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Delaware Courts Confront Question Whether Cleansing Effect of Corwin Applies to Duty of Loyalty Claims

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DELAWARE CORPORATE LAW BULLETIN

Delaware Courts Confront Question Whether "Cleansing Effect" of *Corwin* Applies to Duty of Loyalty Claims

*Robert S. Reder**
*Tiffany M. Burba***

Recent rulings settle apparent divergence between Comstock *and* Larkin *decisions*

Narrow exception to application of Corwin *to cases where controlling stockholder*

extracts personal benefits in a merger transaction

INTRODUCTION 188
I. *IN RE SOLERA* 189
  A. Factual Background 189
  B. Chancellor Bouchard's Analysis 191
II. *IN RE MERGE HEALTHCARE* 193
  A. Factual Background 193
  B. Vice Chancellor Glasscock's Analysis 194
CONCLUSION 196

INTRODUCTION

Since the Delaware Supreme Court handed down its important 2015 decision in *Corwin v. KKR*,[1] its basic teaching that fully-informed, uncoerced and disinterested stockholder approval can "cleanse" certain directorial breaches of fiduciary duty has been analyzed and interpreted in numerous Delaware Court of Chancery ("*Chancery Court*") decisions.[2] When the *Corwin* "cleansing" principle is applicable, the trial court will apply the irrebuttable business judgment rule to dismiss former target company stockholders' post-closing claims for damages arising from an alleged breach of fiduciary duty by target company directors.[3]

While it is clear that *Corwin* applies to a variety of transactions where a breach of the duty of care is the underlying complaint by target company stockholders, until recently the Chancery Court has been less clear on the application of *Corwin* where target stockholders complain about an alleged breach of the duty of loyalty.[4] *In City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock*, Chancellor Andre G. Bouchard seemed to require a finding that the entire fairness standard of review is inapplicable before he would permit *Corwin* to trigger business judgment deference.[5] However, only one day later, Vice Chancellor Joseph R. Slights III indicated in *Larkin*

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1. Corwin v. KKR Fin. Hldgs. LLC,125 A.3d 304 (Del. 2015) ("*Corwin*").

2. *See, e.g.*, Singh v. Attenborough, 137 A.3d 151 (Del. 2016) (affirming a Chancery Court's dismissal "solely on the basis of its decision on reargument . . . finding that a fully informed, uncoerced vote of the disinterested stockholders invoked the business judgment standard of review."); In re Om Group, Inc. Stockholders Litigation, C.A. No. 11216-VCS , 2016 WL 5929951 (Del. Ch. Oct. 12, 2016) (applying the business judgment standard instead of *Revlon* after finding that the stockholder vote on a merger was fully informed); Robert S. Reder, *Delaware Chancery Court Extends "Cleansing Effect" of Stockholder Approval Under KKR Two-Step Acquisition Structure*, 69 Vand. L. Rev. En Banc 227 (2016) (discussing how the Delaware Chancery Court extended the *Corwin* doctrine to mergers initiated pursuant to DCGL § 251(h) in *In re* Zale Corp).

3. *Corwin*, 125 A.3d at 308. Although *Corwin* on its face applied to fully-informed stockholder votes in favor of a merger, *Corwin*'s approval requirement can also be met when stockholders surrender their shares in a tender offer, so long as the disclosures surrounding the offer are adequate. *In re* Volcano Corp. Stockholder Litig., 143 A.3d 727 (Del. Ch. 2016).

4. For a more detailed discussion of how this conflict arose, see Robert S. Reder & Tiffany M. Burba, *Delaware Courts Diverge on Whether "Cleansing Effect" of Corwin Applies to Duty of Loyalty Claims*, 70 Vand. L. Rev. En Banc 1 (2017).

5. City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock, C.A. No. 9980-CB, Slip. Op. (Del. Ch. Aug. 24, 2016) (*aff'd* by City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock, No. 482, 2017 WL 1093185 (Del. Mar. 23, 2017)) ("*Comstock*"); *see also* Reder & Burba, *supra* note 4.

v. Shah that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder."[6]

The Delaware Supreme Court has yet to squarely address whether the *Larkin* interpretation of *Corwin* is correct, but two January 2017 Chancery Court decisions—*In re Solera Holdings, Inc. Stockholder Litigation*[7] authored by Chancellor Bouchard himself and *In re* Merge Healthcare *Inc. Stockholders Litigation*[8] authored by Vice Chancellor Sam Glasscock III—would seem to have resolved this confusion. These decisions also offer some subtle, but instructive, fine points concerning the application of *Corwin*.

I. *IN RE SOLERA*

A. Factual Background

In *Solera*, a former stockholder of Solera Holdings, Inc. ("*Solera*" or the "*Company*") sought post-closing damages from eight former Solera directors following Solera's merger (the "*Merger*") with an affiliate of private equity buyout specialist Vista Equity Partners ("*Vista*").[9] Solera "is a provider of risk and asset management software and services to the ... global property and casualty insurance industry."[10] Over the two year period preceding the buyout, Solera Board Chairman and CEO Tony Aquila engaged in informal discussions regarding a potential go-private transaction.[11] In July 2015, a private equity firm ("*Party A*") made an all-cash offer to purchase Solera for $56-$58 per share. In response, Solera's board formed a special committee (the "*Special Committee*") to consider the offer and potential strategic alternatives. The Special Committee hired Centerview

6. Larkin v. Shah, C.A. No. 10918-VCS, 2016 WL 4485447 at *10 (Del. Ch. Aug. 25, 2016) ("*Larkin*"); *see* also Reder & Burba, *supra* note 4. In December 2016, Vice Chancellor J. Travis Laster cited *Larkin* favorably in Chester County Retirement System v. Collins, No. 12072-VCL, 2016 WL 7117924 (Del. Ch. Dec. 6, 2016) (trial court order) stating: "In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts by individual directors." *Id.* at *2.

7. *In re* Solera Holdings, Inc. Stockholder Litigation, C.A. No. 11524-CB, 2017 WL 57839 (Jan. 5, 2017) ("*Solera*").

8. *In re* Merge Healthcare Inc. Stockholders Litigation, C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017) ("*Merge Healthcare*").

9. *In re Solera,* 2017 WL at 57839 *1.

10. *Id.*

11. The CEO considered strategic acquirers, private equity buyers, employment, and investment opportunities. *Id.* at *2.

Partners LLC ("*Centerview*") as its financial advisor and instructed Centerview to contact several other potential buyers, both strategic and private equity. By August 17th, only three potential private equity buyers submitted indications of interest: Vista, at a price of $63 per share; Party A, at a price of $60 per share; and Party C, at a price between $60 and $62 per share.[12] A Solera competitor who was initially excluded from the process, Party B, emerged with an offer at $60 per share, with an unspecified mix of consideration, after news of the sales process leaked and Solera publicly acknowledged that "it was 'exploring a variety of strategic alternatives.'"[13]

After a series of negotiations and counter-offers in which the proposals declined from the initial bidding, on September 12th, the Solera board unanimously approved a merger agreement providing for Vista's all-cash $3.7 billion acquisition of Solera at $55.85 per share (the "*Merger Agreement*"), representing a 53% premium to market price. The Merger Agreement featured a non-solicitation covenant with a window shop allowing Solera to consider unsolicited offers, a limited go-shop allowing Solera to negotiate with Party B for up to 28 days, a two-tiered termination fee (the top tier of which did not exceed 3% of Merger value) payable by Solera to Vista should Solera elect to pursue a superior proposal, and a 72-hour match right for the benefit of Vista.[14] Party B declined to participate in the go-shop, "citing a decline in its stock price and volatility in the financing markets."[15]

In August 2015, "in the midst of the sales process,' the Special Committee had referred discussions of a new management retention and compensation plan to the Compensation Committee, which consisted of two Special Committee members and one other director (the "*Compensation Committee*").[16] Ultimately, the Compensation Committee approved a Retention Plan allocating $33 million to Solera's management team (the "*Retention Plan*"), plus a special $10 million cash award to CEO Aquila for his contributions to the Company (the "*Special Cash Award*").[17]

After the Chancery Court denied a Solera stockholder's motion for a preliminary injunction, Solera stockholders voted to approve the Merger. The transaction closed on March 3, 2016. Subsequently, plaintiff amended its complaint to seek class damages based on a single claim for breach of fiduciary duty against Solera's former directors.

12. *Id.*
13. *Id.* at *3.
14. *Id.*
15. *Id.* at *1.
16. *Id.* at *2, *4.
17. *Id.* at *4.

Specifically, plaintiff alleged that, in conducting the sale process, the directors "improperly favored" the interests of Solera's management, failed to establish an "effective" Special Committee, "failed to extract the highest price possible" for the Company, agreed to "preclusive deal protections," and "failed to disclose material information" to stockholders about the value of Solera's stock.[18] Rejecting these contentions, Chancellor Bouchard granted defendant directors' motion to dismiss.

B. Chancellor Bouchard's Analysis

Standard of Review. At the outset, Chancellor Bouchard addressed the applicable standard of review applicable to the directors' conduct. The Chancellor noted the absence of any argument by plaintiff that he should apply the intrusive entire fairness standard of review, adding that there was "no reason is apparent why it would be [applied]. The Merger did not involve a controlling stockholder, and plaintiff does not assert that a majority of the eight members of Solera's board, seven of whom were outside directors, were not independent or disinterested."[19] In fact, plaintiff urged the Chancellor to apply an enhanced scrutiny level of review under *Revlon*[20] and its progeny, but the Chancellor, citing *Corwin*, clarified that *Revlon* "was not a tool 'designed with post-closing money damages in mind.'"[21]

Instead, Chancellor Bouchard invoked *Corwin*: "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."[22] Moreover, citing *Singh v. Attenborough*,[23] the Chancellor remarked, "[w]hen the business judgment standard of review is invoked because of a vote, dismissal is typically the result."[24] Because the Solera stockholders voted to approve the Merger based on disclosures made in a proxy statement, Chancellor Bouchard's next task was to consider whether the stockholders' vote was fully informed.[25]

Burden of Proof; Timing of Disclosure Claims. Chancellor Bouchard next considered "how does the burden of proof operate when

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18. *Id.* at *6.
19. *Id.*
20. Revlon v. MacAndrews & Forbes Hldgs., Inc., 506 A. 2d 173 (Del. 1986) ("*Revlon*").
21. *In re Solera,* 2017 WL at 57839 at *6 (distinguishing *Revlon*).
22. *Id.* (citing *Corwin*, 125 A. 3d at 312).
23. Singh v. Attenborough, 137 A.3d 151 (Del. 2016).
24. *In re Solera*, 2017 WL 57839 at *6.
25. *Id.* at *7.

applying the standard-shifting principles" of *Corwin*?[26] The Chancellor concluded that while the *ultimate burden* to show the vote was fully-informed falls on defendants seeking to prove ratification, the "*burden to plead* disclosure deficiencies in the first place" rests with plaintiff.[27] Chancellor Bouchard was not concerned "about the fairness of requiring plaintiffs to plead disclosure deficiencies before obtaining disclosure," noting that "plaintiffs must plead claims before receiving discovery in American civil litigation all the time."[28] Further to the issue of timing, he explained that "plaintiffs may avail themselves of the relatively low pleading standard of 'colorability' to obtain discovery in aid of disclosure claims before a stockholder vote, which is the *preferred time to address such claims* in order to afford remedial relief appropriate for genuine informational deficiencies."[29]

Examining the facts before him, the Chancellor concluded that plaintiff failed to state a claim for deficient disclosure claims both with regard to alleged conflicts of the Special Committee and the "purpose and effect" of the Retention Plan and Special Cash Award.[30] Because the Solera stockholders were fully informed and uncoerced in approving the Merger, the Chancellor invoked the business judgment rule pursuant to *Corwin*. At that point, he explained, "the transaction may only be attacked on the ground of waste. Since plaintiff does not assert that the board's decision to approve the Merger amounted to waste," its claims must be dismissed.[31]

Larkin and Comstock. Significantly, even though entire fairness was not an issue before him, Chancellor Bouchard chose to address Vice Chancellor Slights' analysis in *Larkin*. First, the Chancellor articulated that "[i]n the post-closing context, the Supreme Court held in *Corwin* that 'when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies.'"[32] Next, in footnote 28, he cited and quoted directly from *Larkin*: "After reviewing the context of this statement, Vice Chancellor Slights concluded in *Larkin v. Shah* that the Supreme Court did not intend to suggest that every form of transaction that otherwise may be subject to

26. *Id.*

27. *Id.* at *7–*8 (citing Harbor Finance P'rs v. Huizenga, 751 A.2d 879 (Del. Ch. 1999)); *see also Corwin*, 101 A.3d at 999 (adopting the same burdens).

28. *Id.* at *8.

29. *Id.* (emphasis added) (citing Nguyen v. Barrett, 2016 WL 5404095, at *3 (Del. Ch. Sept. 28, 2016)).

30. *In re Solera*, 2017 WL 57839 at *9–*12.

31. *Id.* at *13.

32. *Id.* at *6.

entire fairness review was exempt from the potential cleansing effect of stockholder approval, but that 'the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder.'"[33] Although the Chancellor did not mention his somewhat divergent view in *Comstock*, his favorable reference to Vice Chancellor Slights' analysis would seem to indicate that the *Larkin* approach will prevail over the more stringent, and plaintiff-friendly, *Comstock* formulation.

II. *IN RE MERGE HEALTHCARE*

A. Factual Background

In *In re Merge Healthcare*, former stockholders of Merge Healthcare, Inc. ("*Merge*" or the "*Company*"), a healthcare software developer, sought post-closing damages from the former directors following the Company's acquisition by IBM (the "*Merger*").[34] Merge had become engaged in discussions with IBM over a proposed commercial arrangement, in the course of which IBM made an acquisition proposal and obtained an exclusivity period to negotiate a transaction. IBM also sought employment arrangements with members of Company management as a pre-condition to any acquisition.

On August 6, 2015, following board approval, the Company entered into an Agreement and Plan of Merger with IBM (the "*Merger Agreement*"). Pursuant to the Merger Agreement, the Company's common stockholders were to receive $7.13 in cash for each of their shares, representing a 31.8% premium and an approximate transaction value of $1 billion.[35] The Merger was completed on October 13th, following approval by Company stockholders owning 77.3% of the outstanding shares. As part of the Merger, certain members of Company management entered into employment or transition arrangements with IBM.[36] The Merger Agreement also included several deal protections: a no-solicitation covenant with a window shop allowing Merge to consider unsolicited superior offers, a covenant

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33. *Id.* at n. 28.

34. *In re* Merge Healthcare Inc. Stockholders Litigation, C.A. No. 11388-VCG, 2017 WL 395981 at *1 (Del. Ch. Jan. 30, 2017). Unlike most directors of publicly-held corporations, Merge's directors were not protected by an "exculpation clause" authorized by Section 102(b)(7) of the Delaware General Corporation Law. This raised the stakes for the directors, exposing them to "liability for acts violative of their duty of care," requiring "a demonstration of gross negligence" on their part, which is "less formidable than showing disloyalty." *Id.* at *1.

35. Holders of the Company's Series A Convertible Preferred Stock received $1,500 in cash for each of their shares.

36. *In re* Merge Healthcare, 2017 WL 395981 at *2 (internal citations omitted).

requiring Merge to inform IBM within one day following receipt of an unsolicited bid, a five-day match right benefitting IBM, and a $26 million termination fee payable by Merge to IBM should Merge elect to pursue a superior proposal.[37]

Unhappy Company stockholders sought, but failed, to enjoin the transaction. After the Merger closed, plaintiffs sought damages, alleging that the Merge directors had breached their fiduciary duties during the sale process and failed to disclose material information to stockholders in soliciting their votes to approve the transaction. Rejecting these contentions, Vice Chancellor Glasscock granted defendant directors' motion to dismiss.[38]

B. Vice Chancellor Glasscock's Analysis

Standard of Review. Initially, Vice Chancellor Glasscock observed that "Plaintiffs argue that the entire fairness standard of review applies to the Merger because a majority of the Merge board was conflicted. . . . Because I find that a fully informed, uncoerced vote of the Company's disinterested stockholders cleansed the Merger here, resulting in the application of the business judgment rule, I need not conduct an entire fairness analysis."[39] In this connection, the Vice Chancellor noted that "as clarified in a learned discussion by Vice Chancellor Slights in *Larkin v. Shah*, 'the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder.'"[40] Interestingly enough, Vice Chancellor Glasscock did not cite directly to *Larkin* for this language, but rather indirectly through Chancellor Bouchard's footnote 28 in *Solera* (discussed in I.B. *infra*).[41]

Going further with his analysis, Vice Chancellor Glasscock noted that the mere presence of a controlling stockholder is not enough to overcome the *Corwin* presumption. Rather, only "'the absence of a controlling stockholder *that extracted personal benefits*'" is needed to trigger a *Corwin* inquiry.[42] Under those circumstances, "if a majority of the Company's disinterested stockholders approves the transaction with a fully informed, uncoerced vote, then the business judgment rule applies 'even if the transaction might otherwise have been subject to

37. *Id.* at *4.
38. *Id.* at *5.
39. *Id.*
40. *Id.* at *6 (citing *Larkin*, 2016 WL 4485447).
41. *Id.* (citing note 28 of *Solera*).
42. *Id.* (citing *Larkin*, 2016 WL 4485447).

the entire fairness standard due to conflicts faced by individual directors.'"[43]

Turning to the facts before him, the Vice Chancellor was willing to assume, without making any specific finding, that Merge was controlled by its Board Chairman, who indirectly owned 26% of the outstanding stock.[44] However, he found that the Chairman did not extract any personal benefits in the Merger, freeing him to proceed under *Corwin* to consider whether the stockholder vote was fully informed.[45] The Merger "treats all stockholders equally," and the Chairman "as a 28% stockholder is fully aligned with stockholders' interests to obtain the highest price possible, notwithstanding his interest, as demonstrated by a long course of dealing, in liquidating his stock." [46] While "exigent circumstances that require a controller to dump stock, for liquidity purposes, at less than full value, create divergent interests between the controller and the other stockholders," a "simple interest in selling stock ... is insufficient to demonstrate divergent interests." [47] Rather, "the circumstances under which she does so must be akin to a 'crisis' or a 'fire sale' to 'satisfy an exigent need.'" [48]

Burden of Proof; Timing of Disclosure Claims. Like Chancellor Bouchard before him, Vice Chancellor Glasscock next confronted the applicable burden of proof relating to the disclosure deficiencies necessary for plaintiffs to avoid application of "cleansing" under *Corwin*. Consistent with *Solera*, the Vice Chancellor assigned to plaintiffs "the pleading burden to allege material deficiencies" in the disclosures made to stockholders to obtain their votes.[49]

However, defendant directors balked at allowing plaintiffs, at this stage of the proceedings, to present any evidence of disclosure violations because no such allegations had been made in the original complaint. While noting that he had stated in an earlier case that "the preferred way of proceeding is for plaintiffs to bring these claims pre-closing to ensure that stockholders can exercise their right to a fully informed vote," [50] Vice Chancellor Glasscock ruled here that "[i]n light of the evolving nature of our jurisprudence, I decline to consider these

43. *Id.*

44. *Id.* at *7. In fact, Merge's annual disclosure to the Securities and Exchange Commission stated that the Chairman's "significant ownership of our voting stock will enable [him] to influence or effectively control us ...." *Id.*

45. *Id.* at *7–*9.

46. *Id.* at *8.

47. *Id.*

48. *Id.*

49. *Id.* at *9.

50. Nguyen v. Barrett, C.A. No. 11511-VCG, 2016 WL 5404095 (Del. Ch. Sept. 28, 2016).

policy issues here, and assume that the Plaintiffs may proceed with these claims post-closing."[51]

On this basis, Vice Chancellor Glasscock allowed plaintiffs to proceed with several claimed disclosure violations, including that the proxy statement distributed to Company stockholders did not adequately describe certain aspects of the Goldman Sachs fairness opinion, and that the Company board failed to disclose the Board Chair's motivation for waiving a consulting fee in connection with the Merger.[52] The Vice Chancellor ultimately concluded that defendant directors "have met their burden ... to demonstrate that the vote was informed." [53] Accordingly, the Vice Chancellor applied the business judgment rule to the Merge directors' conduct, and "[s]ince the Plaintiffs do not allege waste with respect to that decision, the Complaint must be dismissed . . . ."[54]

CONCLUSION

These two recent Chancery Court decisions—*Solera* and *Merge Healthcare*—demonstrate a judicial acceptance of the *Larkin* trigger to *Corwin* cleansing in the post-closing damages context. This is a helpful clarification in light of the apparent divergence on this important issue between *Larkin* and *Comstock*. Now it seems clear that rather than requiring an initial finding that entire fairness review does not apply to a board of directors' conduct in pursuing a merger transaction, the Chancery Court will launch straight into the *Corwin* inquiry, so long as there is no sufficient allegation of a controlling stockholder who *extracted personal benefits*. Once the Chancery Court determines that stockholder approval of a challenged transaction satisfies *Corwin*, plaintiffs who do not plead corporate waste in connection with the transaction will likely have their cases dismissed under the business judgment rule.

Solera and *Merge Healthcare* offer other important insights on the application of *Corwin*:

- To detour the trial court from proceeding directly to a *Corwin* inquiry into the disclosures, plaintiffs must establish not only the presence of a control stockholder, but one who "extracted personal benefits" from the transaction. This might come in the form of a buyout by

51. *In re* Merge Healthcare, 2017 WL 395981 at *10.

52. *Id.* at *10, *12.

53. *Id.* at *13.

54. *Id.*

the control stockholder of the public stockholders, or a transaction that bestows benefits not shared proportionately by all target company stockholders.

- While a desire to obtain immediate liquidity on the part of a control stockholder could represent the extraction of personal benefits, it must be in the context of a "crisis" or "fire sale" and not a simple desire to sell a large block of stock.[55]
- In terms of the burden of proof, while the *ultimate burden* to show the vote was fully-informed falls on defendant directors seeking to achieve "cleansing," the "*burden to plead* disclosure deficiencies in the first place" rests with plaintiffs.[56]
- Plaintiffs are expected to fulfill this burden even in the absence of a full discovery process, although they can rely on the fact that the pleading standard at this stage is but one of "colorability."[57]
- It would appear that, pending conclusive judicial determination, plaintiffs will be permitted to assert disclosure claims at the post-closing damages stage for *Corwin* purposes, even if those allegations were not pursued before the stockholder vote, the "preferred time" for disclosure claims to be made.[58]

55. *See In re* Merge Healthcare, 2017 WL 395981 at *9; *see also* Nguyen v. Barrett, 2016 WL 5404095 (Del. Ch. Sept. 28, 2016).

56. *See In re Solera*, 2017 WL 57839 (emphasis added) ((citing Nguyen v. Barrett, 2016 WL 5404095, at *3).

57. *See id.* at *13.

58. *See In re* Merge Healthcare, 2017 WL 395981 at *13.