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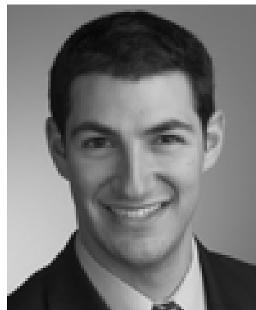
Delaware Corporate Law: Notable Developments in 2010



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During 2010, the Delaware Court of Chancery and the Delaware Supreme Court were particularly active and issued numerous noteworthy decisions examining the fiduciary duties of directors of Delaware corporations and otherwise addressing issues of concern to anyone engaged in the practice of Delaware corporate law and corporate litigation before the Delaware Chancery Court. Some of the most significant matters addressed by the Court included shareholders' rights to demand inspection of books and records and the use of those rights during active litigation, rights of preferred shareholders to assert fiduciary duty claims, the adoption and use of poison pills, duties of boards of directors in change of control transactions, proxy disclosures in the mergers and acquisitions context, and the settlement of mergers and acquisitions litigation. This article highlights some noteworthy decisions from each of these areas and suggests some practice tips going forward.

I. Demands For Corporate Books and Records

Under 8 Del. C. § 220 (''Section 220''), shareholders of Delaware corporations are generally entitled to in-

spect corporate records upon demand where they can show a ''proper purpose'' to do so. In 2010, the Court of Chancery and the Delaware Supreme Court decided three cases that will alter the contours of Section 220 demands and litigation to enforce those demands.

In *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, 1 A.3d 281 (Del. 2010), the Delaware Supreme Court affirmed the Chancery Court's dismissal of a Section 220 action, and clarified the application of Section 220 in the context of a ''plurality plus'' governance policy. Under the ''plurality plus'' policy adopted by the Axcelis Board of Directors, any nominee in an uncontested election who received a greater number of votes ''withheld'' than ''for'' that candidate was required to tender a letter of resignation to the board. Three directors sought reelection, received less than a majority of the votes cast, and submitted letters of resignation. When the board declined to accept those resignations and refused plaintiff's demand for books and records relating to that decision, the plaintiff sued to enforce its Section 220 rights. The question for the Supreme Court was whether the plaintiff had asserted a credible basis from which a court could infer possible mismanagement thus warranting further investigation and establishing a ''proper purpose'' entitling the plaintiff to inspect the corporate books and records.

The Court concluded that the plaintiff had not provided a credible basis to support his mismanagement theory, and established two important principles. First, the Court declined to adopt the *Blasius* standard when reviewing a board of directors' discretionary decision to reject director resignations in cases where a ''plurality plus'' governance policy is triggered and requires that resignations be tendered. Under *Blasius*, a corporation's board must demonstrate a ''compelling justification'' for board-adopted measures that interfere with or frustrate a shareholder vote. The plaintiff argued that since a majority of shareholders did not vote for the directors, the board's decision to reject their letters of resignation interfered with the will of the shareholders. Nevertheless, the Court emphasized that in the context of Section 220, applying *Blasius* would improperly shift the burden of establishing a ''proper purpose'' from the shareholder to the corporation.

Second, the Court went beyond the facts of the case to state that a plaintiff *can* have a proper purpose under Section 220 if it seeks to determine an individual's suitability to serve as a director. However, in order to prevail under Section 220 on these grounds, a plaintiff must also prove that the information it seeks is ''necessary and essential'' to assessing director suitability, and a defendant will retain the opportunity to show that the plaintiff's ''real or primary purpose'' is improper. In this case, the plaintiff did not rely on this purpose as the basis for seeking corporate records, and therefore did not meet the proper purpose element of Section 220.

In *King v. Verifone Holidngs, Inc.*, 994 A.2d 354 (Del. Ch. May 12, 2010), Vice Chancellor Strine emphatically rejected the notion that seeking books and records to supplement discovery in pending litigation in another forum constitutes a ''proper purpose'' under Section 220. Shortly after Verifone announced a financial restatement due to accounting errors, numerous lawyers ''sped to the court'' and filed putative class actions and derivative lawsuits in federal district court. The winner of the race to the courthouse was appointed lead plaintiff (and lead counsel), but his complaint was ultimately dismissed without prejudice for failure to plead that demand was excused. At the suggestion of the district court that dismissed the case, the plaintiff eventually filed a Section 220 action in Delaware, partly in order to determine whether he had grounds to plead that demand was excused. When the Section 220 demand was challenged before the Court of Chancery, the Chancery Court reasoned that a shareholder ''may not use § 220 . . . to rescue him from his own self-interested premature rush to file.'' The Chancery Court concluded that the plaintiff's purpose was improper and contrary to public policy because: (1) it was an attempt to circumvent federal discovery rules, (2) it contravened the value of judicial efficiency, and (3) it encouraged plaintiffs to file the fastest lawsuit instead of the best-pled.

In January 2011, the Delaware Supreme reversed, holding that the Chancery Court's bright-line rule that the prior filing of a derivative action precluded a plaintiff from later seeking relief in a Section 220 proceeding was in error. *King v. Verifone Holdings, Inc.*, No. 330 (Del. Jan. 28, 2011). The Court suggested that narrower remedies were available to prevent abusive ''race to the courthouse'' litigation, including denying such a plaintiff lead plaintiff status, dismissing a prematurely filed complaint with prejudice without leave to amend as to the named plaintiff, or allowing one amendment, but conditioned on the payment of defendants' attorneys' fees.

The related case of *Baca v. Insight Enterprises, Inc.*, C.A. No. 5105-VCL, 2010 WL 2219715 (Del. Ch. June 3, 2010) demonstrates the importance of *timing* to the proper purpose inquiry. In *Baca*, the plaintiff filed a derivative action in Federal District Court. The defendant moved to dismiss for failure to make demand or properly plead demand futility. Nine days later, the plaintiff served a demand letter requesting access to books and records—essentially to investigate the exact topics already at issue in the derivative action—and sued when the defendant rejected the demand. Echoing Vice Chancellor Strine in *King*, Vice Chancellor Laster held, ''[b]ecause of the sequence in which he proceeded, Baca cannot establish a proper purpose for his Section 220 demand.'' Put another way, ''a stockholder does not act with a proper purpose when the stockholder attempts to use Section 220 to investigate matters that the same stockholder already put at issue in a plenary derivative action.'' The Court suggested that plaintiffs act responsibly by conducting meaningful pre-suit investigations, ''including by using Section 220 *before* filing a complaint.'' Although the Delaware Supreme Court recently cut back on the Chancery Court's authority to readily preclude late-served Section 220 demands, *King* and *Baca* strongly suggest that the Chancery Court will look very suspiciously on a plaintiff who hastily files a lawsuit, and then seeks to bolster it by using a follow-on Section 220 demand.

II. Rights of Preferred Shareholders

May 2010 brought two important decisions regarding the rights of holders of preferred stock.

In *Fletcher Int'l, Ltd v. ION Geophysical Corp.*, 2010 WL 2173838 (Del. Ch. May 28, 2010), Vice Chancellor Parsons considered two key issues: whether a convertible promissory note constituted a ''security,'' and whether a preferred shareholder could simultaneously bring claims alleging breaches of contract and fiduciary duties relating to the note. Fletcher International was

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the beneficial owner of all outstanding Series D Preferred Stock of ION. The Certificates of Rights and Preferences associated with Fletcher's stock provided that Fletcher's consent was necessary prior to ION (or its subsidiary) issuing or selling ''any security.'' In late 2009, ION caused the issuance of two convertible promissory notes, without having sought or obtained Fletcher's consent. Fletcher filed suit challenging the issuance.

The Chancery Court emphasized that a ''preferred stockholder's rights are primarily contractual in nature,'' and the interpretation of preferred stock provisions was properly a matter of judicial contract interpretation. Examining the Certificates of Rights and Preferences at issue, the Court found that the term ''security'' was not ambiguous, and that because ION's promissory notes were debt instruments convertible into equity instruments, they qualified as ''securities.'' The Court also concluded that the notes were securities because they were ''most naturally understood as an investment in ION.'' Since the notes constituted securities within the meaning of Fletcher's preferred stock provisions, Fletcher was entitled to enforce its contractual rights. The Court made clear, however, that while preferred stockholders are owed *some* fiduciary duties, rights arising from documents governing a preferred class of stock (enjoyed solely by the holders of that stock) do not give rise to fiduciary duties. And while directors may owe fiduciary duties to preferred stockholders to the extent that the preferred stockholders are not protected by their contracts, if claims for breach of fiduciary duties are based on the same facts underlying a breach of contract claim and relate to rights and obligations expressly provided by contract, the fiduciary duty claims cannot survive.

The Court of Chancery in *MCG Capital Corp. v. Maginn*, 2010 WL 1782271 (Del. Ch. May 5, 2010) clarified another important issue with respect to the rights of preferred shareholders. Chancellor Chandler articulated the ''interesting question of law'' as follows: does a preferred shareholder have standing to bring a derivative suit and, if so, are there any limitations on the type of preferred shareholder who may bring a derivative suit? Reasoning that ''all stock is created equal,'' which is to say that all classes of stock enjoy the same rights and privileges absent an affirmative expression to the contrary, the Court held that ''preferred shareholders have standing to bring derivative claims unless the ability to bring a derivative claim has been expressly limited in the articles, preferred stock designations, or some other appropriate document.'' Because MCG Capital Corp. was a preferred shareholder and there was no express limitation on its right to bring derivative actions, MCG Capital Corp. had standing. In addition to producing a likely upsurge in litigation filings by plaintiff preferred shareholders, this case is likely to impact the issuance of preferred shares going forward; in the future, issuers may consider expressly addressing the extent of a preferred stockholder's right to sue derivatively.

III. Poison Pills

During 2010, the Chancery Court announced three significant decisions construing the enactment of corporate defensive measures commonly referred to as ''poison pills.'' In two of the decisions, the Court upheld the medicine; in one, it deemed the drug too strong. Together, the three decisions show the state of the art with respect to the adoption of poison pills under Delaware law.

The *Selectica, Inc. v. Versata, Inc.*, C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010) case turned on the question of whether a board acted reasonably in adopting a rights plan designed to prevent 5% shareholders from reducing the value of net operating loss carryforwards (NOLs) by triggering an ''ownership change'' under Section 382 of the Internal Revenue Code. During late 2008, Trilogy (and its subsidiary, Versata) began acquiring substantial Selectica common stock, increasing its position to over 5%. In response, and to protect its substantial NOLs, the Selectica board amended its rights plan in several ways, which included reducing the trigger threshold from 15% to 4.99%. Trilogy and Versata continued to increase their ownership interest well past 6%, and Selectica ultimately activated its rights plan, exchanging each outstanding right held by shareholders other than Trilogy and Versata for one share of common stock, thus diluting the position held by Trilogy and Versata to roughly 3.3%. Vice Chancellor Noble faced the somewhat unusual task of analyzing a poison pill provision that sought, as its primary goal, *not* to protect against hostile takeovers, but rather to protect the value of potentially worthless assets.

In part due to the excellent record created by the Selectica board of directors, the Court concluded that Selectica's actions survived analysis under *Unocal*, the Delaware Supreme Court's decision that explained that the business judgment rule does not automatically apply to defensive actions taken by a board when faced with a possible change in control. First, the Court held that protecting company NOLs *may* be an appropriate corporate policy meriting a defensive response. Next, the Court accepted the board's good faith and reliance on experts, and applied a relatively generous standard in assessing whether the various actions taken by the board were a reasonable response to the perceived threat or ''preclusive'' and ''draconian'' under the second *Unocal* prong. Despite Trilogy's testimony that it would be extremely unlikely and difficult to wage a proxy battle, the Court noted that *Unocal* ''operates to exclude only the most egregious defensive responses,'' and held that to be preclusive, an action ''must render a successful proxy contest a near impossibility or else utterly moot.'' That high standard was not met, and the Selectica actions were found to be reasonable and proportionate, and need not have been the most narrowly or precisely tailored. The takeaway from this opinion is twofold: Delaware corporations can utilize NOLs to support a corporate policy meriting defensive measures, and the Chancery Court is likely to apply a relatively deferential *Unocal* standard when reviewing well-documented and thorough actions taken by largely disinterested board members.

In *Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. Aug. 12, 2010), Vice Chancellor Strine upheld a poison pill adopted by the Barnes & Noble board of directors. The case arose from the well-known efforts of billionaire Ronald Burkle to exert control over Barnes & Noble in late 2009. After expressing disappointment over Barnes & Noble's management, Burkle caused his Yucaipa funds to quickly amass an 18% interest in the bookstore. The board responded by adopting a poison pill that (among other things) would be triggered when a shareholder acquired over 20% of the company's outstanding stock. Since Leonard Rig-

gio, the founder of Barnes & Noble, already held approximately 30% of the company, the board adopted a grandfather provision that limited Riggio from increasing his position while exempting him from triggering the pill. Burkle promptly sued the directors, asserting that the adoption of the pill and the board's refusal to modify the pill at his suggestion, constituted a breach of fiduciary duty.

As a threshold matter, the Court rejected Burkle's argument that the poison pill should be analyzed under either entire fairness review or the *Blasius* ''compelling justification'' standard. The Court reaffirmed that the *Unocal* standard would govern inquiries into whether a poison pill was exercised consistent with the fiduciary duties of directors. Applying the familiar *Unocal* two-prong analysis, the Court concluded that the poison pill was a reasonable response to a legitimate threat to the company and its stockholders. Despite affirming the use of the poison pill, Vice Chancellor Strine took issue with the generous definition of ''preclusive'' set out in the Chancery Court decision in *Selectica* (described above), and in a lengthy footnote (number 182) called for a ''robust'' review of the effects of the pill on proxy contests. While *Selectica* suggested that a pill would not be preclusive as long as there was a mathematical possibility that the target of the pill could wage a successful proxy contest, V.C. Strine disagreed, opining that ''the mere fact that the insurgent might have some slight possibility of victory does not render the measure immune from judicial proscription as preclusive.'' In *Yucaipa*, the point was moot: the Court found that Burkle had a fair chance of prevailing in a proxy contest.

The tension between the definitions of ''preclusive'' set forth in *Selectica* and *Yucaipa* was resolved in the Delaware Supreme Court's opinion affirming the *Selectica* opinion. The Delaware Supreme Court held that a defensive measure will be preclusive under *Unocal* if it renders a successful proxy context ''realistically unattainable given the specific factual context.'' *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010). Practitioners should note that this standard, while not met in that case, appears less strenuous than that imposed by the Chancery Court in *Selectica*.

Finally, in *eBay Domestic Holdings, Inc. v. Newmark*, C.A. No. 3705-CC, 2010 WL 3516473 (Del. Ch. Sept. 9, 2010), Chancellor Chandler struck down two of the three protective measures that craigslist—a private Delaware corporation with three stockholders—deployed in an effort to prevent eBay from monetizing its business and acquiring additional craigslist shares. Craigslist's three stockholders at the time of the dispute were Craig Newmark, Jim Buckmaster, and eBay. Jim and Craig, as Chancellor Chandler refers to them, own a majority of their company's shares and occupy two of three total board seats. Their relationship with eBay was never great, but rapidly deteriorated when eBay decided to compete directly with craigslist by launching a rival website.

Uncomfortable that a ''Goliath'' might turn their community-focused enterprise into a profit-maximizing ''villain,'' Jim and Craig took three actions designed to reduce the power of eBay. They (1) amended the corporate charter and bylaws to provide for staggered elections of board members; (2) adopted a stockholder rights plan; and (3) offered to issue one new share of craigslist stock in exchange for every five shares on which a craigslist stockholder granted a right of first refusal in favor of craigslist. eBay alleged that each of these actions constituted a breach of Craig and Jim's fiduciary duties. Despite the fact that these actions were implemented simultaneously, the Court did not deem them ''inextricably related'' such that all three would be subject to collective scrutiny under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Instead, the Court applied a different standard to each action.

Applying a business judgment standard, the Court upheld the staggered board amendments; applying the *Unocal* standard, the Court required craigslist to rescind its rights plan (the poison pill); and applying entire fairness review, the Court required craigslist to rescind its right of first refusal provision. With respect to the staggered board amendments, the Court concluded that this was not a defensive measure subject to *Unocal* because Jim and Craig controlled a majority of the craigslist board even without staggered voting. The amendments constituted a reasonable response to the legitimate concern that eBay would misuse confidential information that it learned at board meetings. With respect to the rights plan, the Court held that potential changes in corporate culture (after Jim and Craig's deaths), standing alone, were not a threat to corporate policy or effectiveness sufficient to justify a defensive measure, and even if they were, the rights plan was not a reasonable response to the threat. ''Ultimately, defendants failed to prove that craigslist possesses a palpable, distinctive, and advantageous culture that sufficiently promotes stockholder value to support the indefinite implementation of a poison pill.'' (In this sentence, the Court appeared to furnish future corporations with an additional rationale behind adopting poison pill provisions.) With respect to the right of first refusal provision, the Court determined that the transaction failed the ''fair price'' prong of the entire fairness test.

While the *eBay* opinion is an interesting read, it is difficult to foresee its impact on future litigation. As the Court itself noted, ''[t]his case involves a unique set of facts heretofore not seen in the context of a challenge to a rights plan.'' Poison pill provisions are typically adopted by publicly-traded corporations with a large number of shareholders in efforts to fend off hostile takeovers. The poison pill in craigslist was adopted by a closely-held corporation with three stockholders in an effort to ''eschew[] stockholder wealth maximization,'' a goal shared by few, if any, other corporations. Thus, the other decisions approving poison pill provisions discussed above may—while perhaps less interesting reading—provide better guidance for the future.

IV. Duties of the Board of Directors In Particular Contexts

In 2010, Delaware Courts issued decisions addressing duties of boards of directors (and committees thereof) in the context of a change in control transaction (the so-called ''Revlon'' duties), and in the context of a minority shareholder ''freeze out.''

A. Revlon Duties

The familiar *Revlon* standard requires a board of directors in the context of a change in corporate control to maximize the value received by shareholders. One time-tested way to meet this standard is through a public auction of the company, ideally resulting in competing bidders offering a premium for shares of the company being sold. But what happens when there is only

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one bidder, and no auction? This year, the Chancery Court had occasion to discuss this scenario twice.

In *In re Dollar Thrifty Shareholder Litigation*, Cons. C.A. No. 5458-VCS, 2010 WL 3503471 (Del. Ch. Sept. 8, 2010), the Chancery Court declined to enjoin the proposed merger between Hertz and Dollar Thrifty. After years of on-and-off merger talks with both Hertz and Avis, Dollar Thrifty entered into a merger agreement with Hertz whereby Hertz agreed to acquire Dollar Thrifty at a price of $41 per share, including a $200 special cash dividend to be paid by Dollar Thrifty if the deal went through. The merger price represented a relatively meager 5.5% premium over Dollar Thrifty's market price, but the agreement contained a no-shop provision with a fiduciary out, matching rights, a termination fee (between 3.5-4% of the total deal value), a reverse termination fee, and a commitment of $335 million (by Hertz) to help achieve antitrust approval. Shortly after the parties executed the agreement, Avis offered to acquire Dollar Thrifty for $46.50 per share. Avis's proposal did not include matching rights, a termination fee, or a reverse termination fee, and posed more serious antitrust concerns (that Avis was less willing to mitigate). Although Avis's bid would be superior to Hertz's if the deal ultimately closed, Dollar Thrifty's board concluded that the Hertz deal was far more likely to go through, and rejected Avis's offer. Suing to enjoin this merger, plaintiffs argued that the Dollar Thrifty board breached their fiduciary duty of maximizing shareholder value under *Revlon* by failing to draw Avis into a bidding war with Hertz.

In the end, Vice Chancellor Strine concluded that the board was properly motivated, was closely engaged in the negotiation process, made a deliberate choice not to draw Avis into a public auction, and complied with its fiduciary duties. While the plaintiff's suggested negotiating strategy *could have been* reasonable for the board to adopt, the question, properly framed, was whether the actual approach adopted was ''a reasonable choice [to maximizing sale value] that a loyal and careful board could adopt in the circumstances.'' *Revlon* does not require more. The Court rejected the plaintiffs' claim that a board is required to conduct a *pre-signing* market check, and found the board's decision not to engage Avis reasonable. Nor was it unreasonable to enter into a deal that provided only a 5.5% premium over Dollar Thrifty's market price on the eve of the merger—the board reasonably focused on the company's fundamental value, and the $41 price was ''near the top range'' of the discounted cash flow valuations presented to the Board. Finally, the deal protective measures were neither preclusive nor coercive, and with no likelihood of success on the merits and the balance of harms tipping against the plaintiffs, the Court declined to enjoin the transaction. The Court suggested that when presented with a process that appears to be fair, deference is appropriate: ''When directors who are well motivated, have displayed no entrenchment motivation over several years, and who diligently involve themselves in the deal process choose a course of action, this court should be reluctant to second-guess their actions as unreasonable.''[1]

In another *Revlon* claim in the single-bidder context, Vice Chancellor Strine again declined to enjoin a merger in *Forgo v. Health Grades, Inc.*, No. 5732-VCS (Del. Ch. Sept. 3, 2010) (Transcript). Health Grades had agreed to be acquired by Vestar Capital Partners, a private equity firm. Despite the Court's decision not to grant injunctive relief—which V.C. Strine believed would have been ''an act of arrogance'' by the Court—the Court expressed serious reservations about the process by which the merger came about, and suggested that the plaintiffs could demonstrate a likelihood of success on the merits. While Health Grades did not need ''to go on eBay,'' Strine criticized the company for failing to ''take market soundings'' and conduct a searching (''sifting'') inquiry into other potential acquirers. The Court also suggested that the board failed to create an adequate record to support its process, and that it was particularly concerned here where the CEO may have had divergent interests from other shareholders, given he would likely maintain a role at the company after the transaction.

B. Tender Offers By Controlling Shareholders

The *In re CNX Gas Corp. Shareholders Litigation*, 4 A.3d 397 (Del. Ch. May 25, 2010) case raises the unresolved question of what standard of review should apply when evaluating the propriety of a transaction initiated by a controlling stockholder to ''freeze out'' minority shareholders. CONSOL Energy, Inc. held 80% of stock issued by its subsidiary, CNX Gas Corp. Seeking to acquire the remaining 20%, CONSOL entered into an agreement with T. Rowe Price, which held 37% of the outstanding shares, in which T. Rowe Price agreed to tender its shares to CONSOL in a public tender offer. The CNX board appointed its sole independent director to a one-person special committee tasked with evaluating the tender offer. The special committee lacked the authority to negotiate the terms of the offer or consider alternatives. CONSOL launched its public tender offer (subject to a majority-of-the-minority condition) and committed to effect a short-form merger at the same price. Although the special committee did not recommend the offer at that price, CONSOL did not increase the price. When minority shareholders sued to enjoin the freeze-out, the Court was forced to confront ''a critical and much debated issue of Delaware law: the appropriate standard of review for a controlling stockholder freeze-out.''

After considerable discussion, Vice Chancellor Laster adopted the ''unified standard'' described in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005). Under that standard, a controlling stockholder freeze-out will be evaluated under the business judgment rule only if the first-step tender offer is *both* (i) negotiated and recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority-of-the-minority shares. If either requirement is not satisfied, the transaction will be reviewed under the entire fairness standard. Because CNX's special committee did not recommend the tender offer, the Court applied the entire fairness standard and concluded that the plaintiffs had shown a probability of success on the merits. Nevertheless, the Court declined to issue an injunction, as any harm to the shareholders could be adequately

[1] The story of this transaction continues. In the weeks following the Court's opinion, Avis increased its bid to $53/share and Dollar Thrifty shareholders voted to reject the merger with Hertz. According to press reports, Avis and Dollar Thrifty are presently pursuing a business combination.

remedied by monetary damages. Going forward, V.C. Laster recognized that he had not spoken the final word on the subject: the choice of a standard among *Lynch, Pure Resources*, and *Cox Communications* ''implicates fundamental issues of Delaware law and public policy that only the Delaware Supreme Court can resolve.'' Unless and until the Supreme Court takes up V.C. Laster's invitation—which it declined to do, refusing to consider the defendants' interlocutory appeal from the Laster's decision—the law remains unresolved.

V. M&A Litigation

Each year, Delaware Courts are presented with the opportunity to clarify and advance the all-important law governing M&A transactions and follow-on litigation. Indeed, the Wall Street Journal reported in a January 10, 2011 article that M&A litigation filings have risen steadily each year from 20 cases (2006), to 36 (2008), to 191 (2009), to well over 200 (2010). Last year, this raft of litigation yielded numerous important M&A decisions from Delaware courts, addressing issues such as the *Revlon* duties of a board (described above), the use of so-called deal protection measures, the adequacy of public disclosures, and the Court's review of proposed settlements.

A. Deal Protection Measures

During 2010, the Chancery Court addressed the propriety of various ''deal protection'' measures. In *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487 (Del. Ch. Oct. 5, 2010), Vice Chancellor Parsons rejected plaintiffs' motion to enjoin a two-step transaction that would result in 3M Company acquiring Cogent, Inc. The facts are simple: 3M proposed to acquire Cogent for $10.50 per share, another company submitted a contingent, preliminary, and non-binding indication of interest in acquiring Cogent for up to $12.00 per share, and the board of directors elected to pursue the merger with Cogent at $10.50. The parties eventually entered into a merger agreement containing several deal protection measures: the deal featured a no-shop provision with a fiduciary out clause, a $28.3 million termination fee (representing 3% of Cogent's equity value and 6.6% of its enterprise value), a five-day period in which 3M could match any superior offer, and a top-up option granting 3M the option to purchase approximately 139 million shares of Cogent stock at the tender offer price of $10.50 per share, which could be financed with a promissory note due in one year. Plaintiffs sued to enjoin the merger arguing that the price and sales process were inadequate, that the deal protection devices were unreasonable and preclusive, and that the Schedule 14D-9 contained material misstatements and omissions. The Court rejected each of these contentions.

In doing so, the Court first rejected a *Revlon* challenge and concluded that the Board acted reasonably in proceeding with 3M's firm offer even though another suitor proposed a higher price. The opinion devotes considerable attention to the plaintiffs' allegations relating to the deal protection mechanisms. The Court found that the no-shop and matching rights provisions were reasonable and mitigated by the fiduciary out provision. The Court also rejected the plaintiffs' argument that cash on Cogent's balance sheet should be excluded for purposes of evaluating the reasonableness of the termination fee, and concluded that the fee was not unreasonable. Finally, the Court found that the top-up option was likely reasonable because: (1) the exercise of the option was conditioned upon a majority of the outstanding shares being tendered to 3M, subject to waiver only with the consent of the Cogent board; (2) in order for 3M to meet the 90% threshold necessary to effect a short-form merger, 3M would have to acquire a majority of the minority's outstanding shares; and (3) the Merger Agreement explicitly provides that a promissory note issued by 3M to pay for the top-up shares is a recourse obligation against 3M. In light of these findings, the Court concluded that the deal protection provisions, separately and in combination, were not unreasonable or preclusive, and the directors did not breach their fiduciary duties by including them in the transaction. The Chancery Court subsequently denied the plaintiffs' request to certify an interlocutory appeal from the portion of the Court's opinion addressing the top-up option, a decision affirmed by the Delaware Supreme Court. Taken together, the *Cogent* and *Dollar Thrifty* opinions suggest a broad range within which deal preclusive measures will be found reasonable. These cases also reinforce the conclusion that the board's fiduciary duties do not obligate directors to accept (or pursue) a potentially higher bid when another bidder offers a lower price, but one that the board concludes is nonetheless a better overall deal.

B. Public Disclosures

1. Free Cash Flows In 2010, the Chancery Court issued two decisions addressing the materiality of free cash flow estimates omitted from proxy statements. In *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, C.A. No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010), the Court enjoined the challenged merger pending disclosure of free cash flow estimates. The opposite result followed in *Steamfitters Local Union 447 v. Walter*, C.A. No. 5492-CC (Del. Ch. June 21, 2010) (Transcript), where the Court denied a motion to expedite, holding that disclosure of free cash flow estimates would not be material and distinguishing *Maric*.

In *Maric*, plaintiff opposed Thoma Bravo, LLC's acquisition of PLATO Learning Inc. Vice Chancellor Strine enjoined the merger until PLATO issued corrective disclosures relating to three issues, and the Court engaged in a noteworthy discussion of the obligations to include free cash flow estimates in proxy statements. PLATO's management had provided free cash flow estimates to its investment bank, but omitted those estimates from its proxy statement. The Court deemed this omission ''inexplicable'' and ''odd,'' particularly in light of V.C. Strine's opinion that ''management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is *clearly material information*.'' The importance of future cash flow estimates is based on ''sound corporate finance theory'' which posits that ''the value of stock should be premised on the expected future cash flows of the corporation.'' The company's failure to adequately explain the absence of the free cash flow estimates was fatal to its opposition to the injunction.

By contrast, Chancellor Chandler denied plaintiffs' motion to expedite a challenge to the acquisition of inVentiv Health, Inc. by Thomas H. Lee Partners, L.P. Among other things, the plaintiffs protested that the proxy failed to include free cash flow projections. While the addition of such projections would add to the total mix of available information, the Court concluded that it would not meaningfully alter the total mix of information in such a way as to render it material. Crucially, un-

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like *Maric*, inVentiv never provided its investment bank with free cash flow estimates. There was therefore no ''deliberate excising'' of free cash flow data as there (arguably) was in *Maric*. At least as important, the proxy disclosed management's projections including net revenue, net income, and EPS and EBITDA estimates for five years. All of this information served to dilute the significance of free cash flow projections.

The tension between these two cases remains—despite Chancellor Chandler's invitation to certify an interlocutory appeal to the Delaware Supreme Court as to whether free cash flow estimates must always be included in proxy solicitations, the plaintiffs did not appeal. Until the Delaware Supreme Court weighs in, clients would be well-advised to consider including free cash flow projections in proxy statements, especially where management has provided those projections to its investment advisor.

2. Disclosure of Fees Paid To Investment Banks In *In re Art Technology Group S'holder Litigation*, No. 5955-VCL (Del. Ch. Dec. 20, 2010) (Transcript), Vice Chancellor Laster enjoined a shareholder vote in a merger transaction whereby Orcale was to purchase Art Technology Group. In so doing, the Court accepted the plaintiff's argument that the proxy omitted material information because it failed to disclose the fees that Orcale had paid to Morgan Stanley (which served as investment bank for Art Technology Group) since 2007. The ruling is potentially noteworthy insofar as the Court required disclosure of fees (based in part on their ''magnitude'') and required disclosures going back four years. The time frame of the ruling, however, may be largely peculiar to its facts: the Court explained that it was persuaded the banker's fees were material as far back as 2007 because other portions of the proxy materials contained disclosures concerning events during that time period.

C. Settlement of M&A Litigation

Finally, no treatment of M&A litigation would be complete without addressing the Court's latest articulation of its views on settlement. The Court has characterized these cases on the one hand as the proverbial ''race to the courthouse'' by firms looking to earn a legal fee, while on the other describing them as important mechanisms for the protection of shareholder interests. The Court's view of M&A litigation, and in particular of the settlement of such litigation, continues to evolve. Here are a few cases in which the Court gave lengthy written treatment to the settlement of M&A litigation during 2010.

In *In re Revlon, Inc. Shareholders Litigation*, 990 A.2d 940 (Del. Ch. March 16, 2010), four plaintiffs filed cases in the Chancery Court challenging a tender offer whereby the controlling stockholder of Revlon offered to acquire all of Revlon's publicly traded common stock in exchange for a new series of preferred stock. A flurry of litigation followed as the law firms fought for control of the litigation, but ultimately, the parties reached a settlement and the case came before the Court on a motion for approval of the settlement.

The Court's decision in large measure reflected skepticism with the conduct of the litigation. The Court described the initial litigation activity as ''the opening steps in the *Cox Communications* Kabuki dance,'' referring to *In re Cox Communications, Inc.*, 879 A.2d 604 (Del. Ch. 2005). The Court described the ''dance'' whereby representative plaintiffs hastily file complaints after disclosure of a corporate transaction. Once the plaintiffs' leadership structure is settled, litigation activity stops and the plaintiffs seek a settlement and payment of their attorneys' fees. The defendants, meanwhile, move forward with the transaction and agree to a settlement to achieve deal certainty, pay a modest attorneys' fee award and obtain a broad, transaction-wide release.

Presented with this ''dance,'' the *Revlon* Court expressed concern that a number of events should have alerted the plaintiffs' counsel that the proposed transaction warranted closer attention and more vigorous litigation efforts. For example, the transaction was originally structured as a merger until the financial advisor to Revlon's special committee indicated that it could not provide a fairness opinion. The special committee then disbanded, and Revlon restructured the transaction as a tender offer even though Revlon's outside directors did not believe they could obtain a fairness opinion for the tender offer either. Additionally, the Court suggested that the Revlon board's involvement with the tender offer could have resulted in the application of the stringent entire fairness review to the transaction.

Events came to a head after the tender offer closed and Revlon announced third quarter results which exceeded expectations, at which point several other stockholders filed separate actions. The existing lead plaintiffs' counsel reacted by filing an amended complaint and moving to consolidate the new actions into the prior consolidated action and to confirm the then-existing leadership structure. The Court, however, was concerned that the only real litigation activity occurred when there was a dispute over control of the case and counsel's path to a fee. The Court appointed the plaintiffs that had filed the new actions as new lead plaintiffs and gave decision-making authority to the one firm the Court did not consider to be ''entrepreneurial litigators'' who manage a portfolio of cases to maximize returns through attorneys' fees. The Court also ordered the newly appointed lead counsel to investigate the negotiations of the settlement and the work done by the law firms they replaced.

If *Revlon* is a cautionary settlement tale for the plaintiff's bar, then *Scully v. Nighthawk Radiology Holdings*, No. 5890-VCL (Del. Ch. Oct. 21, 2010) (Transcript) is the cautionary tale for the defense bar. The case began the way M&A litigation often does: a company announced a deal (a sale to a private equity firm) and lawsuits challenging the transaction were quickly filed in Delaware and Arizona courts. On October 21, 2010, the parties appeared before Vice Chancellor Laster on the plaintiff's motion for expedited discovery on a single disclosure issue, whether proxy disclosures of free cash flows were sufficient. The Court, after expressing that the transaction raised potentially interesting process-based claims (which the plaintiff had disavowed pursuing on an expedited basis), found the plaintiffs' proposed disclosure claim not sufficiently colorable to warrant expedited discovery. (Following *Maric*, the Court would have expedited discovery if management had provided cash flow projections to its financial advisor, but the failure to disclose cash flow projections that the advisor independently derived did not trouble the Court.)

The defendants and the shareholder class thereafter proceeded with negotiations and ultimately reached a

class-wide, disclosure-based settlement, which they submitted to the Arizona court for approval. Matters quickly soured when V.C. Laster received a letter from the parties notifying him of the disclosure settlement in Arizona. On December 21, 2010, the Vice Chancellor convened a conference and made plain his serious concern: had there been defense-counsel-driven collusion by the parties to (i) intentionally direct the settlement away from the Chancery Court, (ii) so that the parties could obtain court approval (from Arizona) of a class settlement (and accompanying class release) based on disclosure claims that the Chancery Court had already found non-colorable? In a lengthy transcript ruling, the Court discussed at length its views that such collusion, if it occurred, could constitute a breach of counsels' duties as officers of the courts of Delaware. The Court closed the hearing by instructing all counsel to submit briefing describing the settlement negotiation process, and stating the intention of the Court to engage special counsel to aid the Court's investigation of the issue. On March 11, 2011, special counsel filed a 42-page brief extensively discussing the duties of plaintiffs' and defense counsel involved in multi-jurisdictional merger litigation, but finding no evidence of collusion or impropriety in the *Scully* case. At the time of writing, the matter appears to be unresolved.

VI. Conclusion

2010 was an active year for the Chancery Court, in which it provided guidance on a series of important issues for practitioners and litigators in Delaware. Looking forward, plaintiffs may make greater use of Section 220 at the outset of litigation—and should not expect a rubber stamp approval process for any settlements of M&A litigation at the back-end unless there was merit to their claims and substantial work was undertaken in pursuing the case. Preferred shareholders may bring derivative actions unless their right to do so is expressly limited. Corporations may adopt poison pills to protect NOLs, even when those assets may be potentially worthless, and the Court will analyze defensive measures in the close-corporation context just as it does in the usual corporate context. Despite this guidance, the Court raised questions that will play out in the years ahead, including what defensive actions will be found ''preclusive'' under the definition provided by the Delaware Supreme Court, and whether corporations will be routinely required to disclose free cash flows in connection with merger disclosures. These, and other questions remain unanswered, and will likely require resolution by the Delaware Supreme Court in the future.

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