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DELAWARE CORPORATE LAW BULLETIN

Chancery Court Dismisses *Revlon* Claims Without Considering Directors' Potential *Corwin* Defense

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Demonstrates high bar faced by stockholders asserting non-exculpated claims of board domination by controlling stockholder, disabling board conflicts, and directorial bad faith

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INTRODUCTION

Stockholders unhappy with corporate mergers can seek damages from target company directors based on their alleged breach of standards first prescribed in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) ("*Revlon*"). Simply stated, *Revlon* requires target company directors, when engaged in a sale of the company, to seek the highest value reasonably available to stockholders under the circumstances. *Revlon* challenges usually are accompanied by claims that the directors violated their duty to provide materially correct disclosures in the documents used to solicit stockholder consent to the merger.

Defendant-directors may contest *Revlon* and related disclosure claims on both substantive and procedural grounds. At the substantive level, pursuant to section 102(b)(7) of the Delaware General Corporation Law, most Delaware corporations include an exculpatory provision in their certificates of incorporation insulating directors from personal liability for breach of their duty of care ("*Exculpatory Provision*"). Thus, a plaintiff-stockholder seeking damages from target company directors must adequately allege that the directors violated their non-exculpated fiduciary duty of loyalty, because of board domination by a controlling stockholder, board-level conflicts, or bad faith. As such, the plaintiff-stockholder faces a heavy pleading burden to defeat the directors' inevitable motion to dismiss for failure to state a claim.

At the procedural level, *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) ("*Corwin*"), has armored defendant-directors with a powerful defense to *Revlon* and other claims of breaches of fiduciary duty. Under *Corwin*, a fully informed, uncoerced, disinterested stockholder vote in favor of a merger can cleanse related breaches of fiduciary duty, thereby invoking business judgment review and, usually, pleading-stage dismissal. It should be noted, however, that *Corwin* is not applicable to a transaction benefiting a controlling stockholder ("*Controller*").

Some recent pleading-stage decisions of the Delaware Court of Chancery ("*Chancery Court*") addressing *Revlon*-related damages claims have tackled both the substantive and *Corwin* defenses, while others have ruled solely on the basis of one of those defenses. These different approaches have produced varied results, as detailed in the examples below.

- *In re Cyan, Inc. S'holders Litig.*, No. 11027-CB, 2017 WL 1956955 (Del. Ch. May 11, 2017) was an opinion in which the

Chancery Court *granted* dismissal on two *independent* grounds: (i) plaintiffs' failure to "plead sufficient facts to support a reasonable inference that the directors of Cyan breached their duty of loyalty or acted in bad faith," and (ii) cleansing under *Corwin*. *See* Robert S. Reder & Miron Klimkowski, *Delaware Court Summons Corwin to Dismiss Breach of Fiduciary Duty Claim Grounded in Allegations of Director Self-Interest in Connection with Merger*, 71 VAND. L. REV. EN BANC 145 (2018).

- In *Sciabacucchi v. Liberty Broadband Corp.*, No. 11418-VCG, 2017 WL 2352152 (Del. Ch. May 31, 2017), the Chancery Court *denied* defendant-directors' motion to dismiss, finding *Corwin* unavailable because the stockholder vote was "structurally coerced," but deferred action on the substantive arguments raised by defendant-directors pending "supplemental briefing." *See* Robert S. Reder & Victoria L. Romvary, *Delaware Court Determines Corwin Not Available to "Cleanse" Alleged Director Misconduct Due to "Structurally Coercive" Stockholder Vote*, 71 VAND. L. REV. EN BANC 131 (2018).
- In *Morrison v. Berry*, No. 12808-VCG, 2017 WL 4317252 (Del. Ch. Sept. 28, 2017), the Chancery Court, in "an exemplary case of the utility of [the] ratification doctrine," *granted* pleading-stage dismissal based on *Corwin* without addressing the plaintiffs' substantive allegations. On appeal in *Morrison v. Berry*, 191 A.3d 268 (Del. 2018), the Delaware Supreme Court *reversed*, finding the disclosures to stockholders anything but "exemplary" and remanding for Chancery Court consideration of the plaintiffs' substantive allegations. *See* Robert S. Reder, *Delaware Supreme Court Once Again Reverses Dismissal of Fiduciary Breach Claims Brought Against Target Company Directors*, 72 Vand. L. Rev. En Banc 71 (2018). Given a second opportunity, in *Morrison v. Berry*, No. 12808-VCG, 2019 WL 7369431 (Del. Ch. Dec. 31, 2019), the Chancery Court again *granted* pleading-stage dismissal (to all but one of the defendant-directors), but this time citing the plaintiff's failure to adequately plead facts satisfying the high bar imposed by the target company's Exculpatory Provision. *See* Robert S. Reder & Lorin Hom, *Chancery Court Dismisses Breach of Fiduciary Duty Claims Against Target Company Directors Despite Unavailability of Corwin Defense*, 73 VAND. L. REV. EN BANC 111 (2020).
- In *Van der Fluit v. Yates*, No. 12553-VCMR, 2017 WL 5953514 (Del. Ch. Nov. 30, 2017), although the Chancery Court found

Corwin unavailable due to inadequate disclosures, it *granted* the defendant-directors' motion to dismiss because the plaintiff failed to adequately plead a breach of the duty of loyalty or bad faith. *See* Robert S. Reder & Elizabeth F. Shore, *Chancery Court Holds that Defendant Directors' Failure to Disclose Material Facts Defeated Application of Corwin, but Nevertheless Dismisses Claims Against Directors Due to Plaintiff's Failure to Adequately Plead Directorial Breach of Their Duty of Loyalty*, 72 VAND. L. REV. EN BANC 41 (2018).

- *In re Rouse Props., Inc. Fiduciary Litig.*, No. 12194-VCS, 2018 WL 1226015 (Del. Ch. Mar. 9, 2018) was an opinion in which the Chancery Court *granted* the defendant-directors' motion to dismiss because (i) a significant minority stockholder who engaged in a buyout of the target company was deemed not to be a Controller and (ii) *Corwin's* requirements had been satisfied. The Chancery Court *did not address* the substantive aspects of the claims against the defendant-directors. *See* Robert S. Reder, *Chancery Court Finds Corwin Applicable to Merger Transaction Negotiated with 33.5% Stockholder*, 72 VAND. L. REV. EN BANC 51 (2018).
- *In re Tesla Motors, Inc. S'holder Litig.*, No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018) was an opinion in which the Chancery Court *denied* the defendant-directors' motion to dismiss because CEO Elon Musk, though a minority stockholder, was deemed Tesla's Controller. *Corwin*, therefore, was unavailable to cleanse a transaction with a Musk affiliate. The Chancery Court *did not address* the substantive aspects of the claims against the defendant-directors. *See* Robert S. Reder, *Chancery Court Determines That 22.1% Stockholder Controls Corporation, Rendering Corwin Inapplicable*, 72 VAND. L. REV. EN BANC 61 (2018).
- *In re Tangoe, Inc. S'holders Litig.*, No. 2017-0650-JRS, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018) was an opinion in which the Chancery Court *denied* the defendant-directors' motion to dismiss because (i) stockholders had been left in an "information vacuum" for purposes of *Corwin* and (ii) the defendant-directors had yet to show that they discharged their duty of loyalty. *See* Robert S. Reder & Amanda M. Mitchell, *Chancery Court Refuses Pleading Stage Dismissal Under Corwin When Stockholders Not Fully Informed of Long-Overdue Financial Restatement*, 73 VAND. L. REV. EN BANC 35 (2020).

- *In re Xura, Inc. S'holder Litig.*, No. 12698-VCS, 2018 WL 6498677 (Del. Ch. Dec. 10, 2018) was an opinion in which the Chancery Court *denied* a director/CEO's motion to dismiss due to (i) inadequate disclosures to stockholders for purposes of *Corwin* and (ii) the plaintiffs' pleading a viable claim for breach of fiduciary duty. The Chancery Court also discussed a potential third defense—ratification of the challenged transaction *via* approval by a majority independent board of directors—but inadequate disclosures to the board also doomed this defense. *See* Robert S. Reder & Robert W. Dillard, *Chancery Court Declines to Apply Corwin at Pleading Stage to "Cleanse" Breach of Fiduciary Duty Claim Due to Material Non-Disclosures*, 73 VAND. L. REV. EN BANC 17 (2020).
- In *Chester Cnty. Emps.' Ret. Fund v. KCG Holdings, Inc.,* No. 2017-0421-KSJM, 2019 WL 2564093 (Del. Ch. June 21, 2019), the Chancery Court *denied* the defendant-directors' motion to dismiss because (i) cleansing under *Corwin* was unavailable due to inadequate disclosures and (ii) the plaintiff's allegations concerning the negotiation and approval process for the challenged transaction supported an "inference of bad faith" on the part of the defendant-directors. *See* Robert S. Reder & Kelsey McKeag, *Delaware Court Refuses Corwin "Cleanse" Due to Inadequate Disclosures of Conflicts of Interest and Financial Projections*, 73 VAND. L. REV. EN BANC 1 (2020).

Against this backdrop, in *In re Essendant, Inc. S'holder Litig.*, No. 2018-0789-JRS, 2019 WL 7290944 (Del. Ch. Dec. 30, 2019) ("*Essendant*"), Vice Chancellor Joseph R. Slights III granted dismissal of *Revlon*-based claims to target company directors, finding the plaintiffs' allegations of favoritism shown to one bidder *versus* another inadequate to establish a pleading-stage inference of bad faith or breach of the duty of loyalty. Due to the plaintiffs' failure to plead "litigable *affirmative* claims under Delaware law," the Vice Chancellor did "not reach the validity of the *Corwin defense*."

I. FACTUAL BACKGROUND

Former stockholders ("*Plaintiffs*") of Essendant Inc. ("*Essendant*" or "*Company*") brought suit in Chancery Court alleging, among other things, that Essendant's board of directors ("*Board*") breached its fiduciary duties by failing to "obtain the highest value reasonably available" in the wake of competing offers from Genuine Parts Company ("*GPC*")—a stock-for-stock combination—and

Sycamore Partners (“*Sycamore*”)—a cash buyout. After the defendant-directors moved to dismiss, the Plaintiffs “add[ed] a claim against Sycamore for breaching its fiduciary duties as a controlling stockholder” of Essendant.

A. GPC Merger

Essendant, “a national wholesale distributor of office supplies and equipment,” began discussions of a ***stock-for-stock*** combination with competitor S.P. Richards Co., a GPC wholly owned subsidiary (“*GPC Merger*”), after which Essendant stockholders would own “49% of the combined company” with GPC owning the remainder. Projections for the GPC Merger forecasted “more than $75 million in net cost synergies” and “more than $100 million in working capital improvements.” Indeed, “Essendant’s financial advisor, Citigroup Global Markets Inc. (“*Citi*”), conducted a pro forma discounted cash flow analysis” which estimated that the GPC Merger “would represent a value range of $13.30–$23.90 per share for Essendant stockholders, including $8.35–$11.25 per share from anticipated synergies” (“*Citi Valuation Range*”).

Although attractive from an economic standpoint, the GPC Merger likely would “confront serious antitrust compliance issues.” Given the “considerable resources” required to consummate the GPC Merger, GPC requested that certain assurances be built into the merger agreement (“*GPC Agreement*”), including (i) a “non-solicitation” provision (“*Non-Solicitation Covenant*”) permitting Essendant to consider and ultimately accept “alternative proposals” and (ii) a requirement for GPC “to use its reasonable best efforts to seek antitrust approval of the GPC merger.” On that basis, Essendant and GPC announced the signing of the GPC Agreement on April 12, 2018.

B. Sycamore’s Competing Proposal

Three days before the GPC Agreement was signed, the Board received unsolicited interest from Sycamore, a private equity firm seeking “to protect its $6.9 billion investment in Staples and ‘create a combined entity that [would] be a powerhouse in the office supply industry.’ ” Shortly following signing, on April 17, Sycamore formally offered to purchase Essendant for $11.50 per share *in cash* (“*First Offer*”). The Board rejected the First Offer as likely being inferior to the GPC Merger but encouraged Sycamore to submit a revised offer. Meanwhile, according to GPC, the Board “slow-walked its efforts to

obtain regulatory approvals" for the GPC Merger "to facilitate negotiations with Sycamore." On April 29, Sycamore returned with a "renewed" proposal ("*Renewed Offer*"), offering the same cash price of $11.50 per share. This time, the Board found the Renewed Offer "reasonably likely to lead to a superior acquisition proposal."

Shortly thereafter, Essendant informed GPC of the Renewed Offer and encouraged a counterbid. This was the first time Essendant revealed Sycamore's interest in acquiring Essendant to GPC. GPC responded by offering to add a cash payment of $4 per share to the total consideration, payable post-closing but contingent on the occurrence of specified future events.

While negotiating with the Board, Sycamore began to buy Essendant shares in the open market, eventually acquiring 11.16% of Essendant's outstanding shares. In response, the Board adopted a "poison pill" to prevent Sycamore from buying more shares. After further negotiations, on September 10, the Board accepted Sycamore's enhanced $12.80 per share cash offer ("*Final Offer*") and terminated the GPC Agreement as permitted by the Non-Solicitation Covenant. The Board's decision to accept the Final Offer—representing an "11% discount" to Essendant's trading price at that time of $14.24 per share—was, "in part, due to 'risk related to continued secular decline in the Company's industry' that threatened the long-term success of the combined company" following a GPC Merger. Although Citi found that "the GPC merger presented a value range greater than the all-cash Sycamore merger, Citi opined that the Sycamore merger was fair from a financial perspective to Essendant's stockholders." Sycamore completed its cash buyout *via* merger with Essendant ("*Sycamore Merger*") on January 31, 2019.

As an aside, before the Board could proceed with the Sycamore Merger, the Non-Solicitation Covenant gave GPC the opportunity to match the Final Offer. GPC's decision not to compete further "triggered Essendant's obligation to pay a $12 million termination fee to GPC." For a discussion of litigation between GPC and Essendant over whether GPC's remedies under the Non-Solicitation Covenant were limited to the termination fee, see Robert S. Reder & Alexandra Sasha Gombar, *Chancery Court Rejects Target Company Claim That Termination Fee Was Jilted Merger Partner's Exclusive Remedy*, 73 VAND. L. REV. EN BANC 45 (2020).

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

Plaintiffs alleged that the Board breached its fiduciary duties "by 'caving to the will of Sycamore and knowingly and willfully allowing the GPC [merger] to be sabotaged by Sycamore so that [Sycamore] could acquire Essendant at an unfair price.' " Because Essendant's certificate of incorporation included an Exculpatory Provision, the Plaintiffs were required to establish that the defendant-directors breached their duty of loyalty or acted in bad faith in order to avoid pleading-stage dismissal.

In his analysis of the defendant-directors' motion to dismiss, Vice Chancellor Slights focused on whether the Plaintiffs pled facts sufficient to allege that either (i) each member of the Board was beholden to Sycamore in its alleged capacity as Essendant's Controller and therefore improperly "acceded" to its will, (ii) a majority of the Board "operated under some broader conflict of interest" by virtue of being either "interested" in the Sycamore Merger or lacking "independence" in connection with approving the Sycamore Merger, or (iii) the Board had acted in "bad faith." Answering these questions in the negative, the Vice Chancellor *granted* the defendant-directors' motion to dismiss. Based on his finding that "Plaintiffs have not stated litigable *affirmative* claims under Delaware law" against the defendant-directors, the Vice Chancellor had no need to discuss their potential *Corwin* defense.

A. Sycamore Is Not a Controller

Under Delaware law, a Controller owns either "more than 50% of the company's voting power" or "less than 50% of the voting power of the corporation but *exercises control* over the business affairs of the corporation." Sycamore, merely Essendant's *third*-largest stockholder, "owned less than 12%" of the outstanding shares. Accordingly, the Plaintiffs were required to plead facts sufficiently illustrating Sycamore's minority stake as being "so potent" that "as a practical matter, it [was] no differently situated than if it had majority voting control." As the Vice Chancellor cautioned, this standard "is not an easy one to satisfy."

The Vice Chancellor found that the Plaintiffs failed to allege any of the indicia of control needed to establish Sycamore as Essendant's Controller. Specifically, Sycamore did not: (i) nominate Board members, (ii) enjoy "coercive contractual rights," (iii) have "personal relationships" with Board members, (iv) have "commercial

relationships with Essendant" affording leverage during negotiations, (v) threaten to oust or retaliate against Board members, or (vi) in any other way exert "outsized influence" over the Board.

The Plaintiffs' failure to plead Sycamore's Controller status led the Vice Chancellor to reject two aspects of their claims. *First*, the Board "cannot be held to answer for alleged breaches of fiduciary duty based on allegations that its members caved to the will of the controller." And, *second*, "Sycamore is not a fiduciary owing duties to Essendant stockholders . . . ."

B. Board-Level Conflicts

To rebut "the presumption of independence" bestowed on corporate directors by Delaware law, the Plaintiffs were required to "count heads" among the Board members in a "'director-by-director analysis' of interestedness or lack of independence." The Plaintiffs instead asserted generally that the Board "plac[ed] Sycamore's interests ahead of the interests of the Company's non-controlling stockholders" by pursuing the Sycamore Merger. This was not sufficient.

Among other failures, the Plaintiffs failed to allege anything "highly unusual" in the Sycamore Merger as "compared with other transactions," nor "any improper relationship or tie between individual members of the Essendant Board and Sycamore." The Vice Chancellor explained that the Plaintiffs' allegations demonstrated only the "Board's preference for a cash deal" rather than "support[ing] an inference that it was interested in the Sycamore merger or that it somehow lacked independence." Indeed, choosing "a cash transaction with Sycamore rather than a stock deal with GPC" was "a judgment call well within a board's prerogative when pursuing the 'highest value reasonably available to . . . shareholders.' "

C. Bad Faith

Consistent with its fiduciary duties as described in *Revlon*, a board engaged in the sale of a corporation must act "in the service of a specific objective: maximizing the sale price" by "act[ing] in a neutral manner to encourage the highest possible price for shareholders." The Board breached this duty, the Plaintiffs asserted, when it "acted in bad faith" by failing to pursue "the best value-maximizing transaction" between those offered by GPC and Sycamore. In particular, the Board misdirected Essendant stockholders with "'materially incomplete and

misleading' information" and proceeded with the Sycamore Merger even though it "inadequately compensated Essendant stockholders for their shares."

The Vice Chancellor explained that "[a] director acts in bad faith when she 'intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for . . . her duties.' " The Plaintiffs' attacks on the Board's disclosure to stockholders and the process followed by the Board to arrive at the Sycamore Merger failed to meet this high bar.

1. Disclosure

To "plead a non-exculpated disclosure claim," the Vice Chancellor noted that the "Plaintiffs are obliged to do more than allege 'erroneous judgment' regarding the 'proper scope and content' of a disclosure. Instead . . . Plaintiffs must allege a knowing or intentional misstatement or omission of a material fact." In his view, "they have not come close to this mark."

Among other shortcomings, the Vice Chancellor cited the Plaintiffs' failure to provide more than instances of the Board's "declining to adopt Plaintiffs' characterization of its behavior" or "making business decisions, whether right or wrong, in an effort to maximize stockholder value." For example, the Board was not required to disclose (even if true) that "it intentionally slow-walked the GPC merger's regulatory approval process in order to delay consummation of that transaction." This "sort of self-flagellation is not required in disclosures to stockholders." Similarly, the Vice Chancellor was not critical of the Board's failure to disclose its request to Sycamore for the Renewed Offer: this was "nothing more than a negotiating strategy" and "the sort of 'blow-by-blow description' that this court regularly finds immaterial . . . and certainly lacking as an indicator of bad faith."

2. Deal Process

As for the "Plaintiffs' process-related allegations," the Vice Chancellor differentiated between "bad faith" and "'an inadequate or flawed effort' to obtain the highest value reasonably available." "Absent direct evidence of an improper intent," the Vice Chancellor explained, "a plaintiff must point to 'a decision [that] lacked any rationally conceivable basis' associated with maximizing stockholder value to survive a motion to dismiss." Effectively, this requires allegations of an "'extreme set of facts' necessary to support an inference that the Essendant Board acted in bad faith."

For instance, the Plaintiffs characterized the Board's alleged breach of the Non-Solicitation Covenant as evidence of bad faith. The Vice Chancellor rejected this argument. Absent "well-pled allegations," the Board breached "for no reason"; a contractual breach alone cannot "serve as a factual predicate to support a non-exculpated breach of fiduciary duty claim," especially when the "efficient breach" doctrine provides for fiduciary discretion if "the 'benefits [of breach] (broadly conceived) exceed the costs (broadly conceived).' "

The Plaintiffs also argued that the Final Offer constituted an "'unfair' . . . discount to Essendant's [$14.24] GPC merger-affected trading price" and fell below the Citi Valuation Range. However, "without more," dissatisfaction with the price ultimately negotiated by the Board "does not a bad [ ] faith claim make." Moreover, the Board's decision to jettison the GPC Merger in favor of the Sycamore Merger seemed "imminently explicable as a measured determination that a cash payment *today* is superior to uncertain returns derived from remaining in the highly-competitive office supply business *tomorrow*."

CONCLUSION

Essendant reinforces the heightened pleading standard a stockholder-plaintiff must overcome to survive a motion to dismiss its claims of directorial breach of fiduciary duty in the *Revlon* context. Absent well-pled facts challenging a board's independence, disinterestedness, or good faith intent "to serve as anchor, [ ] conclusory allegations of domination and control drift over the falls." Moreover, because Vice Chancellor Slights was comfortable dismissing the Plaintiffs' complaint for failure to state a valid, non-exculpated claim—finding the preference for cash over stock to fall squarely within the Board's business judgment—the Vice Chancellor had no need to consider the defendant-directors' potential *Corwin* defense.