Vanderbilt Law Review

Volume 73
Issue 7 *En Banc*

Article 1

2020

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Recommended Citation

Robert S. Reder and Kelsey R. McKeag, Delaware Court Refuses Corwin "Cleanse" due to Inadequate Disclosures of Conflicts of Interest and Financial Projections, 73 *Vanderbilt Law Review* (2024)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol73/iss7/1

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DELAWARE CORPORATE LAW BULLETIN

Delaware Court Refuses *Corwin* "Cleanse" Due to Inadequate Disclosures of Conflicts of Interest and Financial Projections

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Court also declines to dismiss related aiding and abetting claims against financial advisor and purchaser

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INTRODUCTION

The Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*") allows for the "cleansing" of breaches of fiduciary duties by target company directors in approving a sale transaction, but only if the transaction "is approved by a fully informed, uncoerced vote of disinterested stockholders." Application of *Corwin* facilitates pleading-stage dismissal of fiduciary breach claims. *Corwin's* progeny have delineated the boundaries of its applicability. For instance, in *Appel v. Berkman*, 180 A.3d 1055 (Del. 2018) ("*Appel*"), the Delaware Court of Chancery (the "*Chancery Court*") held that material omissions or materially misleading inclusions in disclosures provided to stockholders in connection with their vote will preclude application of *Corwin*. (For a discussion of *Appel*, see Robert S. Reder & John L. Daywalt, *Delaware Supreme Court Reverses Dismissal of Fiduciary Breach Claims Against Target Company Directors*, 71 VAND. L. REV. EN BANC 59 (2018).)

Even in the absence of a "cleansing" stockholder vote, plaintiffs face a high bar to successfully plead a breach of fiduciary duty against target company directors. Section 102(b)(7) of the Delaware General Corporation Law ("*DGCL § 102(b)(7)*") permits corporations to exculpate directors from damages arising from a breach of their duty of care. As a result, to avoid dismissal of their claims in the face of a DGCL § 102(b)(7) provision, unhappy stockholders must plead that the directors breached their duty of loyalty or failed to act in good faith.

In *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, C.A. No 2017-0421-KSJM (Del. Ch. June 21, 2019) ("*Chester County*"), Vice Chancellor Kathaleen St. J. McCormick refused to grant dismissal of a former stockholder's challenge of a completed sale of the target company. *First*, she found that defendant directors' *Corwin* defense failed due to the inadequacy of disclosures made to stockholders. *Second*, the "inference of bad faith" on the part of defendant directors was adequately supported by allegations relating to both the negotiation and approval process for the transaction.

Moreover, the *Chester County* plaintiff was found to have successfully pled that the target company's financial advisor and the purchaser of the target company aided and abetted the directors'

alleged fiduciary breach, despite the high bar faced by a plaintiff asserting such claims. Finding that the plaintiff adequately pled "knowing participation" on the part of the financial advisor and purchaser in the target board's alleged breach, the Vice Chancellor likewise refused to dismiss the aiding and abetting claims.

I. FACTUAL BACKGROUND

A. Virtu Discusses Acquiring KCG with Jefferies

KCG Holdings, Inc. ("*KCG*") was a financial services firm offering "market-making, high-frequency trading services across asset classes, product types, and time zones." KCG's long-standing financial advisor, Jefferies LLC ("*Jefferies*"), held a significant equity stake in KCG. In fact, after advising KCG to repurchase stock from a large institutional investor, Jefferies became KCG's largest stockholder, owning 24% of KCG's outstanding shares.

In December 2016, Virtu Financial, Inc. ("*Virtu*"), one of "KCG's primary competitors," informed Jefferies of its interest in acquiring KCG. In response to Virtu's proposed purchase price of $17 to $18 per share, Jefferies proposed an alternative valuation of KCG assuming the sale of its "standalone bond trading platform, BondPoint." In particular, Jefferies believed the sale of BondPoint would "raise KCG's TBV ['the value of a company's equity after removing intangible assets'] by more than $2.20 per share to between $21 and $21.50 per share."

Without disclosing its previous discussions with Virtu, Jefferies suggested to KCG's CEO, Daniel Coleman, that KCG sell BondPoint. At the time, KCG and Jefferies were working on a restructuring plan ("*Restructuring Plan*"). Coleman rebuffed this suggestion, stating that "a sale of BondPoint might be worth considering after the restructuring."

On February 14, 2017, Jefferies provided confidential, non-public information to Virtu concerning KCG. Jefferies had obtained this information in its capacity as KCG's financial advisor. The following day, Jefferies "floated a potential price range" of $18 to $20 per share to Virtu. Subsequent discussions between Jefferies and Virtu regarding "the timing and contents of Virtu's initial bid to KCG" indicated "Jefferies and Virtu had reached a meeting of the minds that Jefferies would support Virtu's acquisition" of KCG at $20 per share.

Then, on February 21st, Jefferies first informed KCG of Virtu's interest in acquiring KCG. However, Jefferies "did not disclose to Coleman or anyone else at KCG that [t]he[y] had been negotiating with Virtu over the past two months." The following day, a Jefferies

representative did mention the February 14th meeting with Virtu to KCG's deputy general counsel, but neglected to address the other communications with Virtu.

B. Virtu Makes an Offer

On February 23rd, Virtu presented KCG with a "non-binding indication of interest to acquire KCG at a price in the range of $18.50 to $20 per share in cash." This offer "represented a significant premium" over KCG's then-current stock price of $14.31. In response, Coleman "accelerated management's efforts on the Restructuring Plan," believing it more lucrative and stable than a deal with Virtu. Coleman, still unaware of Jefferies' interactions with Virtu, engaged Jefferies "to help formulate the Restructuring Plan." At the same time, a four-person committee of outside directors established by KCG's board of directors (the "*Board*") selected Goldman Sachs ("*Goldman*") to advise KCG in its negotiations with Virtu.

On March 14th, Jefferies "reached out to KCG to encourage it to engage in discussions with Virtu." Unaware of Jefferies' behind-the-scenes maneuvering, at a March 15th meeting, the Board followed Jefferies' recommendation to engage with Virtu, even though the Board had "concluded that Virtu's offer, even at the $20 per share price at the top-end of the range, undervalued KCG." Subsequently, Coleman sent a letter to Virtu conditioning "further discussion" on Virtu raising the offer price and providing "retention and compensation plans for KCG's employees." By March 17th, Virtu and KCG signed a non-disclosure agreement granting Virtu access to KCG's data room.

Jefferies, frustrated that "KCG [had] selected Goldman over Jefferies," continued to insist it be "retained as an advisor on the merger." For his part, due to his growing concern about Jefferies's trustworthiness, Coleman requested further information from Jefferies regarding its communications with Virtu and directed Virtu to interact directly with Goldman. In response to this request, Jefferies provided Coleman with an incomplete timeline which omitted "reference to the February 16 meeting . . . regarding KCG's value; that [Jefferies] assisted Virtu in drafting its initial February 23 bid letter; and that Jefferies shared confidential information with Virtu regarding BondPoint." To placate Jefferies, Coleman "offered Jefferies a $1 million advisory fee for the Restructuring Plan" and proposed to the Board that "Jefferies serve as a co-advisor with Goldman on the merger." The Board rejected this recommendation.

Subsequent to the March 15th Board meeting, several news outlets released articles about Virtu's offer for KCG. This led both KCG

and Virtu to confirm the news accounts publicly. After KCG revealed the offer from Virtu was "to acquire all of the outstanding KCG common stock for $18.50 to $20.00 per share in cash," KCG's stock price increased and several other potential acquirers contacted Coleman. However, each of these parties ultimately withdrew its interest.

C. KCG and Virtu Conclude Negotiations

Virtu made a formal offer of $18.50 per share in cash in an April 10th bid letter that also mandated "a voting agreement requiring Jefferies to support a sale of KCG to Virtu." Jefferies then emailed Coleman, stating it had "direct reason to be highly confident" that "V[irtu] would do a deal at 20 dollars per share." Coleman reported this to the Board on April 11th, while at the same time "reiterat[ing] that the Restructuring Plan could return $500 million to KCG shareholders within the next five fiscal years," creating about 25% more value than Virtu's bid with "significant additional upside" depending on market volatility. KCG's Board countered Virtu's bid with "an open-ended price per share above $20.00."

The next day, Virtu responded with a $20 per share "best and final" offer. Jefferies informed KCG it would support the offer. At a meeting held later that day, all Board members, with the notable exception of Coleman, voted to counteroffer at $20.21 per share. Coleman believed Virtu's offer was "still too low," but "promised to support the offer if Virtu could eliminate 'closing risks,' " particularly risks for KCG employees. Accordingly, Coleman delivered the $20.21 counteroffer to Virtu, adding that Board approval was conditioned on "Virtu's agreement to a compensation and retention pool for KCG's employees." After Virtu delayed in responding, KCG's Board Chair suggested in an email to Coleman that Coleman could "perhaps . . . get the comp issue resolved and *then* . . . resolve the price issue."

Taking up this suggestion, Coleman created an exhibit for Virtu "illustrating . . . a $13 million difference on the amount of bonus compensation for KCG's top management (close to the $13.5 million difference between KCG's $20.21 counter-offer and Virtu's $20 bid)." On April 17th, Virtu rejected KCG's counteroffer but agreed to the compensation pool suggested by Coleman. KCG's Board Chair welcomed this as "good news," despite Virtu's rejection of the counteroffer, and responded to Coleman via email: "[G]reat news. Thank you for your understanding on this. The Board is very appreciative of this."

On this basis, the Board "unanimously approved Virtu's $20 offer," conditioned on a fairness opinion from Goldman, and Jefferies

signaled its willingness to sign the voting agreement with Virtu. Seemingly to facilitate Goldman's fairness analysis, Coleman proceeded to "revise[ ] KCG's projections downward." The Board approved this revision via email that very evening to meet the "Board's self-imposed deadline" for the transaction. Goldman then utilized the newly-revised projections to change cash flow assumptions, causing Virtu's bid to move "from the bottom to the middle of the DCF range." Goldman's fairness opinion was circulated to the Board early on the morning of April 20th. By 7 a.m., the Board met to approve the transaction.

KCG filed its definitive proxy statement to solicit stockholder support of the transaction with the Securities and Exchange Commission on June 1st. At a special stockholder meeting held on July 19th, 75.5% of KCG's shares were voted in favor of the transaction. Virtu's acquisition of KCG closed the following day.

The day after KCG filed the proxy statement, Virtu informed Jefferies of its intention to proceed with the sale of BondPoint once it completed the purchase of KCG. Jefferies provided a BondPoint pitch book to Intercontinental Exchange, Inc., a potential acquirer, well before the KCG stockholder vote. By October 24th, Virtu agreed to sell BondPoint to Intercontinental Exchange for $400 million. Jefferies received a $7 million fee for its role as Virtu's financial advisor on this transaction.

D. Litigation Ensues

On February 14, 2018, a former KCG stockholder filed a complaint with the Chancery Court against the KCG directors (the "*Director Defendants*"), Jefferies, and Virtu, asserting, among other things: (1) the "Director Defendants breached their fiduciary duties" and (2) "Virtu and Jefferies respectively aided and abett[ed] in the Director Defendants' breach of fiduciary duties." The Director Defendants moved to dismiss.

II. VICE CHANCELLOR MCCORMICK'S ANALYSIS

A. Breach of Fiduciary Duties

Plaintiff claimed Director Defendants breached their fiduciary duties to KCG stockholders while facilitating the transaction with Virtu. Vice Chancellor McCormick divided this part of her analysis into two segments: *first,* did plaintiff adequately plead—for purposes of surviving the motion to dismiss—that the KCG stockholder vote was not fully informed and uncoerced, thereby precluding business

judgment review under *Corwin*, and *second*, even if *Corwin*-cleansing was not available, did plaintiff adequately plead a non-exculpated claim for breach of fiduciary duties against the Director Defendants? Answering both questions in the affirmative, the Vice Chancellor denied Defendant Directors' motion to dismiss.

1. Stockholder vote not fully informed

One way for a plaintiff to avoid business judgment review under *Corwin* is to plead a disabling deficiency in the disclosures provided to stockholders to solicit their votes. To plead such a disclosure deficiency, the complaint must "support[ ] a rational inference that material facts were not disclosed or that the disclosed information was otherwise materially misleading." In *Corwin*, the Delaware Supreme Court specified that partial disclosure "is not sufficient to meet a fiduciary's disclosure obligations" but, rather, "[o]nce defendants travel[ ] down the road of partial disclosure . . . accurate, full, and fair" disclosure becomes necessary. Of the five categories of alleged inadequate disclosures, Vice Chancellor McCormick determined three "demonstrate[d] that it [was] reasonably conceivable that the stockholder vote was not fully informed":

- *First*, the Vice Chancellor accepted plaintiff's argument that the proxy statement did not adequately disclose that the BondPoint divestiture became a "working assumption" in Virtu's pricing strategy after Jefferies provided "BondPoint-specific information" to Virtu for that reason.

- *Second*, the proxy statement failed to address either Coleman's change in position on the adequacy of the price offered by Virtu or that he "secured a benefit" (the management compensation plan) as part of his change in position. The Vice Chancellor concluded this information was more substantial than mere "play-by-play details" and, instead, "support[ed] an inference of a material deficiency."

- *Finally*, the Vice Chancellor rejected the Director Defendants' proposed "bright-line rule" that the proxy statement need disclose only the financial projections actually "relied upon by the Board and its financial advisor" to the exclusion of the earlier management projections. Rather, "if the circumstances surrounding the preparation of final projections relied upon by the Board and disclosed to stockholder[s] cast doubt on their

> reliability, then those circumstances should be disclosed." In this case, the last-minute creation and overnight Board approval of more pessimistic projections, immediately after the transaction price had been approved in conjunction with the negotiation of the management compensation package, as well as their impact on Goldman's fairness opinion, "cast doubt on their reliability."

Based on these findings, Vice Chancellor McCormick deemed business judgment review under *Corwin* unavailable.

2. Plaintiff stated a non-exculpated claim for breach of fiduciary duties

KCG's certificate of incorporation, consistent with DGCL § 102(b)(7), exculpated Director Defendants from personal liability for breach of their duty of care. As a result, to survive a motion to dismiss, plaintiff was required to plead that the Director Defendants breached their duty of loyalty or failed to act in good faith. In this vein, plaintiff argued "the majority of the Director Defendants acted in bad faith by failing to cabin Coleman's conflict or prevent Coleman from downwardly revising the projections."

To support this claim, plaintiff contended that Coleman's interest in the management compensation plan conflicted with his role as prime negotiator of the transaction price with Virtu. The Director Defendants not only were aware of this conflict, but "authorized Coleman to negotiate both the compensation pool *and* the deal price" and, in the case of the Board Chair, applauded the results of his efforts to trade the former for the latter. Moreover, the Board countenanced the downward revision of the financial projections, making the Virtu offer "look more attractive," and approved those revisions over email "without any deliberation."

Vice Chancellor McCormick found, on the strength of plaintiff's pleadings, "it is reasonably conceivable that the Director Defendants placed management's interests ahead of their obligation to maximize stockholder value." Therefore, she concluded, plaintiff's complaint "supports an inference of bad faith, and states a non-exculpated claim" for breach of fiduciary duties for purposes of Director Defendants' motion to dismiss.

B. Aiding and Abetting

Turning to the claims asserted against Jefferies and Virtu, Vice Chancellor McCormick explained that when a party "knowingly

participates in any fiduciary breach," it may face liability for "aiding and abetting" that breach. To "knowingly participate" in a fiduciary breach, the aider and abettor must act "with the knowledge that the conduct advocated or assisted constitutes such a breach." Participation in the creation of an "informational vacuum," or otherwise misleading a board of directors, can lead to liability if there are "well-pled facts that the aider and abettor acted with 'scienter,' or 'knowingly, intentionally or with reckless indifference.' " The Vice Chancellor, finding plaintiff's pleadings met this high bar, refused to grant early dismissal to Jefferies and Virtu.

1. Jefferies

Plaintiff claimed Jefferies, through its creation of an "informational vacuum" and by intentionally misleading the Director Defendants, knowingly participated in the Director Defendants' breach of fiduciary duties. Utilizing "allegedly confidential KCG information," Jefferies and Virtu essentially committed to a transaction price before Jefferies even informed the Director Defendants of Virtu's interest in acquiring KCG. Later, when asked to disclose these communications to the Board, Jefferies failed to provide comprehensive information. The Vice Chancellor concluded this was ample evidence to "give rise to an inference" of Jefferies' "knowing participation at the pleadings stage" in the Director Defendants' breach of fiduciary duties.

2. Virtu

Similarly, plaintiff claimed Virtu aided and abetted the Director Defendants' breach of fiduciary duties by working with Jefferies "to pressure 'the Board to approve the Merger for a less-than-value-maximizing price,' " utilizing "confidential information" provided to it by Jefferies, and "exploit[ing] Coleman's conflict to obtain his support." Though Vice Chancellor McCormick characterized these allegations as "slightly less compelling" than those against Jefferies, she nevertheless determined they were sufficient to survive pleading stage dismissal.

CONCLUSION

Vice Chancellor McCormick's opinion in *Chester County* is a useful summary of the factual basis necessary to plead a disclosure deficiency sufficient to overcome application of the business judgment rule under *Corwin* and, subsequently, to state a non-exculpated claim for breach of fiduciary duties. Though by no means groundbreaking, this decision exemplifies a consolidation of previous case law

manifesting the classic problems inhibiting *Corwin*-cleansing and, ultimately, a refusal by the trial court to dismiss allegations of fiduciary breach at the pleadings stage: a conflicted financial advisor, priority given to management compensation over stockholder value, a negotiation led by management, an undisclosed CEO dissent, and the downward revision of financial projections under suspect circumstances. Moreover, the Vice Chancellor's refusal to dismiss the related aiding and abetting claims against Jefferies and Virtu indicates that awareness of and participation in such problematic matters by other transaction participants—in this case, the target company's financial advisor and the acquiring company—may similarly prevent these participants from obtaining pleadings-stage dismissal.