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CLIENT ALERT

Delaware M&A and Shareholder Litigation Review: Lessons from 2018

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Over the last half-decade, Delaware courts have systematically narrowed the scope of merger-related litigation. They have done so by providing a pathway to business judgment rule protection for controller acquisitions in *MFW*; a mechanism to effectively ratify third-party mergers through *Corwin*; and, in *Dell* and *DFC*, a means to more effectively defend against appraisal claims seeking valuations significantly above deal price. The common thread throughout these cases has been that, absent distortions caused by structural or informational flaws, Delaware courts should defer to the will of stockholders and the markets and not judicially second-guess the decisions of economic actors. At the same time, the courts have shown a growing skepticism toward giving such deference where conflicts of interest infect the actions of traditional fiduciaries, especially in the new economy, which is often marked by webs of early-stage investor and management interrelationships.

In 2018, the courts continued to refine these themes, focusing on who is and is not a controlling stockholder, what information boards must disclose, and how deal price impacts appraisal claims. In addition, for the first time, a Delaware court permitted a buyer to terminate a transaction based upon the occurrence of a material adverse change in the seller's business. The courts also addressed a number of important issues involving shareholder derivative actions and the scope of post-closing claims.

Material Adverse Effects (MAEs) in Merger Transactions

In October, the Chancery Court issued its landmark 247-page decision in ***Akorn, Inc. v. Fresenius Kabi AG***,[1] which was subsequently upheld in a summary order by the Delaware Supreme Court on appeal. This case represented the first time the Delaware courts had found that a party was entitled to terminate a merger agreement based upon the occurrence of a material adverse effect ("MAE"). The merger agreement by which Fresenius agreed to acquire Akorn contained standard representations and warranties by Akorn, including that it was in compliance with applicable regulatory requirements. It also required Akorn to use commercially reasonable efforts to operate in the ordinary course of business in all material respects between signing and closing. Finally, the buyer was not required to complete the acquisition if Akorn were to suffer a "general" MAE (*i.e.*, an MAE not tied to a specific representation).

The Chancery Court found that Akorn's dramatic declines in EBITDA (86% year-over-year) as well as revenue, operating income, and earnings per share constituted a general MAE. While the court acknowledged that a buyer seeking to avoid a transaction due to an MAE bears a "heavy burden," it found that Akorn's declines were material and "durationally significant." It also rejected Akorn's argument that an MAE could not be based on matters that were contemplated or disclosed during diligence. Instead, it concluded that such a "tort-like concept of assumption of risk" would be contrary to the language of the contract.

Separately, the court found that a "regulatory MAE" had occurred because Akorn materially breached its representation that it was FDA-compliant. The court found that this breach was qualitatively material because FDA compliance was critical to its business, and quantitatively material, because the estimated remediation costs represented roughly 20% of its equity value. Finally, the court held that Akorn breached its covenant to operate in the ordinary course of business in all material respects. Borrowing from disclosure case law, the court held that a breach in this context would be material if it would have been "viewed by the reasonable investor as having significantly altered the 'total mix' of information."

The decision, and the Delaware Supreme Court's summary affirmance, confirm that Delaware will enforce MAE clauses as well as ordinary course covenants. However, the bar remains high and requires evidence of significant and relatively permanent changes to the target's business distinct from broader industry-wide or macroeconomic downturns. In addition, the Chancery Court's detailed analysis of the risk allocations inherent in the terms of the MAE clause and related definitions demonstrates the importance of careful drafting and negotiation of these provisions. Finally, the Chancery Court was clearly concerned by the conduct of Akorn's management team, which was fully laid out at trial; such conduct cannot be discounted in determining whether *Akorn* marks a paradigm shift in Delaware's MAE jurisprudence, or is a case truly unique on its facts.

[1] C.A. No. 2018-300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018).

Corwin **and Challenges to Mergers**

Since the Delaware Supreme Court's landmark 2015 decision in *Corwin v. KKR Financial Holdings LLC*, applying the business judgment rule to arm's-length acquisitions that are subsequently ratified by a non-coerced, fully informed majority of the target's disinterested stockholders, plaintiffs have tested the limitations of the *Corwin* doctrine. They have sought to expand the definition of controlling stockholder, what constitutes a coercive transaction and what a target's board must disclose to its stockholders. In 2018, Delaware's courts continued to refine the *Corwin* doctrine, narrowing the availability of the stockholder vote "cleansing" where boards fail to disclose material information prior to the stockholder vote, but at the same time largely declining stockholder plaintiffs' invitation to expand the definition of controlling stockholder.

The Adequacy of Disclosures

In ***Appel v. Berkman***,[2] the Delaware Supreme Court found that a stockholder vote approving the acquisition of Diamond Resorts International was not sufficient to permit dismissal of plaintiff's claims under *Corwin* because the board failed to disclose that its Chairman, the company's founder and largest stockholder, did not support the transaction. Reversing the Chancery Court's dismissal, the Supreme Court found that the Chairman's view about the timing of the sale was material and undisclosed, precluding the application of *Corwin*. Specifically, the court explained that, in this case, the "Chairman's views regarding the wisdom of selling the company were ones that reasonable stockholders would have found material in deciding whether to vote for the merger or seek appraisal, and the failure to disclose them rendered the facts that were disclosed misleadingly incomplete." The court also made clear that in assessing materiality, it "adhere[s] to the contextual approach that has long been Delaware law, which requires an examination of whether a fact . . . would materially affect the mix of information, or whether the disclosure is required to make sure that other disclosures do not present a materially misleading picture."

Similarly, in ***Morrison v. Berry***,[3] the Delaware Supreme Court found that *Corwin* did not apply because the stockholders were not fully informed in connection with a tender offer for their shares. In reversing the Chancery Court's pleadings stage dismissal, the Supreme Court held that the company's "partial and elliptical disclosures" failed to satisfy *Corwin* because stockholders should have been informed about an agreement between the company's founder and the acquirer to roll the founder's equity in the deal, the fact that the founder had told the board that he would "give serious consideration" to selling his shares if the board did not initiate a sales process, and the fact that the company was under existing stockholder pressure to sell. The court ruled that a "reasonable stockholder would have found these facts

[2] 180 A.3d 1055 (Del. 2018).

[3] 191 A.3d 268 (Del. 2018).

material because they would have shed light on the depth" of the founder and the acquirer's "pressure on the Board, and the degree that this influence may have impacted the structure of [the] sale process."

The Chancery Court's decision in ***In re Tangoe, Inc. Stockholders Litigation***[4] likewise found *Corwin* cleansing inapplicable where there were credible allegations that, in the midst of significant turmoil surrounding a previously announced financial restatement, the board failed to provide stockholders with adequate financial information about the company, including its audited financial statements, or sufficient details regarding the status of the restatement, which had triggered a NASDAQ delisting and a threatened SEC deregistration. Indeed, the court emphasized that "[e]xtraordinary transactions proposed to stockholders in the midst of extraordinary times must be explained with commensurate care" and "the directors must remain focused on the best interests of stockholders, not their own interests." The court also found that the complaint adequately alleged non-exculpated breach of fiduciary duty claims against the directors arising from their potential entitlement to lucrative equity awards upon a change of control, which separately precluded dismissal under the Delaware Supreme Court's earlier decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*.

Finally, in ***In re PLX Techs. Inc. Stockholders Litigation,***[5] the Chancery Court rejected application of *Corwin* because the company's disclosures in connection with a tender offer were found to be materially misleading. According to the plaintiffs, the PLX board breached its fiduciary duties by making the misleading disclosures and by allowing an activist investor, through its board designee, to effectively take control of and manipulate the sale process. Following a trial on aiding and abetting claims against the activist investor (all other claims having been dismissed or settled), the court found that the plaintiffs had proved that the disclosures did not adequately describe the significant role and influence of the activist director in the sale process and they also misleadingly characterized adjustments to the company's financial projections. Applying *Revlon*, the court also found that the non-activist directors were "susceptible to activist pressure" and had breached their fiduciary duties by capitulating to the activist's desire to effect a quick sale without adequately considering the company's standalone value. Notwithstanding its findings of breach and aiding and abetting, the court ultimately held that the plaintiffs had failed to establish any monetary harm under a "quasi-appraisal" measure of damages. Drawing on recent statutory appraisal precedents, including *Dell* and *DFC*, the court found that the sale process, notwithstanding its flaws, generated a sufficiently reliable arm's-length deal price that undercut plaintiffs' contention that the company's standalone value was significantly higher. The *PLX* decision is a timely reminder to companies and their directors that the Delaware courts will still require directors to consider all options, including not selling, and to exercise their collective judgment, and not simply accept the demands of a single stockholder. It also serves as a warning for activist investors that the actions of their board representatives can, in certain circumstances, be imputed to the stockholder for liability purposes.

[4] C.A. No. 2017-0650-JRS, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018).

[5] C.A. No. 9880-VCL, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018).

The Definition of Control

Two Chancery Court decisions in 2018 explored the contours of "control" by non-majority stockholders, another key battleground for plaintiffs seeking to avoid the application of *Corwin*. Taken together, these decisions reinforce the principle that absent outright voting control, a plaintiff must demonstrate either actual dominance over the day-to-day operations of a corporation or undue influence over the negotiation of the challenged transaction. However, even the use of bargained-for rights, approvals or vetoes, if abused to harm other stockholders or the corporation, could result in a minority stockholder being found to be in control.

In ***In re Rouse Props Inc. Fiduciary Litigation***,[6] the Chancery Court applied *Corwin* to the acquisition of Rouse by Brookfield Asset Management. In response to an offer by Brookfield, which owned 33.5% of Rouse and had three seats on Rouse's board, to acquire Rouse's non-Brookfield shares, the board formed a special committee of non-Brookfield directors to negotiate with Brookfield. Plaintiffs' theory was that Brookfield was a *de facto* controlling stockholder, and the case should therefore be analyzed under the relatively more rigorous requirements of *MFW* rather than the more forgiving standard under *Corwin*. In the alternative, plaintiffs contended that the *Corwin* cleansing mechanism was unavailable to defendants because material nondisclosures in the proxy statement rendered the stockholder vote approving the merger coerced and uninformed. In granting dismissal, the court held that Brookfield was not a controller because the plaintiffs failed to adequately allege that, as a less than 50% stockholder, Brookfield actually dominated and controlled either the challenged transaction or the board more generally. Applying *Corwin*, the court granted dismissal because the complaint failed to adequately allege "inherent," "structural," or "situational" coercion in the transaction or that any of the company's disclosures contained "a [material] deficiency."

Although it did not directly consider the application of *Corwin*, the Chancery Court's decision in ***Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC***,[7] held that a minority stockholder was a controller and imposed a substantial $20.3 million damages award because the minority stockholder had abused its bargained-for consent rights as a preferred stockholder, together with "hardball" negotiating tactics, to thwart any alternative transactions and force the company to accept an unfair deal or face imminent collapse. The decision is notable because the consent rights at issue—which required the company to obtain the stockholder's consent to any new financing or extraordinary transaction—are commonplace in many venture capital and private company financings. While investors remain free to leverage such rights to their own advantage, the court found that the "hardball" tactics used by the defendants here, including freezing management out of negotiations with alternative financing sources, sabotaging alternative transactions and using compliance with its own funding obligations to impose onerous terms on the company, resulted in a process that was "decidedly unfair" and benefited the defendants at the expense of the company and its other investors.

[6] C.A. No. 12194-VCS, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018).

[7] C.A. No. 11802-VCL, 2018 WL 3326693 (Del. Ch. July 6, 2018).

***MFW* and the Definition of "*Ab Initio*"**

Since the seminal 2014 *MFW* decision, the business judgment rule has applied to a merger proposed by a controlling shareholder as long as two procedural safeguards are established "*ab initio*," or from the beginning: the merger is conditioned on the approval of an independent special committee and a majority vote by the minority stockholders. (Willkie represented the special committee in the *MFW* matter.)

In ***Flood v. Synutra International, Inc.***,[8] the Delaware Supreme Court considered the meaning of "*ab initio*" in such cases. In *Flood*, the majority stockholder's first proposal made no mention of complying with the dual *MFW* procedural conditions. Two weeks later, however, before any negotiations had commenced, he made a second proposal clearly stipulating that he would not proceed with the transaction unless it was approved by a special committee and by the holders of a majority of the voting minority stock. Plaintiff argued that the belated addition of the *MFW* conditions failed to meet the *ab initio* requirement. In affirming the Chancery Court decision dismissing the complaint, the majority opinion rejected the plaintiff's "cramped" interpretation of that requirement, finding instead that *ab initio* had a flexible meaning that encompassed "the beginning stages of the process of considering" a proposal or the period "before any substantive economic negotiations begin." The majority viewed this interpretation as consistent with the main goal of *MFW*, which was to incentivize controllers to commit to the dual protections early in the process so as to benefit from business judgment review. In a strongly worded dissent, Justice Karen Valihura took issue with this more flexible approach as muddying the waters and instead advocated for a bright-line test that would avoid the need for fact-intensive inquiries at the motion to dismiss stage.

The practical approach adopted by the majority opinion has been viewed by many as a welcome clarification of how the *MFW* mechanism can be implemented. While the decision may sanction leaving out the two *MFW* conditions from a controller's initial proposal, the safer course would be to make those conditions explicit in the first formal communication of an offer so as to avoid potential disputes over when "substantive economic negotiations" began.

Appraisal Actions

2018 continued to be a busy year for appraisal litigation. Following the important guidance handed down in 2017 by the Delaware Supreme Court in the *Dell* and *DFC Global* decisions, which held that the deal price should have heavy, if not dispositive, weight in appraisal analysis, a number of decisions from the Chancery Court in 2018 continued to grapple with the circumstances under which courts should deviate from deal price. The fair value determination reached by courts in most of those decisions was *below*, and in one case, significantly below, the deal price.

[8] 195 A.3d 754 (Del. 2018).

In ***Verition Partners v. Aruba Networks***,[9] the first public company appraisal decision following *Dell*, the Chancery Court adopted the 30-day average unaffected pre-deal market price, which was 30% lower than the deal price, as the most persuasive evidence of fair value. While acknowledging the Delaware Supreme Court's admonition in *Dell* to give "substantial probative value" to deal price when a widely held, publicly traded company has been sold in an arm's-length transaction, the court concluded that the difficulties in quantifying the synergies involved in the Aruba transaction, which must be excluded from the deal price, made this metric a less reliable indicator of fair value. The court also considered, but ultimately rejected, relying on a Discounted Cash Flow (DCF) analysis, finding that it was a valuable substitute only in cases with a lack of credible market information. Here, with no evidence that market price could not be relied upon as a proxy for fair value, the court expressed "significant doubt regarding the reliability" of the proposed DCF analysis despite "its seemingly sound methodology." Instead, the court found that because "Delaware law has embraced a traditional formulation of the efficient capital markets hypothesis, the unaffected market price provides a direct route to the [fair value], at least for a company that is widely traded and lacks a controlling stockholder." On the facts before the court—an arm's-length third-party deal with robust negotiations—the market price was a good proxy for the company's fundamental value, even if not the "highest conceivable value." While adopting market price as the correct measure in *Aruba*, the court was careful to limit its conclusions to the facts presented: "By awarding fair value based on the unaffected market price, this decision is not interpreting *Dell* and *DFC* to hold that market price is now the standard for fair value. Rather, Aruba's unaffected market price provides the best evidence of its going concern value." The *Aruba* decision is currently on appeal and it remains to be seen whether the Chancery Court's novel approach will be affirmed by the Delaware Supreme Court.

The two later Chancery Court appraisal decisions also departed from deal price, but instead of relying on the unaffected market price used in *Aruba*, both courts afforded full weight to a DCF analysis. In ***In re Appraisal of AOL Inc.***,[10] the court's DCF analysis resulted in a value that was 2.6% lower than the deal price. In reaching that conclusion, the court determined that the particulars of the AOL deal process—namely, the no-shop and matching right provisions in the merger agreement and public statements by AOL's CEO that could have impacted the likely emergence of other prospective buyers—negated the legitimacy of transaction price as a persuasive measure of AOL's fair value. Rather, the court held that in order for the market indicators underlying *Dell* to apply, or, as the court put it, for the transaction to be "*Dell* compliant," the evidence must show that "(i) information was sufficiently disseminated to potential bidders, so that (ii) an informed sale could take place, (iii) without undue impediments imposed by the deal structure itself." Because these factors were not present here, and the court found no "principled way" to afford any weight to deal price, it served only as a "check" on the court's DCF analysis. In applying the DCF analysis, the court dismissed entirely the plaintiff's expert valuation as unreasonable and potentially the result of impartiality. Instead, beginning with the valuation proffered by the

[9] No. 11448-VCL, 2018 WL 922139 (Del. Ch. Feb. 15, 2018).

[10] No. 11204-VCG, 2018 WL 1037450 (Del. Ch. Feb. 23, 2018).

defendant's expert, the court made various adjustments to the projections and other inputs to arrive at its final fair-value determination.

In ***Blueblade Capital Opportunities LLC v. Norcraft Cos.***,[11] the Chancery Court gave sole weight to its own DCF analysis in light of "significant flaws" in the sale process that undermined, in the court's view, the reliability of the deal price. That analysis led to a fair value determination that was 2.5% above the deal price. While acknowledging *Dell's* embrace of deal price as a "strong indicator of fair value," the court departed from that approach based on the presence of only one bidder and no pre-signing market check. While not finding a single-bidder strategy per se problematic, the court found no evidence that the Norcraft board adopted that strategy for the purpose of maximizing value for stockholders or other strategic advantage. Compounding the "shambolic" pre-signing process was a 35-day post-signing go-shop that was rendered ineffective as a price discovery tool by a "clutch of deal-protection measures," including an unlimited matching right, that discouraged potential competing bidders. The court also faulted the Norcraft board for not being sufficiently informed about the process or the terms of the merger and for failing to take any steps to effectively manage the conflicts of interest of the company's CEO and lead negotiator. All of these factors led the court to conclude that it could not give deal price any weight in its analysis. The court also did not give any weight to the unaffected market price approach in *Aruba*, given that Norcraft's IPO was relatively recent and the company's stock was not widely covered by analysts or actively traded. Accordingly, the court resorted to the more "traditional" DCF methodology to determine fair value. As many courts have before it, the court noted that the parties' competing expert DCF valuations were "miles apart," and it therefore "borrowed" the most credible components of each in performing its own valuation to arrive at a value $0.66 higher than the deal price. The relatively small difference between the deal price and the court's valuation provided comfort that the court's DCF analysis was "grounded in reality."

Finally, the Chancery Court in ***In re Appraisal of Solera Holdings, Inc.***[12] applied *Dell* to conclude that deal price was the best evidence of fair value, which after excluding anticipated synergies, resulted in a valuation that was 3.4% below deal price. In giving the deal price "sole and dispositive weight," the court found that the sales process was not perfect, but was nevertheless sufficient to constitute the most reliable evidence of fair value. Specifically, the court noted that the open sale process was the product of a two-month outreach to private equity firms followed by a six-week auction conducted by an independent and fully authorized special committee of the board with competent advisors and the power to say no to an underpriced bid. While the court expressed concern that the special committee could have done a better job monitoring the Solera CEO's interactions with potential buyers, the court ultimately concluded that those communications did not compromise the effectiveness of the sales process. Further, the broad trading base for Solera's shares and active analyst coverage also reflected an efficient market that supported reliance on the merger price. In adjusting the deal price to exclude expected synergies, the court held that a financial buyer may, in certain circumstances, realize synergies from the deal as a strategic acquirer would, noting in this case the buyer's ownership of various related

[11] No. 11184-VCS, 2018 WL 3602940 (Del. Ch. July 27, 2018).

[12] C.A. No. 12080-CB, 2018 WL 3625644 (Del. Ch. Jul. 30, 2018).

software businesses from which synergies could be derived. In estimating the specific synergies, the court accepted the "conservative" estimate of Solera's expert that approximately 31% of the total synergies remained with the seller and should therefore be deducted from the deal price. In giving complete weight to deal price, the court considered and rejected both parties' "dueling" DCF analyses, noting in particular that the plaintiffs' DCF value was "facially unbelievable" because it valued Solera's shares at approximately 52% above the merger price, suggesting the improbable circumstance that "potential buyers left almost $2 billion on the table by not outbidding [the buyer]." The court also rejected Solera's argument based on the unaffected market price adopted in *Aruba*, which was 35% below deal price, finding that the argument was raised too late.

Shareholder Derivative Actions

2018 also saw the Delaware courts issue a number of decisions touching on a range of important issues arising in the context of shareholder derivative lawsuits, including director independence for demand futility purposes, the scope of issue preclusion in derivative actions, and liability for *Brophy* insider trading claims against outside directors based on sales by their affiliated funds.

In ***In re Oracle Corporate Derivative Litigation***,[13] the Chancery Court built upon the often-cited principles relating to director independence and disinterestedness handed down in a 2003 derivative lawsuit decision also involving Oracle. In that prior case, then-Vice Chancellor Strine held that non-economic ties gave rise to "bias-creating relationships" among members of a special litigation committee and Oracle's founder, Larry Ellison, thereby precluding a finding of independence. In the 2018 derivative lawsuit, the court reached a similar conclusion in assessing whether the plaintiffs had adequately alleged demand futility. Focusing its analysis on three outside directors, all of whom remained on the board solely because of Ellison's support, the court catalogued the series of interconnecting relationships alleged in the complaint between these directors and Ellison, including high-level positions or directorships at companies that did substantial business with Oracle, investments in businesses run by Oracle executives, a CEO position at a joint venture between Oracle and two other technology companies, and ownership of condos on a Hawaiian island in which Ellison owns a 98% stake along with a majority of the island's businesses and infrastructure. While each director's own "entanglement" with Ellison might be insufficient to imply a lack of independence, the court found that "taken together" they raised a reasonable doubt as to whether those directors could impartially evaluate a demand to sue. The decision serves as a timely reminder that Delaware courts will continue to give considerable scrutiny to relationships among directors and interested parties, whether economic, personal or otherwise, in assessing directorial independence for purposes of evaluating demand futility.

[13] C.A. No. 2017-0337-SG, 2018 WL 1381331 (Del. Ch. Mar. 19, 2018).

In ***California State Teachers' Retirement System v. Alvarez***,[14] the Delaware Supreme Court settled an open question concerning the preclusive effect a federal court decision dismissing a shareholder derivative suit on demand futility grounds would have on a separate Delaware derivative action asserting the same claims. Following press reports concerning an alleged bribery scheme at the Mexican subsidiary of Walmart, competing derivative lawsuits were filed in Arkansas federal court and the Delaware Chancery Court. Unlike the federal plaintiffs, the Delaware plaintiffs pursued a books and records demand, and the resulting litigation over that demand lasted several years. In the meantime, the Arkansas court dismissed the federal complaint for failure to plead demand futility. Armed with that dismissal, the defendants moved to dismiss in Delaware on the grounds of collateral estoppel. The Chancery Court granted that motion, but its ruling was reversed on appeal with a direction from the Supreme Court that the court expressly consider the Delaware plaintiffs' due process arguments. On remand, the Chancery Court again dismissed the complaint on the basis of controlling law, but also recommended that, on appeal, the Supreme Court adopt a new rule under which a derivative lawsuit would not bind later derivative plaintiffs unless the first complaint survived a motion to dismiss (or the company board did not oppose the suit). The court reasoned that such a rule would avoid penalizing shareholder plaintiffs who heeded the Delaware courts' longstanding admonition to pursue a books and records demand prior to filing suit. In its ruling affirming dismissal, the Supreme Court declined to adopt the Chancery Court's proposed rule, finding instead that preclusion was appropriate where, as here, the competing derivative plaintiffs were in "privity" because they all sought to enforce the same legal rights (*i.e.*, the corporation's). On the issue of due process, the Supreme Court found that the federal plaintiffs adequately represented the later plaintiffs' interests as stockholders and the record showed no conflicts of interest. While the federal plaintiffs' decision to forego pursuing a pre-filing books and records demand may have been a "tactical error," it was not "grossly deficient" given that "reasonable litigants can differ" on the issue. By affirming the general application of issue preclusion in these circumstances, the *Alvarez* decision strengthened the protections available to boards of directors in defending against multiple shareholder derivative lawsuits and materially lowered the risk of defendants having to re-litigate the issue of demand futility in subsequent derivative actions.

In ***In re Fitbit, Inc. Stockholder Derivative Litigation,***[15] plaintiffs alleged that certain of Fitbit's directors and the company's CFO breached their fiduciary duties under *Brophy v. Cities Service Co.* by selling stock based on insider knowledge and that the rest of the board members breached their fiduciary duties by permitting such sales to occur, including by waiving customary lock-up agreements. The Chancery Court denied the defendants' motion to dismiss, finding the plaintiffs had established demand futility because a majority of the board faced a substantial likelihood of liability in connection with the alleged insider trading. The decision is notable because, in finding that plaintiffs had adequately alleged demand futility on their *Brophy* claim, the Chancery Court extended liability to include stock trades made by two venture capital funds that were allegedly controlled by two of the directors, rather than trades by the directors themselves. In doing so, the court reasoned that "to allow these directors, through their controlled funds, to profit

[14] 179 A.3d 824 (Del. 2018).

[15] C.A. No. 2017-402-JRS, 2018 WL 6587159 (Del. Ch. Dec. 14, 2018).

from inside information without recourse would be inconsistent with the policy of extinguishing all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation that undergirds Delaware's insider trading law." *Fitbit* thus serves as an important reminder that, when a venture capital, private equity, or other investment fund appoints representatives to a portfolio company board, the fund's trading may be subject to judicial scrutiny based on non-public information held by the designee director.

Post-Closing Disputes

The Chancery Court had occasion during 2018 to revisit several recurring issues that arise in the context of post-closing disputes, and several of these decisions illustrate potential pitfalls of drafting M&A agreements.

In ***ChyronHego Corporation v. Wight***,[16] ChyronHego brought suit alleging fraud and breach of contract against the seller of the acquired company, Click Effects, arising out of alleged pre-signing misrepresentations relating to the financial condition and value of the business. Defendant moved to dismiss, arguing that the presence of an anti-reliance clause in the stock purchase agreement precluded a misrepresentation claim based on statements outside the contract. The court agreed and held that the plaintiff's claims were barred by the explicit anti-reliance clause. In reaching that conclusion, the court drew further support from the contract's integration clause, exclusive remedies provision, definition of excluded liabilities and exclusion of "fraud" from the limitations in the indemnification provision, all of which, the court found, confirmed that the plaintiff's extra-contractual fraud claim could not survive. The court declined, however, to dismiss the buyer's claims for fraud and breach of contract relating to representations, warranties and covenants in the agreement itself. The *Wight* opinion provides a helpful roadmap showing how to draft a purchase contract to limit post-closing litigation exposure for extra-contractual fraud claims.

The Chancery Court decision in ***Post Holdings, Inc. v. NPE Seller Rep LLC***[17] involved competing claims between buyers and sellers of a business post-closing. The buyer initially sued the seller seeking indemnification under the agreement on the basis of alleged fraud and breach of representations and warranties. The seller counterclaimed, seeking enforcement of covenants under the agreement requiring the buyer to remit certain tax refunds and insurance proceeds. In granting judgment to the seller on its counterclaims, the court rejected the buyer's argument that its remittance obligation was excused by sellers' prior material breach. Specifically, the court held that the Delaware law does not allow a party to "continue to accept the benefits of the contract—as they seek to do in this action through their claim for indemnification—while disclaiming their contractual obligation to remit the tax refunds and insurance proceeds to the sellers promptly after they were received." The court also rejected the buyer's alternate argument that it was permitted to offset the tax refunds against its indemnification claims, finding that, under the parties' agreement, the offset

[16] C.A. No. 2017-548-SG, 2018 WL 3642132 (Del. Ch. Jul. 31, 2018)

[17] C.A. No. 2017-772-AGB, 2018 WL 5429833 (Del. Ch. Oct. 29, 2018).

right applies only to indemnification payments that are "owed" to buyer, and therefore its currently unliquidated claims against the seller could not be used for purposes of set off.

In ***QC Holdings, Inc. v. Allconnect, Inc.***,[18] the Chancery Court considered the effect of a merger on a contractual put right. Pursuant to a written put agreement, the plaintiff had the right to cause the defendant company to repurchase certain shares, subject to its having funds legally available to do so and no senior debt outstanding. Plaintiff exercised its put right, but at the time payment would have been due under the agreement, the company did not comply with plaintiff's demand because it had senior debt outstanding and lacked sufficient legally available funds to make the payment. The company was later acquired in a merger and, immediately prior to closing, paid down all of its senior indebtedness. Plaintiff filed suit seeking recovery of the put price, claiming that the company had funds legally available immediately prior to the merger and therefore was required to repurchase the put shares. The company, on the other hand, asserted that its obligation to pay the put price was extinguished when it could not make the redemption payment prior to the merger. The court rejected both parties' theories, holding instead that the exercise of the put right pre-merger gave rise to a contractual redemption right in the plaintiff's favor, which survived the merger and became an obligation of the surviving corporation under Section 259 of the DGCL. The court emphasized that its ruling should not be read as holding that whenever a party exercises its redemption right, it becomes a contractual claimant rather than a stockholder. Rather, parties can draft redemption rights, and the consequences of the exercise of such rights, in any number of ways and the result here turned on the particular language of the contract at issue.

<u>Federal Forum Selection Clauses</u>

In ***Sciabacucchi v. Salzberg,***[19] a closely watched case, the Chancery Court held that corporate charter and bylaw provisions requiring stockholders to bring claims under the federal Securities Act of 1933 only in federal court were invalid and ineffective. In 2015, Delaware law was amended expressly to permit the adoption of forum selection bylaws governing internal corporate governance claims. Those amendments were silent regarding other claims, neither endorsing nor precluding provisions like the federal forum provisions at issue in *Sciabacucchi*. The court held that such provisions were invalid, finding that neither existing precedent nor the principles underlying a corporation's authority to adopt charter and bylaw provisions allow a corporation to impose restrictions on where a stockholder may bring claims for violating the 1933 Act. The court concluded that 1933 Act claims are <u>not</u> internal affairs claims against a corporation's directors and officers. Rather, they are a "specialized and wholly statutory cause[] of action" under federal law. If upheld by the Delaware Supreme Court, this decision will remove a tool that Delaware corporations have recently employed to prevent the proliferation of state court 1933 Act claims following the United States Supreme Court's ruling in *Cyan, Inc. v. Beaver Cnty Employees Ret. Fund*.

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18 C.A. No. 2017-715-JTL, 2018 WL 4091721 (Del. Ch. Aug. 28, 2018).

19 C.A. No. 2017-0931-JTL, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018).

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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