Vanderbilt Law Review

Volume 70
Issue 7 *En Banc*

Article 13

2017

Delaware Court Refuses to Invoke Corwin to Cleanse Alleged Director Misconduct Despite Stockholder Vote Approving Merger

Robert S. Reder

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Recommended Citation

Robert S. Reder, Delaware Court Refuses to Invoke Corwin to Cleanse Alleged Director Misconduct Despite Stockholder Vote Approving Merger, 70 *Vanderbilt Law Review* (2024)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol70/iss7/13

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

DELAWARE CORPORATE LAW BULLETIN

Delaware Court Refuses to Invoke *Corwin* to "Cleanse" Alleged Director Misconduct Despite Stockholder Vote Approving Merger

*Robert S. Reder**

Alleged material omissions in disclosures to stockholders lead court to deny defendant directors' motion to dismiss; also addresses meaning of "coercion" in Corwin *context*

INTRODUCTION 199
I. FACTUAL BACKGROUND 202
II. VICE CHANCELLOR SLIGHTS' ANALYSIS 205
A. *Standard of Review* 205
B. *Breach of Fiduciary Duty* 207
CONCLUSION 208

INTRODUCTION

In the relatively brief period since the Delaware Supreme Court decided *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"), the opinion has taken on near-iconic proportions. Under *Corwin*, a fully-informed, uncoerced and disinterested

* Robert S. Reder, Professor of the Practice of Law at Vanderbilt University Law School, has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

stockholder approval can "cleanse" certain directorial breaches of fiduciary duty for purposes of a post-closing damages action contesting a merger and acquisition ("*M&A*") transaction. The medium for *Corwin* cleansing is a shift in the applicable standard of review to the business judgment rule, which generally results in dismissal of plaintiff's lawsuit. The *Corwin* court also clarified that stockholder approval is not limited to a formal ratification vote, but also applies to a vote required by the Delaware General Corporation Law ("*DGCL*"), such as a vote in connection with a statutory merger. In view of the explosion of M&A-related litigation, as well as the traditional respect shown by Delaware courts for informed stockholder votes, the *Corwin* court's willingness to defer to stockholder decisions in this context is, in retrospect, by no means surprising.

In the wake of *Corwin*, the Delaware Court of Chancery ("*Chancery Court*") has dismissed a not insignificant number of post-closing damages claims challenging target company director conduct in effecting M&A transactions. *Corwin* itself related to an alleged directorial breach of duty of care in the context of a one-step merger. The Chancery Court subsequently extended *Corwin* to two-step mergers,[1] as well as to breach of duty of loyalty claims arising from M&A transactions not involving "a controlling stockholder *that extracted personal benefits*."[2] *Corwin* also has been employed to dismiss an aiding and abetting claim against an allegedly conflicted financial advisor by cleansing the predicate breach of fiduciary duty by the target company board.[3] Further, on the procedural side, Delaware courts have ruled that:

- when *Corwin* is applicable, the shift in the standard of review to the business judgment rule essentially is "irrebutable";[4]

1. *Corwin*'s stockholder approval requirement also can be met when stockholders surrender their shares in a tender offer in the first step of a two-step merger, so long as the disclosures surrounding the offer are adequate. *In re* Volcano Corp. S'holders Litig., 143 A.3d 727 (Del. Ch. 2016), *aff'd*, Lax v. Goldman, Sachs & Co. (*In re* Volcano Corp. S'holder Litig.), 156 A.3d 697 (Del. 2017). For a discussion of the *Volcano* decision, see 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).

2. *In re* Merge Healthcare Inc. S'holders Litig., C.A. No. 11388-VCG, 2017 WL 395981 at *6 (Del. Ch. Jan. 30, 2017) (quoting Larkin v. Shah, C.A. No. 10918-VCS, 2016 WL 4485447 at *1 (Del. Ch. Aug. 25, 2016)). For a discussion of these and related decisions, see Robert S. Reder & Tiffany M. Burba, *Delaware Courts Confront Question Whether "Cleansing Effect" of* Corwin *Applies to Duty of Loyalty Claims*, 70 VAND. L. REV. EN BANC 187 (2017).

3. *See* Singh v. Attenborough, 137 A.3d 151 (Del. 2016) (affirming a Chancery Court 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.").

4. *Id.*

- 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;[5]
- plaintiffs are expected to fulfill their pleading burden even in the absence of a full discovery process, although they can rely on the fact that the pleading standard at this stage of the proceedings is only one of "colorability";[6] and
- plaintiffs are 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.[7]

Most of the decisions that have relied on *Corwin* to dismiss claims against target company directors have recited numerous infirmities in the challenged sales process yet, in light of fully informed, uncoerced approvals by stockholders, elected to defer to stockholder will. Given the apparent breadth of *Corwin* and the manner in which it has been applied by the Chancery Court, it is interesting to speculate on the level of directorial misconduct required for the Chancery Court to decide *not to defer* to a stockholder vote approving an M&A transaction. The recent decision by Vice Chancellor Joseph R. Slights III in *In re Saba Software, Inc. Stockholder Litigation*[8] ("*Saba Software*") presents those very circumstances. In the words of the Vice Chancellor, "[t]he so-called *Corwin* doctrine . . . only applies 'to fully informed, uncoerced stockholder votes, and if *troubling facts* regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked.' "[9] The "troubling facts" that led Vice Chancellor Slights to refuse to apply *Corwin* in *Saba Software* were indeed extreme: "[T]here was an elephant in the [Saba Software] boardroom from 2012 forward. The Company had engaged in fraud."[10]

5. *In re* Solera Holdings, Inc. S'holder Litigation, C.A. No. 11524-CB, 2017 WL 57839 at *7-8 (Del. Ch. Jan. 5, 2017) (emphasis added).
6. *Id.* at *8 (citing Nguyen v. Barrett, C.A. No. 11511-VCG, 2016 WL 5404095 at *3 (Del. Ch. Sept. 28, 2016)).
7. *In re* Merge Healthcare Inc. S'holders Litigation, C.A. No. 11388-VCG, 2017 WL 395981 at *10 (Del. Ch. Jan. 30, 2017).
8. C.A. No. 10697-VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017).
9. *Id.* at *7 (emphasis added).
10. *Id.* at *20.

I. FACTUAL BACKGROUND

Saba Software, Inc. ("*Saba*" or the "*Company*") is a provider of "cloud-based human resources solutions, such as products and services for employee training, performance evaluations, employee planning, collaboration tools, succession planning and recruiting."[11] Saba's common stock was traded on the Nasdaq Stock Exchange ("*Nasdaq*") until Nasdaq delisted the stock in June 2013. After that time, the stock traded in the over-the-counter market.

In September 2014, the Securities and Exchange Commission ("*SEC*") issued a complaint charging that "Saba's Indian subsidiary engaged in millions of dollars of financial fraud beginning in 2008 and ending in the second half of 2012."[12] This fraud in turn caused "Saba to overstate its pretax earnings by $70 million from 2007 to 2011."[13] An understanding of what happened next is best gained by examining the chronology of events:

- *September 24, 2014*: Saba enters into a settlement with the SEC providing for a substantial civil penalty, a cease and desist order and, notably, an agreement to publicly file restated financial statements (the "*Restatement*") by February 15, 2015. Following the announcement of the SEC settlement, the trading price of Saba's common stock falls to $14.08 per share.
- *November 17, 2014*: Saba receives an oral indication of interest from private equity firm Thoma Bravo, LLC ("*Thoma Bravo*") to purchase Saba at $11 per share.
- *November 19, 2014*: Saba's financial advisor, Morgan Stanley, advises that it has approached eleven potential buyers but, due to their "concerns about the impact of the restatement and SEC regulations on consummating a timely transaction . . . ,"[14] only Thoma Bravo is interested in pursuing a bid.
- *December 10, 2014*: Morgan Stanley advises that Thoma Bravo, who remains the only active bidder, is going to drop its bid to below $9 per share due "at least in part, to Saba's inability to complete the Restatement and concerns about the SEC's reaction to an acquisition."[15]

---

11. *Id.* at *2.
12. *Id.* at *3.
13. *Id.*
14. *Id.* at *4.
15. *Id.*

- *December 15, 2014*: Saba publicly announces it will not complete the Restatement by the required date, it is "evaluating strategic alternatives, including a sale of the Company" and, to that end, it is "engaging in 'preliminary discussions with potential acquirers.' "[16] By the end of the day, Saba's trading price falls to $8.75 per share.
- *December 31, 2014*: Although Morgan Stanley has contacted 26 potential bidders, the only bid on the table is Thoma Bravo's $8-$9 per share proposal.
- *January 15, 2015*: Private equity firm Vector Capital Management, L.P. ("*Vector*") submits an indication of interest to purchase Saba at $9 per share; shortly thereafter, Saba receives offers from several other private equity firms at prices "ranging from $5.25-$9 per share."[17]
- *January 20, 2015*: Saba publicly announces (without specifying a buyer or any deal terms) "its intention to enter into a definitive acquisition agreement prior to the February 15, 2015 Restatement deadline if the Board determined that pursuing a sale was in the best interests of the Company."[18]
- *February 2, 2015*: Vector confirms its $9 per share offer, indicating that it is prepared to sign a merger agreement in short order following "some confirmatory accounting and legal diligence." Saba offers a counterproposal of $9.25 per share.
- *February 3, 2015*: Vector rejects Saba's counterproposal.
- *February 4, 2015*: Saba grants Vector exclusive negotiating rights for one week.
- *February 9, 2015*: The Saba board (i) grants themselves over $5 million of restricted stock units (the "*Equity Awards*") "that would be cashed out upon consummation of the merger in place of 'unvested, suspended, lapsed and/or cancelled equity awards,' including those suspended, lapsed and/or canceled due to the Company's failure to complete the Restatement";[19] and (ii) approves Vector's acquisition of the Company at $9 per share, slightly above that day's $8.94 market close.

16. *Id.* at *3.
17. *Id.* at *5.
18. *Id.*
19. *Id.* at *6.

- *February 10, 2015*: Saba and Vector execute a merger (the "Merger") agreement and publicly announce the transaction.
- *February 15, 2015*: Saba misses the SEC deadline for filing the Restatement.
- *February 19, 2015*: The SEC deregisters Saba's common stock due to its failure to timely file the Restatement, "meaning that the stock was ineligible for trading using means of interstate commerce and, therefore, essentially illiquid."[20]
- *March 6, 2015*: Newly-freed from the SEC's proxy rules, Saba mails its proxy materials to its stockholders soliciting their votes in favor of the transaction, only 24 days after signing the Merger agreement.
- *March 26, 2015*: Saba stockholders, faced with "the choice ... either to accept the $9 per share Merger consideration, well below its average trading price over the past two years, or continue to hold their now-deregistered, illiquid stock," vote to approve the transaction.
- *March 30, 2015*: Transaction closes.

Post-closing, a former Saba stockholder brought suit in the Chancery Court, seeking damages from Saba's directors. Plaintiff claimed that the directors breached their fiduciary duties in connection with the sales process. The defendant directors moved to dismiss, asserting grounds that generally have been successful in the post-*Corwin* era:

- *First*, relying on *Corwin*, the directors argued the transaction had been " 'cleansed' by a fully informed, uncoerced stockholder vote and therefore is subject to the business judgment rule."[21]
- *Second*, even if "cleansing" under *Corwin* was not available, the directors claimed they were exculpated from personal liability by virtue of a provision in Saba's

20. *Id.* This was not necessarily a bad development for Saba. As Morgan Stanley explained to the board, "by signing a deal before the deregistration date, Saba 'would be able to consummate a transaction ... [that] it may not normally be able to accomplish if it was still under the purview of the SEC.' " *Id.* at *4.

21. *Id.* at *7.

certificate of incorporation authorized by section 102(b)(7) of the DGCL (the "*Exculpation Provision*").[22]

In denying defendant directors' motion to dismiss, Vice Chancellor Slights rejected both of these arguments.

II. VICE CHANCELLOR SLIGHTS' ANALYSIS

A. Standard of Review

At the outset, Vice Chancellor Slights addressed the "gating issue" of the standard of review applicable to the Saba directors' conduct. To that end, the Vice Chancellor considered whether "cleansing" under *Corwin* might be available, dividing his analysis into two segments: *first*, the now typical *Corwin* question, did plaintiff adequately plead that "the stockholder vote was not fully informed" [23] and, *second*, an unaddressed area of analysis, did plaintiff adequately plead that "the stockholder vote was coerced"? Answering both questions in the affirmative, the Vice Chancellor ruled that *Corwin* cleansing would not be available and, as a result, defendant directors' conduct would be subject to "enhanced scrutiny."[24]

Was the vote fully informed? The Vice Chancellor explained that "to overcome a *Corwin* defense, 'the plaintiff ... must first identify a deficiency in the operative disclosure document, at which point the burden would fall to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of that vote.' "[25] Plaintiff identified four potential material omissions in Saba's proxy statement, two of which the Vice Chancellor believed met the threshold necessary to deny directors' motion to dismiss. Specifically,

---

22. *Id.* A third argument, that plaintiff was barred, post-merger, from bringing claims of a derivative nature against former Saba directors, was rejected by Vice Chancellor Slights on the basis that plaintiff's claim was direct and not derivative. *Id.*

23. *Id.* at *8. In this connection, Vice Chancellor Slights noted that plaintiff had not raised disclosure issues in a pre-stockholder vote action to enjoin the transaction, the "preferred means to address serious disclosure claims . . . ." *Id.* at *8. Such failure, however, did not bar plaintiff from bringing "disclosure claims post-closing." *Id.* This is consistent with the position taken earlier this year by Vice Chancellor Sam Glasscock III in *In re Merge Healthcare Inc. Stockholders Litigation*, C.A. No. 11388-VCG, 2017 WL 395981 at *10 (Del. Ch. Jan. 30, 2017). *See supra* note 7.

24. The court declined to address which party bore the burden of proof in this context: "Which party will bear what burden in the context of this post-close *Revlon* claim, and the impact of the exculpatory provision in Saba's charter on the burden of proof, are issues that the parties have not had an opportunity to address and which the Court will address as appropriate later in this litigation." *Saba Software.*, C.A. No. 10697-VCS, 2017 WL 1201108 at *17 n.101.

25. *Id.* at *8 (citing *In re* Solera Holdings Inc. S'holder Litig., C.A. No. 11524-CB, 2017 WL 57839 at *7-8 (Del. Ch. Jan. 5, 2017)).

the Vice Chancellor was concerned that Saba stockholders were not provided with adequate information concerning the reasons for the Company not having prepared the Restatement and prospects for coming into compliance with the SEC order so as to put them in a position to "evaluate the choice they were being asked to make—accept merger consideration that reflected the depressed value caused by the Company's regulatory non-compliance or stay the course in hopes that the Company might return to the good graces of the SEC."[26]

Was the vote coerced? The Vice Chancellor explained that "[t]he court will find wrongful coercion where stockholders are induced to vote 'in favor of the proposed transaction for some reason other than the economic merits of the transaction.' "[27] Accordingly, the Vice Chancellor asked "whether the stockholders have been permitted to exercise their franchise free of undue external pressure created by the fiduciary that distracts them from the merits of the decision under consideration."[28] Answering this question in the negative, the Vice Chancellor again focused on the "Hobson's choice" faced by Saba stockholders of either voting in favor of the transaction or retaining their stock "in the midst of its regulatory chaos."[29] The "forced timing" of the transaction, as well as the "failure to disclose why the Restatement had not been completed" and "what financing alternatives might be available to Saba if it remained a standalone company," left "Saba stockholders staring into a black box as they attempted to ascertain Saba's future prospects as a standalone company," leaving them "with no practical alternative but to vote in favor of the Merger."[30]

In response to defendant directors' contention that "affirmative action is a predicate to wrongful coercion," Vice Chancellor Slights explained that "[i]nequitable coercion can exist as well when the fiduciary *fails to act* when he knows he has a duty to act and thereby coerces stockholder action."[31] In examining whether "inequitable coercion" might have occurred, the Vice Chancellor focused not so much on the disclosure's "words or even its tone," but rather on "the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction. Stated succinctly, the Board created a 'circumstance[ ] [that was] impermissibly coercive.' "[32]

---

26. *Id.* at *12.
27. *Id.* at *14.
28. *Id.*
29. *Id.* at *15.
30. *Id.*
31. *Id.* at *16 (emphasis added).
32. *Id.*

B. Breach of Fiduciary Duty

Applying the lens of enhanced scrutiny rather than business judgment, Vice Chancellor Slights turned to the specific claims brought against the Saba directors. Plaintiff alleged the directors breached their fiduciary duties "by 'fail[ing] to negotiate a full and fair price for Saba's public shares following a process riddled with missteps and conflicts of interest.' "[33] The Vice Chancellor explained that the Exculpation Provision, which protected Saba directors "from claims they violated their duty of care," offered no such protection when it comes to "alleged acts of bad faith or other breaches of the duty of loyalty."[34]

Of course, pleading facts to establish that degree of culpability on the part of individual directors is no small task. Specifically, plaintiff was required to plead that the directors "consciously disregarded their duties, 'knowingly and completely failed to undertake their responsibilities,' and 'utterly failed to attempt to obtain the best sale price.' "[35] According to the Vice Chancellor, plaintiff had pled "adequate facts" to "justify a pleading-stage inference of bad faith," including that the Saba directors "rushed the sales process," "refused to consider alternatives," "cashed-in significant, otherwise worthless equity awards," encouraged their financial advisor to rely on "the most pessimistic projections," and "rushed the stockholder vote after supplying inadequate disclosures."[36] Similarly, he found that plaintiff's assertions that "each member of the Board ... endors[ed] a less than value-maximizing transaction so that they could achieve material personal benefits in the form of cash for their otherwise illiquid equity awards" supported a pleading stage determination the directors violated their duty of loyalty.

Based on the foregoing, Vice Chancellor Slights concluded:

> Plaintiff has pled a non-exculpated claim of bad faith and breach of the duty of loyalty by stating facts that support pleadings-stage inferences that the Board knowingly failed to disclose material information to stockholders and was motivated to approve the Merger so that its members could cash-in on equity options and restricted stock units that would otherwise have been illiquid as a consequence of the deregistration of the Company's stock.[37]

As a result, the Vice Chancellor denied the directors' motion to dismiss.

33. *Id.* at *17.
34. *Id.* at *19.
35. *Id.* at *20.
36. *Id.* at *21.
37. *Id.* at *1.

CONCLUSION

Vice Chancellor Slights' opinion in *Saba Software* demonstrates that, post-*Corwin*, plaintiffs and their litigation counsel still have an opportunity to avoid the cleansing effect of a stockholder vote by pleading adequate facts demonstrating material misstatements or omissions in disclosures to stockholders, or circumstances indicating coercion of the vote. The pleading bar to avoid invocation of *Corwin*, however, is a high one.