

PERSPECTIVES

THE CLEANSING EFFECT OF A STATUTORILY REQUIRED SHAREHOLDER VOTE ON A TROUBLED TRANSACTION

BY **STEPHEN B. BRAUERMAN AND SARA E. BUSSIERE**
> BAYARD, P.A.

Delaware law has long recognized that the uncoerced vote of fully informed stockholders can cure even the most questionable of self-interested transactions. This policy is enforced through the standard of review Delaware courts use to judge these otherwise interested transactions. This article discusses Delaware's increasing comfort with the curative powers of fully-informed stockholder votes, as evidenced by the Delaware Supreme Court's recent decision in *Corwin v. KKR Financial Holdings, LLC*,

in which the Court extended deferential judicial review to transactions approved by a majority of disinterested stockholders, even where the stockholder vote was statutorily required. *Corwin* exemplifies the sanitising benefits of a vote – even when the company did not call the vote for its sanitising effect.

Delaware's standards of judicial review

The standard of review determines the deference the court will apply in reviewing a challenged



transaction and is often outcome determinative. Thus, the application of the appropriate standard of review is "essential to a proper judicial review of challenges to the decision-making process of a corporation's board of directors". *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 927 (Del. 2003). Delaware courts employ three levels of judicial review: (i) the business judgment rule; (ii) enhanced scrutiny; and (iii) entire fairness.

The business judgment rule, the most deferential standard, reflects the "cardinal precept of the

General Corporation Law of the State of Delaware... that directors, rather than shareholders, manage the business and affairs of the corporation". As such, under the business judgment rule, Delaware courts will uphold corporate decisions "absent an abuse of discretion". However, a plaintiff may rebut the business judgment rule in various ways, including by showing that a controlling stockholder stood on both sides of the transaction, a majority of the board was interested in a particular transaction or lacked independence, or that the board failed to act in good

faith in approving the transaction. *Id.*; see also *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 36 (Del. Ch. 2010).

If a plaintiff successfully rebuts the business judgment rule, the burden of proof shifts to the defendant director to prove that the challenged transaction was entirely fair to the company – an exacting standard.

Entire fairness requires the defendant director to “establish to the court’s satisfaction that the transaction was the product of both fair dealing and fair price”. *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) (emphasis in original). Somewhere between the business judgment rule and entire fairness lies enhanced scrutiny, an intermediate level of judicial review that requires the defendant director to prove that the actions he or she took were reasonable”. *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 2000).

Corwin and mandatory votes

In *Corwin*, the Delaware Supreme Court affirmed the dismissal of a complaint for breaches of fiduciary duty, and aiding and abetting such breaches, because “the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review”, which plaintiffs failed to rebut. Plaintiffs’ claims arose from

a stock-for-stock merger whereby KKR & CO. L.P. (KKR) acquired KKR Financial Holdings LLC (KFN).

Plaintiffs argued the Court should apply entire fairness review because KKR, which held less than 1 percent of KFN’s stock, constituted a controlling

“If a plaintiff successfully rebuts the business judgment rule, the burden of proof shifts to the defendant director to prove that the challenged transaction was entirely fair to the company – an exacting standard.”

stockholder and a majority of the KFN board lacked independence. After finding that it could not reasonably infer from the well-pled facts that KKR could prevent the board from exercising its independent judgment, the Court of Chancery found that the fully informed, uncoerced vote of disinterested stockholders invoked the business judgment rule.

In reaching this conclusion, the Court of Chancery relied upon longstanding Delaware precedent to hold that the “legal effect of a fully-informed stockholder vote of a transaction with a non-controlling stockholder is that the business judgment

rule applies and insulates the transaction from all attacks other than on the grounds of waste, even if a majority of the board approving the transaction was not disinterested or independent". The Court of Chancery rejected a recent interpretation of the Delaware Supreme Court's decision in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), which suggested that a statutorily mandated stockholder vote altered this precedent ("I do not read *Gantler* to have altered the legal effect of a stockholder vote when it is statutorily required").

On appeal, the Delaware Supreme Court agreed with the Chancellor's finding that the uncoerced, informed stockholder vote was outcome-determinative. The Court wrote: "To erase any doubt on the part of practitioners, we embrace the Chancellor's well-reasoned decision and the precedent it cites to support an interpretation of *Gantler* as a narrow decision focused on defining a specific legal term, 'ratification,' and not on the question of what standard of review applies if a transaction not subject to the entire fairness standard is approved by an informed voluntary vote of disinterested stockholders. This view is consistent with well-reasoned Delaware precedent".

The Supreme Court rejected plaintiffs' argument that such a reading impairs existing stockholder protections, or exposes stockholders to abuse by directors without adequate protections. The Court explained that "the doctrine applies only to informed, uncoerced stockholder votes, and if troubling facts

regarding director behaviour were not disclosed that would have been material to a voting stockholder, then business judgment rule is not invoked". In the present matter, KKR's interests were fully disclosed to the stockholders and therefore, the Court of Chancery properly dismissed plaintiffs' claims ("for sound policy reasons, Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder in their best interests").

Zale and Corwin's immediate impact

Corwin's confirmation that business judgment review applies to stockholder approval of an interested transaction, even where such stockholder vote is required by statute, had immediate impact. The Delaware Supreme Court issued *Corwin* on 2 October 2015. The day before, the Court of Chancery decided *In re Zale Corporation Stockholders' Litigation*, 2015 WL 5853693 (Del. Ch.), in which it denied a motion to dismiss aiding and abetting claims against Zale Corporation's (Zale) financial adviser, Merrill Lynch, Pierce, Fennell, & Smith Inc. (Merrill Lynch).

Zale involved a post-merger challenge to the all-cash acquisition of Zale by its chief competitor, Signet Jewelers Ltd. (Signet). The plaintiff alleged that the Zale board of directors breached its fiduciary duties of care and loyalty by undermining the board's ability to maximise shareholder value through

undisclosed conflicts of interest and an unfair sales process. Merrill Lynch aided and abetted the board's breaches, according to the plaintiff, by, among other things, making a presentation to Signet extolling a potential acquisition of Zale while it had access to Zale's confidential information. After announcing the merger, several large institutional stockholders publicly expressed their opposition, in response to which Zale made a number of filings with the Securities and Exchange Commission extolling the virtues of the transaction. With these substantial disclosures, a bare majority of Zale stockholders voted to approve the merger.

Even though a majority of Zale's public stockholders voted to approve the merger, the Court of Chancery applied enhanced scrutiny to review the transaction because after the Zale board decided to sell the company, it had an obligation under *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173, 182-3 (Del. 1986) to take all reasonable steps to maximise the value of transaction. Aware of the tension between *Gantler* and the Court of Chancery's decision in *KKR* (which was then on appeal), the *Zale* Court conservatively declined, "until the Supreme Court signals otherwise", to apply business judgment review to a challenged transaction approved by a majority of fully-informed and disinterested stockholders because the stockholder vote was required under Section 251 of the DGCL.

Applying the more stringent enhanced scrutiny standard, the Court of Chancery found that it was reasonably conceivable that Merrill Lynch aided and abetted a breach of fiduciary duty because the Zale board did not learn about Merrill Lynch's presentation to Signet until after the merger agreement was signed and the Court denied Merrill Lynch's motion to dismiss.

The Supreme Court issued *Corwin* the next day. Under *Corwin*, business judgment review applies to a transaction approved by a fully informed majority of disinterested stockholders even where that stockholder vote is statutorily required. Citing *Corwin*, Merrill Lynch timely moved for reargument of the *Zales* decision. *Corwin* offered the "signal" for which the *Zale* Court was looking. The Court of Chancery granted Merrill Lynch's motion for reconsideration in light of *Corwin* because it "misapprehended the cleansing effect of a fully informed, statutorily required vote by a majority of disinterested stockholders".

On reconsideration and after applying the deferential business judgment rule, the Court of Chancery found that the board's investigation of Merrill Lynch's alleged conflicts and its ultimate decision to retain Merrill Lynch were not grossly negligent and could not support the breach of fiduciary duty claim on which the aiding and abetting claim against Merrill Lynch necessarily rested. Even though the Court found "the conduct of Merrill Lynch in this case troubling", the fully informed stockholder

vote saved Merrill Lynch and the Court dismissed the claims it previously sustained against Merrill Lynch under the less onerous business judgment standard.

Conclusion

The *Corwin* decision and the Court of Chancery's self-correction in *Zale* following *Corwin* demonstrate the cleansing power of a fully informed vote of disinterested stockholders. Even when a stockholder vote is statutorily required (i.e., to approve a merger or a sale of all or substantially all of the assets of a company), the curative effects of the vote remain. As such, corporate actors can take solace knowing that if they can convince their stockholder constituencies

– after full disclosure – of the merits of the deal, Delaware courts will not lightly second guess them.

CD



Stephen B. Brauerman

Director and
Bayard, P.A.

T: +1 (302) 655 5000

E: sbrauerman@bayardlaw.com



Sara E. Bussiere

Associate
Bayard, P.A.

T: +1 (302) 655 5000

E: sbussiere@bayardlaw.com