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Delaware Chancery Court Extends Cleansing Effect of Stockholder Approval under KKR to Two-Step Acquisition Structure

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DELAWARE CORPORATE LAW BULLETIN

Delaware Chancery Court Extends "Cleansing Effect" of Stockholder Approval Under *KKR* to Two-Step Acquisition Structure

*Robert S. Reder**

Court finds stockholder tender of majority shares in first step of DGCL § 251(h) merger equivalent to stockholder vote in one-step merger

Dismisses breach of fiduciary duty claim against target board and related aiding and abetting claim against its financial advisor

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INTRODUCTION

In the last nine months, Delaware courts have gone a long way towards clarifying the impact of a fully-informed stockholder vote on otherwise suspect actions of target corporation boards of directors and their financial advisors. Prior to this time, the Delaware Supreme Court's decision in *Gantler v. Stephens* ("*Gantler*")[1] left some doubt whether a stockholder vote *required* under the Delaware General

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1. 965 A.2d 695 (Del. 2009).

Corporation Law ("*DGCL*")—for instance, in the case of a statutory merger—could ratify otherwise tainted actions of a target board. On October 2, 2015, in *Corwin v. KKR Financial Holdings LLC* ("*KKR*"),[2] the Delaware Supreme Court resolved this issue. By declaring that "the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review,"[3] the Supreme Court provided an *ex post* vehicle to overcome a target board's potential breach of its duty of care in negotiating and approving a merger. Not insignificantly, this ruling also undercut a related aiding and abetting claim against the board's sell-side financial advisor.

The potential impact of the *KKR* "cleansing device" was demonstrated almost immediately in *In re Zale Corp. Stockholders Litigation ("Zale")*. In *Zale I*,[4] decided *before KKR*, Vice Chancellor Donald Parsons cited *Gantler* for the proposition that he could not dismiss an aiding and abetting claim against a sell-side financial advisor despite a fully-informed stockholder vote in favor of the merger. Soon after *KKR*, in *Zale II*, Vice Chancellor Parsons reversed course.[5] Applying the deferential business judgment standard of review to the target board's conduct, the Vice Chancellor determined that plaintiffs had not established a breach of duty of care on the part of the target board and, therefore, dismissed the related aiding and abetting claim against the sell-side financial advisor.[6]

Of course, corporate dealmakers and their legal advisors have two options for structuring acquisition transactions. Both *KKR* and *Zale* involved one-step mergers under DGCL § 251(c), which requires a target stockholder vote to approve a merger recommended by the target board.[7] Alternatively, DGCL § 251(h) contemplates a two-step transaction: a target board-recommended tender offer pursuant to a negotiated merger agreement, followed by a merger at the same consideration to convert shares not tendered in the first step.[8]

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2. 125 A.3d 304 (Del. 2015).

3. *Id.* at 306.

4. *In re* Zale Corp. Stockholders Litig., No. CV 9388-VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015) [hereinafter *Zale I*].

5. *In re* Zale Corp. Stockholders Litig., No. CV 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015) [hereinafter *Zale II*].

6. For a discussion of the Chancery Court decisions in the *Zale* litigation, *see* Robert S. Reder & Stephanie Stroup Estey, *Sell-Side Financial Advisors in the M&A Crosshairs*, 68 Vand. L. Rev. En Banc 279 (2016). *Zale II* was affirmed by the Delaware Supreme Court in *Singh v. Attenborough*, No. 645, 2015, 2016 WL 2765312 (Del. 2016). For a discussion of this decision, *see* Robert S. Reder, *Delaware Supreme Court Clarifies "Cleansing Effect" of Fully-Informed Stockholder Vote*, 68 Vand. L. Rev. En Banc 219 (2016).

7. DEL. CODE ANN. tit. 8, § 251(c) (2016).

8. DEL. CODE ANN. tit. 8, § 251(h) (2016).

Assuming that a majority of the outstanding shares are owned by the acquirer after the first step, the second step merger can be accomplished almost immediately by the filing of a certificate with the Delaware Secretary of State; no further action by the target board or the remaining stockholders is required.[9]

Following *KKR* and *Zale*, one obvious question was whether the "cleansing effect" of stockholder action in a one-step transaction is available in a two-step acquisition. In other words, is the first-step tender offer in a DGCL § 251(h) two-step transaction equivalent to the stockholder vote in a DGCL § 251(c) one-step transaction? This question was squarely addressed—and answered in the affirmative—by the Delaware Court of Chancery recently in *In re Volcano Corporation Stockholder Litigation*.[10]

I. BACKGROUND

Volcano Corporation ("Volcano") was "the global leader in intravascular imaging for coronary and peripheral applications[ ] and physiology."[11] In 2012, Volcano, in need of funds, pursued a convertible note offering underwritten by Goldman, Sachs & Co. ("Goldman") and J.P. Morgan Securities LLC. To offset the dilution that could arise from the eventual conversion of these notes into Volcano stock, Volcano entered into a hedging arrangement with the underwriters. This arrangement would be required to be unwound, with potential payments to the underwriters, in connection with a future sale of Volcano.

Two years later, the Volcano board decided to explore a sale of the company and, to that end, "retained Goldman to help perform a market check to gauge other companies' interest in a transaction."[12] Goldman contacted five potential strategic acquirers on behalf of Volcano, but none was willing to make a formal offer. Shortly thereafter, a U.S.-based subsidiary of the giant Dutch technology company Koninklijke Philips, N.V. ("Philips") "delivered a non-binding indication of interest to acquire Volcano for $24 per share, subject to an eight-week period of exclusivity during which it would perform due diligence."[13] At the time, Volcano's stock was trading at $16.18.

9. *Id.*
10. 2016 Del. Ch. LEXIS 99, C.A. No. 10485-VCMR (Del. Ch. June 30, 2016).
11. *Id.* at *3 (omission in original).
12. *Id.* at *9.
13. *Id.* at *11.

After an extended period of back and forth negotiations, during which Volcano's stock price declined to $12.56, Philips and Volcano ultimately agreed on a buyout at $18 per share. The acquisition was structured as a two-step acquisition under DGCL § 251(h). The transaction was received favorably by Volcano stockholders, who tendered nearly 95% of the outstanding shares into the first step tender offer. The second step was accomplished shortly after the closing of the tender offer. As a result, the hedging arrangements previously entered into automatically terminated, netting a $24.6 million payment to Goldman. This was in addition to the $17 million advisory fee that Goldman earned on the transaction.

After the merger was consummated, several Volcano stockholders, unhappy that Philips initially offered $24 per share but was able to buy the company at $18 per share, brought suit in the Chancery Court, seeking damages from both the Volcano directors and Goldman. Plaintiffs claimed that the "Board breached its duties of care and loyalty"[14] by (i) acting "in an uninformed manner in approving the Merger";[15] (ii) being "motivated by certain benefits—including the [CEO's] Consulting Agreement and the other Board members' accelerated vesting of stock options and restricted stock units—that its members stood to receive as a result of the Merger";[16] and (iii) relying on " 'flawed advice' rendered by its 'highly conflicted financial advisor,' Goldman."[17] Not only was Goldman conflicted due to its financial interest in the unwinding of the hedging arrangements, plaintiffs alleged, but Goldman "hid its conflicts from the Board and Volcano's stockholders."[18] As such, plaintiffs charged that Goldman aided and abetted the Board's breach.

Relying on *KKR* and *Zale*, the defendants moved to dismiss on the ground, among others, that "Volcano's stockholders approved the Merger by overwhelmingly tendering into the Tender Offer."[19]

II. THE CHANCERY COURT'S ANALYSIS

The primary task for Vice Chancellor Tamika Montgomery-Reeves in ruling on defendants' motion was to fix the applicable standard of review. Although the cash out of Volcano stockholders

14. *Id.* at *22.
15. *Id.* at *23.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at *24.

normally would trigger an enhanced level of scrutiny under *Revlon*,[20] the Volcano stockholders and Goldman argued that "because Volcano's fully informed, uncoerced, disinterested stockholders approved the Merger by tendering a majority of the Company's outstanding shares into the Tender Offer, the business judgment rule standard of review irrebuttably applies."[21] Plaintiffs countered that enhanced scrutiny remained applicable, because the stockholders' decision to tender their shares in the first step was not analogous to a stockholder vote in favor of a merger.[22]

To address this dispute, the Vice Chancellor both reviewed the Chancery Court and Supreme Court decisions in *KKR* and *Zale* and analyzed the background of the adoption of DGCL § 251(h). Based on this review and analysis, the Vice Chancellor concluded that:

> "[A]cceptance of a first-step tender offer by fully informed, disinterested, uncoerced stockholders representing a majority of a corporation's outstanding shares in a two-step merger under Section 251(h) has the same cleansing effect under [*KKR*] as a vote in favor of a merger by a fully informed, disinterested, uncoerced stockholder majority."[23]

As such, "the statutorily required vote" under DGCL § 251(h) "renders the business judgment rule irrebutable."[24] The Vice Chancellor cited the following factors in support of this conclusion:

- The "target board's role in negotiating a two-step merger subject to a first-step tender offer under DGCL § 251(h) . . . is substantially similar to its role in a merger subject to a stockholder vote under DGCL § 251(c) . . . ."[25] Specifically, DGCL § 251(h) "mandate[s] that a target corporation's board negotiate, agree to, and declare the advisability of the terms of both the first-step tender offer and the second step merger . . . just as a target corporation's board must negotiate, agree to, and declare

20. Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

21. *In re* Volcano, 2016 Del. Ch. LEXIS 99 at *25.

22. *Id.* at *26.

23. *Id.* at *51.

24. *Id.* at *28. In this connection, Vice Chancellor Montgomery-Reeves explained that "if the business judgment rule is 'irrebuttable,' then a plaintiff only can challenge a transaction on the basis of waste–*i.e.*, that it "cannot be 'attributed to any rational business purpose.' " *Id.* at *21, fn. 16. By contrast, absent a stockholder vote approving a transaction, when the applicable standard of review is business judgment, plaintiffs have an opportunity to rebut the favorable presumption of the rule by providing evidence of "a board's violation of either the duty of care or duty of loyalty" in order to "render the business judgment rule inapplicable." *Id.*

25. *Id.* at *36.

the advisability of a merger involving a stockholder vote under DGCL § 251(c)."[26]

- Moreover, "the target corporation's board has the same disclosure obligations" and is "subject to the same common law fiduciary duties, regardless of the subsection under which the merger is consummated."[27]
- The two-step cash merger is no more "coercive" than its one-step cousin, inasmuch as (1) the first step "must be for all of the target company's outstanding stock," (2) the second step must take place "as soon as possible following the first step," (3) the consideration paid in the two steps must be the same, and (4) appraisal rights are available to stockholders who dissent from either merger.[28]
- Additionally, "the same number of the target corporation's outstanding shares must approve a merger, regardless of whether it is consummated under Section 251(c) or Section 251(h)."[29]
- In the first step of a two-step merger, "[a] stockholder is no less exercising her 'free and informed chance to decide on the economic merits of a transaction' simply by virtue of accepting a tender offer rather than casting a vote."[30] And, similarly, "judges are just as 'poorly positioned to evaluate the wisdom of' stockholder-approved mergers under Section 251(h) as they are in the context of corporate transactions with statutorily required stockholder votes.' "[31]

With the deferential business judgment rule as her guidepost, Vice Chancellor Montgomery-Reeves next considered whether adequate disclosures had been provided to Volcano stockholders in connection with the first-step tender offer so as to make them "fully informed." Once she concluded adequate disclosure had been made,[32] and because

26. *Id.* at *37.
27. *Id.* at *37–38.
28. *Id.* at *39–40.
29. *Id.* at *40 n.52.
30. *Id.* at *42.
31. *Id.*
32. According to the Vice Chancellor, being "fully-informed" as to a transaction means being "apprised of 'all material information' related to that transaction." *Id.* at *55. Or, "[s]tated another way, there must be 'a substantial likelihood that the disclosure of the omitted fact would have been

no issue had been raised by plaintiffs whether the stockholders had been "coerced" or were "interested" in the transaction, the Vice Chancellor dismissed the fiduciary duty claims against the Volcano directors. And in the absence of either a predicate fiduciary duty breach by the directors or sufficient "financial advisor misconduct,"[33] the Vice Chancellor summarily dismissed the aiding and abetting claim against Goldman.[34]

CONCLUSION

One of the most interesting features of the *Volcano* decision is Vice Chancellor Montgomery-Reeves' reconciling of the two most typical public company acquisition structures. In fact, the reconciling of these two structures has been the focus of a long-standing debate over whether the Delaware courts should apply different standards of review to transactions structures that have the same result: the cashing-out of public company stockholders. Most of this debate has focused, not surprisingly, on buy outs of public company stockholders by control stockholders.[35]

In *Volcano*, the Vice Chancellor clearly opines that there should be no difference in the judicial treatment of these two acquisition structures when it comes to the "cleansing" effect of stockholder approval. Whether the acquisition is "approved" by a traditional stockholder vote under DGCL § 251(c) or *via* a tender of shares in a two-step transaction under DGCL § 251(h), if the stockholders are determined to have been fully-informed, disinterested, and uncoerced, irrebutable application of the deferential business judgment presumption will follow.

Moreover, the *Volcano* ruling should provide an additional degree of comfort to sell-side financial advisors who recommend alternative transaction structures to target company boards. Going forward, assuming the Delaware Supreme Court does not disagree, both directors and their legal and financial advisors will be free to recommend the optimal transaction structure for an acquisition

viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available.' " *Id.* at *54.

33. To the significant degree described in *RBC Capital Markets*. *Id.* at *60 (citing RBC Capital Mkts. v. Jervis, 129 A.2d 816, 865 (Del. 2015)).

34. *Id.*

35. *See, e.g.*, the proposals of then-Vice Chancellor Leo E. Strine, Jr. and Vice Chancellor J. Travis Laster about reconciling the judicial analysis of these two acquisition structures in *In re* Pure Res., Inc. Stockholders Litig., 808 A.2d 421 (Del. Ch. 2002); *In re* Cox Commc'ns Stockholder Litig., 879 A.2d 604 (Del. Ch. 2005); and *In re* CNX Gas Corp. Stockholders Litig., 4 A.3d 397 (Del. Ch. 2010).

transaction, without regard to the potential impact of that choice on their potential exposure to individual liability if things go wrong with the transaction.