

Significant Delaware Supreme Court Decisions

12.23.19



(Article from *Securities Law Alert*, Year in Review 2019)

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Business Judgment Rule Did Not Apply to a Controlling Stockholder Transaction Where the Parties Allegedly “Set the Field of Play for the Economic Negotiations” Before the Transaction Was Conditioned on MFW’s Procedural Protections

On April 11, 2019, the Delaware Supreme Court found that the business judgment standard of review did not apply where plaintiffs alleged that the company and its controlling stockholder “substantially negotiated the financial state of play” before the transaction was conditioned on the procedural protections set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*). [Olenik v. Lodzinski](#), 208 A.D.3d 704 (Del. 2019) (Seitz, J.).

The *MFW* court held that the business judgment standard of review applies to a controlling stockholder transaction if the transaction “is conditioned *ab initio* upon the approval of both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.”^[1] In *Flood v. Synutra Int’l*, 195 A.3d 754 (Del. 2018), the Delaware Supreme Court held that *MFW*’s *ab initio* requirement is satisfied “so long as the controller conditions its offer on the key protections” before the commencement of “substantive economic negotiations with the controller.”^[2]

The *Olenik* court held that the *ab initio* requirement was not met in the case before it because “the *MFW* procedural protections were [allegedly] not put in place until after almost eight months of substantive economic dealings among the parties.” The court found it significant that the parties allegedly “engaged in a joint exercise to value” the target company, which allegedly “fix[ed] the range in which offers and counteroffers might be made.”

Chancery Court Erred in Appraising Shares Using the Unaffected Market Price, Rather Than the Merger Price Less Synergies, in an Arm’s Length Transaction Following a Fair Sales Process

On April 16, 2019, the Delaware Supreme Court held that the Chancery Court erred in appraising a company’s shares using the unaffected market price, rather than the merger price less synergies, in an arm’s length transaction following a fair sales process. [Verition Partners Master Fund v. Aruba Networks](#), 210 A.D.3d 128 (Del. 2019) (*per curiam*). The Chancery Court found the deal price less synergies valuation unreliable because “it needed to make an additional deduction . . . for unspecified ‘reduced agency costs.’” But the Delaware Supreme Court

determined that there was no evidence of any “agency cost reductions that were not already captured by [the acquirer’s] synergies estimate.”

The Delaware Supreme Court noted that a stock’s market price “is an important indicator of its economic value.” However, the court underscored that when a company is sold in an arm’s length transaction that is preceded by extensive due diligence, “the price that results . . . is even more likely to be indicative of so-called fundamental value” than the unaffected market price. The court found that the deal price “could be seen as reflecting a better assessment of [the company’s] going-concern value” than the unaffected market price because the acquirer “had more incentive to study [the company] closely than ordinary traders in small blocks of [the company’s] shares, and also had material, nonpublic information that, by definition, could not have been baked into the public trading price.”

Caremark Imposes a “Bottom-Line” Requirement of a Board-Level Oversight System

On June 19, 2019, the Delaware Supreme Court reversed the dismissal of a derivative suit alleging that the directors of an ice cream manufacturing company “breached their duty of loyalty under *Caremark*” by failing to oversee the company’s operations.^[3] [*Marchand v. Barnhill*, 212 A.3d 805 \(Del. 2019\) \(Strine, C.J.\)](#). The court found “the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at [the company].”

The Delaware Supreme Court recognized that “*Caremark* is a tough standard for plaintiffs to meet” and imposes an “onerous pleading burden.” The court noted that “directors have great discretion to design context- and industry-specific approaches tailored to their companies’ businesses and resources” when establishing a board-level oversight system. The court also observed that Delaware “case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful activities escaped detection” by the board’s oversight system. However, the court underscored that *Caremark* imposes a “bottom-line requirement” that directors must at least “try . . . to put in place a reasonable board-level system of monitoring and reporting.”

Plaintiffs Failed to Allege That Venture Capital Investors Who Collectively Controlled 60% of a Company’s Shares Constituted a “Control Group”

On October 4, 2019, the Delaware Supreme Court affirmed the dismissal of a shareholder action premised on the legal theory that several venture capital firms constituted a “control group.” [*Sheldon v. Pinto Tech Ventures*, 2019 WL 4892348 \(Del. 2019\) \(Valihura, J.\)](#). Plaintiffs alleged, *inter alia*, that the venture capital firms (1) collectively controlled over 60% of the company’s shares, (2) were parties to a voting agreement that provided them with the right to appoint three directors, who in turn chose two additional directors; and (3) had a history of investing together. The court found these allegations insufficient to demonstrate that the venture capital firms “were connected in a legally significant way, either before or during” the transactions at issue.

The Delaware Supreme Court noted that the voting agreement “bound all of [the company’s stockholders]” and “was unrelated” to the transactions in question. Moreover, the court observed that the agreement “does not require [the stockholders] to vote together on any transaction.” The court also pointed out that plaintiffs did “not identify any instance in which all three [v]enture [c]apital [f]irms participated in any investment,” or “allege that they held themselves out as a group of investors or that they reported as such to the SEC.” Instead, the court found the “allegations merely indicate that venture capital firms in the same sector crossed paths in a few investments” and had a “concurrence of self-interest.”

Generalized Allegations of a Controller’s Need for Liquidity Do Not, Standing Alone, Warrant Application of the Entire Fairness Standard of Review

On November 1, 2019, the Delaware Supreme Court affirmed the dismissal of a shareholder class action alleging that a company’s controlling stockholder “orchestrated a sale of the company [to a third party] for less than fair value to address a personal need for liquidity prompted by his retirement as the company’s CEO.” [*English v. Narang*, 2019 WL 1300855 \(Del. Ch. Mar. 20, 2019\), aff’d, 2019 WL 5681416 \(Del. Nov. 1, 2019\) \(Vaughn, Jr., J.\)](#). The Chancery Court found plaintiffs alleged “no concrete facts from which it can reasonably be inferred that [the CEO] had an exigent or immediate need for liquidity” that created a disabling conflict of interest with respect to the transaction. The court also deemed it significant that the company engaged in a lengthy sales process that included outreach to “numerous potential buyers.”

Because the court found the transaction was approved by a majority of the company’s uncoerced and fully-informed stockholders, the Chancery Court dismissed the complaint based on the application of the business judgment rule. The Delaware Supreme Court affirmed the dismissal “on the basis of and for the reasons assigned by” the Chancery Court. *English*, 2019 WL 5681416.

[1] Please [click here](#) to read our discussion of the Delaware Supreme Court’s decision in *MFW*.

[2] Please [click here](#) to read our discussion of the Delaware Supreme Court’s decision in *Synutra*.

[3] In *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Chancery Court stated that “where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

Authors and
Contacts

Paul Gluckow
Partner and General Counsel
pgluckow@stblaw.com
+1-212-455-2653

Jonathan Youngwood
Partner
jyoungwood@stblaw.com
1-212-455-3539

Peter Kazanoff
Partner
pkazanoff@stblaw.com
+1-212-455-3525

