement

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485. 2015 Del. Ch. LEXIS 251 (Del. Ch. Oct. 2, 2015) (Bouchard, C.) (denying third-party defendants’ motion to dismiss claims for equitable contribution); C.A. No. 9681-CB (Del. Ch. Nov. 9, 2015) (TRANSCRIPT) (“*AngioScore* 11/9/15 Tr.”) (Bouchard, C.) (entering summary judgment for defendant on its third-party claims for equitable contribution).

486. 120 A.3d 19 (Del. Ch. 2015) (Parsons, V.C.).

487. 2015 Del. Ch. LEXIS 251, at \*2. The Court has granted discovery into the plaintiff’s other sources of entitlement to advancement in a prior ruling. C.A. No. 9681-CB, at 120:11:24 (Del. Ch. Aug. 6, 2014) (TRANSCRIPT) (Bouchard, C.) (entering summary judgment for defendant and staying discovery on third-party defendants except to permit the defendant to discover any “documents that contain an obligation to advance or indemnify” the plaintiff).

488. 2015 Del. Ch. LEXIS 251, at \*2.

489. *Id.* at \*33 (discussing *Chamison*, 735 A.2d 912, 926 (Del. Ch. 1999), *aff’d*, 748 A.2d 407 (Del. 2000)).

490. *Chamison*, 735 A.2d at 926.

491. 924 A.2d 210, 220 (Del. Ch. 2007).

492. *See Sodano v. Am. Stock Exchange LLC*, 2008 Del. Ch. LEXIS 92, at \*58-59 n.84 (Del. Ch. Apr. 25, 2008) (Strine, V.C.).

to *Konstantino*.<sup>493</sup> The Court cited to no authorities that “provide any meaningful guidance in determining the appropriate allocations among the sources of advancement that are available to [the plaintiff],” and thus the Court established a 50/50 split between AngioScore and the third-party defendants.<sup>494</sup> The Court’s order, however, was limited to going-forward payments.<sup>495</sup> Although AngioScore had paid around \$11.7 million in advancement before it obtained summary judgment, the Court declined to obligate the third-party defendants to retroactively “advance” half of that amount by paying AngioScore damages.<sup>496</sup> Instead, “[g]iven the fluid nature of the situation,” the Court ordered that the third-party defendants would be liable for 100% percent of the plaintiff’s advancement expenses going forward until such time as it has paid out an amount equivalent to what AngioScore incurred to date[.]<sup>497</sup>

In *Silicon Valley*, the Court of Chancery resolved the “previously unanswered” question of whether, in the context of a receivership estate under Delaware law, advancement claims are administrative expenses warranting priority or unsecured creditor claims to be paid pro rata with the other unsecured creditors.<sup>498</sup> Section 298 of the Delaware General Corporation Law provides that, before making distributions in a receivership, the Court shall give priority to (i) “reasonable compensation to the receiver,” (ii) “the costs and expenses incurred in and about the execution of such receiver’s . . . trust,” and (iii) “the costs of the proceedings in the Court.”<sup>499</sup> In contending that their advancement claims warranted priority under Section 298, the plaintiffs argued that “advancement is a cost of bringing a lawsuit against a former officer with advancement rights.”<sup>500</sup> They further argued that Delaware policy favoring advancement also favors giving priority to advancement claims. The plaintiffs also argued that a receivership is distinguishable from bankruptcy, and thus the analogous bankruptcy standards under which advancement claims would be treated as unsecured claims should not apply.<sup>501</sup>

The Court held that advancement claims are not afforded priority in a receivership before the Court of Chancery. In rejecting the plaintiffs’ arguments, the Court noted its “broad discretion in the receivership context,”<sup>502</sup> and identified four reasons for treating advancement obligations as unsecured claims. First, the Court observed that Delaware’s pro-advancement policy was offset by policies in play during the winding up of a corporation where “there is no long-term horizon” and “the focus is on winding up the entity’s affairs.”<sup>503</sup> Under these circumstances, “the relevant importance of the policy justification of advancement as an inducement to attract qualified individuals to manage the company is

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493. *AngioScore* 11/9/15 Tr. at 117:12-21.

494. *Id.*

495. *Id.* at 117:21-24.

496. *Id.* at 117:21-24.

497. *Id.* at 118:15-22.

498. 120 A.3d at 20.

499. 8 DEL. C. § 298.

500. *Id.*

501. 120 A.3d at 22-23 (citing 11 U.S.C. § 503(b)(1)(A)).

502. 120 A.3d at 25.

503. *Id.*

diminished.”<sup>504</sup> The Court further observed that granting administrative priority to advancement claims “seriously could undermine, if not entirely eliminate the ability of companies in receivership to pursue claims against former management.”<sup>505</sup> Second, the Court held that because advancement claims are contractual in nature, they should be placed on par with similar contractual claims.<sup>506</sup> Third, the Court observed that advancement claimants typically may recover expenses through director and officer insurance policies, which provide a better market solution for obtaining fees from an insolvent entity.<sup>507</sup> Fourth, and finally, the Court expressed concerns about “becoming embroiled in time-consuming, line-item accounting disputes” necessitated by distinguishing between priorities and “super-priorities” of unsecured creditors versus the receiver and other professional who administer the entity in receivership.<sup>508</sup>

## B. Clarification Concerning The “By Reason Of The Fact” Standard

In addition to resolving issues of first impression in 2015, the Court also added clarity to issues commonly litigated in the advancement and indemnification context, including the “by reason of the fact” requirement. To be entitled to indemnification or advancement under 8 *Del. C.* § 145, a plaintiff must demonstrate that the claims for which he seeks advancement were brought “by reason of the fact” that the plaintiffs acted in his or her official capacity. Three cases in 2015 addressed this standard: *Mooney v. Echo Therapeutics, Inc.*,<sup>509</sup> *Charney v. American Apparel, Inc.*,<sup>510</sup> and *Lieberman v. Electrolytic Ozone, Inc.*<sup>511</sup>

*Mooney* involved the common scenario present in *Konstantino* (discussed *supra*)—litigation arising between a corporate officer and his or her former employer after a corporate officer left the corporate defendant to work for a competitor. In these circumstances, companies often attempt to avoid advancement in connection with the litigation by relying on *Cochran v. Stifel Financial Corp.*<sup>512</sup> and *Weaver v. ZeniMax Media, Inc.*,<sup>513</sup> which hold that advancement will be denied when the underlying claims are in the nature of an employment dispute based on personal obligations to the corporation.

In *Mooney*, the Court of Chancery concluded that the defendant entities may not avoid advancement obligations by pleading claims designed to implicate the covered person’s personal, as opposed to official, capacity. There, the plaintiff

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504. *Id.*

505. *Id.*

506. *Id.* at 26.

507. *Id.* & n.31 (citing William D. Johnston et al., *Bankruptcy: The Game-Changer for Directors & Officers Who May Face Claims by Shareholders of Others*, SEC. LIT. REPORT, Dec.-Jan. 2010, at 3-4).

508. 120 A.3d at 26.

509. 2015 Del. Ch. LEXIS 146 (Del. Ch. May 28, 2015) (Parsons, V.C.).

510. 2015 Del. Ch. LEXIS 238 (Del. Ch. Sept. 11, 2015) (Bouchard, C.).

511. 2015 Del. Ch. LEXIS 231 (Del. Ch. Aug. 31, 2015) (Noble, V.C.).

512. 2000 Del. Ch. LEXIS 179 (Del. Ch. Dec. 13, 2000) (Strine, V.C.), *aff’d in part, rev’d in part*, 809 A.2d 555 (Del. 2002).

513. 2004 Del. Ch. LEXIS 10 (Del. Ch. Jan. 30, 2004) (Noble, V.C.).

sought advancement in part for defending against counterclaims and affirmative defenses asserted by his former employer in an employment dispute against the former employer.<sup>514</sup> The counterclaims all implicated the plaintiff's conduct when serving as an officer of the company.<sup>515</sup> Relying on *Cochran* and *Weaver*, the defendant argued that the misconduct at issue was undertaken in the plaintiff's personal capacity.<sup>516</sup> The defendant even amended its counterclaims to target misconduct allegedly undertaken in the plaintiff's personal capacity in a "deliberate[]" and "conscious effort" to bolster this defense and "avoid triggering [the plaintiff's] advancement rights."<sup>517</sup> The Court of Chancery rejected the defendant's argument, distinguishing and eschewing the defendant's reliance on *Cochran* and *Weaver*, which the Court observed were "authored over a decade ago," in favor of the more recent rule espoused in *Paolino v. Mace Security International*,<sup>518</sup> namely: that the presumption at the advancement stage favors advancement, and that any claim for which a corporation seeks to avoid advancement based on a capacity defense "must *clearly* involve a specific and limited contractual obligation without any nexus or causal connection to official duties."<sup>519</sup>

The Court concluded that the defendant failed to demonstrate that the underlying counterclaims, even as amended, had *no* causal connection to the plaintiff's official duties. This result, the Court observed, is consistent with the policy behind advancement. The Court explained that:

Deferring resolution of less clear-cut disputes to the indemnification stage helps avoid excessive litigation over advancement. In addition to saddling the parties with unnecessary costs, litigation-related delays over advancement threaten to undermine the summary nature of the proceedings envisioned by 8 *Del. C.* § 145, as well as the policy of providing prompt reimbursement to present and former directors and officers who have had to incur attorneys' fees and related expenses.<sup>520</sup>

Different results based on different facts were reached in the next two 2015 cases addressing the "by reason of the fact" standard—*Lieberman*<sup>521</sup> and *Charney*.<sup>522</sup> As in *Mooney*, *Lieberman* involved a legal proceeding arising after a corporate officer left his employment to work for a competitor. And, as in *Mooney*, the defendant entity sought to avoid advancement obligations by arguing that the alleged misconduct was undertaken in the person's personal, not official, capacity. Unlike in *Mooney*, however, the claims at issue in *Lieberman* arose "*solely* from alleged post-termination breaches of personal obligations under [the governing agreements] ...."<sup>523</sup> The Court placed significant weight on this fact in denying

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514. 2015 Del. Ch. LEXIS 146, at \*13-14.

515. *Id.* at \*20.

516. *Id.* at \*23.

517. *Id.* at \*18, \*22.

518. 985 A.2d 392, 408 (Del. Ch. 2009).

519. 2015 Del. Ch. LEXIS 146, at \*25-26 (quoting *Paolino*, 985 A.2d at 407) (emphasis in *Mooney*).

520. *Id.* at \*23-24.

521. 2015 Del. Ch. LEXIS 231.

522. 2015 Del. Ch. LEXIS 238.

523. *Id.* at \*15-16 (emphasis added).

the plaintiff advancement. Similar facts were present in *Charney*, where the Court also denied advancement. There, the Court concluded that the plaintiff had not met the “by reason of the fact” requirement because the alleged misconduct lacked the “causal connection” between the claims in the underlying proceeding and the plaintiff’s official capacity.<sup>524</sup> The misconduct at issue in *Charney*—violation of a standstill agreement—took place after the plaintiff’s “suspension as an officer and resignation as a director” in connection with a “privately discussed ... potential takeover” of the defendant entity.<sup>525</sup> The Court held that the plaintiff’s status “as the founder and past leader” of the corporation “may have made his violations of the Standstill Agreement more damaging, but that former status was not necessary for the violations themselves.”<sup>526</sup>

In *Charney*, the Court also interpreted a broadly worded agreement that mandated advancement for events or occurrences “related to the fact” to be the equivalent of the statutory “by reason of the fact” language, rejecting plaintiff’s argument that the “related to” language demanded a broader scope.<sup>527</sup> Delaware law construes the statutory “by reason of the fact” requirement to be met “if there is a nexus or causal connection between” the underlying proceeding and a party’s official capacity.<sup>528</sup> The plaintiff argued that the choice of the phrase “related to the fact” suggests a broader scope of advancement than “by reason of the fact”—if the latter demands a causal nexus, the former requires a more attenuated “but for” connection.<sup>529</sup> The Court rejected this argument, first and foremost, on the ground it would lead to “absurd results to which no reasonable person would have agreed.”<sup>530</sup> The Court also concluded that “to construe ‘related to the fact’ more broadly than ‘by reason of the fact’ as used in Section 145, would render the indemnification provision in the Indemnification Agreement invalid under Delaware law.”<sup>531</sup> The Court observed that the weight of Delaware case law supports the proposition that contractual advancement provisions must comply with the requirements of Section 145 and may not exceed the powers as circumscribed under Section 145.<sup>532</sup> Thus, in *Charney*, the Court made clear that the “by reason of the fact” statutory provision is a mandatory requirement in any corporation’s advancement agreement that cannot be expanded.

### C. Advancement For Claims Or Actions Initiated By The Advancement Claimant

Two 2015 Court of Chancery decisions—*Mooney*<sup>533</sup> and *In re Genelux Corp.*<sup>534</sup>—addressed another commonly disputed advancement issue of when a person is entitled to advancement in connection with claims or actions initiated

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524. 2015 Del. Ch. LEXIS 238, at \*47-57.

525. *Id.* at \*49.

526. *Id.* at \*53-54.

527. *Id.* at \*33-47.

528. *Id.* at \*35 (quoting *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 214 (Del. 2005)).

529. *Id.* at \*34.

530. *Id.*

531. *Id.* at \*41.

532. *Id.* at \*41-42 (discussing cases).

533. 2015 Del. Ch. LEXIS 146.

534. 2015 Del. Ch. LEXIS 269 (Del. Ch. Oct. 22, 2015) (Parsons, V.C.).

by that person. As the Court observed, “[w]hen a corporation provides for broad, mandatory advancement[,] ... an individual’s entitlement to advancement often depends on whether the expenses in question were incurred in ‘defending’ the litigation.”<sup>535</sup> The Court in *Mooney* denied the plaintiff advancement in connection with a second, separate lawsuit commenced by the plaintiff, which the Court concluded was “neither compulsory nor would it defeat or offset any affirmative claim of [the former employer].”<sup>536</sup> In reaching this conclusion, the Court was mindful that “[i]f the term defending were construed more broadly, advancement would have the potential to become an unfettered license enabling disgruntled former officers and directors to litigate at the Company’s expense.”<sup>537</sup>

In the second case of 2015 addressing the question of entitlement to advancement for affirmative conduct, *Genelux*,<sup>538</sup> the former CEO of Genelux Corp. sought advancement in connection with a proceeding in which he moved to intervene. Although Genelux had not named the plaintiff as a defendant in the underlying proceeding, which the plaintiff alleged was a conscious effort to avoid triggering his advancement rights, the underlying proceeding directly implicated the plaintiff’s rights—namely, the validity of Genelux shares issued to plaintiff as well as plaintiff’s right to elect directors to the Genelux board.<sup>539</sup> The Court thus held that were it to rule in favor of Genelux in the underlying proceeding, the plaintiff “could be barred on collateral estoppel grounds from arguing that he had discharged his fiduciary duties properly in connection with the challenged actions.”<sup>540</sup> For these reasons and others, the Court concluded that the plaintiff’s intervention in the underlying proceed “is akin to a compulsory counterclaim in that it was ‘necessarily part of the same dispute’” and therefore subject to advancement.<sup>541</sup>

#### **D. Disputes Concerning The Scope Or Reasonableness Of Demanded Advancement Amounts Determined After A Finding Of Entitlement To Advancement**

Increasingly, the Court of Chancery is first determining the issue of entitlement to advancement and only later dealing with disputes concerning the scope of that advancement.<sup>542</sup> Two 2015 Court of Chancery decisions reflecting this trend arose in the context of a challenge concerning the scope or reasonableness of the demanded advancement amounts: *Konstantino v. AngioScore, Inc.*<sup>543</sup> and *Holley v. Nipro Diagnostics, Inc.*<sup>544</sup>

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535. 2015 Del. Ch. LEXIS 146, at \*13-14.

536. *Id.* at \*35.

537. *Id.* at \*34.

538. 2015 Del. Ch. LEXIS 269.

539. *Id.* at \*11.

540. *Id.* at \*12.

541. *Id.* at \*12.

542. See, e.g., *Danenberg v. Fittracks, Inc.*, 58 A.3d 991 (Del. Ch. 2012); *Konstantino v. AngioScore, Inc.*, C.A. No. 9681-CB (Del. Ch. Aug. 15, 2014) (ORDER); *Holley v. Nipro Diagnostics, Inc.*, C.A. No. 9679-VCP (Del. Ch. Mar. 13, 2015) (ORDER).

543. C.A. No. 9681-CB (Del. Ch. Feb. 16, 2015) (TRANSCRIPT) (Bouchard, C.) (“*AngioScore* 2/16/15 Tr.”).

544. 2015 Del. Ch. LEXIS 212 (Del. Ch. Aug. 14, 2015) (Parsons, V.C.).

In both *Konstantino* and *Holley*, the Court resolved the question of whether expenses incurred in connection with both claims subject to advancement and claims not subject to advancement should be advanced in their entirety, by applying the rule of *Danenberg v. Fitracks*.<sup>545</sup> *Holley* involved objections to expenses incurred in connection with both a proceeding subject to advancement as well as a proceeding not subject to advancement; *Konstantino* involved the same objections, as well as objections to expenses incurred in the defense of a party entitled to advancement as well as a co-defendant who is not entitled to advancement.<sup>546</sup> In both cases, the Court employed a similar inquiry that erred on the side of granting advancement, asking, essentially, whether the expenses would have been incurred in connection with the covered persons or proceeding even if the persons or proceeding not covered “did not exist.”<sup>547</sup> In *Holley*, the Court held that “if the work was useful for both sets of claims, then the fees will be advanced in whole.”<sup>548</sup> In *Konstantino*, the Court held that “if something was a matter that [the plaintiff] would undertake as an effort in his own defense, then he would receive 100 percent advancement for those amounts, even if another defendant might benefit from that work.”<sup>549</sup> The Court in *Holley* observed that “the Court generally will not determine at the advancement stage whether fee requests relate to covered claims or excluded claims, unless such discerning review can be done realistically without significant burden on the Court,” and further directed that such disputes are more easily resolved at the indemnification stage.<sup>550</sup>

### E. Effect Of Representations In A Form Of Undertaking Executed In Connection With An Advancement Demand

Lastly, the Court of Chancery’s decision resolving an advancement dispute in *Blankenship v. Alpha Appalachia Holdings, Inc.*,<sup>551</sup> is notable, in part due to its length. In *Blankenship*, a defendant entity attempted to cease paying advancement amounts after its former director and officer was indicted in a criminal proceeding.<sup>552</sup> The corporate defendant

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545. 58 A.3d at 997-98.

546. *AngioScore* 2/16/15 Tr. at 12:23-13:3, 23:1-3.

547. 2015 Del. Ch. LEXIS 212, at \*7 (articulating the inquiry as “whether [the disputed] fees would have been incurred if the [proceeding that was not subject to advancement] did not exist”).

548. 2015 Del. Ch. LEXIS 212, at \*3.

549. *AngioScore* 2/16/15 Tr. at 87:23-88:4 (applying Paragraph 2 of *Konstantino v. AngioScore, Inc.*, C.A. No. 9681-CB (Del. Ch. Aug. 15, 2014) (ORDER) and discussing *Danenberg v. Fitracks, Inc.*, 58 A.3d 991 (Del. Ch. 2012)); see also *Konstantino*, 2/16/15 Tr. at 88:8-16 (“But the intent of this order is that if Dr. Konstantino could use the work for his own defense and it was in his counsel’s judgment something that could be used for his defense, if it had some collateral benefit to another party, or even if it had an obvious other benefit that was duplicative for another party, it doesn’t matter, he gets 100 percent advancement for that. That was the intent.”).

550. 2015 Del. Ch. LEXIS 212, at \*3-4. The Court echoed these sentiments in *Mooney* in determining entitlement to advancement, directing that if “the fee requests relate to *both* advanceable claims and non-advanceable claims, *i.e.*, the work is useful for both types of claims, that work is entirely advanceable if it would have been done independently of the existence of the non-advancement claims.” 2015 Del. Ch. LEXIS 146, at \*17 (citing *Danenberg*, 58 A.3d at 997-98 (noting that the nature of the advancement right counsels against granular review of each and every charge); *Paolino v. Mace Sec. Int’l*, 985 A.2d 392, 408 (Del. Ch. 2009); *AngioScore* 2/16/15 Tr. at 10-12 (concluding that fees need not be apportioned among co-defendants if the legal work would have been done regardless of the existence of co-defendants)).

551. 2015 Del. Ch. LEXIS 145 (Del. Ch. May 28, 2015) (Bouchard, C.).

552. *Id.* at \*19.

based this decision on unusual language in the former officer and director's undertaking executed in connection with his advancement demands, which provided: "It is my understanding that Massey will indemnify me and/or advance on my behalf the fees and costs associated with this representation, contingent upon the following factual representations and undertakings... I had no reasonable cause to believe that my conduct was ever unlawful."<sup>553</sup> The corporate defendant argued that this contractual contingency permitted the corporation to cease advancement if the representations were found to be untrue.<sup>554</sup> The plaintiff argued that the representations need only be true when advancement commenced, and served as assurances only to the defendant corporation.<sup>555</sup> The Court of Chancery agreed with the plaintiff, and found that a plain reading of the undertaking provided no basis upon which to deny advancement to the plaintiff.<sup>556</sup>

## V. JUDICIAL RATIFICATION UNDER 8 DEL. C. § 205

Sections 204 and 205 of the DGCL became effective on April 1, 2014, providing for the first time a path for corporations to ratify void or voidable corporate acts.<sup>557</sup> Section 204 provides a means for a board to remedy such acts.<sup>558</sup> Section 205 authorizes judicial ratification to accomplish these ends when the board cannot, such as in situations when the board's status is questionable.<sup>559</sup> More than a hundred corporations took advantage of Section 204 within the first year of its existence.

In *In re Numoda Corp. Shareholders Litigation*, the Court of Chancery's first written opinion interpreting Section 205,<sup>560</sup> the Court carefully analyzed what constitutes an "act" subject to ratification under Section 205.<sup>561</sup>

*Numoda* concerned the ratification of invalid stock theoretically issued at multiple points in time by Numoda Corporation ("Numoda Corp.") and Numoda Technologies, Inc. ("Numoda Tech").<sup>562</sup> Both corporations were primarily

553. *Id.* at \*13.

554. *Id.* at \*41-42.

555. *Id.* at \*42.

556. *Id.* at \*42-60. Careful analysis should be given to the unusual facts in *Blankenship* before applying its holdings to other cases. *See, e.g.*, *Thompson v. ORIX USA Corp.*, C.A. No. 11746-CB (Dec. 8, 2015) (Bouchard, C.) (TRANSCRIPT), at 28:11-21 (observing that *Blankenship* raised an unusual set of circumstances that might preclude it from analogizing to other advancement cases).

557. 8 DEL. C. §§ 204, 205.

558. 8 DEL. C. § 204.

559. 8 DEL. C. § 205.

560. In 2014, the Court of Chancery issued two bench rulings interpreting Section 205. *See In re Trupanion, Inc.*, C.A. No. 9496-VCP (Del. Ch. Apr. 28, 2014) (ORDER AND TRANSCRIPT) (approving ratification pursuant to Section 205) and *In re Cheniere Energy, Inc. S'holders Litig.*, C.A. No. 9710-VCL (Del. Ch. Jul. 10, 2014) (TRANSCRIPT) (addressing the procedural interplay between Section 205 and traditional stockholder actions).

561. 2015 Del. Ch. LEXIS 30 (Del. Ch. Jan. 30, 2015) (Noble, V.C.); *see also* *Boris v. Schaheen*, 2013 Del. Ch. LEXIS 292, at \*1 (Del. Ch. Dec. 2, 2013) (Noble, V.C.) (reciting background facts concerning 2015 Del. Ch. LEXIS 30).

562. *Id.* at \*2-3.

controlled by three siblings Ann S. Boris (“Ann”), John A. Boris (“John”), and Mary S. Schaheen (“Mary”), who served on both boards at various times.<sup>563</sup> Both corporations followed very informal corporate governance practices, which often failed to comply with the DGCL’s requirements.<sup>564</sup> On November 9, 2012, John and Ann purported to act by written consent to remove Mary from the boards of both corporations and to elect themselves to both boards.<sup>565</sup> Mary challenged the validity of the written consents; John and Ann responded by filing a Section 225 Action (the “225 Action”) seeking confirmation of the validity of the written consents.<sup>566</sup> In the 225 Action, the Court found that the written consent with respect to Numoda Corp. was valid, because much of the stock that Numoda Corp. had purported to issue to Mary was void.<sup>567</sup> The Court found that the written consent with respect to Numoda Tech. was invalid because Numoda Tech. had never validly issued any stock.<sup>568</sup>

*Numoda* was the consolidation of multiple cases filed after the resolution of the 225 Action seeking to validate or to obtain declaratory judgment with respect to the various invalid attempts to issue and return stock of Numoda Corp. and Numoda Tech. at issue in the 225 Action.<sup>569</sup> The primary factor assessed by the Court in determining whether to ratify each purported stock issuance or return was whether “the moving parties have provided sufficient evidence of a corporate act for the Court to confirm fairly and with reasonable certainty.”<sup>570</sup>

Before delving into the validity of the individual acts at issue, the Court considered what powers were conferred by Sections 204 and 205. At a high level, it concluded that “[t]he legislation ... empowers the Court to grant an equitable remedy for corporate acts that once would have been void at law and unreachable by equity.”<sup>571</sup> Guided by the legislative synopsis for Sections 204 and 205, the Court reasoned that the statute permitted the Court “to act even in situations where corporate formalities are barely recognizable[,]” but that “[t]he Court cannot determine the validity of a defective corporate act without an underlying corporate act to analyze.”<sup>572</sup> Under this metric, “[e]ven an *ultra vires* act can be a corporate act[,]” but “[o]ur law would fall into disarray if it recognized, for example, every conversational agreement of two of three directors as a corporate act.”<sup>573</sup> The Court therefore explained that it “looks to organizational documents, official minutes, duly adopted resolutions, and a stock ledger, for example, for evidence of corporate acts.”<sup>574</sup>

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563. *Id.*

564. *Id.* at \*4; *Boris*, 2013 Del. Ch. LEXIS 292, at \*4-5.

565. *Boris*, 2013 Del. Ch. LEXIS 292, at \*1.

566. *Boris*, 2013 Del. Ch. LEXIS 292.

567. *Id.* at \*31-39, \*64.

568. *Id.* at \*2-3.

569. 2015 Del. Ch. LEXIS 30, at \*17.

570. 2015 Del. Ch. LEXIS 30, at \*1.

571. *Id.* at \*25.

572. *Id.* at \*28-29.

573. *Id.* at \*31-32.

574. *Id.* at \*32.

Applying this rule to the purported acts at issue in *Numoda*, the Court first concluded that there was sufficient evidence of a corporate act attempting to grant stock to third parties in 2004 where there were defective stock certificates for the putative stock, unsigned board minutes of a meeting concerning the issuance, and where the parties had reached an agreement to attempt to ratify the stock (although that ratification was itself ineffective).<sup>575</sup> Second, the Court concluded that testimony by various parties and sundry documents reflecting Mary holding 400,000 Numoda Corp. shares were insufficient to prove that some corporate act occurred because Mary could not establish when any board approved an issuance of these 400,000 shares to her.<sup>576</sup> Third, in contrast, the Court found that Mary had shown that a corporate act purporting to issue her 5,750,000 Numoda Corp. shares had occurred where Ann and Mary met to discuss board business and directed the issuance of the shares at that time.<sup>577</sup> Fourth, the Court also found sufficient evidence of a corporate act purporting to issue 5,100,000 shares of Numoda Corp. stock to a third-party where a defective stock certificate was issued and there was a later, albeit, invalid attempt to ratify the initial issuance.<sup>578</sup> Fifth, and finally, the Court found that, although the parties had generally believed and acted as though Numoda Tech. had been or would be spun off from Numoda Corp., there was no defective corporate act by Numoda Tech. purporting to effect the spin-off in the absence of completed stock certificates or evidence of Numoda Tech. board meetings.<sup>579</sup> After determining that there was no underlying corporate act to ratify with respect to the spin-off, the Court separately noted that the various equitable factors set forth in Section 205(d) did not convince the Court that a different outcome was appropriate.<sup>580</sup>

Based on the various ratifications effected in *Numoda*, the Court found that the outcome of the 225 Action should be reversed because the retroactive ratification of various stock issuances by Numoda Corp. diluted Ann and John's stockholdings such that Ann and John's written consent removing Mary from the Numoda Corp. board was invalid.<sup>581</sup>

The Court of Chancery's decision in *In re Genelux*,<sup>582</sup> resolved an issue of first impression, holding that Section 205 of the DGCL, which permits the Court of Chancery to "[d]etermine the validity of any corporate act or transaction and any stock, rights or options to acquire stocks,"<sup>583</sup> can only be used to validate defective corporate actions, not to declare an action invalid.

*Genelux* involved a contested annual election of directors, which hinged on whether certain shares of stock were issued validly or lacked consideration when issued.<sup>584</sup> The plaintiffs, the corporation and one of its founders, sought to

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575. *Id.* at \*36.

576. *Id.* at \*37.

577. *Id.* at \*38.

578. *Id.* at \*41.

579. *Id.*

580. *Id.* at \*42.

581. *Id.* at \*53-54.

582. 126 A.3d 644 (Del. Ch. 2015).

583. 8 DEL. C. § 205(a)(4).

584. 126 A.3d at 647.

set aside the intervenor's election of two directors by having the Court declare stock issued to the intervenor invalid.<sup>585</sup> The plaintiffs contended that inherent within the Court's power to "determine the validity" of "any stock" lies the power to deem such stock invalid.<sup>586</sup> The defendants and intervenor disagreed, arguing that "viewing that phrase in a vacuum ignores the overall structure of the statute, which makes clear that the relief available under Section 205 is the validation of presumed defective and otherwise incurable acts (which the Court can then grant or deny), not the invalidation of acts presumed for years by a company or a stockholder to be valid."<sup>587</sup> Because the Court viewed both the plaintiffs' and the defendants' interpretation of Section 205 as reasonable, the Court deemed Section 205 ambiguous, and looked to outside sources to discern the statute's meaning.

The Court concluded that outside sources supported the interpretation of Section 205 preferred by the defendants—that "Section 205 was intended to be a remedial statutes designed in conjunction with Section 204, to cure otherwise incurable defective corporate acts, not a statute to be used to launch a challenge to stock issuances on grounds already available through the assertion of plenary-type claims ...."<sup>588</sup> This reading is supported by the legislative history of Sections 204 and 205, which makes clear that the legislative intent behind Section 205 was to abrogate the draconian effects of prior Delaware case law that made acts void under law incurable in equity.<sup>589</sup> The Court further deemed this conclusion consistent with several provisions of Section 205, including factors in Section 205(d) concerning "whether the company believed the act was valid and treated it that way" and "whether validating the act would cause harm that the act itself originally would not have cause," among others.<sup>590</sup>

While a similar claim might be made in a Section 225 case, there are limits to who might pursue a Section 225 claim, so *Genelux* sets forth a meaningful limitation as to the scope of relief available under Delaware law.<sup>591</sup>

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585. *Id.*

586. *Id.* at 666.

587. *Id.*

588. *Id.* at 668.

589. *Id.* at 667 (discussing *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991) and *Blades v. Wisheart*, 2010 Del. Ch. LEXIS 227 (Del. Ch. Nov. 17, 2010)).

590. *Id.* at 668.

591. *Id.* at 669.



## RECENT DEVELOPMENTS IN DELAWARE COMMERCIAL LAW: IMPORTANT DECISIONS AND LEGISLATION FOR CONTRACT DRAFTING

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Over the past few years, there have been numerous developments in Delaware commercial law as a result of court decisions and legislation. This article addresses a few of these developments that are particularly relevant to drafting and interpreting certain provisions in merger agreements, stock purchase agreements, asset purchase agreements and other transaction documents. This article is not intended to address all such recent developments, but instead discusses a subset of cases and legislation specifically involving the following topics: (i) availability of remedies for breach of an agreement to negotiate in good faith; (ii) enforceability of indemnification and release provisions in a merger agreement; (iii) legislation passed in Delaware in 2014 authorizing a statute of limitations of up to twenty years for breach of contract claims; and (iv) interpretation of contractual provisions that bar claims for misrepresentations based on statements or omissions made outside the express terms of a written agreement.

### I. AGREEING TO NEGOTIATE IN GOOD FAITH: AN ANALYSIS OF THE *PHARMATHENE, INC. V. SIGA TECHNOLOGIES, INC.* DECISIONS

A term sheet or similar document outlining the material terms of a transaction may include a provision that the parties agree to negotiate in good faith. Prior to the Delaware Supreme Court's (the "Court") decision in *SIGA Technologies, Inc. v. PharmAthene, Inc.*,<sup>1</sup> it was unsettled as a matter of Delaware law whether expectation damages were recoverable for breach of such a provision.<sup>2</sup> The Court in *SIGA Technologies* answered that question in the affirmative, through resolving an initial appeal by remand back to the Chancery Court and then, following a second appeal, affirming the Chancery Court's subsequent decision. The series of decisions in *SIGA Technologies* provides helpful guidance to practitioners who advise clients on whether to include agreements to negotiate in good faith in deal documents. The discussion below provides a summary of the *SIGA Technologies* decisions followed by an analysis of their implications for practitioners.

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1. *SIGA Techs., Inc. v. PharmAthene, Inc.*, 67 A.3d 330 (Del. 2013).
2. *See id.* at 350.

## A. SUMMARIZING THE *SIGA TECHNOLOGIES* DECISIONS

### I. Factual Background<sup>3</sup>

#### a. The License Agreement Term Sheet

The dispute in this case arose from a proposed collaboration between two biodefense companies, plaintiff, PharmAthene, Inc. (“PharmAthene”), and defendant, SIGA Technologies, Inc. (“SIGA”), to develop a drug to prevent and treat smallpox. SIGA acquired the technology for the smallpox drug, ST-246, at a time when commercial prospects were largely unknown. However, SIGA encountered financial difficulties and, therefore, was independently unable to develop ST-246. Also, SIGA lacked the administrative know-how to take ST-246 to market. SIGA approached PharmAthene, and the parties discussed collaborating to develop ST-246 and introduce it into the stream of commerce. PharmAthene initially attempted to engage SIGA in merger discussions; SIGA resisted because the parties had unsuccessfully attempted to consummate a merger years earlier due to the reservations of PharmAthene’s board members. Therefore, SIGA wanted to put in place a framework for a license agreement with PharmAthene before engaging in further merger discussions.

As the parties realized that the market potential for ST-246 could be in excess of \$1 billion, they began negotiating the terms of a license agreement in earnest. SIGA and PharmAthene negotiated through several versions of a license agreement term sheet (the “LATS”). Toward the end of negotiations of the LATS, SIGA requested two changes, which PharmAthene incorporated into the version that it presented to its board. The meeting minutes, however, did not indicate that PharmAthene’s board approved the LATS and the LATS remained unsigned. However, a representative of PharmAthene informed SIGA’s representative that the PharmAthene board had indeed approved the LATS as revised to reflect SIGA’s two requested changes. PharmAthene believed that the parties “had ‘a deal’ ... [and] ‘could now talk about a merger.’”<sup>4</sup>

A clean copy of the revised LATS was prepared, which included the parties’ collaborative objective and various terms relating to patents, licenses, royalties and fees. The LATS was not signed and included a footer on each page that stated “Non Binding Terms.” The LATS contemplated that: (i) SIGA would grant PharmAthene a “worldwide exclusive license ... to use, develop, make, have made, sell, export and import” ST-246 products;<sup>5</sup> (ii) the license would cover ST-246-related products worldwide and know-how related to ST-246; (iii) research and development committees would include both PharmAthene and SIGA representatives; and (iv) PharmAthene would fund the research and development based on a specified budget. The LATS also contained economic terms. Specifically, it provided that PharmAthene would pay SIGA: (i) a license fee in three portions (upfront, deferred and triggered); (ii) specified amounts upon achievement of development milestones; and (iii) certain royalty payments. Additionally, once net margins on sales to the United States government hit a certain mark, SIGA was entitled to fifty percent (50%) of those profits.

#### b. The Merger Discussions

After completing negotiations of the LATS, the PharmAthene board re-evaluated its position and communicated to SIGA that it wished to consider a merger. Still in perilous financial condition, however, SIGA asked PharmAthene

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3. The facts in Section I.A.1. are based on the findings in the Chancery Court’s opinion in *PharmAthene, Inc. v. SIGA Technologies, Inc.*, C.A. No. 2627-VCP, 2011 WL 4390726 (Del. Ch. Sept. 22, 2011).

4. *PharmAthene, Inc.*, 2011 WL 4390726, at \*5.

5. *Id.*

for bridge financing to enable SIGA to continue to develop ST-246 while negotiating the terms of the merger. The parties' discussions ultimately led them to pursue a merger with a definitive license agreement as a fallback should merger negotiations prove unsuccessful, and an agreement that PharmAthene would provide SIGA with the requested bridge financing. SIGA did not want to pay lawyers to draft a formal license agreement while merger talks were ongoing and suggested that PharmAthene, instead, attach the LATS to the merger agreement with the understanding that the parties would, at a minimum, enter into a license agreement in accordance with the terms of the LATS if the merger was never consummated. This proposal was acceptable to PharmAthene, and the final term sheet for the merger both referred to the LATS and included the LATS as an attached exhibit. The merger term sheet provided that "SIGA and PharmAthene will negotiate the terms of a definitive License Agreement in accordance with the terms set forth in the Term Sheet ... attached on Schedule 1 hereto."<sup>6</sup> The parties also signed a letter of intent, to which they also attached the merger term sheet and the LATS.

### **c. The Loan Agreement**

SIGA and PharmAthene then entered into a binding bridge loan agreement (the "Loan Agreement") whereby PharmAthene loaned SIGA \$3 million for expenses relating to development of ST-246 and overhead costs. The Loan Agreement provided that if the merger was terminated (by termination of the merger term sheet or the merger agreement, or if the merger agreement was not executed), "SIGA and PharmAthene will negotiate in good faith with the intention of executing a definitive License Agreement in accordance with the terms set forth in the License Agreement Term Sheet attached as Exhibit C ...."<sup>7</sup>

### **d. The Failed Merger**

SIGA and PharmAthene then signed a merger agreement (the "Merger Agreement"), also a binding agreement, which provided that "if the merger were terminated, the parties would negotiate a definitive license agreement in accordance with the terms of the LATS."<sup>8</sup> The Merger Agreement further provided that the parties would use "best efforts to take such actions as may be necessary or reasonably requested by the other parties hereto to carry out and consummate the transactions contemplated by this Agreement."<sup>9</sup> Internal SIGA emails suggested that SIGA would likely have a long-term relationship with PharmAthene based on the parties' talks. PharmAthene began to provide development assistance in its areas of expertise to SIGA and assisted SIGA in getting ST-246 to several important milestones, including a clinical trial paid for with proceeds from the PharmAthene loan. The National Institutes of Health then awarded \$16.5 million (the "NIH Award") to SIGA for ST-246's development.

However, approvals required from the Securities and Exchange Commission (the "SEC") relating to the merger lagged. Therefore, PharmAthene requested that SIGA extend the termination date set forth in the Merger Agreement.

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6. *Id.* at \*6.

7. *Id.* at \*7.

8. *Id.* at \*8.

9. *Id.*

Given ST-246's recent successes, however, SIGA cooled to the idea of a merger with PharmAthene, and SIGA's board terminated the merger. SIGA subsequently announced ST-246 successes, including the NIH Award and ST-246's one hundred percent (100%) success rate in preventing smallpox in primates. SIGA stock began trading over three times the price it had been trading when SIGA and PharmAthene began their discussions.

### e. The Failed License Agreement

After the Merger Agreement's termination, PharmAthene sent to SIGA a proposed license agreement that incorporated the LATS terms (the "Proposed License Agreement"). SIGA insisted on meeting with PharmAthene before revising the Proposed License Agreement. At the meeting, SIGA emphasized the title of the LATS — a "Siga/PharmAthene partnership" — and its desire to revise some economic terms in light of the clinical successes of ST-246 since the negotiation of the LATS. PharmAthene expressed its position that the parties were bound by the terms of the LATS, but was willing to listen to SIGA's proposal.

SIGA then forwarded a limited liability company agreement (the "LLC Agreement") to PharmAthene. PharmAthene viewed that document as "completely ignor[ing] the LATS,"<sup>10</sup> given the fact that both economic and noneconomic terms of the deal were revised to significantly favor SIGA. PharmAthene asserted this position to SIGA, but nonetheless expressed a willingness to consider some changes to the LATS. SIGA responded that the LATS was not binding because of the "Non Binding Terms" footer. SIGA demanded that PharmAthene "negotiate 'without preconditions' regarding the binding nature of the LATS, [or] the parties had 'nothing more to talk about.'"<sup>11</sup>

PharmAthene responded by filing suit, asserting claims for breach of contract, promissory estoppel and unjust enrichment. Specifically, PharmAthene sought: (a) specific performance of a license agreement that conformed to the terms of the LATS; (b) a declaration ordering SIGA to execute a license agreement that conformed to the terms of the LATS and prohibiting SIGA from entering into a joint venture with anyone else to develop ST-246; (c) damages for (i) breach of contract, (ii) SIGA's failure to execute a license agreement and (iii) SIGA's breach of its obligation to negotiate in good faith and to use best efforts to complete the LATS-envisioned transactions; and (d) damages on grounds of promissory estoppel and unjust enrichment.

SIGA denied liability, and particularly, that the parties reached a binding license agreement. In that regard, SIGA argued that the parties lacked intent to be bound and did not include the necessary, definitive terms of a license agreement in the LATS. SIGA further asserted that the agreement regarding the LATS was an unenforceable agreement to agree. SIGA also counterclaimed that PharmAthene breached the duty to negotiate a license agreement in good faith in accordance with the LATS, resulting in SIGA incurring expenses relating to the preparation of the LLC Agreement that PharmAthene refused to consider.

## 2. The Chancery Court's Initial Decision

The first issue the court addressed was whether the LATS constituted a binding contract. The court found that the LATS, standing alone, was not an enforceable contract because it was unclear whether the parties' intended to be

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10. *Id.* at \*10.

11. *Id.*

bound. The LATS was also attached to the letter of intent, the Loan Agreement and the Merger Agreement (each of which included a provision that the parties would negotiate a license agreement in good faith in accordance with the LATS if the merger did not close). However, due to the “murky” factual record surrounding the LATS’s “Non Binding Terms” footer and the terms of the Loan Agreement and Merger Agreement (which stated that the parties would negotiate a license agreement), the court was unconvinced that the parties “intended to be bound to a specific license agreement when they agreed to attach the LATS” to such transaction documents.<sup>12</sup> Further, the court was persuaded that the LATS did not include all essential terms of a license agreement and, for that reason, the court could not order specific performance of a license agreement based upon the LATS.

The court then addressed whether SIGA breached its obligation to “negotiate in good faith” a license agreement that contained “substantially the same economic terms” as the LATS, as expressly provided in both the Loan Agreement and the Merger Agreement.<sup>13</sup> The court found that SIGA did, in fact, breach that obligation. The court recited the “number of promising events” that occurred between the time the parties signed the Merger Agreement and its termination, which showed ST-246’s potential for large-scale success. The court also noted that after termination of the Merger Agreement, PharmAthene prepared the Proposed License Agreement, which incorporated the LATS’s terms, and that SIGA responded by proffering the LLC Agreement in which “virtually every term ... was more favorable to SIGA than the corresponding provision in the LATS”.<sup>14</sup> In its analysis, the court noted the following:

In considering the duty to negotiate in good faith, this Court has held that an attempt to condition future agreement on a previously “contested and compromised” point is “an unambiguous act of bad faith” where the other party performed in reliance on that compromise. PharmAthene has made such a showing in this case. Specifically, the evidence proves that SIGA and PharmAthene contested and compromised the primary economic terms of a license to ST-246 in the LATS, that PharmAthene acted in reliance on that compromise, and that SIGA disregarded those terms and attempted to negotiate a definitive license agreement that contained economic and other terms drastically different and significantly more favorable to SIGA than those in the LATS. Accordingly, I find that SIGA acted in bad faith in relation to its duty to negotiate the terms of a licensing agreement in accordance with the terms of the LATS.<sup>15</sup>

When the Merger Agreement was terminated, the provisions in the Loan Agreement and Merger Agreement relating to the LATS were triggered, requiring SIGA to negotiate in good faith a license agreement that contained economic terms similar to the LATS. The court found that SIGA’s proposed economic terms in the LLC Agreement were sufficiently different from the LATS evidencing that SIGA was acting in bad faith.<sup>16</sup> Further, SIGA attempted to renegotiate the terms of its deal after PharmAthene upheld its end of the bargain and undertook an economic risk by providing

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12. *Id.* at \*16.

13. *Id.* at \*19.

14. *Id.* at \*21.

15. *Id.* at \*22.

16. “The terms proposed under the Draft LLC Agreement, however, were not similar to the LATS, nor were they intended to be.” *Id.* at \*24.

SIGA a loan pursuant to the terms of the Loan Agreement. Upon consideration of all of these factors, the court found that “SIGA breached its duty to negotiate a license agreement in good faith in accordance with the terms of the LATS.”<sup>17</sup>

After finding that PharmAthene provided sufficient evidence to support the elements of promissory estoppel, but that PharmAthene’s unjust enrichment claim was subsumed within its other claims, the court turned to the question of remedies.

The court noted that remedies for breach of contract and promissory estoppel could overlap within its consideration of the appropriate remedy for SIGA’s breach of its obligation to negotiate in good faith. PharmAthene requested specific performance or expectation damages. The court stated that while specific performance likely was a permissible remedy for breach of an agreement to negotiate in good faith, it is practically difficult to enforce such an order in situations (like here) where the relationship between the parties has deteriorated. Therefore, the court determined that ordering SIGA to negotiate a license agreement in accordance with the terms of the LATS was not an appropriate remedy.<sup>18</sup>

The court then addressed the propriety of expectation damages — the standard remedy for breach of contract under Delaware law — which must be proven with reasonable certainty. The court analyzed whether damages in this case were speculative or merely lacked mathematical precision.<sup>19</sup> The court looked to “whether the contingencies remaining after the parties had agreed to agree were such that the value of the lost opportunity was fairly measurable.”<sup>20</sup> Applying the facts, the court stated that it could not award PharmAthene estimated lost profits on a license agreement with SIGA when such an agreement was never consummated and, had it been, may have resulted in no profits.<sup>21</sup> The present value of future profits PharmAthene would have received absent SIGA’s breach was “speculative and too uncertain, contingent and conjectural.”<sup>22</sup> However, the court left open the possibility that, in an appropriate case, expectation damages could provide the claimant the net present value of what the parties had (or demonstrably would have) agreed to exchange when the breach occurred.<sup>23</sup>

Having rejected specific performance and expectation damages as appropriate remedies, the court relied upon its broad discretion under the equities to fashion an appropriate remedy and analyzed an equitable payment stream. In its analysis, the court found that, but for SIGA’s bad faith, the parties likely would have entered into a license agreement that generally conformed to the LATS (albeit with somewhat varied terms), which PharmAthene indicated it was willing to consider.<sup>24</sup> The court found that the appropriate remedy would be to award PharmAthene a future stream of payments for a defined period of time after sales of ST-246 commenced, taking into account certain expenses, on economic terms

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17. *Id.* at \*26.

18. *See id.* at \*31.

19. *See id.*

20. *Id.* at \*33.

21. *See id.*

22. *Id.* at \*37.

23. *See id.* at \*33.

24. *See id.* at \*38.

that the court found aligned with the parties' negotiations.<sup>25</sup> The court also awarded PharmAthene attorneys' fees and a portion of PharmAthene's expert witness fees.<sup>26</sup>

SIGA, unsatisfied with this outcome, appealed.<sup>27</sup>

### 3. The Delaware Supreme Court's Decision On Appeal

On appeal, the Court affirmed the Chancery Court's determination that SIGA breach its contractual obligation to negotiate a license agreement in good faith and, in doing so, reaffirmed its precedent that an obligation to negotiate in good faith is enforceable.<sup>28</sup> Further, the Court decided an unsettled question of Delaware law, holding that, in the context of a preliminary agreement that includes material terms but leaves other terms open for further good faith negotiation, "[w] here a trial judge makes a factual finding, supported by the record, that the parties would have reached an agreement but for the defendant's bad faith negotiation, we hold that a trial judge may award expectation damages."<sup>29</sup> The court reversed the Chancery Court's finding that SIGA was liable under the grounds of promissory estoppel, noting that PharmAthene and SIGA's promise to negotiate in good faith was fully enforceable and, therefore, a promissory estoppel claim could not be supported.<sup>30</sup> The Court also reversed the Chancery Court's award of equitable damages and directed the Chancery Court to revisit its damages award in light of the Court's opinion.

Notably, within its consideration of the proper remedy for PharmAthene, the Court analyzed case law from other jurisdictions which recognize the existence of "Type I" and "Type II" binding preliminary agreements and the types of remedies available for their breach.<sup>31</sup> A "Type I" agreement exists when the parties have agreed on all points that require negotiation but have not yet memorialized their agreement in a formal contract; a "Type II" agreement exists when parties "agree on certain major terms, but leave other terms open for negotiation."<sup>32</sup> The Court also noted that its decision in *Titan Investment Fund II, LP v. Freedom Mortgage Corporation*<sup>33</sup> left open the question of whether expectation

25. "I find that a payment stream consistent with the above terms would compensate PharmAthene for its expectancy interest with sufficient certainty to meet the requirements for relief from a breach of contract and promissory estoppel and to prevent injustice in the circumstances of this case." *Id.* at \*42.

26. *See id.* at \*43-45.

27. SIGA's appeal went forward after the Court of Chancery denied SIGA's motion for reargument based on the courts "unprecedented remedy" of an equitable payment stream/lien. *See PharmAthene, Inc. v. SIGA Tech's, Inc.*, C.A. No. 2627-VCP, 2011 WL 6392906 (Del. Ch. Dec. 16, 2011).

28. *SIGA Techs., Inc. v. PharmAthene, Inc.*, 67 A.3d 330, 333-334, 343-344 (Del. 2013).

29. *Id.* at 334.

30. "Promissory estoppel does not apply, however, where a fully integrated, enforceable contract governs the promise at issue." *Id.* at 348.

31. *Id.* at 349.

32. *Id.* (quoting *Adjustrite Sys., Inc. v. GAB Bus. Servs., Inc.*, 145 F.3d 543, 548 (2d Cir.1998)).

33. 53 A.3d 984 (Del. 2012).

damages could be awarded when a trial judge finds that the parties would have reached an agreement but for the defendant's breach.<sup>34</sup> The Court's discussion of remedies culminated in its finding: "where the parties have a Type II preliminary agreement to negotiate in good faith, and the trial judge makes a factual finding, supported by the record, that the parties would have reached an agreement but for the defendant's bad faith negotiations, the plaintiff is entitled to recover contract expectation damages."<sup>35</sup>

The Chancery Court made such a factual finding in this case; however, when forming its remedy, the Chancery Court recognized that *Titan Investment* did not provide guidance regarding whether expectation damages are available in such a factual setting.<sup>36</sup> Due to the previous lack of clarity in the law, and because the Court could not ascertain to what extent the Chancery Court's damages award was based on the now-reversed finding of promissory estoppel rather than liability based on breach of contract, the Court reversed the Chancery Court's award and remanded the matter for reconsideration of damages in light of the Court's opinion.<sup>37</sup>

#### 4. The Chancery Court's Decision On Remand

On remand, PharmAthene and SIGA's contentions centered on the issue of potential remedies. PharmAthene contended that all potential remedies, even those previously analyzed and discarded by the Chancery Court, were available.<sup>38</sup> SIGA contended that, based on the Court's decision, only contractual remedies were available and PharmAthene failed to prove expectation damages with reasonable certainty.<sup>39</sup>

The crux of the dispute regarding expectation damages was the applicable legal standard for awarding such damages; specifically, "what does it mean to be able to prove damages with reasonable certainty?"<sup>40</sup> The court stated that if the fact of damages is proven, less certainty can exist regarding the proof of the amount of damages and the circumstances surrounding the breach can affect the level of proof required.<sup>41</sup> The court disagreed with SIGA, found that PharmAthene adequately proved its entitlement to expectation damages and awarded damages to PharmAthene in a lump sum representing lost profits.<sup>42</sup>

In reconsidering the testimony (including expert testimony) presented at trial, the court found that PharmAthene established by a preponderance of the evidence several key metrics which informed the Court's

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34. *SIGA Techs., Inc.*, 67 A.3d 300, 350.

35. *Id.* at 350-351.

36. *See id.* at 350.

37. *See id.* at 351-352.

38. *PharmAthene, Inc. v. SIGA Techs., Inc.*, C.A No. 2627-VCP, 2014 WL 3974167, at \*1 (Del. Ch. Aug. 8, 2014).

39. *See id.*

40. *Id.* at \*8.

41. *See id.* (citing *Cura Fin. Servs. N.V. v. Elec. Payment Exch., Inc.*, 2001 WL 1334188, at \*20 (Del. Ch. Oct. 22, 2001)).

42. *See id.*

determination of the amount of lump sum expectation damages to which PharmAthene was entitled.<sup>43</sup> The court awarded over \$113 million in damages to PharmAthene.<sup>44</sup>

SIGA, once again, appealed.

## 5. The Delaware Supreme Court's Decision On Appeal

In considering SIGA's second appeal, the majority of the Court affirmed the Chancery Court's decision that PharmAthene met its burden to prove expectation damages with reasonable certainty and the amount of its award of monetary damages.<sup>45</sup> Justice Valihura filed an opinion concurring in part and dissenting in part.<sup>46</sup>

SIGA's appeal focused on two issues: (1) whether the law of the case doctrine precluded the Chancery Court from reevaluating whether expectation damages were an appropriate remedy; and (2) if not, whether the Chancery Court should have found on remand, as it had in the first instance, that expectation damages were too speculative to issue an award.<sup>47</sup> In its decision resolving SIGA's earlier appeal, the Court: (i) "expressly instructed [the Court of Chancery] to reconsider expectation damages;"<sup>48</sup> (ii) decided a previously-undecided question of law regarding whether expectation damages were available for breach of a Type II agreement; and (iii) overturned the Chancery Court's award of damages based on a theory of promissory estoppel and directed the Chancery Court to analyze the appropriate damages available under a breach of contract theory.<sup>49</sup> Therefore, the Court resolved the issues raised in SIGA's second appeal by finding that the law of the case doctrine did not preclude the Chancery Court from reevaluating the availability of expectation damages.<sup>50</sup>

The Court also found that the Chancery Court did not abuse its discretion in determining that PharmAthene met its burden of proving expectation damages and awarding a lump-sum payment.<sup>51</sup> The Court affirmed that the Chancery Court applied the correct legal standard, that "expectation damages must be proven with reasonable certainty."<sup>52</sup> However, under Delaware law, where the fact of damages (*i.e.*, that there would have been profits from the contract) has

43. These included (i) that the parties reasonably expected ST-246 to be commercialized in the near future, (ii) that sales would begin by 2010 at the latest, (iii) the price at which ST-246 and quantity of ST-246 that would be sold to the U.S. government, (iv) that quantity of sales to other parties. *See id.* at \*10-18.

44. *See PharmAthene, Inc. v. SIGA Techs., Inc.*, C.A. No. 2627-VCP, 2015 WL 98901 (Del. Ch. Jan. 7, 2015).

45. *See Siga Techs., Inc. v. PharmAthene, Inc.*, No. 20, 2015, 2015 WL 9467037, at \*1 (Del. Dec. 23, 2015), as corrected (Dec. 28, 2015).

46. *See id.* at \*23.

47. *See id.* at \*1.

48. *Id.* at \*15.

49. *See id.*

50. *See id.*

51. *See id.* at \*15-16.

52. *Id.* at \*16.

been proven, less certainty is required regarding the amount of damages.<sup>53</sup> The Chancery Court found that PharmAthene “firmly established the fact of damages,”<sup>54</sup> with PharmAthene losing out on a very attractive economic and reputational opportunity to develop, market and sell ST-246.<sup>55</sup> The Court also found that the Chancery Court applied the “wrongdoer rule,” where doubts regarding the extent of damages are generally resolved against the breaching party, in “a limited and proper way” where SIGA’s breach resulted in the lack of more particular information regarding damages.<sup>56</sup> Further, the Court found that the Chancery Court’s reliance on post-breach evidence, when it used the LATS economic terms to decide what expectation damages were available, was also limited and proper and that the Chancery Court’s factual findings were not clearly erroneous.<sup>57</sup> Therefore, the Court affirmed the Chancery Court’s decision that SIGA was liable to PharmAthene for expectation damages of over \$113 million.<sup>58</sup>

Justice Valihura concurred with the majority’s conclusion that the trial court’s earlier decision, finding that expectation damages were too speculative to award, was not the law of the case because the Court directed the trial court to reconsider a damages award.<sup>59</sup> However, Justice Valihura emphasized that “this Court also stated clearly . . . that expectation damages must be proven with reasonable certainty. No recovery can be had for damages that are ‘uncertain, contingent, conjectural, or speculative.’”<sup>60</sup> In her dissent, Justice Valihura disagreed with several of the majority’s findings, including its stated standard of proof for awarding expectation damages.<sup>61</sup> Justice Valihura analyzed the body of New York case law on preliminary “Type I” and “Type II” agreements and stressed how those courts “disfavor[ed] awarding expectation damages in cases of a breach of a Type II preliminary agreement,”<sup>62</sup> and, instead, favored awarding reliance damages, which she considered to be appropriate in this case.<sup>63</sup>

## B. The Implications Of The *PharmAthene* Decisions

Although *PharmAthene* involved an award of expectation damages for a breach of an agreement to negotiate in good faith, the *PharmAthene* decisions suggest that whether expectation damages should be awarded for such a breach

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53. *See id.*

54. *Id.* at \*17

55. *See id.*

56. *See id.* at \*18

57. *See id.* at \*18-22

58. *See id.* at \*23

59. *See id.*

60. *Id.* (quoting *SIGA Techs., Inc.*, 67 A.3d 330, 351 n.99)

61. *See id.* at \*24.

62. *Id.* at \*26.

63. *See id.* at \*23, \*27.

depends on the facts and circumstances of a particular case. As discussed above, the particular facts and circumstances in *PharmAthene* included a provision requiring good faith negotiation in ancillary, binding agreements coupled with highly negotiated terms (including economic terms) relating to an anticipated additional agreement. Also, the found bad faith conduct by SIGA resulted in SIGA's realization of significant economic benefits.

In other contexts, such as a non-binding letter of intent, it is unclear whether *PharmAthene* would have any application. In that regard, Delaware courts applying Delaware law have generally held that a letter of intent will be nonbinding if it expressly states that it is nonbinding.<sup>64</sup> However, the landscape of Delaware law relating to agreements to negotiate in good faith has now changed as a result of the *PharmAthene* decisions. Importantly, *PharmAthene* established that expectation damages may be available for a breach of an agreement to negotiate in good faith and affirmed that, while the fact of damages in such a case must be proven with reasonable certainty, the amount of damages can be proven with less certainty.<sup>65</sup> However, we note that, as a matter of Delaware law, contractual clauses that preclude various types of damages, such as consequential damages, are typically enforceable, and no such limitation was involved in *PharmAthene*.<sup>66</sup>

Among other lessons from the *PharmAthene* decisions that may be relevant to practitioners, we specifically highlight that it seems that a court applying Delaware law in determining remedies for breach of an agreement to negotiate in good faith may look to at least two factors: (1) the factual record of the parties' negotiations; and (2) the facts and circumstances that may exist at the time of future negotiations.

## 1. Factual Record Of Negotiations

Delaware courts (including the Court of Chancery in *PharmAthene*) have held that an "attempt to condition future agreement on a previously 'contested and compromised' point is 'an unambiguous act of bad faith' where the other party performed in reliance on that compromise."<sup>67</sup> In *PharmAthene*, the parties "contested and compromised" the primary economic terms relating to the license of ST-246 by negotiating the LATS.<sup>68</sup> PharmAthene acted in reliance on the agreement to negotiate in good faith by providing operational and other assistance to SIGA in the early stages of ST-246's development.<sup>69</sup> SIGA then refused to enter into an agreement on the terms of the LATS and, instead, proposed a deal with significantly different economic terms which, under Delaware law, was held to be *de facto* bad faith.<sup>70</sup>

64. See *Global Asset Capital, LLC v. Rubicon US REIT, Inc.*, No. 5071-VCL, Tr. at 89 (Del. Ch. Nov. 16, 2009).

65. See *SIGA Techs., Inc.*, 67 A.3d at 351-51; *Siga Techs., Inc.*, 2015 WL 9467037, at \*16.

66. *eCommerce Indus., Inc. v. MWA Intelligence, Inc.*, C.A. No. CV 7471-VCP, 2013 WL 5621678, at \*45 (Del. Ch. Sept. 30, 2013); see *Eisenmann Corp. v. Gen. Motors Corp.*, 2000 WL 140781, at \*22 (Del. Super. Jan. 28, 2000) (enforcing a limitation of liability provision stating that "neither party shall be liable to the other for consequential damages whatsoever and/or lost profit"); *Yellow Book USA v. Sullivan*, 2003 WL 1848650, at \*7 (Del. Com. Pl. Feb. 20, 2003) (upholding a limitation of liability clause). Delaware courts recognize that Delaware's strong presumption in favor of freedom of contract suggests that "parties to a contract should be entitled to draft agreements so as to avoid certain of the duties and liabilities that are normally part of a contractual relationship." *eCommerce Indus., Inc.*, 2013 WL 5621678, at \*45.

67. *PharmAthene, Inc.*, 2011 WL 4390726, at \*22.

68. See *id.*

69. See *id.* at \*8, 22.

70. See *id.* at \*22.

The lesson from *PharmAthene* is clear — one cannot benefit from the present certainty of an agreement to negotiate in good faith based on previously compromised terms and then abandon those terms if the future presents a better opportunity. Therefore, practitioners should consider the factual record in negotiating and compromising on terms of a potential transaction with an understanding that a future proposal to change such terms could be evidence of bad faith negotiations.

## 2. Facts And Circumstances That May Exist At The Time Of Future Negotiations

In *PharmAthene*, SIGA abandoned its obligation to negotiate in good faith a license agreement that conformed to the terms of the LATS, at least in part, because the facts and circumstances surrounding the development of ST-246 changed.<sup>71</sup> During the course of SIGA and PharmAthene's negotiations, market conditions surrounding the development and sale of ST-246 became more favorable and it became clear that ST-246 likely would be a viable and much-sought-after drug.<sup>72</sup> The record suggests that these facts and circumstances were a major factor in SIGA's decision to all but abandon the terms of the LATS and propose an agreement that "contained economic and other terms drastically different and significantly more favorable to SIGA than those in the LATS."<sup>73</sup> These facts underscore the importance of considering during negotiations whether to include a binding agreement to negotiate in good faith and whether to leave certain terms open for future discussion.

## II. STRUCTURING RELEASE AND INDEMNIFICATION PROVISIONS IN PRIVATE COMPANY MERGERS: LESSONS FROM *CIGNA HEALTH & LIFE INSURANCE COMPANY V. AUDAX HEALTH SOLUTIONS, INC.*

### A. Summary Of The Case

*Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc.* involved a private company merger wherein Optum Services, Inc. ("Optum"), an affiliate of UnitedHealth, acquired Audax Health Solutions, Inc. ("Audax") by merger via Audax Holdings, Inc. ("Holdings" and, together with Optum, "United").<sup>74</sup> While almost 70% of the Audax stockholders entitled to vote approved the merger by written consent (in the form of support agreements), Cigna Health and Life Insurance Co. ("Cigna"), one such stockholder, was not among them.<sup>75</sup>

The support agreements: (i) released any stockholder claims against United (the "Release Obligation"); (ii) bound stockholders to the terms of the merger agreement, which included indemnifying United, up to the *pro rata* amount of the merger consideration they received, for Audax's breach of certain representations and warranties (the "Indemnification Obligation"); and (iii) appointed a stockholder representative (the "Representative Obligation" and, collectively with the

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71. *See id.* at \*10.

72. *See id.* at \*8-9.

73. *Id.* at \*22.

74. *See Cigna Health & Life Ins. Co. v. Audax Health Sols., Inc.*, 107 A.3d 1082, 1084 (Del. Ch. 2014).

75. *See id.* at 1085.

Release Obligation and the Indemnification Obligation, the “Obligations”).<sup>76</sup> Cigna, as a non-consenting stockholder, did not sign a support agreement.<sup>77</sup> The merger agreement required stockholders to both surrender their shares and execute a letter of transmittal in order to receive merger consideration.<sup>78</sup> The letter of transmittal required the stockholder to agree to the Obligations.<sup>79</sup> Cigna refused to execute a letter of transmittal and, therefore, the defendants refused to pay Cigna its merger consideration.<sup>80</sup>

Cigna alleged that it should not be required to sign the letter of transmittal to obtain the merger consideration and that the Indemnification Obligation was invalid under Delaware law.<sup>81</sup> The Court of Chancery first noted that, because the Release Obligation was not mentioned in the merger agreement, it was not supported by consideration and could not be a condition to receiving the merger consideration.<sup>82</sup> With respect to the Indemnification Obligation, the court issued a narrow ruling that addressed certain indemnity obligation provisions in the merger agreement that purported to survive for an indefinite length and covered the full merger price.<sup>83</sup> The effect of such provisions, the court indicated, could render “the value of the merger consideration unknowable,” which the court viewed as contrary to section 251 of the Delaware General Corporation Law.<sup>84</sup>

The court stated, however, that its opinion did not address: (i) merger agreements in which a percentage of the consideration is placed in escrow to cover future indemnification claims; (ii) the general validity of post-closing price adjustments requiring direct repayment from the stockholders; or (iii) “whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid.”<sup>85</sup> This decision is relevant to practitioners when considering how to structure and draft release and indemnification provisions in the context of private company mergers.

## **B. Structuring Release And Indemnification Provisions In A Private Company Merger After *Cigna***

We note that *Cigna* does not eliminate the enforceability of all release, indemnification and escrow provisions in merger agreements and related documents.<sup>86</sup> However, it does provide guidance on how practitioners should incorporate

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76. *See id.* at 1085-1086.

77. *See id.* at 1085.

78. *See id.* at 1085-86.

79. *See id.* at 1086.

80. *See id.*

81. *See id.* at 1085-1086.

82. *See id.* at 1091.

83. *See id.* at 1092-95. (“I note that Cigna’s primary challenge to the Indemnification Obligation relates to the fact that certain aspects of it are not limited in terms of (1) the amount of money that might be subject to a clawback and (2) time. This Opinion focuses only on those aspects of the Indemnification Obligation.” *Id.* at 1093).

84. *Id.* at 1099.

85. *Id.*

86. “This is a limited holding. This Opinion does not concern escrow agreements, nor does it rule on the general validity

those concepts to ensure that such provisions would be enforceable. In that regard, based on the Court of Chancery's findings in *Cigna*, it appears that there are at least four approaches that could be considered when structuring release, indemnification and escrow provisions in a private company merger: (1) the contractual approach; (2) the statutory approach; (3) a hybrid of the statutory and contractual approaches; and (4) the use of pre-existing drag-along rights, as applicable.

### 1. The Contractual Approach

In the contractual approach to releases and indemnities, the target stockholders would enter into a pre-closing joinder or support agreement with the acquiror that would contain provisions relating to release and indemnification as a condition to closing. In *Cigna*, some stockholders did enter into such support agreements, but *Cigna* did not. *Cigna* also refused to consent to the merger and sign a letter of transmittal, which included an agreement to the Obligations.<sup>87</sup> Both of these facts supported the court's finding that the Obligations were not supported by consideration where the stockholder was required to agree to the Obligations to receive merger consideration. A Delaware court would likely view a joinder or support agreement as a true contract, to which each stockholder is a consenting party, that is supported by pre-closing consideration (the elements lacking in *Cigna*) and, thus, that the provisions therein are binding and enforceable on the shareholders party to the agreement.<sup>88</sup>

### 2. The Statutory Approach

The statutory approach,<sup>89</sup> which makes use of a post-closing price adjustment compliant with section 251 of the Delaware General Corporation Law, may be used whether cash or securities are provided as consideration to target stockholders. If the consideration is paid in cash, practitioners implementing the statutory approach would either include a provision in the merger agreement or another agreement, which is binding on the target stockholders (such as a support agreement), allowing the acquiror to hold back a portion of the consideration in escrow or include a clawback provision for a formulaic purchase price adjustment to reimburse the acquiror for breaches of representations and warranties. If target

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of post-closing price adjustments requiring direct repayment from the stockholders. This Opinion does not address whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid. I hold only that the combination of these factors present in this case—indefinite length and the contingent nature of the entirety of the consideration—renders the value of the merger consideration unknowable and, therefore, violates Section 251.” *Id.*

87. *See id.* at 1085-86.

88. “While individual stockholders may contract—such as in the form of a Support Agreement—to accept the risk of having to reimburse the buyer over an indefinite period of time for breaches of the Merger Agreement’s representations and warranties, such a post-closing price adjustment cannot be foisted on non-consenting stockholders.” *Id.* at 1095.

89. The “statutory approach” is so named because practitioners would be using a method—the post-closing price adjustment—that Delaware courts have stated is permissible if the price adjustment complies with the requirements under Section 251 of the Delaware General Corporation Law. *See id.* at 1093 (stating that “[p]ost-closing price adjustments are permissible if they satisfy the requirements of DGCL § 251”); *see also id.* at 1095 (stating that “individual stockholders may contract ... to accept the risk of having to reimburse the buyer over an indefinite period of time for breaches of the Merger Agreement’s representations and warranties” so long as such an adjustment is not “foisted on non-consenting stockholders”).

stockholders receive securities as consideration, the acquiror could embed a purchase price adjustment in the security itself by deducting indemnification losses from the security's liquidation preference. In *Cigna*, certain of the representations and warranties survived closing of the merger by eighteen months, others survived for thirty-six months and still others survived indefinitely.<sup>90</sup> Notably, while *Cigna* cautions against indefinite survival of representations and warranties, it did not state that a definite survival period of thirty-six months was unreasonable or unenforceable.<sup>91</sup>

### a. The Hybrid Approach

Alternatively, a practitioner could employ a hybrid of the statutory and contractual approaches to indemnification and escrow provisions. In so doing, a certain percentage of the merger consideration will be held back in escrow for a specified number of years to satisfy indemnification claims, but such consideration will be released early to any stockholder that contractually agrees to a clawback.

## 3. The Use Of Pre-Existing Drag-Along Rights

Finally, if applicable, an acquiror could exercise an existing drag-along right (a "drag") to compel minority stockholders to vote for a merger approved by the majority and, therefore, be bound by the terms of the merger. The Court of Chancery's decision in *Halpin v. Riverstone National, Inc.* provides insight on how to successfully implement the exercise of a drag in such a situation.<sup>92</sup>

In *Halpin*, the minority common stockholders sought to exercise appraisal rights in connection with an acquisition of the company that took the form of a merger.<sup>93</sup> The minority stockholders were party to a stockholders agreement that required them to vote for a change-in-control transaction, which was approved by a majority of stockholders.<sup>94</sup> However, to trigger the drag, the company was required to give the minority stockholders notice before the vote.<sup>95</sup> The company failed to provide such notice and comply with the terms of the drag.<sup>96</sup> Further, it is worth noting that the stockholders agreement did not give the majority stockholders a proxy to vote the minority stockholders shares. The court, while not reaching the question of whether common stockholders can contractually waive appraisal rights,<sup>97</sup> ultimately held that

90. *See id.* at 1086.

91. "The longest specified time period regarding any portion of the Indemnification Obligation appears to be 36 months. This Opinion is without prejudice to any argument either Cigna or Defendants might make in future proceedings as to aspects of the Indemnification Obligation that are limited to 36 months or less." *Id.* at 1099 n.65.

92. *Halpin v. Riverstone Nat'l, Inc.*, C.A. No. 9796-VCG, 2015 WL 854724 (Del. Ch. Feb. 26, 2015).

93. *See id.* at \*1, 3.

94. *See id.* at \*1.

95. *See id.* at \*6.

96. *See id.* at \*9.

97. *See id.* at \*1.

because the company “failed to exercise its drag-along rights as provided by contract,”<sup>98</sup> the minority stockholders were not bound to vote for the merger and their appraisal rights were not lost.<sup>99</sup>

*Halpin* provides two takeaways for practitioners. First, if minority stockholders are bound by a drag-along provision, practitioners must ensure that the company carefully complies with the provisions of the drag to eliminate the potential for a court to find the drag unenforceable. Second, when drafting drag-along provisions, it may be advisable to include a proxy from the minority stockholders. The failure of the company in *Halpin* to comply with the drag’s provisions and to obtain a proxy from the minority stockholders resulted in a minority that was unbound by the terms of the majority-approved, consummated merger and free to exercise its appraisal rights.<sup>100</sup>

In conclusion, *Cigna* does not absolutely bar including a stockholder release of claims, indemnification or the use of escrow accounts in private company mergers; it is, by its own terms, “a limited holding.”<sup>101</sup> Rather, *Cigna* cautions practitioners to ensure that any agreements with stockholders relating to release and indemnification are supported by consideration and that an indemnification obligation is not unlimited in both duration and amount.<sup>102</sup> As outlined above, practitioners have alternative approaches to structuring release and indemnification provisions in private company mergers that would achieve the parties’ objectives and comply with the guidance from *Cigna*.

### III. LENGTHENING THE STATUTE OF LIMITATIONS PERIOD: THE ADOPTION AND APPLICATION OF 10 DEL.C. § 8106

#### A. The Enactment Of House Bill No. 363

Until recently, the statute of limitations of general applicability for breach of contract claims under Delaware law was three years,<sup>103</sup> breach of a contract for the sale of goods under Article 2 of the Delaware Uniform Commercial Code was four years,<sup>104</sup> and a cause of action arising from a promissory note was six years.<sup>105</sup> If contracting parties wished to avail themselves of a statute of limitations of 20 years, they were required to use a sealed contract. However, as of August 1, 2014, parties to a contract involving at least \$100,000 could select a limitations period of up to 20 years without resorting to a contract under seal. House Bill No. 363, which was codified into law at 10 DEL. C. § 8106(c) (“Section 8106(c)”), authorizes contracting parties to contract beyond the otherwise-applicable statutory limitations periods without resorting to the use of a sealed contract.<sup>106</sup> Section 8106(c) provides as follows:

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98. *Id.* at \*10.

99. *See id.* at \*9-10.

100. *See id.* at \*10.

101. *See supra* note 87.

102. *See supra* note 87.

103. 10 DEL. C. § 8106(a).

104. 6 DEL. C. § 2-725.

105. 10 DEL. C. § 8109.

106. Gen. Assemb. 147-363, at 1 (Del. 2014).

Notwithstanding anything to the contrary in this chapter (other than subsection (b) of this section) or in § 2-725 of Title 6 [of the Delaware Code], an action based on a written contract, agreement or undertaking involving at least \$100,000 may be brought within a period specified in such written contract, agreement or undertaking provided it is brought prior to the expiration of 20 years from the accruing of the cause of such action.<sup>107</sup>

The synopsis to this legislation provides examples of a “period specified” to include, without limitation: “(i) a specific period of time, (ii) a period of time defined by reference to the occurrence of some other event or action, another document or agreement or another statutory period and (iii) an indefinite period of time.”<sup>108</sup> This legislation has already been interpreted and upheld by the Court of Chancery in *Bear Stearns Mortgage Funding Trust 2006-SL1 v. EMC Mortgage LLC*, as discussed *infra*.

## B. Benefits Of Section 8106(C)

Prior to the adoption of Section 8106(c), parties negotiating a contract could only select a 20-year limitations period by entering into a contract under seal and complying with somewhat archaic procedural requirements.<sup>109</sup> Although parties may, generally, shorten a statute of limitations by contract, provisions purporting to extend a statute of limitations have been interpreted as impermissible.<sup>110</sup> In *GRT, Inc. v. Marathon GTF Technology, LTD*, the Court of Chancery noted a “freely made contractual decision among private parties to shorten, rather than lengthen, the permitted time to file a lawsuit does not violate the unambiguous negative command of 10 DEL. C. § 8106, but a decision to lengthen it does and allows access to the state’s courts for suits the legislature has declared moribund.”<sup>111</sup>

In the context of private entity acquisition agreements that include sections or provisions requiring the seller of an entity to indemnify the buyer post-closing for losses that may arise from a breach of the seller’s representations and warranties, parties may attempt to allocate risk through a combination of survival clauses, notice provisions and contractual indemnification obligations.<sup>112</sup> Such indemnification obligations could, by their terms, extend beyond closing. In the case of indemnification for breach of certain “fundamental” representations,<sup>113</sup> parties may provide in their agreement that the

107. 10 DEL. C. § 8106(c).

108. Gen. Assemb. 147-363, at 1 (Del. 2014).

109. See *id.*; see also Louis G. Hering & R. Jason Russell, *A New Del. Statute of Limitations Will Be Useful For M&A*, LAW360 (Aug. 5, 2014, 10:46 AM), <http://www.law360.com/articles/563992/a-new-del-statute-of-limitations-will-be-useful-for-m-a> (providing background information on the enactment of Section 8106(c)).

110. See *GRT, Inc. v. Marathon FTF Technology, LTD*, 2011 WL 2682898, at \*15 (Del. Ch. July 11, 2011) (addressing *in dicta* that a contractual provision providing for indefinite survival of representations and warranties contained in a securities purchase agreement may be impermissible under Delaware law).

111. *Id.* at \*15 n.80.

112. See Louis G. Hering & Melissa DiVincenzo, *Considerations for Contractual Provisions Extending Statutes of Limitations*, 69 BUS. LAW. 1007 (2014).

113. Examples of such “fundamental” representations in a typical asset purchase or merger agreement include those relating to the existence of the parties, authorization of the transactions and title to the assets. See Hering & Russell, *supra* note 111.

indemnification rights extend indefinitely. In *GRT*, the Court of Chancery interpreted such survival clauses in a securities purchase agreement as a contractual statute of limitations.<sup>114</sup> In doing so, the court enforced the survival clause to the extent it was consistent with Delaware public policy, which prohibits contractually lengthening a statute of limitations.<sup>115</sup>

As previously discussed, survival provisions are often combined with notice requirements and indemnification covenants for breaches of representations or warranties arising during a specified period. Indemnification covenants, such as environmental hazards indemnifications, can relate to claims arising from third parties, as well as between the contracting parties themselves. Under Delaware law, however, the analysis of a claim for breach of representations or warranties resulting in diminution in value of transferred assets is analyzed differently than a claim for breach giving rise to a third-party indemnification claim.<sup>116</sup> Claims for breach of representation or warranty resulting in diminution of value, generally accrue at closing.<sup>117</sup> Accordingly, the statute of limitations for such breach will begin to run upon closing, absent any basis for tolling.<sup>118</sup> Third-party indemnification claims, however, may not accrue until post-closing payment is made to the third party.<sup>119</sup>

For example, a seller represents there is no environmental contamination of a parcel of real estate. In fact, however, there is such contamination, which has already affected neighboring properties owned by third parties. In such instance, that breach of representation could give rise to a claim for diminution of property value, as well as a claim for payments made to any third party for the environmental contamination.<sup>120</sup> The claim for loss of value damages would, generally, accrue at closing.<sup>121</sup> However, the environmental indemnification claim arising from a third-party payment would, generally, accrue upon payment to the third party subsequent to closing.<sup>122</sup> Prior to the enactment of Section 8106(c), a contract or agreement that obligated a seller to “indemnify” a buyer for losses arising from a breach of representation or warranty for a period lasting longer than three years may have constituted an impermissible attempt to extend the statute of limitations. However, other third-party indemnification claims within the same agreement may have been enforceable obligations if timely brought within the statute of limitations period following the post-closing date on which the claim accrued. Of course, contracting parties must consider which State’s statute of limitations would apply to a particular claim.

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114. See *GRT*, 2011 2L 26828989, at \*12. In this case, the survival clause had the effect of shortening the applicable statute of limitations.

115. See *id.* at \*15 n.80 (noting Delaware’s policy of prohibiting contractual lengthening of the applicable statute of limitations).

116. Hering & DiVincenzo, *supra* note 115, at 2.

117. *Id.*

118. See *CertainTeed v. Celotex Corp.*, 2005 WL 217032 (Del. Ch. Jan. 24, 2005).

119. Hering & DiVincenzo, *supra* note 115, at 2.

120. *Id.*

121. *Id.*

122. *Id.*

In Delaware, the statute of limitations is generally considered a procedural issue, rather than substantive law.<sup>123</sup> Accordingly, the statute of limitations of the forum would generally govern.<sup>124</sup> It follows that Delaware courts typically apply the relevant Delaware statute of limitations,<sup>125</sup> rather than the statute of limitations under a choice-of-law provision or under the applicable law governing the contract in the absence of a choice-of-law provision.<sup>126</sup> For causes of action arising in another jurisdiction, Delaware has a “borrowing statute,”<sup>127</sup> providing that a cause of action arising outside Delaware cannot be brought in a Delaware court after the expiration of the shorter of the Delaware statutory period or the statutory period of the state (or country) where the cause of action arose.<sup>128</sup>

In essence, the borrowing statute mandates that Delaware courts apply the shorter limitations period between the Delaware statute of limitations and that of the foreign jurisdiction where the cause of action arose.<sup>129</sup> The policy behind the borrowing statute is to “protect Delaware’s courts from having to adjudicate stale out-of-state claims.”<sup>130</sup> By mandating the application of the shorter limitations period, “the General Assembly sought to prevent forum shopping to take advantage of a longer limitations period.”<sup>131</sup> Nevertheless, assuming Delaware law applies, a court would then need to determine if Section 8106(c) applies to the limitations period set forth in the contract. As discussed in the next section, unless the contract is clear, the answer to this question may be subject to court interpretation.

## **C. The Application Of Section 8106(C): *Bear Stearns***

### **1. Factual Background**

Defendant, EMC Mortgage LLC (“EMC”), was involved in the creation and sale of residential-mortgage-backed securities.<sup>132</sup> In the securitization giving rise to the case, EMC sold 8,447 mortgage loans to the plaintiff, Bear Stearns Mortgage Funding Trust 2006-SL1 (the “Trust”).<sup>133</sup> The sale was governed by a Mortgage Loan Purchase Agreement

123. See *Bear Stearns Mortgage Funding Trust 2006-SL1 v. EMC Mortgage LLC*, C.A. No. 7701-VCL, 2015 WL 139731, at \*13 (Del. Ch. Jan. 12, 2015).

124. See *Cheswold Volunteer Fire Co. v. Lambertson Constr. Co.*, 489 A.2d 413, 421 (Del. 1984); *David B. Lilly Co., Inc. v. Fisher*, 799 F. Supp. 1562, 1568 (D. Del. 1992), *aff’d*, 18 F.3d 1112 (3d Cir. 1994).

125. We note that the Court of Chancery applies the doctrine of laches, the equity analog to the statute of limitations. See *Dragon Gp., L.L.C.*, 991 A.2d 1 (Del. 2009).

126. *Hering & DiVincenzo*, *supra* note 115, at 2.

127. See 10 DEL. C. § 8121.

128. *Hering & DiVincenzo*, *supra* note 115, at 2.

129. *Id.*

130. *Juran v. Bron*, 2000 WL 1521478, at \*12 (Del. Ch. Oct. 6, 2000).

131. *Id.*

132. *Bear Stearns*, 2015 WL 139731, at \*1.

133. *Id.*

(the “Purchase Agreement”).<sup>134</sup> The Trust then created and issued certificates representing beneficial interests in the cash flows generated by the mortgage loans (the “Certificates”).<sup>135</sup> The Certificates were then sold to investors, who ultimately received distributions of cash stemming from principal and interest payments on the mortgage loans.<sup>136</sup> However, by the second year following the securitization, the mortgage loans experienced high rates of defaults and delinquencies and the Trust ultimately suffered approximately \$295 million in losses, which represented nearly 60 percent of the original principal loan balance.<sup>137</sup> At the direction of certain investors, U.S. Bank, the trustee of the Trust (the “Trustee”), asked EMC for various documents and records relating to the mortgage loans.<sup>138</sup> After investigating the mortgage loans, the Trustee notified EMC that some of the mortgage loans did not comply with the representations and warranties contained in the Purchase Agreement about the characteristics and quality of the mortgage loans.<sup>139</sup> The Trustee then asked EMC to comply with a remedial procedure in the Purchase Agreement that generally required that, in the event of a breach of such a representation, EMC would cure the breach, repurchase the non-conforming loan or replace the loan with a conforming loan if the breach occurred within the first two years after the securitization.<sup>140</sup> The remedial procedure was the sole and exclusive remedy for any breaches of such representations.<sup>141</sup>

In response to the Trustee’s inquiry, EMC agreed to repurchase some loans but declined to repurchase others.<sup>142</sup> Although the Trustee made its first requests four-and-a-half years after the securitization closed, EMC did not contest the Trustee’s breach claims for violating the applicable statute of limitations.<sup>143</sup> Rather, the Purchase Agreement provided the following accrual provision:

Any cause of action against [EMC] or relating to or arising out of a breach by [EMC] of any representations and warranties made in this Section 7 shall accrue as to any Mortgage Loan upon (i) discovery of such breach by [EMC] or notice thereof by the party discovering such breach and (ii) failure by [EMC] to cure such breach, purchase such Mortgage Loan or substitute a qualifying Replacement Mortgage Loan pursuant to the terms hereof.<sup>144</sup>

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134. *Id.*

135. *Id.*

136. *Id.* at \*2.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.* at \*3-\*4.

141. *Id.* at \*4.

142. *Id.*

143. *Id.*

144. *Id.*

After EMC declined to repurchase the bulk of the non-conforming loans, the Trustee filed its original complaint.<sup>145</sup> Although the original complaint was filed nearly six years after the closing of the securitization, EMC and its fellow defendants did not assert a timeliness defense.<sup>146</sup> The parties exchanged information and conferred regarding the status of the loans for the next two years, after which the Trustee filed the operative complaint.<sup>147</sup>

The operative complaint alleged, *inter alia*, claims for breaches of representations and warranties within the Purchase Agreement.<sup>148</sup> EMC and its fellow defendants then moved to dismiss the complaint as untimely.<sup>149</sup> The defendants argued that two intervening New York decisions applied, one of which held that any breach of representations about underlying mortgage loans occurred at closing,<sup>150</sup> and the other held that New York law does not permit an accrual provision to lengthen a statute of limitations.<sup>151</sup> The Court of Chancery dismissed the complaint.<sup>152</sup> The court's decision relied heavily on *Central Mortgage Co. v. Morgan Stanley Mortgage Capital Holdings, LLC*,<sup>153</sup> which also involved claims for breaches of representations about loans underlying residential-mortgage-backed-securities.<sup>154</sup> *Central Mortgage* held that Delaware's borrowing statute required the application of Delaware's shorter three-year limitations period, rather than the six-year period available under New York law.<sup>155</sup> The court also relied on *Central Mortgage's* holding that, absent tolling, the statute of limitations for any claim for breach of representations and warranties relating to underlying loans begins to run at the time the securitization closed.<sup>156</sup>

## 2. The Motion For Reargument

The Trustee filed a motion for reargument claiming, *inter alia*, that the recently enacted Section 8106(c) should have been applied.<sup>157</sup> The court agreed that reconsideration was warranted because Section 8106(c) became effective

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145. *Id.* at \*5.

146. *Id.*

147. *Id.*

148. *Id.* at \*6.

149. *Id.*

150. *Id.* (citing *ACE Sec. Corp. v. DB Structured Prods., Inc.*, 112 AD.3d 522 (N.Y. App. Div. 2013)).

151. *Id.* (citing *Lehman XS Trust, Series 2006-4N ex rel. U.S. Bank, Nat'l Ass'n v. GreenPoint Mortg. Funding, Inc.*, 991 F.Supp.2d 472 (S.D.N.Y. 2014)).

152. *Id.* at \*7 (“In assessing the question of timeliness, both sides agreed that the doctrine of laches provided the appropriate framework. But because equity follows the law, “a party’s failure to file within the analogous period of limitations will be given great weight in deciding whether the claims are barred by laches.” (citing *Dragon Gp., L.L.C.*, 991 A.2d at 9 & n.17)).

153. C.A. No. 5140-CS, 2012 WL 3201139 (Del. Ch. Aug. 7, 2012).

154. *Bear Stearns*, 2015 WL 139731, at \*7.

155. *See Cent. Mortg.*, 2012 WL 3201139, at \*16.

156. *See id.* at \*17.

157. *See id.* at \*8-\*15.

before the court's ruling to dismiss.<sup>158</sup> The court noted that although it was aware that the General Assembly had enacted Section 8106(c), it did not take into account the effective date.<sup>159</sup> Importantly, the court noted that Section 8106(c) was outcome-determinative as to the initial dismissal of the Trustee's complaint.<sup>160</sup>

Citing the General Assembly's synopsis to the legislation in bill form, the court reasoned that the legislative intent behind Section 8106(c) is to allow contracting parties to govern their contractual relationship outside of Delaware's otherwise applicable statute of limitations for certain causes of action.<sup>161</sup> The court further noted that by stating that a written agreement could refer to a "period specified," Section 8106(c) created "a flexible framework" for defining the time in which suit could be brought.<sup>162</sup> The court explained that "period specified" is not limited to a particular date or a period measured in traditional units of time (*e.g.*, months, days, years), but contemplates other measures of time, including "a period of time defined by reference to the occurrence of some other event or action, another document or agreement or another statutory period" or even "an indefinite period of time."<sup>163</sup> The court reasoned that even if a contract specified an indefinite period, however, a claim must still be brought "prior to the expiration of 20 years from the accruing of the cause of such action."<sup>164</sup>

The court then addressed EMC's argument that because the General Assembly enacted Section 8106(c) after the securitization closed, the new legislation should not apply retroactively to the Trustee's claims.<sup>165</sup> The court highlighted that a modification of a limitations period was a procedural matter affecting remedies as opposed to a change in substantive law.<sup>166</sup> On that basis, the court held that ordinary judicial presumptions against retroactivity were inapplicable to Section 8106(c) and the newly enacted legislation would apply to ongoing suits unless there was a showing of manifest injustice.<sup>167</sup> The court found no concerns of injustice that would limit the application of Section 8106(c).

Before applying Section 8106(c), the court noted preliminarily that the General Assembly has the power to modify statutes of limitations at any point in time, including the authority to revive stale claims.<sup>168</sup>

Statutes of limitation find their justification in necessity and convenience rather than in logic.... They are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the avoidable and unavoidable delay.... Their shelter has never been regarded as ... a "fundamental

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158. *Id.* at \*9-\*12.

159. *Id.*

160. *See id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. 10 DEL. C. § 8106(c).

165. *Bear Stearns*, 2015 WL 139731, at \*13.

166. *Id.*

167. *Id.*

168. *Id.* (citing *Sheehan v. Oblates of St. Francis de Sales*, 15 A.3d 1247, 1259 (Del. 2011)).

right”.... [T]he history of pleas of limitation shows them to be good only by legislative grace and to be subject to a relatively large degree of legislative control.<sup>169</sup>

The court further stated that once the legislature alters a statute of limitation, that change governs not only future claims, but is also presumed to govern existing claims.<sup>170</sup> The court reasoned that because statutes of limitations are procedural limitations on remedies, statutory changes to the limitations period are given retrospective construction in the absence of injustice.<sup>171, 172</sup> However, the court ruled that in the present case, applying Section 8106(c) to the Trustee’s claims would not be unjust to the defendants.<sup>173</sup>

The court then applied Section 8106(c) to the Purchase Agreement.<sup>174</sup> The court noted that the Purchase Agreement contained provisions designed to modify the statute of limitations for purposes of claims for breaches of representations and warranties.<sup>175</sup> The court found that, under Section 8106(c), those provisions were valid and effective. The court then noted that contracting parties typically make representations in a transaction agreement so that the representations “can provide a basis to avoid closing to the extent that their truth is made a condition to closing.”<sup>176</sup> However, the court noted, that absent contract language providing to the contrary, under the same rationale that causes representations about real property to merge with a warranty deed, pre-closing representations about the acquired property interest become ineffective post-closing.<sup>177</sup> The court also noted that representations may survive closing by way of a survival clause in the transaction

169. *Id.* (quoting *Chase Sec. Corp. v. Donaldson*, 325 U.S. 304, 314 (1945)) (alterations in original).

170. *See id.* (citing *State ex rel. Brady v. Pettinaro Enters.*, 870 A.2d 513, 529 (Del. Ch. 2005)); *see also* *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 354 (Del. 1993) (“[A] statutory amendment is remedial, and may apply retroactively, when it relates to practice, procedure or remedies and does not affect substantive or vested rights.”).

171. *Id.*; *see also* *Sokolove v. Marenberg*, 2013 WL 6920791, at \*5 (Del. Super. Dec. 5, 2013); *Waterhouse v. Hollingsworth*, 2013 WL 5803136, at \*3 (Del. Super. Oct. 10, 2013); *Brady*, 870 A.2d at 529. The court noted that the defendants’ authorities supporting the proposition that statutes do not operate retroactively were inapposite because they addressed substantive changes in law, not procedural or remedial matters.

172. *See* *FDIC v. New Hampshire Ins. Co.*, 953 F.2d 478, 487 (9th Cir. 1991) (explaining that a change to statute of limitations would operate retroactively absent legislative intent to the contrary or “manifest injustice”); *Brady*, 870 A.2d at 530–31 (considering whether retroactive revival of claims would be unjust).

173. *See id.* (“First, the Trustee filed its claims before the statute of limitations had expired in New York, so the claims were timely under the law of the jurisdiction governing the claims. Second, the defendants did not assert a timeliness defense until two years after the dispute arose, including after the parties had engaged in a lengthy meet-and-confer process that contemplated resolving loan disputes on their merits. During the meet-and-confer process, the defendants never argued that the Trustee’s claims were untimely. Third, the case was still pending when the General Assembly enacted Section 8106(c) and when the statute became effective, so the amendment addressed live claims. It did not have the effect of reviving extinguished claims. Finally, the relevant agreements contained an Accrual Provision that contemplated permitting claims to be asserted well after the securitization closed, and the defendants committed through the Binding Representation Provision that the Accrual Provision was effective. Under the circumstances, it is not manifestly unjust to apply Section 8106(c) to the Trust’s claims.”).

174. *Id.* at \*14-\*15.

175. *Id.*

176. *Id.* (citing *GRT*, 2011 WL 2682898, at \*13).

177. *Id.* (citing *GRT*, 2011 WL 2682898, at \*13 & n.70).

agreement.<sup>178</sup> The court explained that once a contractual agreement provides for representations to survive closing, the next issue presented is how long those representations could survive under Delaware law.<sup>179</sup> Prior to the effective date of Section 8106(c), the maximum survival period for a contractual representation or warranty was three years.<sup>180</sup> The court stated that this three-year survival period resulted from various Delaware decisions holding that parties could shorten, but not lengthen, a statute of limitations by contract.<sup>181</sup> Critically, the court noted that, pursuant to Section 8106(c), parties could now permissibly extend the statute of limitations up to a maximum of twenty years.<sup>182</sup>

Looking to the text of the Purchase Agreement, within its analysis the court found contractual support for the survival of representations and warranties by way of the following provision:<sup>183</sup>

All representations, warranties and agreements contained in this Agreement, or contained in certificates of officers of [EMC] submitted pursuant hereto, shall remain operative and in full force and effect and shall survive delivery of the Mortgage Loans to [to the Trustee]. Subsequent to the delivery of the Mortgage Loans ... each of [EMC's] representations and warranties contained herein with respect to the Mortgage Loans shall be deemed to relate to the Mortgage Loans actually delivered ... and included in the Final Mortgage Loan Schedule and any Replacement Mortgage Loan....<sup>184</sup>

Next, the court held that provisions in the Purchase Agreement, which provided for the accrual of causes of action related to the representations and warranties, effectively extended the statute of limitations up to the new Section 8106(c) maximum period of twenty years.<sup>185</sup> Specifically, the Purchase Agreement stated as follows:

[a]ny cause of action against [EMC] or relating to or arising out of a breach by [EMC] of any representations and warranties made in this Section 7 shall accrue as to any Mortgage Loan upon (i) discovery of such breach by [EMC] or notice thereof by the party discovering such breach and (ii) failure by [EMC] to cure such breach, purchase such Mortgage Loan or substitute a qualifying Replacement Mortgage Loan pursuant to the terms hereof.<sup>186</sup>

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178. *Id.* (citing *GRT*, 2011 WL 2682898, at \*14).

179. *Id.*

180. *Id.*; *see also id.* at n.17 (listing Delaware cases supporting the proposition).

181. *See, e.g.,* *Menefee, ex rel. Menefee v. State Farm Mut. Ins. Co.*, 1986 WL 630314, at \*1 (Del. Super. July 11, 1986) (“[A] contract provision for a longer period of limitation than provided by the applicable statute would be void as against public policy.”).

182. *Bear Stearns*, 2015 WL 139731, at \*14.

183. *Id.* at \*15.

184. *Id.* (quoting Section 17 of the Purchase Agreement).

185. *Id.*

186. *Id.* (quoting Section 7 of the Purchase Agreement).

Under this accrual provision, the court articulated that a cause of action would accrue only when both conditions were met, *i.e.*, after both discovery of the breach by EMC and EMC's failure to take remedial action.<sup>187</sup>

In considering the survival and accrual provisions together, the court found that the Purchase Agreement provided "a period of time defined by reference to the occurrence of some other event or action" that is a sufficient "period specified" for purposes of Section 8106(c).<sup>188</sup> The court noted that these provisions established a "period specified" in which EMC's representations remained operative following closing, and the three-year statute of limitations for the Trustee's cause of action for breach would not begin to run until after the conditions precedent were satisfied.<sup>189</sup> The court further found that, because these provisions did not specify an outside date for bringing claims, the 20-year statutory maximum provided in Section 8106(c) was applicable.<sup>190</sup>

For these reasons, the court held that any claim by the Trustee must be brought prior to the expiration of twenty years after the closing of the securitization and that the Trust brought its claims within that period of time.<sup>191</sup>

#### **D. Implications Of *Bear Stearns* And Section 8106(C)**

The adoption of Section 8106(c) furthers the general policy in Delaware to give maximum effect to the principles of freedom of contract and enforcement of agreements in accordance with their terms. In that regard, Section 8106(c) enables parties to select a statute of limitations of up to 20 years. Also, where an agreement provides that certain claims survive "indefinitely," such language would be interpreted to apply Section 8106(c)'s 20-year statute of limitations. Although *Bear Stearns* provides some guidance as to the meaning of a "period specified," and suggests that term would be interpreted broadly, and notwithstanding the examples of a "period specified" listed in the synopsis to House Bill No. 363, there are presumably existing and future agreements where it is (or will be) unclear whether a limitations period was "specified." From a drafting perspective, if parties wish to provide for a certain limitations period, it is important to expressly and clearly state such limitations period in the subject agreement so as to not leave the limitations period up to a matter of court interpretation. In addition, if parties desire to apply Section 8106(c) to their agreement, it may be advisable to expressly provide for jurisdiction in Delaware since, as discussed above, the applicable statute of limitations could be treated as a procedural matter for the forum jurisdiction, rather a substantive matter controlled by the governing law of the agreement.

### **IV. INTERPRETATION OF INTEGRATION AND CHOICE-OF-LAW CLAUSES IN MERGER AGREEMENTS: *FDG LOGISTICS LLC V. A&R LOGISTICS HOLDINGS, INC.***

Parties to transaction documents, particularly merger agreements, may negotiate the scope of their reliance on the other party's representations. In *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*,<sup>192</sup> the Court of Chancery addressed

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187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. 131 A.3d 842 (Del. Ch. 2016).

the tension between two Delaware public policy considerations: (i) holding sophisticated parties to the terms of their transactions; and (ii) protecting against the abuses of fraud.<sup>193</sup> *FdG Logistics* provides an instructive overview of anti-reliance provisions in merger agreements. This Section IV provides a summary of the *FdG Logistics* decision followed by an analysis of its implications for practitioners.

## A. Summary Of *Fdg Logistics*

### 1. Factual Background

#### a. The Merger Agreement

The dispute in this case arose from a merger agreement entered into by the plaintiff, FdG Logistics LLC (“FdG Logistics”), and A & R Merger Corp. (“Buyer”).<sup>194</sup> FdG Logistics held a majority interest in A&R Logistics Holdings, Inc. (“Old A & R”), which was the parent company of a trucking operation based out of Louisville, Kentucky.<sup>195</sup> Buyer was a subsidiary of Mason Wells, a private equity firm based out of Milwaukee, Wisconsin.<sup>196</sup> In 2012, Buyer entered into negotiations with Old A & R’s senior management team to discuss a potential sale of the company.<sup>197</sup> Over the course of negotiations, Buyer received several documents from Old A & R’s management, including a confidential information memorandum, a PowerPoint presentation and various other materials in conducting due diligence (the “Pre-Merger Materials”).<sup>198</sup> In December 2012, Buyer entered into a merger agreement (the “Merger Agreement”) with Old A & R and two of Old A& R’s major shareholders, one of which was FdG Logistics.<sup>199</sup> Under Article 5 of the Merger Agreement, Old A & R made a series of representations and warranties regarding Old A & R and its subsidiaries.<sup>200</sup> One particular provision stated that Old A & R made no representations or warranties except as set forth in Article 5 (the “Disclaimer Provision”).<sup>201</sup> The Merger Agreement also included a standard integration clause, which stated that the Merger Agreement superseded any prior understandings, agreements or representations made by or between the parties (the “Integration Clause”).<sup>202</sup>

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193. *Id.* at 859.

194. *Id.* at 849.

195. *Id.* at 847.

196. *Id.*

197. *Id.* at 848.

198. *Id.* at 848, 857.

199. *Id.* at 849.

200. *Id.*

201. *Id.* at 849, 857-58.

202. *Id.* at 858.

## b. Fdg Logistics Sues And Buyer Counterclaims

Shortly after the merger closed, Buyer discovered numerous issues at Old A & R that Buyer alleged were fraudulently concealed during negotiations.<sup>203</sup> For example, Buyer alleged that Old A & R systematically falsified corporate records, violated environmental laws, concealed massive structural impairments in its facilities and hired aliens who were not authorized to work in the United States.<sup>204</sup> In May 2014, FdG Logistics filed a complaint alleging a single breach of contract claim for failing to remit a tax refund in accordance with the terms of the Merger Agreement.<sup>205</sup> Buyer counterclaimed, asserting, among other claims,<sup>206</sup> common law fraud stemming from the aforementioned issues.<sup>207</sup> FdG Logistics subsequently moved to dismiss Buyer's counterclaim.<sup>208</sup>

## 2. The Integration Clause Analysis

In deciding FdG Logistics' motion, the court analyzed whether Buyer properly asserted a claim for common law fraud based on the Pre-Merger Materials.<sup>209</sup> The court first noted the elements of a *prima facie* claim for common law fraud under Delaware law: (1) the defendant falsely represented or omitted facts that the defendant had a duty to disclose; (2) the defendant knew or believed that the representation was false or made the representation with a reckless indifference to the truth; (3) the defendant intended to induce the plaintiff to act or refrain from acting; (4) the plaintiff acted in justifiable reliance on the representation; and (5) the plaintiff was injured by its reliance.<sup>210</sup> The basis of FdG Logistics' motion was that Buyer could not establish as a matter of law that it justifiably relied on representations contained in any of the Pre-Merger Materials because of the effects of the Disclaimer Provision and the Integration Clause.<sup>211</sup>

The court noted that under Delaware law, courts "enforce[ ] clauses which identify the specific information on which a party has relied and foreclose reliance on other information."<sup>212</sup> The court referred to its decision in *Abry Partners V, L.P. v. F & W Acquisition LLC*,<sup>213</sup> where then-Vice Chancellor Strine noted Delaware's dual policies of enforcing contracts

203. *Id.* at 850.

204. *Id.* at 850-51.

205. *Id.* at 851.

206. Buyer's other claims are out of the scope of this article.

207. *FdG Logistics*, 131 A.3d at 851.

208. *Id.* at 851.

209. *Id.* at 857.

210. *Id.* (quoting *DCV Hldgs., Inc. v. ConAgra, Inc.*, 889 A.2d 954, 958 (Del. 2005)).

211. *Id.* at 857.

212. *Id.* at 858 (citing *RAA Mgmt., LLC v. Savage Sports Hldgs., Inc.*, 45 A.3d 107, 116-17 (Del. 2012)).

213. 891 F.2d 1032 (Del. Ch. 2006).

by their terms and protecting contracting parties from fraudulent representations.<sup>214</sup> In *Abry*, the court reasoned that a contracting party cannot promise in an integration clause that it will not rely on representations outside of the agreement, then later evade its contractual obligations by claiming fraudulent inducement in reliance on representations outside of the contract.<sup>215</sup> However, the court in *Abry* also noted Delaware's "venerable public policy to guard against fraud,"<sup>216</sup> and further reasoned that it will not insulate a party from liability stemming from its counterparty's reliance on fraudulent representations made outside the four corners of an agreement, unless the counterparty makes a clear statement disclaiming such reliance.<sup>217</sup> To qualify as such a clear statement, the Court in *Abry* explained, an integration clause must contain clear anti-reliance language by which the claimant (*i.e.*, the aggrieved buyer) has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract.<sup>218</sup> In applying the *Abry* rule to the facts *sub judice*, the *FdG* court noted that neither the Disclaimer Provision nor the Integration Clause contained an affirmative expression by Buyer of what it was relying on when it decided to enter into the Merger Agreement.<sup>219</sup> Similarly, there was no affirmative expression by Buyer that it was not relying on any representations made outside of the Merger Agreement.<sup>220</sup> Rather, the court held that the Disclaimer Provision was merely a disclaimer by Old A & R of what it was (and was not) representing and warranting.<sup>221</sup> In addition, the court found that the Integration Clause simply stated that the Merger Agreement constituted the entire agreement between the parties, without an unambiguous anti-reliance statement by the Buyer.<sup>222</sup>

The court reasoned that the difference between disclaimers from the perspective of the party accused of fraud, versus the counterparty who believes it was defrauded, is critical given Delaware's strong public policy against fraud.<sup>223</sup> Given this public policy concern, the court emphasized that it will not bar a contracting party from asserting claims for fraud based on extra-contractual representations unless "*that contracting party* unambiguously disclaims reliance on such statements."<sup>224</sup> Although there are no "magic words" under Delaware law to disclaim such reliance, the disclaimer must come from the aggrieved party, or all parties to a contract, to ensure preclusion of fraud claims under the principles articulated in *Abry*.<sup>225</sup>

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214. *FdG Logistics*, 131 A.3d at 858 (citing *Abry*, 891 F.2d at 1058).

215. *Id.* (citing *Abry*, 891 F.2d at 1057).

216. *Id.* at 859.

217. *See id.* (quoting *Abry*, 891 A.2d at 1058-59).

218. *Id.* (citing *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch. 2004) (Strine, V.C.)).

219. *Id.* at 860.

220. *Id.*

221. *Id.*

222. *Id.* (emphasis in original).

223. *Id.*

224. *Id.*

225. *Id.* (citing *Prairie Capital III, L.P. v. Double E Hldg. Corp.*, 2015 WL 7461807, at \*9 (Del. Ch. Nov. 14, 2015)).

### **b. The Implications Of *Fdg Logistics***

*FdG Logistics* demonstrates the importance of precision in drafting the scope of anti-reliance provisions and integration clauses when the parties desire to limit representations and warranties to those expressly set forth within the four corners of an agreement. To the extent such provisions are unclear, a court applying Delaware law may interpret such provisions in favor of the party that relied on the alleged misrepresentations or warranties outside of the agreement. Importantly, as discussed above, *FdG Logistics* instructs that an anti-reliance provision may not be effective as intended, unless it reads as a statement by the *buyer*. Relatedly, a statement by a seller that it has not made any representations or warranties other than those set forth in the applicable agreement may not preclude a fraud claim based on other documents provided to the buyer. Thus, based on the teachings of *FdG Logistics*, to support an argument that disclaimer and integration provisions limited the representations and warranties made by a seller to those within the four corners of an agreement, such provisions should include affirmative and express statements by the buyer that it only relied on the representations and warranties in the subject agreement and did not rely on any representations or warranties made outside of that agreement.



## KEY DECISIONS OF 2015 IN DELAWARE ALTERNATIVE ENTITY LAW

Tammy L. Mercer, Richard J. Thomas, and Nicholas J. Rohrer\*

### I. FIDUCIARY DUTIES IN THE ALTERNATIVE ENTITY CONTEXT

In 2015, the Delaware Court of Chancery furthered its jurisprudence concerning fiduciary duties in the alternative entity arena in three separate opinions. In the first opinion, *Lewis v. AimCo Properties, L.P.*,<sup>1</sup> the Court of Chancery demonstrated that traditional control analyses do not necessarily apply in the alternative entity context, in holding that the owner of a majority equity stake was not a controller with corresponding fiduciary duties because, despite its large equity holdings, the limited partnership agreement precluded its exercise of control. In two other opinions—*In re El Paso Pipeline Partners, L.P. Derivative Litigation*<sup>2</sup> (“*El Paso*”) and *In re Kinder Morgan Inc. Corporate Reorganization Litigation*<sup>3</sup> (“*Kinder Morgan*”)—the Court of Chancery analyzed whether the defendants had breached contractual provisions establishing a subjective belief standard. In *El Paso*, the Court entered judgment against the general partner who was found to have not formed a subjective belief that a transaction was in the best interests of the limited partnership. In *Kinder Morgan*, the Court dismissed the complaint, holding that while the operative agreement required that the defendants consider the best interests of the limited partnership, the complaint alleged only that the defendants failed to consider the best interests of the limited partners. Each of these decisions is discussed in greater detail below.

In *Lewis v. AimCo*,<sup>4</sup> the Court of Chancery considered whether entities that indirectly owned a majority of a limited partnership’s units through a series of affiliates constituted a control group of the limited partnership that owed fiduciary duties to the limited partnership and its limited partners. The Court held that the entities were not controllers and did not owe fiduciary duties.

The plaintiffs held limited partnership units in four limited partnerships (the “LP Defendants”).<sup>5</sup> Each of the LP Defendants was managed by a corporate entity-general partner, and each of those general partners was indirectly owned by non-party Apartment Investment and Management Company (“AimCo”).<sup>6</sup> AimCo also owned a majority of

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1. C.A. No. 9934-VCP, 2015 Del. Ch. LEXIS 33 (Del. Ch. Feb. 10, 2015).
2. C.A. No. 7141-VCL, 2015 Del. Ch. LEXIS 116 (Del. Ch. Apr. 20, 2015).
3. C.A. No. 10093, 2015 Del. Ch. LEXIS 221 (Del. Ch. Aug. 20, 2015), *aff’d sub nom, Haynes Family Trust v. Kinder Morgan G.P., Inc.*, 135 A.3d 76 (Del. 2016).
4. 2015 Del. Ch. LEXIS 33.
5. *Id.* at \*3.
6. *Id.*

the limited partnership units of each of the LP Defendants.<sup>7</sup> Another defendant, Aimco Properties L.P. (“Aimco OP”), was an affiliate of AimCo. Defendant Terry Considine (“Considine”) was an officer of AimCo.<sup>8</sup>

The plaintiffs brought a breach of fiduciary duty claim challenging a series of mergers through which the LP Defendants were merged into a subsidiary of Aimco OP.<sup>9</sup> The fiduciary duty claims against many of the defendants were dismissed when the Court found that the limited partnership agreements contained a broad arbitration clause and that the arbitrability of the claims should be decided by an arbitrator.<sup>10</sup> Aimco OP and Considine moved separately to dismiss the Complaint on the basis that they did not owe fiduciary duties to the plaintiffs and therefore could not be liable for any breach thereof.<sup>11</sup>

With regard to Aimco OP, the Court first pointed out that the Complaint had alleged only that non-party AimCo owned the majority stake in the LP Defendants, not Aimco OP.<sup>12</sup> The Court found that this was not altered by the plaintiffs’ “less precise” assertion that AimCo and its affiliates, which included AimCo OP, owned a majority of the limited partnership units of the LP Defendants.<sup>13</sup> The Court explained:

Underlying this proposition is a misplaced invocation of the concept in corporate law that a majority or controlling stockholder owes fiduciary duties to the corporation and its minority stockholders. The fundamentally different nature of limited partnerships renders Plaintiffs’ overly simplistic argument in this regard unavailing. . . . A general partner of a limited partnership generally has rights and powers to manage and control the business and affairs of the limited partnership. It is not uncommon, however, for the general partner to have a small ownership stake in the limited partnership. By contrast, a limited partner may have a large or even a majority ownership interest in the limited partnership, but, by design, that limited partner would not have any power to manage or control the business and affairs of the partnership . . . . Thus, the fact that AimCo, through its affiliates, may have a majority interest in the LP Defendants does not support a reasonable inference that AimCo, or its affiliate Aimco OP, had a fiduciary duty to those limited partnerships or their limited partners.<sup>14</sup>

To determine whether Aimco OP owned fiduciary duties to the plaintiffs, the Court explained that it would not just examine Aimco OP’s equity interest, but rather it “would need to look to the terms of the limited partnership agreements of the LP Defendants and to DRULPA.”<sup>15</sup> As there was no allegation that either AimCo or Aimco OP was a general partner under those agreements, or that they acted as though they were general partners, they did not owe fiduciary duties

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7. *Id.*

8. *Id.* at \*3.

9. *Id.* at \*4-5.

10. *Id.* at \*6-12.

11. *Id.* at \*13.

12. *Id.* at \*15-16.

13. *Id.* at \*15.

14. *Id.* at \*16-17.

15. *Id.* at \*18-19.

to the LP Defendants.<sup>16</sup> The Court explained that even if cases dealing with corporate controllers were relevant, and the plaintiffs had alleged that AimCo OP held a large block of the units of the LP Defendants, the other factual allegations were not sufficient to show that it exercised control.<sup>17</sup> The Court stated:

[W]hile Aimco OP may have been involved in the day-to-day, operational management of AimCo's business, it did not "control" the LP Defendants in the sense that it exercised ultimate decision-making power with respect to partnership policy in general or with respect to the [challenged] Mergers in particular. "The bare conclusory allegation that a [defendant] possessed control is insufficient. Rather, the Complaint must contain well-pled facts" showing that the alleged controller "exercised actual domination and control" over the subject entity[.]<sup>18</sup>

The Court also rejected the plaintiffs' reliance on cases like *In re: USA Cafes*<sup>19</sup> to impose fiduciary duties on Aimco OP.<sup>20</sup> The Court noted that the cases imposing fiduciary duties in that context had looked to individual controllers of entity managers or managing members.<sup>21</sup> In the case at hand, however, the managing entities were the LP Defendants, and the analogous individual controllers were the board of directors of the LP Defendants.<sup>22</sup> To hold Aimco OP liable under such a theory would require the Court to go "materially beyond" *USA Cafes* and cases following it.<sup>23</sup>

The Court found that the same reasoning applied "with even greater force" to Defendant Considine.<sup>24</sup>

Because the plaintiff had not alleged facts showing that Aimco OP and Considine had exercised control over the LP Defendants, the Court concluded that they did not owe fiduciary duties and dismissed the breach of fiduciary duty claim with prejudice.<sup>25</sup>

In *El Paso*,<sup>26</sup> the Court of Chancery evaluated whether the defendant general partner (the "General Partner") of El Paso Pipeline Partners, LP (the "Partnership") breached its obligations under the Partnership's limited partnership agreement (the "LP Agreement") by causing the Partnership to engage in a transaction involving an asset sale by El Paso

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16. *Id.* at \*19.

17. *Id.* at \*19-20.

18. *Id.* at \*20.

19. 600 A.2d 43 (Del. Ch. 1991).

20. 2015 Del. Ch. LEXIS 33, at \*21-22.

21. *Id.* at \*21-22 (citing *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012) and *Cargill Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008)).

22. *Id.*

23. *Id.* at \*22.

24. *Id.* at \*24.

25. *Id.* at \*25.

26. 2015 Del. Ch. LEXIS 116. A second decision in this matter is discussed *infra*. An appeal in this case has been taken to the Delaware Supreme Court.

Corporation (“Parent”), an entity that wholly owned the General Partner.<sup>27</sup> Following a full trial, the Court concluded that the General Partner breached its obligations under the LP Agreement because the members of the special committee appointed to approve the sale transaction did not form a subjective belief that the transaction was in the best interest of the Partnership.<sup>28</sup>

The challenged transaction was one of a series of “drop down” transactions between the Parent and the Partnership, in which the Parent sold the Partnership assets (or rather, percentage interests in these assets) for cash.<sup>29</sup> These “drop down” transactions created an inherent conflict of interest for the General Partner, in light of its position as a wholly-owned subsidiary of the Parent.<sup>30</sup> But the LP Agreement permitted such transactions between the Parent and General Partner, if the transaction received the approval of a special committee appointed to approve the transaction (the “Committee”).<sup>31</sup> The only contractual requirement for the Committee’s approval was that its members *subjectively* believe in “good faith” that the transaction was in the best interest of the Partnership.<sup>32</sup>

In 2010, Parent and the Partnership engaged in three “drop down” transactions—in March, June, and November.<sup>33</sup> These “drop down” transactions involved sales by the Parent to the Partnership of partial interests in each of two assets.<sup>34</sup> The plaintiff, pursuing derivative claims on behalf of the Partnership, challenged the March transaction (the “Spring Dropdown”) and the November transaction (the “Fall Dropdown”).<sup>35</sup> In the Spring Dropdown, Parent sold a 51% interest in a subsidiary natural gas plant (“Sub A”) to the Partnership for \$963 million.<sup>36</sup> In the Fall Dropdown, Parent sold the remaining 49% interest in Sub A, along with a 15% interest in a separate subsidiary natural gas plant (“Sub B”) for \$1.412 billion.<sup>37</sup>

On summary judgment, the Court had earlier dismissed the plaintiff’s challenge to the Fall Dropdown, concluding that the then-available evidence was insufficient to overcome the presumption that the Committee had acted in subjective good faith in approving the Spring Dropdown.<sup>38</sup> The Court partially denied summary judgment as to the Fall

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27. *Id.* at \*1-3.

28. *Id.* at \*5-6.

29. *Id.* at \*2-3.

30. *Id.* at \*1-3.

31. *Id.* at \*3.

32. *Id.* at \*45.

33. *Id.* at \*24-25, 27-28, 40-41.

34. *Id.* at \*10-11.

35. *Id.* at \*42.

36. *Id.* at \*10.

37. *Id.* at \*11.

38. *Id.* at \*43, 46.

Dropdown, concluding that questions of fact remained as to the subjective state of mind of the Committee with respect to that transaction.<sup>39</sup>

Thus, trial in *El Paso* focused on the narrow issue of whether “the Committee members believe[d] subjectively that the Fall Dropdown was in the best interests of [the Partnership].”<sup>40</sup> The Court held that they disregarded their duty to determine that the Fall Dropdown was in the best interests of the Partnership, and concluded that the General Partner breached the LP Agreement on that basis.<sup>41</sup>

The decision was the product of a trial record that “revealed numerous problems” with the Fall Dropdown and, specifically, the process by which the Committee approved the transaction.<sup>42</sup> The Court began by noting that two of the three Committee members had significant ties to the Parent, which impacted their ability to negotiate disinterestedly on behalf of the Partnership.<sup>43</sup> While the Court’s earlier decision rejecting the plaintiff’s challenge to the Spring Dropdown remained the “law of the case,” the Committee’s earlier behavior in that transaction informed the Court’s view of the Committee’s behavior in the context of the Fall Dropdown.<sup>44</sup>

The Court concluded that by the time of the Fall Dropdown—in the wake of the Spring Dropdown and the subsequent dropdown in June 2010—the Committee had fallen into a “comfortable pattern” whereby it merely went “through the motions” in approving the transactions.<sup>45</sup> Despite expressing their opinion in private emails that increasing the Partnership’s percentage ownership of Sub A (beyond the 51% it acquired in the Spring Dropdown) was not in the Partnership’s best long-term interest, the Committee members quickly acceded to the Parent’s proposal to acquire the remaining 49% of Sub A in the Fall Dropdown.<sup>46</sup> The Court also concluded that the Committee “consciously disregarded” lessons learned from the Spring Dropdown in approving the Fall Dropdown. In particular, the Court found that the Committee was privy to market evidence following the Spring Dropdown that indicated it had paid too much for the 51% interest in Sub A, and had not effectively negotiated on behalf the Partnership.<sup>47</sup> In spite of this benefit of hindsight, the Committee negotiated only a minimal price reduction beyond the Parent’s initial offer in the Fall Dropdown for the remaining 49%, but then “blindly gave up” this minimal price reduction after the Parent changed the terms of the deal, proposing instead that the Partnership acquire, in addition to the 49% in Sub A, a 15% interest in Sub B.<sup>48</sup> The Court further faulted the Committee—in the context of the revised deal now for purchase of *both* Sub A and Sub B—for failing

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39. *Id.* at \*43-44.

40. *Id.* at \*45.

41. *Id.* at \*78.

42. *Id.* at \*49.

43. *Id.* at \*8-9, 11.

44. *Id.* at \*43, 60-64.

45. *Id.* at \*50, \*77.

46. *Id.* at \*29, 51.

47. *Id.* at \*60.

48. *Id.* at \*38-40, 61.

to value each asset independently and instead evaluating the transaction as a “unitary whole.”<sup>49</sup> The result was that the price the Committee ultimately negotiated for Sub A in the context of the “unitary” transaction was ultimately *higher* than the price it had previously negotiated, to which the Parent had agreed, when the proposed transaction was for the acquisition of Sub A only.<sup>50</sup>

To be sure, the Court’s analysis of the Committee’s failings was colored significantly by the Court’s conclusion that the Committee’s financial advisor, Tudor, Pickering, Holt & Co., was deeply conflicted, particularly given that it had been retained for *all* of the dropdown transactions, and its fee for each of the transactions was wholly contingent upon its issuance of a fairness opinion.<sup>51</sup> The Court concluded that the Committee was “assisted by a financial advisor that presented each dropdown in the best possible light, regardless of whether the depictions conflicted with the advisor’s work on similar transactions or made sense as a matter of valuation theory.”<sup>52</sup>

Ultimately, the Court concluded that while none of the problems with the Fall Dropdown “standing alone” would have supported a finding that the Committee members did not act in subjective good faith, the “composite picture that emerged” supported such a conclusion.<sup>53</sup>

In *Kinder Morgan*,<sup>54</sup> the Court of Chancery considered whether the defendant general partner (the “General Partner”) of Kinder Morgan Energy Partners LP (the “Partnership”) breached its express and implied contractual obligations to plaintiff limited partner under the Partnership’s limited partnership agreement (the “LP Agreement”) in structuring a reorganization of the Partnership.<sup>55</sup> On a motion to dismiss, the Court rejected the plaintiff’s claims, finding that the General Partner did not breach its obligations under the LP Agreement because the express terms of the LP Agreement supplanted fiduciary duties to individual limited partners and the applicable contractual duty required only that the interests of the Partnership be considered, as opposed to those of the limited partners.<sup>56</sup>

The General Partner was wholly owned by defendant Kinder Morgan, Inc. (“Parent”). The General Partner delegated its authority to manage the Partnership to Kinder Morgan Management, LLC (“GP Delegate”), a limited liability company controlled by the Parent.<sup>57</sup> Prior to the reorganization at issue, Parent, GP Delegate, and the Partnership were all publicly traded entities.<sup>58</sup> Through the reorganization, the Partnership would merge with a wholly-owned subsidiary of the General Partner, and GP Delegate would merge with a different, wholly-owned, subsidiary of the General Partner.<sup>59</sup>

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49. *Id.* at \*42.

50. *Id.*

51. *Id.* at \*12-13, \*64-65.

52. *Id.* at \*4.

53. *Id.* at 49-50.

54. 2015 Del. Ch. LEXIS 221.

55. *Id.* at \*2, 13-14.

56. *Id.* at \*30.

57. *Id.* at \*2.

58. *Id.* at \*3.

59. *Id.*

The intention of the reorganization was to consolidate the entities and have Parent emerge as the only publically traded entity.<sup>60</sup> Because Parent controlled the Partnership through the General Partner, and because Parent would be acquiring total ownership of the Partnership through the reorganization, the transaction created a conflict of interest for the General Partner, which the General Partner addressed by appointing a special committee (the “Special Committee”), under the terms of the LP Agreement, to approve the reorganization.<sup>61</sup>

The plaintiff alleged that the General Partner unfairly structured the reorganization on terms that benefitted the Parent and owners of GP Delegate’s shares—which were disproportionately owned by insiders of Parent—to the detriment of the Partnership’s limited partners.<sup>62</sup>

The Court’s analysis of the pertinent provision of the LP Agreement was guided by the Delaware Supreme Court’s earlier decision in *Norton v. K-Sea Transportation Partners, L.P.*,<sup>63</sup> in which the Court construed a provision in a limited partnership agreement that was identical to the terms of the provision currently at issue. The pertinent provision of the agreement provided:

Any standard of care[,] any duty imposed by this Agreement or under the Delaware Act or any applicable law, rule or regulation shall be modified, waived or limited as required to permit the General Partner to act under this Agreement or any other agreement contemplated by this Agreement and to make any decision pursuant to the authority prescribed in this Agreement *so long as such action is reasonably believed by the General Partner to be in, or not inconsistent with, the best interests of the Partnership.*<sup>64</sup>

Following the Supreme Court’s guidance in *Norton*, the Court of Chancery interpreted the language of the provision “to eliminate[] all common law fiduciary duties” to the limited partners and “substitute in their place a contractual duty under which the General Partner ‘must reasonably believe that its action is in the best interest of, or not inconsistent with, the best interests of the Partnership.’”<sup>65</sup>

The Court concluded that this displacement of common law fiduciary duties to the *limited partners*, in favor of a contractual obligation by the General Partner to take action “in, or not inconsistent with, the best interest of the *Partnership*” was fatal to the plaintiff’s claims for breach of the LP Agreement.<sup>66</sup> The Court emphasized that if the LP Agreement had *not* eliminated fiduciary duties as such, and if the plaintiff had asserted claims for breach of fiduciary duty (which it deemed “they doubtless would have”), then the Court would not have dismissed their claims.<sup>67</sup> But following the Supreme Court’s guidance in *Norton*, the Court ruled that the effect of the provision was to render the analysis “solely contractual.”

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60. *Id.*

61. *Id.* at \*5-6.

62. *Id.* at \*4, 13-14.

63. 67 A.3d 354 (Del. 2013).

64. *Kinder Morgan*, 2015 Del. Ch. LEXIS 221, at \*15-16 (citing Section 6.10(d) of the LP Agreement) (emphasis in original).

65. *Id.* (quoting *Norton*, 67 A.3d at 362).

66. *Id.* (emphasis added).

67. *Id.* at \*17.

The Court concluded that the plaintiff had not adequately alleged a contractual breach by the General Partner. The Court interpreted the relevant contract language, bearing on the General Partner's reliance on the Special Committee, to require only that the Special Committee: (i) believe "subjectively" that the transaction was "fair and reasonable" to the *Partnership*; and (ii) believe "subjectively and reasonably" that it was in the best interest of the *Partnership*.<sup>68</sup> The Court concluded that the Complaint failed to sufficiently allege facts to support a "reasonable inference" that the Special Committee had not satisfied the "minimal" requirements in the LP Agreement.<sup>69</sup> Again, the Court emphasized that it would have reached a different result had the contractual duties of the Special Committee extended to the limited partners *specifically*, as opposed to the Partnership *generally* (which necessarily included *both* the General Partner and the limited partners). As the Court remarked:

If the applicable standard required that the members of the Committee determine that the [Merger] was in the best interests of the limited partners, then the Complaint's allegations would support a pleading-stage inference that the members of the Committee did not act in good faith. It is reasonably conceivable, based on the facts alleged, that the members of the Committee approved the terms of the [Merger] to accommodate Parent, rather than because they believed they were in the best interests of the limited partners.... But the members of the Committee did not have to believe that the MLP Merger was in the best interests of the limited partners. They rather had to believe in good faith that the MLP Merger was in the best interests of the Partnership.<sup>70</sup>

Thus, the Court concluded that the General Partner's reliance on the Special Committee conformed with the terms of the LP Agreement, and dismissed the plaintiff's claim against the General Partner for breach of the same.<sup>71</sup>

## II. DISTINGUISHING BETWEEN DIRECT AND DERIVATIVE CLAIMS

In two separate opinions in 2015, the Court of Chancery considered the distinction between direct and derivative claims and how the traditional analysis applied in the alternative entity context. In *CMS Inv. Holdings, LLC v. Castle*,<sup>72</sup> the Court held that claims against the managers of a limited liability company alleging that they had improperly diverted distributions in an effort to force a company into bankruptcy were direct or, at a minimum, were dual natured. Similarly, in *In re El Paso Pipeline Partners, L.P. Derivative Litigation*,<sup>73</sup> the Court held that breach of contractual claims against a general partner were direct claims or, at a minimum, were dual natured claims and refused to dismiss the claims where the limited partners had lost their standing to pursue derivative claims against the general partner as a result of a post-trial merger.

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68. *Id.* at \*23.

69. *Id.*

70. *Id.* at \*26-28.

71. The Court similarly dismissed Plaintiff's claim for breach of the implied covenant that was founded on allegations that the General Partner appointed conflicted individuals—with divergent allegiances to the Partnership and the GP Delegate—to serve on the Special Committee. The Court concluded that purported conflict was not sufficient to implicate the covenant.

72. C.A. No. 9468-VCP, 2015 Del. Ch. LEXIS 169 (Del. Ch. June 23, 2015).

73. C.A. No. 7141-VCL, 2015 Del. Ch. LEXIS 295 (Del. Ch. Dec. 2, 2015).

*CMS Investment Holdings* involved a dispute over events that led to the demise of a Delaware limited liability company, RP Holdings Group LLC (“RPH”). RPH provided non-legal services to law firms in connection with mortgage foreclosures.<sup>74</sup> RPH was created by the defendants and was purchased by the plaintiff, CMS Investment Holdings, LLC (“CMSIH”).<sup>75</sup> CMSIH received Class A preferred membership units as part of the transaction.<sup>76</sup> After the sale, the defendants continued to run the business as managers, officers and employees of RPH.<sup>77</sup>

In the action, CMSIH alleged that the defendants failed to collect administrative services fees owed to RPH by the law firms and clients, instead retaining the fees for themselves or paying themselves through improper distributions.<sup>78</sup> As this began to place RPH in danger of defaulting on its debt obligations, CMSIH further alleged, the defendants conspired to purposely drive the company into insolvency so that they could buy back its assets at a fire-sale price.<sup>79</sup> CMSIH’s claims included breach of the limited liability company agreement (the “LLC Agreement”), breach of the implied covenant of good faith and fair dealing, unjust enrichment, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, civil conspiracy, and fraudulent transfer.<sup>80</sup>

In a dismissal motion, the defendants argued, among other things, that the claims were derivative and therefore could not be brought by CMSIH absent satisfaction of the demand requirement of Court of Chancery Rule 23.1.<sup>81</sup> The Court rejected this contention, however, and held that the claims were direct or, at a minimum, dual-natured.<sup>82</sup>

The Court began its analysis of the direct/derivative issue by repeating the familiar standard: whether a claim is direct or derivative depends solely on: (1) who suffered the alleged harm (the corporation or the stockholders, individually); and (2) who would receive the benefit of any recovery (the corporation or the stockholders, individually).<sup>83</sup> It then examined CMSIH’s claims.<sup>84</sup>

With respect to the breach of contract and related claims, the Court explained that the allegations could be characterized as follows: the parties to RPH’s LLC Agreement promised CMSIH that the holders of Class A units would receive distributions before the other classes of units.<sup>85</sup> Accepting those allegations as true, the Court explained, there may

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74. 2015 Del. Ch. LEXIS 169, at \*1-2.

75. *Id.* at \*2.

76. *Id.* at \*10.

77. *Id.*

78. *Id.* at \*2-3, \*14.

79. *Id.*

80. *Id.* at \*22.

81. *Id.* at \*24.

82. *Id.* at \*26.

83. *Id.* at \*25-26.

84. *Id.*

85. *Id.* at \*26-27.

have been a sense in which RPH was harmed by the defendants' breach of that agreement, but the predominant harm fell on CMSIH as the Class A unitholder.<sup>86</sup>

The Court used similar logic to find that the fiduciary duty and related claims also were direct.<sup>87</sup> The Court noted that, under Delaware law, equity interests entitle their owners to exercise certain rights by virtue of being the owners, and "[d]irect claims for breach of fiduciary duty arise when those rights are infringed."<sup>88</sup> The Court concluded that CMSIH's complaint adequately alleged that the defendants engaged in a series of actions to dissolve RPH and purchase its assets out of receivership, thereby re-allocating economic and voting power away from Class A unitholders for less than fair value.<sup>89</sup> The Court noted that any recovery for those allegedly wrongful actions would go to the Class A unitholders "individually, and not on a pro rata basis along with all the unitholders of RPA."<sup>90</sup> Moreover, the Court observed that while RPH was also harmed by the defendants' scheme and that a derivative action may lie on behalf of RPH, here CMSIH had "limited the claims it is asserting based on the RPH fiduciaries' alleged breaches of fiduciary duties solely to breaches that [it] can pursue directly."<sup>91</sup> Thus, the fiduciary duty and related claims therefore were deemed direct.<sup>92</sup>

The defendants argued that CMSIH's allegations amounted to nothing more than a "sensational story about how Defendants pillaged RPH for years causing it immeasurable harm and, as a result, Plaintiff lost its investment."<sup>93</sup> The Court acknowledged that this might be "one way to read the Complaint, but it is not the only reasonable one."<sup>94</sup> The Court pointed out that, at the motion to dismiss stage, CMSIH was entitled to have all reasonable inferences drawn in its favor.<sup>95</sup> As such, CMSIH's claims were deemed direct and it was not required to comply with the Rule 23.1 demand requirement.<sup>96</sup>

The Court in *El Paso*<sup>97</sup> undertook a similar analysis, but in connection with its consideration of whether a plaintiff had lost standing to assert derivative claims following a post-trial merger. The underlying facts in *El Paso* are discussed above. As discussed, in a post-trial opinion the Court held that the general partner had breached its contractual duties to the limited partners by failing to act with subjective good faith in approving a drop-down transaction.<sup>98</sup> As a result,

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86. *Id.* at \*27.

87. *Id.*

88. *Id.* at \*28.

89. *Id.*

90. *Id.* at \*28-29.

91. *Id.* at \*29.

92. *Id.*

93. *Id.* at \*30.

94. *Id.*

95. *Id.*

96. *Id.* at \*30-31.

97. 2015 Del.Ch. LEXIS 295, *rev'd* 2016 Del. LEXIS 653 (Del. Dec. 20, 2016).

98. *Id.* at \*18.

the general partner was liable to the limited partners for \$171 million in damages plus pre- and post-judgment interest.<sup>99</sup> Following trial, the limited partnership at issue was merged out of existence in a related party transaction.<sup>100</sup> As a result, the defendants argued that because the plaintiff had pled the claims as derivative, the claims must be dismissed.<sup>101</sup>

The Court rejected this contention. The Court held that if the law required the claims to be characterized as exclusively direct or derivative, then the claims were direct.<sup>102</sup> But in the Court's view, the claims were more properly characterized as "dual-natured" claims which should be viewed as derivative for purposes of Rule 23.1 standing and direct for purposes of determining standing following a merger.<sup>103</sup> The Court's legal analysis on each of these issues is instructive.

The primary holding of the Court is that a breach of contract claim asserted by a unitholder in a limited partnership is a direct claim.<sup>104</sup> In so holding, the Court rejected the defendants' argument that because the limited partnership suffered harm as a result of the defendants' actions, the claim must, under *Tooley*, be characterized as a derivative claim.<sup>105</sup> The Court held that such a view "overstates *Tooley's* reach" in that *Tooley* does not "obviate the need to address 'an important initial question': Does the plaintiff seek to bring a claim belonging to her personally or one belonging to the corporation itself?"<sup>106</sup> The Court also rejected the defendants' argument that *Tooley*, through its elimination of the special injury requirement, eliminated direct claims by stockholders to enforce their rights under the DGCL, charter and bylaws.<sup>107</sup> The Court reasoned that although *Tooley* rejected the term "special injury" when analyzing whether a claim is direct or derivative, it did not reject the concept that stockholders may sue directly to enforce their statutory or contractual rights.<sup>108</sup> Instead, *Tooley* enforced the principle that stockholders may sue directly to enforce contract claims.<sup>109</sup> Further, the Court held that *Tooley's* two-step analysis does not apply to such claims because *Tooley* dealt with fiduciary duty claims, not contract claims.<sup>110</sup> This rule, reasoned the Court, may result in more claims in the alternative entity context being deemed direct claims.<sup>111</sup> It does not, however, make all alternative entity claims (which are largely creatures of contract)

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99. *Id.* at \*2.

100. *Id.*

101. *Id.* at \*3.

102. *Id.* at \*3-4.

103. *Id.* at \*4-5.

104. *Id.* at \*23-24.

105. *Id.* at \*36.

106. *Id.* (citations omitted).

107. *Id.* at \*66.

108. *Id.* at \*70.

109. *Id.*

110. *Id.* at \*72.

111. *Id.* at \*75.

direct.<sup>112</sup> Claims that assert a breach of a specific provision of a governing agreement will be direct.<sup>113</sup> Claims challenging the decision-making of a manager or general partner will continue to be subject to the *Tooley* two-step analysis.<sup>114</sup>

The Court, in *dictum*, went on to analyze whether the claims asserted by the plaintiffs were more properly characterized as dual-natured claims.<sup>115</sup> The Court analyzed whether the plaintiffs' claim was a dual-natured claim, *i.e.*, one that has both direct and derivative characteristics.<sup>116</sup> The Court observed that Delaware recognizes a third category of claims - dual-natured claims.<sup>117</sup> These are claims that "affect *both* the corporation and the stockholder and could be remedied either at the corporate *or* the stockholder level."<sup>118</sup> To determine if a claim is dual-natured, courts use the *Tooley* test.<sup>119</sup> In the case at hand, the Court held that the injury alleged by plaintiffs (eliminating the contractual element) was injury that impacted both the limited partners and the partnership. Specifically, the Fall Dropdown transaction caused the partnership to overpay for assets resulting in injury to the partnership.<sup>120</sup> Because, however, the Fall Dropdown also involved monies being extracted from the entity (here the partnership) and being allocated to a "wrongful insider" (in this case the General Partner) the limited partners suffered injury in the form of a "reallocation of value among the existing entity claimants."<sup>121</sup> The Court explained,

All of the claimants suffer a proportionate loss according to the priority of their claims, but the insider receives an offsetting benefit that exceeds the insider's share of the loss. In reality, the insider isn't injured at all. The insider gains at the expense of the other investors. The net effect is to extract value from the unaffiliated investors for the benefit of the insider.<sup>122</sup>

The limited partners and the general partner suffered a loss as a result of the overpayment. But the general partner obtained an offsetting gain by virtue of its inside position.<sup>123</sup> Thus, the limited partners' loss inured to the benefit of the general

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112. *Id.* at \*73-74.

113. *Id.* at \*75.

114. *Id.*

115. *See id.* at \*33 n.8 ("This aspect of this decision is admittedly dictum, but because this decision effectively decides the fate of the Liability Award, the losing party can be expected to appeal.")

116. *Id.* at \*82.

117. *Id.* at \*83 n.41.

118. *Id.* at \*83 (emphasis in original).

119. *Id.* at \*84.

120. *Id.* at \*86.

121. *Id.* at \*88.

122. *Id.* at \*88-89.

123. *Id.* at \*89.

partner resulting in a “separate and distinct loss” to the unaffiliated limited partners.<sup>124</sup> The Court also held that any remedy for the wrong could operate at either the limited partner or partnership level. If the partnership were to continue as a viable entity, the general partner could repay the overpayment to the limited partnership.<sup>125</sup> Alternatively, the general partner could pay the offsetting benefit it obtained to the limited partners so that all limited partners “receive *pro rata* treatment.”<sup>126</sup>

The Court went on to discuss how dual-natured claims should be treated for purposes of (i) claim initiation and a Rule 23.1 analysis and (ii) claim elimination and a standing analysis, each of which presents different policy considerations.<sup>127</sup> The Court reasoned:

When considering how a dual-natured claim should be treated for purposes of Rule 23.1 and other doctrines that protect the board’s central role in overseeing the business and affairs of the corporation, Delaware law can and should prioritize the derivative aspects of the claim. Classifying the claim as derivative for purposes of this stage of the litigation serves the policy goal of screening for meritless claims through a combination of the demand doctrine and the heightened pleading standards of Rule 23.1. These standards weed out weak claims while permitting strong claims involving breaches of the duty of loyalty to survive. Treating a dual-natured claim as derivative during this stage also serves the pragmatic goal of ensuring that “injury to a whole association [of investors] is adjudicated on behalf of that whole and not just for the benefit of the individuals who have undertaken to pursue the claims.” *In re Cencom Cable Income Partners, L.P.*, 2000 Del. Ch. LEXIS 10, 2000 WL 130629, at \*4 (Del. Ch. Jan. 27, 2000)

When considering how a dual-natured claim should be treated for purposes of whether it can be maintained after a merger, Delaware law can and should prioritize the individual aspects of the claim. The policies supporting a derivative characterization no longer apply once the separate legal existence of the represented entity has terminated. There is no need to screen again for weak claims, because the Rule 23.1 analysis already has served that purpose. Nor is there a continuing need for the entity to play its pragmatic role as a collection agent. In a merger, at the singularity of the effective time, the identities of the investors on whose indirect behalf the derivative action was being pursued become forever fixed. *See Brinckherhoff v. Tex. E. Prods. Pipeline Co., LLC*, 986 A.2d 370, 383 (Del. Ch. 2010). The constituent entities know the identities of those investors because they send them the merger consideration. From that point on, a dual-natured claim “should be seen for what [it is], a form of class action.” *Parfi Hldg. AB v. Mirror Image Internet*, 954 A.2d 911, 940 (Del. Ch. 2008) (Strine, V.C.).<sup>128</sup>

Such treatment, the Court observed, would also address other policy considerations such as the disincentive and the wealth transfer that results when a stockholder invests time and money to assert a derivative claim only to lose standing to assert it at a later time.<sup>129</sup> For purposes of the current case, the Court held:

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124. *Id.* at \*90-91.

125. *Id.* at \*106-07.

126. *Id.* at \*90.

127. *Id.* at \*109-110.

128. *Id.* at \*110-12.

129. *See id.* at \*112-13 (“If derivative actions promote firm value, even marginally, then a rule that forecloses some number of both meritorious and meritless derivative actions will, all things being equal, inherently transfer some degree of wealth from

[F]or as long as El Paso MLP retained its separate legal existence, it was preferable for the action to proceed in the name of El Paso MLP and for any remedy to run through El Paso MLP. Now that El Paso MLP no longer exists as a separate entity, the possibility of remedying the situation through a payment to the entity no longer exists. In my view, that does not mean that the harm no longer exists or that a remedy is no longer warranted. The Proxy Statement admits that the consideration that holders of common units received in the Merger did not incorporate any value for this litigation. Under the circumstances, it does not seem logical or equitable to disregard the Liability Award, dismiss this action, and invite the plaintiff potentially to start all over again by challenging the Merger. Rather, it seems to me that the remedy should be implemented differently. I believe that the direct aspects of the remaining breach of contract claim should enable the unaffiliated limited partners to receive their *pro rata* share of the Liability Award.<sup>130</sup>

### III. STANDING TO SEEK DISSOLUTION

In 2015, the Court of Chancery issued an opinion that held that a non-member of a limited liability company had standing to seek an equitable dissolution of an entity where the same was not available to the non-member by statute or by the parties' agreement. In doing so, the Court explained how its equitable power to grant dissolution was not and could not be usurped by the statutory provision in the Delaware Limited Liability Company Act (the "Delaware LLC Act") providing for dissolution.

In *In re Carlisle Etcetera LLC*,<sup>131</sup> the Court denied a limited liability company member's motion to dismiss a petition for dissolution filed under 6 *Del. C.* § 18-802 by petitioners that included the company's parent and its wholly-owned subsidiary. The member argued that the Delaware LLC Act only permits members and managers to seek dissolution, and that neither the parent nor the subsidiary was a member or a manager.<sup>132</sup> The Court agreed that the petitioners were not managers because the managing power was vested with a board of directors.<sup>133</sup> The Court also agreed that the petitioners were not members because the parent had assigned its rights to the wholly-owned subsidiary, leaving the parent without member rights by operation of 6 *Del. C.* § 18-702(b)(3).<sup>134</sup> Under the Delaware LLC Act, an assignment of interests does not automatically make an assignee a member unless the operating agreement provides otherwise.<sup>135</sup> Because the operating agreement did not otherwise provide, the wholly-owned subsidiary was not a member.<sup>136</sup> Although the Court agreed

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corporations to the individuals who commit corporate wrongs. The resulting wealth transfer confers a windfall on faithless fiduciaries and creates perverse incentives for misbehavior." (quoting *Hamilton Partners v. England*, 11 A.3d 1180, 1206 (Del.Ch. 2010).

130. *Id.* at \*127-28.

131. 114 A.3d 592 (Del. Ch. 2015).

132. *Id.* at 597.

133. *Id.*

134. *Id.* at 598.

135. *Id.* (discussing 6 *Del. C.* § 18-702(b)(1)).

136. *Id.* at 598-99.

with these aspects of the member's arguments, the Court denied the motion to dismiss. The Court reasoned that Section 18-802 was not the exclusive extra-contractual means of seeking dissolution of a limited liability company.<sup>137</sup> The parent and wholly-owned subsidiary were permitted to seek dissolution of the company under the Court's broad equitable power, to avoid becoming "locked-in as a silent and powerless passive investor."<sup>138</sup> Despite not having the ability to seek a statutory dissolution or a contractual dissolution, the Court held that the "real relations" of the parties warranted allowing the subsidiary standing to seek an equitable dissolution.<sup>139</sup> The Court held that Section 6 *Del. C.* §18-802 of the Delaware LLC Act does not (and could not) provide the "exclusive method of dissolving an LLC."<sup>140</sup> *First*, the language of Section 18-802 does not state that it shall be the exclusive means by which to obtain dissolution.<sup>141</sup> Instead, the Delaware LLC Act elsewhere recognizes that in a case not provided for, equity provides a "backstop."<sup>142</sup> *Second*, even if Section 18-802 would purport to provide the exclusive means for dissolving an LLC, it would be unconstitutional because it would divest the Court of its traditional equity jurisdiction and power to order the dissolution of an insolvent entity and the appointment of a receiver.<sup>143</sup> The Court compared its holding to that of the Delaware Supreme Court in *CML V, LLC v. Bax*,<sup>144</sup> which held that creditors did not have standing to sue derivatively on behalf of a limited liability company. The Court observed that, unlike in the current case where the parties had no relief absent an equitable remedy, creditors have sufficient legal remedies available to them to avoid any similar constitutional problem.<sup>145</sup> The Court also observed that while the parties to a limited liability company agreement may waive the right to seek statutory dissolution, the remedy of equitable dissolution may not be waived and is available as a backstop where statutory or contractual dissolution is not available.<sup>146</sup>

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137. *Id.*

138. *Id.* at 606.

139. *Id.* at 601.

140. *Id.* at 607.

141. *Id.* at 601.

142. *Id.* at 602 (citing 6 *Del. C.* §18-1104)

143. *Id.* at 602-03.

144. 28 A.3d 1037 (Del. 2011).

145. 114 A.3d. at 605.

146. *See id.* at n.8 (citing to the adoption of 6 *Del. C.* § 18-1104 providing that "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law of merchant shall govern.") and at 606 (citing *Huatuco v. Satellite Healthcare and Satellite Dialysis of Tracy, LLC*, 2013 Del. Ch. LEXIS 298, at \*1 n.2 (Del. Ch. Dec. 9, 2013) (reserving decision on "whether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires – leaving for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre's *Huis Clos*.")) *aff'd* 93 A.3d 654 (Del. 2014) (Order).



## AN “UNJUSTIFIABLE” STANDARD: PLEADING DEMAND FUTILITY AS A CREDITOR OF AN INSOLVENT CORPORATION

William M. Alleman, Jr.\*

It is well understood that under Delaware law, a stockholder attempting to sue derivatively on behalf of a corporation must first do one of two things: (1) make a pre-suit demand on the corporation’s board to pursue the cause of action, which demand must have been wrongfully refused; or (2) allege in its complaint—with particularity—why such a demand would have been futile.<sup>1</sup> It is also settled in Delaware that when the corporation is insolvent, its creditors gain standing to serve as a derivative plaintiff.<sup>2</sup>

The law is unclear, however, as to whether a creditor seeking to enforce an insolvent corporation’s rights must comply with the demand and demand futility pleading requirements applicable to stockholders. What’s more, if a creditor-plaintiff is subject to the demand or demand futility requirement, what standard is a court to apply to review the adequacy of a creditor’s pleading? These issues are of significant importance because failure to adequately allege demand or demand futility when required may result in dismissal of the plaintiff’s lawsuit.

This article submits that a creditor-plaintiff should be required to make a demand on the board or explain its failure to do so as a prerequisite to litigating a derivative suit. The rationale for the demand requirement—that only the board of directors possesses the authority to assert the corporation’s claims—applies equally, if not more, where the corporation is insolvent. This rationale counsels for a governor on creditors’ ability to sue derivatively.

But where the creditor-plaintiff chooses the demand futility route, it should not be required to satisfy the heightened pleading requirements imposed on stockholders by Court of Chancery Rule 23.1 (“Rule 23.1”) and the case law interpreting that rule. Pleading demand futility with particularity presents several practical and theoretical concerns for the creditor-plaintiff that traditional stockholder-plaintiffs do not share. Creditors lack access to the pre-suit discovery often necessary to establish the particulars of directors’ conflicts of interest—an essential component of the demand futility test under *Aronson*.<sup>3</sup> Further, directors of distressed corporations may be motivated to decline to suit authorization because the corporation may not be able to advance or indemnify defense costs, but it is not clear that an allegation of such motivation would alone rise to the level necessary to excuse a demand. Moreover, the concepts of demand and demand futility have no real theoretical underpinning where a creditor is the plaintiff because the creditor did not elect, and cannot remove, the directors they must confront. For those reasons, Rule 23.1 is an inappropriate procedural implementation of the substantive rationale of board primacy in the insolvency context.

Instead of forcing creditor-plaintiffs to adhere to the pleading requirements tailored for stockholder-plaintiffs, Delaware state courts should follow the lead of the Third Circuit Court of Appeals and Delaware bankruptcy courts by adopting the bankruptcy courts’ standard and procedure for determining whether creditors may sue derivatively on behalf of a debtor corporation. This standard, referred to herein as the *Cybergenics* rule, requires a creditor-plaintiff to affirmatively

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1. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

2. *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2006)

3. *Aronson*, 473 A.2d at 814.

obtain a court order finding that the creditor has alleged “colorable” claims and the board has (or would have) “unjustifiably” refused to pursue them.<sup>4</sup> The *Cybergenics* rule better balances the competing rights of directors and creditors of an insolvent corporation because creditors will not be burdened with the steep, if not impossible, task of marshaling “particularized” facts regarding directors’ ability to exercise independent business judgment without the benefit of the pre-suit discovery tools available to stockholders. At the same time, the corporation will be able to rely on the court (applying the deferential business judgment rule, where appropriate) to serve as a gatekeeper against improper suits. Moreover, application of the *Cybergenics* rule will promote uniformity of law in this area, while still allowing considerable room for analysis of the particular facts and circumstances and weighing of equities, a task that is well-suited for Delaware’s Court of Chancery.

This article begins with an overview of Rule 23.1 and the demand and pleading requirements applicable to stockholder-plaintiffs. With this background, the article turns to decisions of the Court of Chancery that raise the question of whether the requirements applicable to stockholders also apply to a creditor-plaintiffs. Because those cases admit that Delaware law is not clear on this point, this article next turns to an analysis of the substantive rule of law underlying the demand requirement and the procedural implementation of it via Rule 23.1. Finally, this article proposes and discusses the *Cybergenics* standard that could be applied instead of existing demand and pleading requirements where a creditor is the derivative plaintiff.

## I. THE DEMAND REQUIREMENT AND CHANCERY RULE 23.1, GENERALLY

The demand requirement—i.e., the requirement that a would-be derivative plaintiff first “demand” that the board of directors pursue the corporation’s claim—is rooted in the bedrock principle of Delaware law that the board of directors, and not any other corporate constituency, possesses the authority to manage a corporation’s business and affairs, including its potential causes of action.<sup>5</sup> Section 141(a) of the Delaware General Corporation Law (the “DGCL”) provides that “[t]he business and affairs of every corporation organized under [the DGCL] shall be managed by or under the board of directors.”<sup>6</sup> “The requirements of demand futility or demand refusal flow from Section 141(a), which makes the authority of the board of directors paramount.”<sup>7</sup>

As the Delaware Supreme Court stated in its seminal opinion in *Aronson v. Lewis*, “the entire question of demand futility is inextricably bound to issues of business judgment.”<sup>8</sup> By extension, the *Quadrant I* court explained:

A corporate claim is an asset of the corporation, so authority over the claim ordinarily rests with the board of directors. The doctrines of demand excusal and demand refusal protect the board’s authority under Section 141(a) and prevent a derivative plaintiff from usurping the board’s prerogative to decide how to handle a corporate claim.<sup>9</sup>

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4. Official Committee of Unsecured Creditors of *Cybergenics Corp.* ex rel. *Cybergenics Corp.* v. Chancery, 330 F.3d 548 (3d Cir. 2003).

5. See 8 DEL. C. § 141(a).

6. *Id.*

7. *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 182 (Del. Ch. 2014) (“*Quadrant I*”).

8. *Aronson*, 473 A.2d 805, 812 (Del. 1983).

9. *Quadrant I*, 102 A.3d at 181 (citations omitted).

Rule 23.1 implements Section 141(a)’s substantive rule of law.<sup>10</sup> Rule 23.1 provides the procedural requirement that the underlying complaint “allege *with particularity* the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”<sup>11</sup>

A well-developed body of case law explains Rule 23.1’s demand futility pleading requirements. Not surprisingly, given the *Aronson* court’s linking of demand futility to the concept of business judgment, the tests used to determine whether demand futility has been established focus on whether a plaintiff has pleaded that directors are incapable of exercising, or have failed to exercise, sound business judgment.<sup>12</sup> Specifically, when a plaintiff proposes to challenge a particular corporate transaction, Rule 23.1 requires the court to determine “whether, under the particularized facts alleged, a reasonable doubt is created that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”<sup>13</sup> Alternatively, the Delaware Supreme Court in *Rales v. Blasband* explained that where a particular corporate transaction is not at issue, the plaintiff must plead particularized factual allegations that “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”<sup>14</sup>

Rule 23.1 is appropriately described as imposing a “heightened pleading standard” upon a derivative plaintiff.<sup>15</sup> The requirement that demand futility be pled “with particularity” is stressed throughout the Delaware cases.<sup>16</sup> Derivative plaintiffs are often cautioned that “[c]onclusory allegations are not considered as expressly pleaded facts or factual inferences.”<sup>17</sup> Further, although a derivative plaintiff will be given the benefit of all reasonable inferences, “[s]uch reasonable inferences must logically flow from particularized facts alleged by the plaintiff.”<sup>18</sup>

Importantly for would-be plaintiffs, the courts are clear that “[w]here the plaintiff fails to comply with the demand requirement and fails to plead with particularity why a demand would be futile, the complaint will be dismissed.”<sup>19</sup>

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10. *See id.* (“Rule 23.1 implements the substantive requirements of demand futility and demand refusal as pleading requirements....”).

11. DEL. CH. R. 23.1 (emphasis added).

12. *See, e.g.*, *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998).

13. *Aronson*, 473 A.2d at 814.

14. *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

15. *See South v. Baker*, 62 A.3d 1, 14 (Del. Ch. 2012); *see also Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000) (acknowledging that Rule 23.1 imposes a more rigorous pleading requirement than Rule 12(b)(6)).

16. *See, e.g.*, *Beam v. Stewart*, 845 A.2d 1040, 1049 (Del. 2004); *South*, 62 A.3d at 26.

17. *Beam*, 845 A.2d at 1048 (internal quotation marks omitted).

18. *Id.*

19. *Tvi Corp. v. Gallagher*, 2013 Del. Ch. LEXIS 260, \*18 (Del. Ch. June 3, 2013); *see, e.g., South*, 62 A.3d at 6 (dismissing derivative complaint “with prejudice and without leave to amend as to the named plaintiff” for failure to adequately plead demand futility under Rule 23.1).

## II. DELAWARE LAW IS UNCLEAR AS TO WHETHER CREDITORS MUST PLEAD DEMAND FUTILITY

Currently, “[i]t is...possible that creditors may be required to comply with the doctrines of demand futility and demand excusal.”<sup>20</sup> Although the Delaware Supreme Court’s 2006 decision in *North American Catholic Education Programming Foundation v. Gheewalla* resolved long-standing uncertainty regarding the fiduciary relationship between the directors of an insolvent corporation and the creditors of that corporation,<sup>21</sup> neither *Gheewalla* nor its progeny provide guidance on secondary issues regarding the mechanics of creditor-plaintiff’s derivative suit.

Eight years after *Gheewalla*, the Court of Chancery first addressed a subset of the procedural issues facing a creditor-plaintiff proceeding under Rule 23.1. In *Quadrant Structured Prods. Co. v. Vertin*, the court examined whether the creditor-plaintiffs, like shareholder-plaintiffs, are limited to suing for harms that occurred while they were creditors, a limitation known as the “contemporaneous ownership” requirement.<sup>22</sup> The court rejected a “contemporaneous ownership” requirement for creditor-plaintiffs.<sup>23</sup> Months later, in a related opinion, the court also rejected a “continuous insolvency” requirement, holding that a return to solvency after the complaint is on file does not divest the creditor of derivative standing.<sup>24</sup>

Both of the *Quadrant* decisions indicate that Delaware courts do not necessarily view creditors and stockholders as equivalent derivative plaintiffs, nor are the rules necessarily interchangeable. Thus, the possibility remains that a creditor-plaintiff may *not* be required to comply with the doctrines of demand futility and demand excusal.

The uncertainty regarding a creditor-plaintiff’s obligation to satisfy the demand rules applicable to stockholders arises in large part because, although it would stand to reason that the demand rule would apply to a creditor-plaintiff, Rule 23.1 by its plain terms applies only to derivative actions “brought by one or more *shareholders* or members to enforce a right of a corporation or an unincorporated association.”<sup>25</sup> Indeed, the Court of Chancery recently recognized that “Rule 23.1 does not mention creditor-plaintiffs when addressing either contemporaneous ownership or demand futility and demand refusal.”<sup>26</sup>

Moreover, in rejecting a “contemporaneous ownership” requirement for creditor-plaintiffs in *Quadrant I*, the Court of Chancery held that Rule 23.1’s reference to “shareholders” was unambiguous.<sup>27</sup> The rule’s requirement that “the complaint allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains....” cannot be reasonably read to apply to a creditor-plaintiff.<sup>28</sup> Although the court’s ruling was technically grounded

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20. *Quadrant I*, 102 A.2d at 182.

21. *See Gheewalla*, 930 A.2d at 99-103; *Quadrant I*, 102 A.3d at 172-76.

22. *Quadrant I*, 102 A.3d at 177-82.

23. *Id.* at 179-80.

24. *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015).

25. DEL. CH. R. 23.1 (emphasis added).

26. *Quadrant I*, 102 A.3d at 181.

27. *Id.* at 179.

28. DEL. CH. R. 23.1(a); *see Quadrant I*, 102 A.3d at 178-180.

in the language of Section 327 of the DGCL, which provides the substantive basis for the contemporaneous ownership rule, Section 327 and Rule 23.1 use identical language and the court held that by its terms, that language “applies only to stockholders. The plain language of the statute does not apply to other corporate constituencies, like creditors, who can under limited circumstances bring derivative claims.”<sup>29</sup>

By refusing to extend the contemporaneous ownership requirement to creditors based on a plain reading of the word “shareholders,” *Quadrant I* could be read as support for the proposition that a creditor suing derivatively on behalf of an insolvent corporation need not allege demand futility.<sup>30</sup> Under *Quadrant I*, the word “shareholder” in Rule 23.1 means just that—it does not include a creditor suing derivatively on behalf of an insolvent corporation.

Yet, despite interpreting the “plain language” of Section 327 (and, therefore, Rule 23.1) to apply only to shareholders, Vice Chancellor Laster paused to explain that *Quadrant I*’s rationale “does not preclude a requirement that creditor-plaintiffs comply” with the doctrines of demand futility and demand excusal.<sup>31</sup> The court made clear that its holding regarding the contemporaneous ownership rule relies on an important distinction between the substantive mandate of Section 327 and the procedural requirements of Rule 23.1. Extending this substantive-versus-procedural distinction to the demand context, the court stated that because Rule 23.1 is only procedural, “whether a creditor would need to satisfy the demand excusal or demand refusal requirements depends not on Rule 23.1 but rather on the underlying substantive principle of law.”<sup>32</sup> In the contemporaneous ownership context, the “substantive principle of law,” as noted, is supplied by Section 327 of the DGCL, and that statute plainly only applies to “shareholders.”<sup>33</sup> In the demand context, however, Rule 23.1 does not have a corresponding statute that speaks directly to who must plead demand futility.<sup>34</sup> Rather, as discussed, “[t]he requirements of demand futility or demand refusal flow from Section 141(a)” of the DGCL,<sup>35</sup> which provides only that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the board of directors.”<sup>36</sup>

Although Delaware’s General Assembly is free to craft a statute to delineate the contours of the demand and demand-futility requirements for creditor-plaintiffs, without such guidance, the courts will be left to analyze existing case law and the policy and purpose of those requirements to determine the standard that creditor-plaintiffs must meet. Until such time when that standard is clarified, uncertainty surrounds a putative creditor-plaintiff who seeks to sue derivatively.

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29. *Quadrant I*, 102 A.3d at 179.

30. *Id.* at 177-81.

31. *Id.* at 181.

32. *Id.* at 182.

33. See 8 DEL. C. § 327; *Quadrant I*, 102 A.3d at 178-80.

34. See 8 DEL. C. §§ 321-330.

35. *Quadrant I*, 102 A.3d at 182.

36. 8 DEL. C. 141(a).

### III. THE RATIONALE OF THE DEMAND REQUIREMENT APPLIES EQUALLY WHEN A CREDITOR IS THE PLAINTIFF

Delaware case law provides no direct guidance on the issue of whether a creditor-plaintiff must plead demand futility.<sup>37</sup> Although the Court of Chancery has raised the issue *sua sponte* on at least two occasions, in both cases the court was not required to resolve it.<sup>38</sup>

As discussed above, however, Delaware courts have said much about the rationale behind the demand requirement: “The doctrines of demand excusal and demand refusal protect the board’s authority under Section 141(a) and prevent a derivative plaintiff from usurping the board’s prerogative to decide how to handle a corporate claim.”<sup>39</sup>

The rationale of the demand requirement applies equally when the plaintiff is a creditor. As an initial matter, the fact that the corporation is insolvent does not provide a legal basis to allow a plaintiff to bypass the board in asserting the corporation’s claims. A board’s managerial authority under Delaware law does not diminish or change upon insolvency.<sup>40</sup> To the contrary, the Court of Chancery has repeatedly stated that “[n]otwithstanding a company’s insolvency, [t]he directors continue to have the task of attempting to maximize the economic value of the firm.”<sup>41</sup> Likewise, directors do not necessarily become interested or lose independence upon insolvency; consequently, informed and loyal directors of an insolvent corporation continue to be protected by the business judgment rule. According to the Court of Chancery: “If the board of an insolvent corporation, acting with diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value’...the directors are protected by the business judgment rule.”<sup>42</sup> Therefore, since “the entire question of demand futility is inextricably bound to issues of business judgment,”<sup>43</sup> and the rules of business judgment do not change merely because a corporation is insolvent, the demand requirement should be equally applicable to a creditor-plaintiff as a matter of law.

Moreover, the policy rationale underlying the demand requirement and the business judgment rule—promoting corporate efficiency through centralized and informed decision-making—may be even more appropriate in the context of an insolvent corporation.<sup>44</sup> Creditors of a distressed entity are already incentivized to run to the courthouse to seize

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37. See *Quadrant I*, 102 A.3d at 182 (“This court has previously declined to address whether a creditor seeking to bring a derivative action must comply with the requirement to show demand excusal or demand refusal...”); *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 796 (Del. Ch. 2004). (“An independent review of Delaware precedent reveals nothing on point...”).

38. See *Quadrant I*, 102 A.3d at 182; *Prod. Res. Group*, 863 A.2d at 796.

39. *Quadrant I*, 102 A.3d at 181 (citations omitted).

40. See *Quadrant I*, 102 A.3d at 185-86.

41. *Id.* at 185 (quoting *Prod. Res.*, 863 A.2d at 791).

42. *Id.* at 186 (quoting *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006) and *Shandler v. DLJ Merchant Banking, Inc.*, 2010 Del. Ch. LEXIS 154 (Del. Ch. July 26, 2010)).

43. *Aronson*, 473 A.2d at 812.

44. Cf. *Gheewalla*, 930 A.2d at 100 (“[A]n otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership.”).

control of potentially valuable corporate assets. Where cash and other tangible or unencumbered assets are scarce, the ability to control a corporate cause of action would provide the creditor with additional, unbargained-for leverage against the corporation and its other creditors, which the plaintiff-creditor would almost certainly use to extract preferential treatment. Compounding this risk is the likelihood that numerous creditors would likely seek such leverage at once. All of this would occur at a time when the corporation is most vulnerable, threatening to further jeopardize prospects for recovery. If Delaware law is to afford directors the leeway to manage a sinking ship, they should not be worried about creditors hijacking it.<sup>45</sup>

The lack of a demand requirement for creditors would also give creditors an unjustified advantage over the corporation’s stockholders, who must continue to abide by the demand requirement and Rule 23.1 if they wished to pursue the same claim as the creditor. During the time that the putative stockholder-plaintiff must spend making a demand or discovering the particularized facts necessary to plead demand futility, a creditor could file suit.

In light of these concerns, the importance of the board’s managerial authority under Delaware law, and the lengths to which the Court of Chancery went to insert *dicta* into the *Quadrant I* opinion solely to caution against the logical application of its holding to the demand futility requirement, extension of the demand requirement to derivative creditor-plaintiffs seems inevitable and would be appropriate. But, barring any legislative developments or an amendment to Rule 23.1, imposition of a demand-futility *pleading* requirement for creditors would require either (1) a judicial interpretation of Rule 23.1 that extends that rule to creditors; or (2) a judicially crafted demand futility rule applicable only in the creditor-suing-derivatively context. The first option does not appear tenable. Extending Rule 23.1’s demand requirements to “creditors” would, in light of the “plain language” analysis of *Quadrant I*, create an inconsistent interpretation of the word “shareholder” depending on the pleading requirement at issue (i.e., “contemporaneous ownership,” or “demand futility”). Additionally, as discussed below, extending Rule 23.1 and the case law applying it to creditor-plaintiffs poses several practical and theoretical problems.

#### IV. THE PROCEDURAL REQUIREMENTS OF RULE 23.1 ARE NOT PRACTICAL WHERE A CREDITOR IS PLAINTIFF

Although the demand requirement remains important where a creditor is the derivative plaintiff, Rule 23.1 is an inappropriate procedural mechanism for enforcing the requirement against creditor-plaintiffs. The heightened pleading requirements under Rule 23.1 “exist[] at the threshold” of the demand requirement for stockholders for two reasons: “first to ensure that a stockholder exhausts his intercorporate remedies, and then to provide a safeguard against strikesuits.”<sup>46</sup> But, as discussed below, a creditor does not possess “intercorporate” remedies. Moreover, there are at least two practical problems with deploying Rule 23.1 against a creditor-plaintiff that render Rule 23.1 more of an impediment to legitimate actions than a necessary “safeguard” against strikesuits.

The first practical problem with applying Rule 23.1’s heightened pleading standard to creditors is that creditors do not have the same tools for gathering sufficient pre-complaint information to satisfy the rule’s requirements. The general

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45. See *id.* at 103 (“Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”); *cf.* *Trenwick Am. Litig. Trust*, 906 A.2d 168 at 174 (rejecting cause of action for “deepening insolvency”).

46. *Aronson*, 473 A.2d at 811-12.

rule is that “derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility.”<sup>47</sup> Consequently, Delaware courts have repeatedly instructed would-be stockholder plaintiffs to use Section 220 of the DGCL as the primary means for discovering the “particularized” facts that they must plead to satisfy Rule 23.1.<sup>48</sup> “Section 220 provides shareholders of Delaware corporations with a qualified right to inspect corporate books and records.”<sup>49</sup> Specifically, Section 220 provides that “[a]ny stockholder, in person or by attorney or other agent shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose... [t]he corporation’s stock ledger, a list of its stockholders, and its other books and records.”<sup>50</sup> As the plain language of the case law and Section 220 itself suggest, however, creditors have no right under Section 220.<sup>51</sup> Without a means for pre-suit discovery, creditors will more likely than not fall short of the demanding pleading requirements of Rule 23.1.

The second practical problem is that directors of an insolvent corporation may be overly reluctant to authorize suit where there is little cash to fund it or provide for indemnity, advancement, and insurance for the defendants.<sup>52</sup> At the same time, a conclusory allegation of such reluctance, by itself, would likely fall short of the particularity that Rule 23.1 would require to adequately allege that the directors are unable to exercise their independent business judgment as required by the *Aronson/Rales* tests. Ironically, application of a “particularity” requirement in this context makes the very condition that gave the creditor the right to sue derivatively—the corporation’s insolvency—a shield for directors to prevent the creditor from exercising that right.

The third problem with applying Rule 23.1 and the *Aronson/Rales* tests to creditor derivative suits is theoretical: creditors did not elect the board they must confront, and have no extra-contractual power to vote in a new slate of directors.<sup>53</sup> As noted, one of the goals that the Delaware Supreme Court sought to achieve with the *Aronson* test is “to insure that a stockholder exhausts his intercorporate remedies.”<sup>54</sup> This goal is inapplicable where a creditor sues on behalf of the corporation because “[w]hile shareholders rely on directors acting as fiduciaries to protect their interests,” and retain the power to elect different directors if the current board is does not do so adequately, “creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing,

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47. See, e.g., *Beam*, 845 A.2d at 1056; *Levine v. Smith*, 591 A.2d 194, 209 (Del. 1991).

48. See *South*, 62 A.3d at 6 & n.1 (collecting cases); see also, e.g., *Beam*, 845 A.2d at 1056 (dismissing derivative complaint for failure to plead sufficient facts to support her claim of demand futility and stating that “[b]oth this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts.”).

49. *Melzer v. CNET Networks, Inc.*, 934 A.2d 912, 916-17 (Del. Ch. 2007).

50. 8 DEL. C. § 220.

51. See *id.* § 220(b) (allowing “any stockholder” to demand to inspect the corporation’s books and records); *Prod. Res.*, 863 A.2d at 796 (noting “the absence of any right by creditors to seek books and records”).

52. See *Prod. Res.*, 863 A.2d at 796 (recognizing that “directors might be extremely hesitant to granting a demand when the corporation’s financial condition has weakened its ability to provide indemnification and insurance”).

53. See *Prod. Res.*, 863 A.2d at 796.

54. *Aronson*, 473 A.2d at 811.

bankruptcy law, general commercial law and other sources of creditor rights.”<sup>55</sup> The Delaware Supreme Court has held that these existing creditor rights are sufficient tools to allow creditors to protect their interests.<sup>56</sup> Thus, the *Aronson* court’s observation that “a stockholder is not powerless to challenge director action which results in harm to the corporation”<sup>57</sup> stands in stark contrast to the position of an aggrieved creditor.

In short, Rule 23.1’s particularized pleading requirement poses unfair and unfounded obstacles to a creditor’s derivative suit. Delaware should consider a different test to implement the demand requirement for derivative creditor-plaintiffs.

## V. THE *CYBERGENICS* TEST SHOULD BE USED TO DETERMINE DEMAND FUTILITY FOR CREDITORS SUING DERIVATIVELY UNDER *GHEEWALLA*.

Given the obstacles and issues outlined above, Delaware should develop a “procedural embodiment”<sup>58</sup> of the demand requirement for creditors suing derivatively that is more workable than Rule 23.1. Ideally, Delaware’s General Assembly would enact a statute analogous to Rule 23.1 that would give creditor-plaintiffs clear guidance. Alternatively, the courts may establish a judicial rule of pleading demand futility applicable to creditor-plaintiffs, just as the Delaware Supreme Court set forth the test for pleading demand futility for stockholders in *Aronson*.<sup>59</sup> In either scenario, the rule need not be crafted in a vacuum. Bankruptcy courts in Delaware and elsewhere have been ably addressing creditors’ requests for derivative standing to pursue causes of action belonging to a debtor corporation for years.

In 2003, the U.S. Court of Appeals for the Third Circuit approved the practice of granting derivative standing to creditors in *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*.<sup>60</sup> The *Cybergenics* line of cases requires a creditor to satisfy a three-part test before it may pursue the corporation’s causes of action: (1) the creditor must allege “colorable” claims; (2) the creditor must show that the debtor “unjustifiably refused” to assert the claims; and (3) the creditor must affirmatively obtain a court order authorizing the creditor to pursue the claims.<sup>61</sup>

To state a “colorable” claim under *Cybergenics*, the creditor must plead facts that state a “plausible” claim for relief.<sup>62</sup> This test is familiar to federal bankruptcy courts, because it is “the same analysis as when a defendant moves to

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55. *Gheewalla*, 930 A.2d at 99.

56. *Id.*

57. *Aronson*, 473 A.2d at 811.

58. *Quadrant I*, 102 A.3d at 182 (quoting *Rales*, 634 A.2d at 932).

59. *Aronson*, 473 A.2d at 814.

60. 330 F.3d 548 (3d Cir. 2003).

61. *See id.* at 566-67; *Infinity Investors Ltd. v. Kingsborough (In re Yes! Entm’t Corp.)*, 316 B.R. 141, 145 (D. Del. 2004); *In re Optim Energy, LLC*, 2014 Bankr. LEXIS 2155, \*17 (Bankr. D. Del. May 13, 2014), *aff’d*, *Walnut Creek Mining Co. v. Cascade Inv., LLC (In re Optim Energy, LLC)*, 527 B.R. 169 (D. Del. 2015).

62. *See, e.g., In re Optim Energy*, 2014 Bankr. LEXIS 2155, \*18.

dismiss a complaint for failure to state a claim” under Federal Rule of Civil Procedure 12(b)(6).<sup>63</sup> The analysis has two steps: “[f]irst, the factual and legal elements of a claim should be separated. The [trial court] must accept all of the complaint’s well-pleaded facts as true, but may disregard any legal conclusions.”<sup>64</sup> Second, the trial court then “determine[s] whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief.”<sup>65</sup> A complaint should state a “colorable” claim if it alleges enough well-pleaded facts to create, in light of the court’s “judicial experience and common sense,”<sup>66</sup> “a reasonable expectation that discovery will reveal evidence of the necessary element.”<sup>67</sup>

Delaware trial courts may balk at applying a “plausibility” standard at a preliminary stage in litigation. The Delaware Supreme Court has repeatedly held that it is legal error under Delaware law to apply the federal “plausibility” standard to dismiss a complaint under Rule 12(b)(6).<sup>68</sup> In *Central Mortgage*, for example, the Delaware Supreme Court “emphasize[d] that, until this Court decides otherwise or a change is duly effected through the Civil Rules process, the governing pleading standard in Delaware to survive a motion to dismiss is reasonable ‘conceivability’—that is, a Delaware trial court cannot dismiss a complaint “unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances.”<sup>69</sup> The “conceivability” standard is a “minimal” one “more akin to possibility while the federal plausibility standard falls somewhere beyond mere possibility but short of probability.”<sup>70</sup>

Delaware trial courts applying a *Cybergenics* analysis at the outset of a creditor-initiated derivative suit should be able to avoid the holding of *Central Mortgage*, however, because the purpose of applying a “plausibility” test in the *Cybergenics* context is not to judge the sufficiency of the complaint in response to a defendant’s motion under Rule 12(b)(6). Rather, the court would be ruling whether the creditor has satisfied a standard that, akin to Rule 23.1, imposes a barrier to entry for creditors attempting to usurp the board’s managerial authority. Requiring a creditor to allege a “plausible” claim at that stage in the procedure works a compromise between merely stating a “conceivable” claim and alleging the particularized facts required by Rule 23.1.<sup>71</sup> This compromise balances the competing interests of board authority and creditor access discussed above.

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63. *Id.*; see also *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) (“To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.”); *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 (2007) (same).

64. *Walnut Creek Mining Co.*, 527 B.R. at 173-74 (quoting *Fowler v. UPMC Shadyside*, 578 F.3d 203, 210 (3d Cir. 2009)).

65. *Id.* at 174 (quoting *Fowler*, 578 F.3d at 210).

66. See, e.g., *Fowler*, 578 F.3d at 211.

67. *Twombly*, 550 U.S. at 555-56.

68. See *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 27 A.3d 531, 535 (Del. 2011); see also *Canbium Ltd. v. Trilantic Capital Partners III, L.P.*, Case No. 363, 2011 (Del. Jan. 20, 2012) (Order).

69. *Cent. Mortg.*, 27 A.3d at 535, 537; *Canbium Ltd.*, No. 363, 2011 (order).

70. *Cent. Mortg.*, 27 A.3d at 536, 537 & n.13.

71. See *Cent. Mortg.*, 27 A.3d at 537 n.13 (“[T]he federal plausibility standard falls somewhere beyond mere possibility but short of probability.”).

To this end, a creditor’s claim would only be “plausible”—and thus “colorable” for demand futility purposes—if the complaint contained well-pleaded facts that would “raise a reasonable expectation that discovery will reveal evidence”<sup>72</sup> of conduct that would strip directors of the protection of the business judgment rule. This “plausibility” standard also dovetails nicely with the stockholder-demand-futility test that asks whether the plaintiff has pleaded facts giving rise to a “substantial likelihood” that the proposed lawsuit would subject directors to personal liability.<sup>73</sup> Both standards require the court to make a substantive judgment on the merits, while giving the plaintiff the benefit of reasonable inferences.<sup>74</sup>

In addition to alleging a “colorable” claim, a creditor seeking to serve as a derivative plaintiff must convince the court that the board’s refusal (or presumed refusal) to bring the action is “unjustifiable.” It should be the creditor’s burden at the threshold of the litigation to come forward with sufficient (but not particularized) information of “unjustifiable” refusal, taking into consideration that the creditor has not yet taken discovery. The inquiry will necessarily be fact specific, and the court should consider the context in which the challenged transaction arose, the conduct and affiliations of the directors, and any business rationale for refusing to bring the claim.<sup>75</sup> Again, this formulation mirrors the familiar duty of the Court of Chancery to gauge whether a stockholder plaintiff has created a reasonable doubt as to the board’s ability to consider a demand “on a case by case basis, employing an objective analysis.”<sup>76</sup> In both the solvent and insolvent contexts, the court will look closely at the facts and circumstances to determine whether the board could objectively consider a demand.

Only if the court initially concludes that the creditor-plaintiff has alleged a “plausible” claim and that the corporation has “unjustifiably” refused to bring the claim would the derivative complaint then proceed.<sup>77</sup> Adopting this rule would allow the court to serve the gatekeeper role envisioned by Rule 23.1. It maintains the board’s managerial authority by deferring to the board’s business judgment in the absence of a “colorable” claim for breach of fiduciary duty, but permits creditor-plaintiffs to enforce insolvent corporations’ rights without meeting the rigorous and ill-fitting requirements of Rule 23.1.

Finally, applying the *Cybergenics* rule in Delaware state courts would also promote uniformity among different sets of laws. As Chief Justice Strine has observed, Delaware law is sparse in this because “in most situations involving insolvent public companies, the firm is placed in bankruptcy, and the procession of claims belonging to the firm is

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72. *Twombly*, 550 U.S. at 555-56.

73. *See Rales*, 634 A.2d at 936; *South*, 62 A.3d at 14; *Seminaris v. Landa*, 662 A.2d 1350 (Del. Ch. 1995); *In re Baxter Int’l Inc. S’holders Litig.*, 654 A.2d 1268 (Del. Ch. 1995).

74. *See Cent. Mortg.*, 27 A.3d at 537 (stating that the “plausibility” standard “invites judges to...draw on...judicial experience and common sense.”); *South*, 62 A.3d at 14.

75. *See, e.g., In re Yes! Entm’t Corp.*, 316 B.R. at 145 (finding “unjustifiable” refusal where the creditor “only filed the Complaint when the statute of limitations was about to expire, and the Chapter 11 Trustee refused to act based on a lack of familiarity with the facts supporting the claims.”); *In re Std. Register Co.*, Case No. 15-10541, Tr. at 65:2-9 (Del. Bankr. D. Del. June 8, 2015) (“Case Law teaches that creditors have the right to look back at transfers and prepetition conduct and in the present circumstances the Debtor cannot be expected to vigorously consider and pursue these matters given the relative bargaining positions of the parties on a pre-bankruptcy basis.”).

76. *See, e.g., Grobow v. Perot*, 539 A.2d 180, 186 (Del. 1988).

77. *See In re Optim Energy*, 2014 Bankr. LEXIS 2155, at \*35 (denying motion for creditor standing because creditor did not allege “colorable” claims).

addressed through the Bankruptcy Court process.”<sup>78</sup> By adopting the *Cybergenics* standard, Delaware can draw upon the developed body of bankruptcy law and thereby provide creditor-plaintiffs with some degree of certainty, while at the same time retaining the necessary flexibility to rule upon the circumstances of the case, both of which are vital to Delaware’s position in the world of corporate law.

## VI. CONCLUSION

Derivative standing is an important tool for creditors, but one which must be wielded appropriately. Creditors seeking to enforce an insolvent corporation’s rights should be required to first seek redress from the proper authority, the board of directors, before seizing control of a corporate claim. But in instances where making a demand upon the board would be futile, creditors should not be held to the same standards as shareholders, who by contrast to creditors have access to the corporation’s books and records and are enfranchised to remove the directors. Rather, creditors should be able to pursue a corporate claim on behalf of the corporation so long as they can plead a “plausible” claim and convince the court at the outset of the litigation that the directors have “unjustifiably” refused to pursue the claim. This test balances the competing interests of the board and creditors, while allowing the Court of Chancery to serve as a gatekeeper against suits that, under the particular facts and circumstances, should remain under the board’s control.

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78. *Prod. Res. Group*, 863 A.2d at 796.