STANDARDS OF REVIEW IN CONFLICT TRANSACTIONS: AN EXAMINATION OF DECISIONS RENDERED ON MOTIONS TO DISMISS

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ABSTRACT

This article examines how the standard of review affects decisions by Delaware courts on motions to dismiss in conflict of interest transactions, focusing on decisions since Weinberger. *The standard of review at the motion to dismiss stage significantly affects the likelihood of success. Part I discusses the differences between a third-party merger transaction and a self-interested merger transaction. Part II discusses the standard of review for a motion to dismiss under Delaware law. Part III is an evaluation of third-party and self-dealing transactions, which determines that motions to dismiss will likely succeed in third-party transactions because the business judgment rule applies and that motions to dismiss self-dealing transactions will likely be denied because entire fairness applies. Part IV discusses the case law since* Weinberger *and concludes that the availability of appraisal will not necessarily eliminate the defendant's burden of proving entire fairness in a cash-out merger, the standard of review depends upon whether the complaint pleads interested transactions not approved by disinterested and independent directors and shareholders, a motion to dismiss likely will succeed absent well-pleaded allegations that board members are not disinterested and independent, uncoerced stockholder approval on full disclosure provides grounds for dismissal, and a controlling stockholder who bargains and receives the same treatment in a cash-out merge as a minority stockholder may still be required to demonstrate entire fairness. In Part V the author argues that the interest of corporations and their shareholders are best served by boards whose members include well-motivated, disinterested and independent directors who accept responsibility for recommending or approving transactions with interested directors or controlling shareholders.*

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This article examines how the standard of review affects decisions by Delaware courts on motions to dismiss in conflict of interest transactions; however, it is not intended to be exhaustive. The summary focuses on cases decided since the seminal case of *Weinberger v. UOP, Inc.*[1]

I. SETTING THE STAGE: SELF-DEALING V. THIRD-PARTY TRANSACTIONS

Let us assume two contrasting hypothetical merger transactions. In the first (the "Self-Dealing Transaction"), the seven-person board of Company A, consisting entirely of directors who are employed by, and dependent for their livelihood upon, Company B, which is also A's majority shareholder, approves a cash-out merger with Company B. In the second (the "Third-Party Transaction"), the seven-person board of Company X negotiates a cash-out merger with Company Y, whose board and stockholders have no affiliation whatsoever with Company X. In both cases, the plaintiff directly attacks the fairness of the merger and defendants move to dismiss the complaint for failure to state a claim upon which relief can be granted.

II. STANDARD FOR A MOTION TO DISMISS

Under well-settled law, the court of chancery "must determine whether it appears with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiffs would not be entitled to relief."[2] Conclusory allegations which lack specific factual support in the plaintiffs' complaint need not be accepted as true.[3] The alleged facts must be taken as true, and all inferences are viewed in the light most favorable to the plaintiff.[4]

The Delaware Supreme Court explained in *McMullin* the process by which the court of chancery determines the standard of review in the context of a motion to dismiss:

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[1]457 A.2d 701 (Del. 1983). This article does not examine the factors that Delaware courts consider in determining disinterestedness and independence. For an excellent discussion of this issue, see Grover C. Brown et al., *Director and Advisor Disinterestedness and Independence Under Delaware Law*, 23 DEL. J. CORP. L. 1157 (1998).

[2]McMullin v. Beran, 765 A.2d 910, 916 (Del. 2000) (quoting *In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 326 (Del. 1993) (citing Conley v. Gibson, 355 U.S. 41, 45-46 (1957))).

[3]*In re Tri-Star Pictures*, 634 A.2d at 326; *In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 65-66 (Del. 1995).

[4]*McMullin*, 765 A.2d at 916.

> In examining the Chemical Directors' motion to dismiss McMullin's Amended Complaint, the Court of Chancery was required to conduct a two-step analysis: first, to take the facts alleged as true and view all inferences from those facts in the light most favorable to the plaintiff; and, second, to determine whether with reasonable certainty, under any set of facts that could be proven, the plaintiff would succeed in rebutting the presumption of the business judgment rule. If McMullin's Amended Complaint passed judicial muster under that two-step analysis, the motion to dismiss should have been denied. If the Amended Complaint failed to withstand that threshold level of judicial scrutiny, the motion to dismiss was properly granted because, unless effectively pled factual allegations in the shareholder plaintiff's Amended Complaint successfully rebut the procedural presumption of the business judgment rule, the Chemical Directors would be protected by the substantive operation of the business judgment rule.[5]

III. EVALUATION OF THIRD-PARTY AND SELF-DEALING TRANSACTIONS

A. *Third-Party Transaction: Motion to Dismiss Granted Because Business Judgment Rule Applies*

In the Third-Party Transaction, defendants' motion to dismiss will likely succeed unless the plaintiff alleges well-pleaded facts to overcome the presumption of the business judgment rule.[6] Assuming no disclosure claim,[7] the absence of a conflict by the decision makers would essentially require plaintiff to plead that a decision to enter into the transaction was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[8]

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[5]*Id.* at 917-18 (citations omitted).

[6]Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999) (citing *Santa Fe*, 669 A.2d at 71).

[7]For a thorough discussion of the duty of disclosure, see Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (Oct. 1996).

[8]*See In re* J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780-81 (Del. Ch. 1988).

B. *Self-Dealing Transaction: Motion to Dismiss Denied Because Entire Fairness Standard of Review Applies*

In the Self-Dealing Transaction, however, defendants' motion to dismiss will likely fail. This is because the plaintiffs have alleged that the transaction was approved by an entirely conflicted board whose employer benefitted by cashing out the stockholders of Company A at an unfair price. In that circumstance, the court will generally hold that the plaintiff's allegations sufficiently rebut the presumptions of the business judgment rule, and that the majority stockholder has the burden of proving that the transaction was entirely fair.[9] The Delaware Supreme Court, in analogous circumstances, has made clear that the enhanced scrutiny mandated for this Self-Dealing Transaction would prevent expeditious disposition of plaintiffs' claim: "[Such cases] illustrate the difficulty of expeditiously dispensing with claims seeking enhanced judicial scrutiny at the pleading stage where the complaint is not completely conclusory .... This scrutiny will usually not be satisfied by resting on a defense motion merely attacking the pleadings."[10]

IV. CASE LAW SINCE *WEINBERGER*

A. *Availability of Appraisal Will Not Necessarily Eliminate Defendants' Burden of Proving Entire Fairness in Cash-Out Merger Transaction*

A controlling stockholder owning fewer than ninety percent of the outstanding shares of a Delaware corporation and seeking to cash out the minority stands on both sides of the transaction and courts will apply entire fairness review to this transaction.[11] The Delaware Supreme Court's unwillingness to allow a dismissal of complaints where plaintiff adequately alleges that a cash-out transaction is subject to entire fairness review was evident shortly after *Weinberger* in *Rabkin v. Philip A. Hunt Chemical Corp.*[12] In that case, the plaintiff alleged that defendant directors had unfairly destroyed, through manipulative conduct, a contractual right of the minority

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[9]Kahn v. Lynch Communications Sys., 638 A.2d 1110, 1121 (Del. 1994).

[10]*Santa Fe*, 669 A.2d at 72.

[11]A stockholder owning 90% or more of the outstanding shares may cash out the remaining stockholders in a short-form merger pursuant to section 253 of the Delaware General Corporation Law and is not required to demonstrate entire fairness. *In re* Unocal Exploration Corp. S'holders Litig., No. 12,453, 2000 Del. Ch. LEXIS 92, at *1 (Del. Ch. June 13, 2000), *aff'd*, Glassman v. Unocal Exlporation Corp., 777 A.2d 242 (Del. 2001).

[12]498 A.2d 1099 (Del. 1985).

stockholders to receive $25 per share by cashing them out at $20 per share.[13] The court held that "[a]t the very least the facts alleged import a form of overreaching, and in the context of entire fairness they deserve more considered analysis than can be accorded them on a motion to dismiss."[14]

In *Iseman v. Liquid Air Corp.*,[15] the court of chancery relied upon *Rabkin* to sustain a claim of unfair dealing in a cash-out merger. The complaint alleged that all three members of a special committee suffered from a conflict of interest and that the committee's investment banker altered its report to conceal that its own analyses reflected a valuation for the subject company at a price significantly higher than the price offered by the majority stockholder.[16] In addition, the complaint alleged that the disclosures pertaining to the analyses performed by the investment banker for the majority stockholder also were false or misleading.[17] Taken together, the court stated that it was "satisfied that the allegations with respect to the negotiating process and certain of the disclosures [were] sufficient to state a claim for breach of the duty of entire fairness."[18]

More recent cases have applied *Rabkin* to deny motions to dismiss notwithstanding the availability of appraisal as a remedy, at least where the transaction was not accomplished pursuant to the short-form merger statute. In *Wood v. Best*,[19] the court found the following allegations to be sufficient to require defendants to prove that the transaction was entirely fair:

> The plaintiffs have alleged that the individual defendants stood on both sides of the cash out merger, timed the merger so as to minimize cost to themselves at the expense of the shareholders, and failed to provide any method for determining whether the merger was entirely fair to the shareholders independent of the defendants themselves or their financial advisors whom they had hired. They claim that the resulting price was unfair, and that they were damaged as a result. Under *Cede* and *Rabkin* this states a claim sufficient to survive a motion to dismiss, and sufficient to put the defendants to proof that the transaction was entirely fair.[20]

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[13] *Id.* at 1102-03.
[14] *Id.* at 1107.
[15] No. 9694 (Del. Ch. Oct. 23, 1989), *reprinted in* 15 DEL. J. CORP. L. 1041 (1990).
[16] *Id.* at 7, *reprinted in* 15 DEL. J. CORP. L. at 1047.
[17] *Id.* at 8, *reprinted in* 15 DEL. J. CORP. L. at 1047.
[18] *Id.* at 3, *reprinted in* 15 DEL. J. CORP. L. at 1046-47.
[19] No. 16,281, 1999 Del. Ch. LEXIS 141 (Del. Ch. July 9, 1999).
[20] *Id.* at *17.

In *Andra v. Blount*,[21] the court denied a dismissal motion upon finding that a tender offer/back-end merger was subject to the entire fairness standard of review and that the price offered by the majority shareholder was unfair. The court read the plaintiff's complaint as alleging that the majority stockholder:

> took advantage of his 73% position to squeeze out the minority stockholders at an unfair price[;] . . . used short-term adverse developments as a lever to extract the real, long-term value of [the company] for himself at an inequitably advantageous price[;] . . . no adequate procedural protections . . . to the minority, because [among other reasons] the . . . special committee . . . was comprised of a majority of directors with an arguable interest in securing [the majority shareholder's] continued favor[;] . . . and [bought] out the minority at a price that was well below the fair market value of [the company] as identified by the special committee's own investment banker just five months before.[22]

The court rejected defendants' claim that the complaint should be dismissed on the ground that plaintiff should be relegated to the appraisal remedy.[23]

B. *Standard of Review Depends upon Whether Complaint Pleads Interested Transaction Not Approved by Disinterested and Independent Directors or Shareholders*

The case law since *Weinberger* demonstrates that plaintiffs can avoid dismissal at the motion to dismiss stage by adequately pleading facts from which the court may conclude that no disinterested, independent body approved the transaction at issue. If a plaintiff cannot adequately allege a conflict of interest by a majority of the director decision makers, or a conflicted controlling stockholder, then "'the judgment of the majority stockholders and/or the board of directors . . . is presumed [to be] made in good faith and inspired by a bona fides of purpose.' This presumption of sound business judgment fails only where the stockholders or directors, who control the transaction, stand on both sides of that transaction."[24]

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[21]No. 17,154 (Del. Ch. Mar. 29, 2000), *reprinted in* 26 DEL. J. CORP. L. 215 (2001).

[22]*Id.* at 16-17, *reprinted in* 26 DEL. J. CORP. L. at 229.

[23]*Id.* at 17, *reprinted in* 26 DEL. J. CORP. L. at 230.

[24]Lewis v. Leaseway Transp. Corp., No. 8720, mem. op. at 12 (Del. Ch. May 16, 1990), *reprinted in* 16 DEL. J. CORP. L. 815, 825 (1991) (citations omitted) (dismissing complaint where plaintiff failed to allege that a majority of the directors expected to derive personal financial benefit

Chaffin v. GNI Group, Inc.[25] illustrates the consequences where the court finds that the plaintiff has adequately pleaded that a majority of disinterested directors did not approve a proposed transaction. There the son of a director stood to benefit from forgiveness of promissory notes, reimbursement for any federal income tax liability incurred by reason of the loan forgiveness, and special entitlement to purchase certain post-merger preferred stock.[26] The court held that such a director was interested, that the merger was not approved by a majority of disinterested directors, and that the entire fairness standard would apply.[27] The court found that at the pleading stage, the plaintiff had alleged a breach of the duty of loyalty sufficient to overcome the presumption afforded by the business judgment standard.[28]

The court expressly recognized the significance of the standard of review to its decision on a motion to dismiss in *Litle v. Waters*.[29] There the court found that the plaintiff had adequately alleged that the defendant directors were serving their own personal financial interests in causing the corporation not to declare dividends.[30] The court then held that:

> Since plaintiff's complaint sufficiently alleges facts which justifies [sic] the applicability of the entire fairness standard and defendant has not adequately rebutted its applicability, I apply the standard in deciding this motion. Therefore, the burden shifts to defendants to demonstrate that the decision to not declare dividends and to repay the company's debt to Waters was intrinsically fair. At this stage, of course, the complaint's allegations must be accepted as true. Nor have defendants pointed to any evidence that the decision was entirely fair. Therefore, plaintiff's claim continues to be one for which I can grant relief. Defendants' motion to dismiss Count I is denied.[31]

The court of chancery has been reluctant, however, to permit "[c]onclusory allegations alone . . . [to] be the platform for launching an extensive, litigious fishing expedition for facts through discovery in the hope

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from the transaction, that they lacked independence or were grossly negligent).

[25]No. 16,211, 1999 Del. Ch. LEXIS 182 (Del. Ch. Sept. 3, 1999).

[26]*Id.* at *17.

[27]*Id.* at *14-*16.

[28]*Id.* at *19.

[29]No. 12,155 (Del. Ch. Feb. 10, 1992), *reprinted in* 18 DEL. J. CORP. L. 315 (1993).

[30]*Id.* at 10-11, *reprinted in* 18 DEL. J. CORP. L. at 323-24.

[31]*Id.* at 11, *reprinted in* 18 DEL. J. CORP. L. at 324 (citation omitted).

of finding something to support them."[32] But where the plaintiff alleges that a majority of decision makers are not disinterested and that they benefitted uniquely to the detriment of the entity and its owners to whom they owe fiduciary duties, a motion to dismiss will not succeed.[33] In contrast, where shareholders knowingly approve a director stock option plan, a plaintiff's attack on directors' receipt of options under the plan will be dismissed absent well-pleaded allegations of waste.[34]

The *Parnes* case is an example of those rare cases where the plaintiff pleaded facts sufficient to convince the court that "the decision under attack [was] 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'"[35] In that case, the plaintiffs alleged that the chairman and chief executive officer (CEO) of Bally Entertainment Corporation controlled the merger negotiations and demanded that any potential acquiror pay him individually, which the Delaware Supreme Court characterized as "demanding a bribe."[36] Accepting those facts as true, the court held that it is inexplicable that independent directors, acting in good faith, could approve the deal.[37] The court recognized that its decision was mandated at that stage of the proceeding and that facts developed thereafter might cause a different result:

> The facts that are developed during the course of the litigation may cast a very different light on the merger and the Bally directors' decisions. At the pleading stage, however, we must accept all of Parnes' factual allegations as true and give her the benefit of all inferences that may be drawn from those facts. Using this standard, we find that the complaint states a claim challenging the fairness of the Bally/Hilton merger and

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[32]Nebenzahl v. Miller, No. 13,206, mem. op. at 8 (Del. Ch. Aug. 29, 1996), *reprinted in* 22 DEL. J. CORP. L. 779, 789 (1997) (dismissing complaint where four disinterested directors and majority of stockholders approved merger on full disclosure).

[33]*In re* Boston Celtics Ltd. P'ship S'holders Litig., No. 16,511 (Del. Ch. Aug. 6, 1999) (denying motion to dismiss where plaintiffs alleged self-dealing whereby three of general partner's directors approved a reorganization which permitted them and related entities to become substantial majority owners of a privately-held partnership not subject to corporate tax and free from regulation under the Investment Company Act, as opposed to owners of 47.8% of the outstanding units of a publicly-traded partnership subject to corporate tax).

[34]*In re* 3Com Corp. S'holders Litig., No. 16,721 (Del. Ch. Oct. 25, 1999), *reprinted in* 25 DEL. J. CORP. L. 1060 (2000).

[35]*Parnes*, 722 A.2d at 1246 (quoting *In re* J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780-81 (Del. Ch. 1988)).

[36]*Id.* at 1247.

[37]*Id.*

challenging the Bally directors' approval of the merger as having lacked a rational basis.[38]

In *Crescent/Mach I Partners, L.P. v. Turner*,[39] the court of chancery relied upon *Parnes* to find that the approval of a merger, cashing out all holders of a certain class of common stock not controlled by Mr. Turner, the company's chair, CEO, and indirect majority stockholder, constituted a violation of the duty of loyalty because of the defendant directors' approval of various side deals which benefitted the majority stockholder uniquely.[40] The court found that the two directors other than Turner "may have breached their fiduciary duty of loyalty 'by acquiescing in [Turner's] self-interested negotiations and by approving the merger at an unfair price.'"[41] The court found that "[the] approval of [the] alleged self-interested 'side deals' allegedly taint[ed] the entire merger process and strip[ed] the board of the protection of the business judgment rule."[42]

C. *A Motion to Dismiss Likely Will Succeed Absent Well-Pleaded Allegations That Board Members Are Not Disinterested and Independent*

The court explicitly addressed the significance of the standard of review where a conflict of interest is alleged in *In re Freeport-McMoran Sulphur, Inc. Shareholders Litigation*.[43] In that case, stockholders of Freeport-McMoran Sulphur, Inc. (FSC) challenged in a purported class action a stock-for-stock transaction on the ground that the alleged "interestedness" of the directors of FSC resulted in the stockholders of FSC receiving too few shares.[44] The court noted that the issue of the standard of review:

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[38]*Id.* (citing *In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319 (Del. 1993)). *But see In re* Encore Computer Corp. S'holders Litig., No. 16,044 (Consolidated), mem. op. at 9-12 (Del. Ch. June 16, 2000), *reprinted in* 26 DEL. J. CORP. L. 000, 000 (2001) [26-2] (dismissing complaint attacking two asset sales where the complaint alleged that the two transactions served legitimate business purposes and plaintiffs failed to allege facts to establish that the defendant directors either had a material self-interest in, or failed to act independently with respect to, the challenged transactions).

[39]No. 17,455, 2000 WL 1481002 (Del. Ch. Sept. 29, 2000).

[40]*Id.* at *12.

[41]*Id.* (quoting *Parnes*, 722 A.2d at 1246).

[42]*Id.*

[43]No. 16,729, 2001 Del. Ch. LEXIS 5 (Del. Ch. Jan. 11, 2001).

[44]*Id.* at *2.

> is critical because it is outcome-determinative: if the standard is entire fairness, the motion must be denied because the complaint adequately states a claim that the Merger consideration was unfair. If, however, the applicable standard of review is business judgment, the complaint states no cognizable claim because (a) the plaintiffs have not adequately pled that the FSC defendants acted disloyally or in a grossly negligent manner, and (b) even if the Merger consideration paid to FSC shareholders was unfair, to overcome the business judgment rule presumption the plaintiff must allege that the price was so low as to constitute waste or fraud.[45]

The court also examined the legal significance to the standard of review of FSC's use of a special committee to negotiate the proposed merger. The court's discussion highlights the deference afforded business decisions where the court is satisfied that the decision makers were disinterested and independent:

> Under Delaware law, where a transaction is negotiated and approved by an independent committee of directors and is subsequently approved by the stockholders of the company in an uncoerced, fully informed vote, the transaction is normally reviewed under the business judgment standard. In this case it appears undisputed that the two FSC board members who made up the special committee were disinterested and independent. . . . If true, [this] would establish that the Merger terms were negotiated by directors who had acted "on an informed basis, in good faith and in the honest belief that their actions [were] in the corporation's best interest." In that case the business judgment review standard would govern, and the result would be the dismissal of the complaint for failure to state a claim upon which relief could be granted.[46]

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[45] *Id.* (citing Smith v. Van Gorkom, 488 A.2d 858, 889 (Del. 1985)). "[I]n order for the plaintiff to overcome the presumption of the business judgment rule, they 'have the heavy burden of proving that the Merger price was so grossly inadequate as to display itself as a badge of fraud.'" *In re* Freeport-McMoran Sulphur, Inc. Litig., 2001 Del. Ch. LEXIS 5, at *2 n.5.

[46] *Id.* (citations omitted). The court also found that the plaintiffs had failed to allege that a majority of the FSC board which approved the merger was not disinterested and independent. *Id.* (citing *In re* Western Nat'l Corp. S'holders Litig., No. 15,927 (Del. Ch. May 22, 2000), *reprinted in* 26 Del. J. Corp. L. 806 (2001). The court also noted that plaintiffs never disputed the statements in the proxy statement, which had been incorporated by reference into the plaintiffs' complaint, that the special committee retained independent legal and financial advisors, met on several occasions, and recommended the merger to the full board, which approved the merger terms as recommended.

The court of chancery's decision in *In re New Valley Corp. Derivative Litigation*[47] reflects a different outcome, but a similar effort, to determine if the plaintiffs had adequately pled that the transaction at issue was not approved by disinterested and independent decision makers. In *New Valley*, the plaintiffs, who were stockholders of New Valley, which was indirectly owned by Brooke Group, Ltd (Brooke Group), attacked a transaction whereby New Valley purchased certain assets owned by the Brooke Group.[48] Both sides agreed that the standard of review was entire fairness, but disagreed as to who had the burden of persuasion.[49] The court dispensed with that issue as follows:

> At this stage of the proceedings, I do not have to decide which party bears the ultimate burden on this issue. First, because the Court is evaluating the legal sufficiency of the complaint, it has no evidence from the defendants that would allow it to determine whether they have adequate proof that a truly independent committee with real bargaining power evaluated the transaction. . . .
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> Second, even if the ultimate burden is on the plaintiffs to show the transaction is not entirely fair, these plaintiffs have sufficiently alleged facts which, if true, are reasonably calculated to show that the approval of this transaction was fatally flawed in that it was not the result of a fair process and did not result in a fair price. For these reasons, I conclude that the plaintiffs have alleged facts sufficient to initially plead an entire fairness claim.[50]

Where a special committee negotiates and recommends a transaction on behalf of an otherwise conflicted board, the plaintiff can overcome a motion to dismiss if plaintiff's complaint attacks the disinterest or independence of the special committee. In *In re Shoe-Town, Inc. Stockholders Litigation*,[51] the plaintiff alleged that a majority of the board which took the company private benefitted from the transaction to the

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Id.

[47]No. 17,649, 2001 Del. Ch. LEXIS 13 (Del. Ch. Jan. 11, 2001).

[48]*Id.*

[49]*Id.* at *7.

[50]*Id.* (footnote omitted).

[51]No. 9483, 1990 Del. Ch. LEXIS 14 (Del. Ch. Feb. 12, 1990), *reprinted in* 16 DEL. J. CORP. L. 404 (1991).

detriment of the minority stockholders.[52] The court further found that plaintiffs had adequately alleged that the chairman and chief executive officer of Shoe-Town dominated and controlled the special committee.[53] Further, plaintiffs had alleged that the members of the special committee were not authorized to consider the fairness of any proposed transaction, that they did not have independent counsel to assist them, and that the majority of the board approving the transaction was not disinterested.[54] Under those circumstances, the court held that "[i]n light of the specific allegations of the complaint, combined with the averments that the transaction was approved by an interested board and that the special committee was a sham, . . . the complaint states a claim for breach of fiduciary duty sufficient to withstand a motion to dismiss."[55]

D. *Uncoerced Stockholder Approval on Full Disclosure Provides Grounds for Dismissal*

The fact that a transaction is subject to an entire fairness standard of review does not require the denial of a motion to dismiss in a conflict of interest transaction. In *Harbor Finance Partners v. Huizenga*,[56] stockholders of Republic Industries, Inc. (Republic) brought a derivative claim attacking the acquisition by Republic of AutoNation, Incorporated (AutoNation) as a self-interested transaction accomplished for the benefit of Republic directors who owned a large block of AutoNation shares. The court found that demand was excused because four of the seven directors of AutoNation were interested or not independent and that plaintiffs had adequately pled that the merger was unfair to the public stockholders of Republic.[57] The court, however, also found that because the transaction was approved by a majority of the stockholders and that the plaintiffs had failed to state a claim of nondisclosure or waste, the plaintiff's fairness claim was subject to dismissal.[58] The court's rationale was that "the effect of untainted stockholder approval of the Merger is to invoke the protection of the business judgment rule and to insulate the Merger from all attacks other than on the ground of waste."[59] The comments in dicta demonstrate the court of

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[52] *Id.*

[53] *Id.* at *15-*16, *reprinted in* 16 DEL. J. CORP. L. at 414-15.

[54] *Id.*

[55] *In re Shoe-Town, Inc. Stockholders Litig.*, 1990 Del. Ch. LEXIS 14, at *17, *reprinted in* 16 DEL. J. CORP. L. at 415.

[56] 751 A.2d 879 (Del. Ch. 1999).

[57] *Id.* at 889, 891.

[58] *Id.* at 890.

[59] *Id.* (footnote omitted).

chancery's reluctance to impose the costs of discovery and litigation where a transaction has been approved by independent decision makers:

> If fully informed, uncoerced, independent stockholders have approved the transaction, they have, it seems to me, made the decision that the transaction is "a fair exchange." As such, it is difficult to see the utility of allowing litigation to proceed in which the plaintiffs are permitted discovery and a possible trial, at great expense to the corporate defendants, in order to prove to the court that the transaction was so devoid of merit that each and every one of the voters comprising the majority must be disregarded as too hopelessly misguided to be considered a "person of ordinary sound business judgment." In this day and age in which investors also have access to an abundance of information about corporate transactions from sources other than boards of directors, it seems presumptuous and paternalistic to assume that the court knows better in a particular instance than a fully informed corporate electorate with real money riding on the corporation's performance.
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> Finally, it is unclear why it is in the best interests of disinterested stockholders to subject their corporation to the substantial costs of litigation in a situation where they have approved the transaction under attack. Enabling a dissident—who failed to get her way at the ballot box in a fair election— to divert the corporation's resources to defending her claim on the battlefield of litigation seems, if anything, contrary to the economic well-being of the disinterested stockholders as a class. Why should the law give the dissenters the right to command the corporate treasury over the contrary will of a majority of the disinterested stockholders? The costs to corporations of litigating waste claims are not trifling.[60]

Two transactions involving General Motors Company (GM) demonstrate the significance of fully informed, uncoerced stockholder approval to defeat claims at the motion to dismiss stage even where the plaintiff alleges a possible conflict of interest. In *In re General Motors Class H Shareholders Litig.*,[61] plaintiffs challenged the fairness of

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[60] *Harbor Fin. Partners*, 751 A.2d at 901 (quoting Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979)).

[61] 734 A.2d 611 (Del. Ch. 1999).

transactions which split up one of GM's subsidiaries. The court rejected the plaintiffs' loyalty claim because the shareholder class affected by the transaction was afforded the opportunity to approve or reject the board's decisions.[62]

Two aspects of the court's decision bear emphasis. First, the court held that where stockholders approve a transaction, it is of no import that the board chose not to afford special structural protections in formulating the transactions under attack:

> Where a board of directors offers a group of stockholders the ultimate procedural protection — the right to affirm or veto the decision at the corporate ballot box — and where that vote is untainted by misleading disclosures or improper coercion, I do not believe that plaintiffs can state a claim that the failure to employ lesser protections, such as a special committee mechanism, constitutes, in and of itself, a breach of fiduciary duty.[63]

Second, the court rejected the plaintiffs' argument that because the transaction required the directors to allocate consideration between two stockholder groups with potentially divergent interests, the mere allegation that the directors favored one group over another is sufficient to state a claim, even if the allocation was not tainted by self-interest:

> In my view, that is not the law. Rather, the plaintiffs must plead facts from which one could infer disloyalty or bad faith on the part of GM's directors, in the sense that the directors acted for reasons inimical to their fiduciary responsibilities. An allegation that properly motivated directors, for no improper personal reason, advantaged one class of stockholders over the other in apportioning transactional consideration does not state a claim for breach of the duty of loyalty.[64]

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[62] *Id.* at 616.

[63] *Id.* at 617 n.2.

[64] *Id.* at 618 (citing Gilbert v. El Paso Co., 575 A.2d 1131, 1147-48 (Del. 1990)). Where the plaintiff does plead director self-interest at odds with the interests of the public stockholders, a claim alleging disparate treatment of two classes of stockholders may survive a motion to dismiss. *See* Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377 (Del. Ch. 1999).

A similar result obtained in *Solomon v. Armstrong*,[65] where plaintiffs attacked GM's spin-off of its wholly-owned subsidiary, Electronic Data Systems Holding Corporation. Once again the court emphasized that even if the plaintiff were to plead a self-dealing transaction, defendants could still prevail on a motion to dismiss where the transaction is properly ratified by a fully-informed, independent shareholder vote: "Put simply, so long as the shareholder vote to approve or disapprove the transaction was made on a fully-informed, non-coerced basis, that vote operates *ex proprio vigore* as an independent foundation for the application of the business judgment rule."[66] After determining that the plaintiffs had failed to allege any material omissions or misrepresentations, the court dismissed the complaint as protected by the business judgment rule.[67]

E. *A Controlling Stockholder Who Bargains and Receives the Same Treatment in a Cash-Out Transaction as the Minority Stockholders May Still Be Required to Demonstrate Entire Fairness*

Even where a majority stockholder negotiates a merger transaction and receives the same consideration as the minority, a plaintiff may avoid dismissal by alleging that the majority stockholder has unique reasons for accomplishing the sale which may have caused it to sell at less than the best price possible. Thus, in *McMullin v. Beran*,[68] the court concluded that the defendants, directors of ARCO Chemical Co. (Chemical), an entity eighty percent owned by Atlantic Richfield Company (ARCO), were required independently to assess whether a proposed tender offer and merger transaction negotiated by ARCO was fair to the minority stockholders of Chemical. There, the court stated that the plaintiff, a shareholder of Chemical, had adequately alleged in her amended complaint that the price negotiated by ARCO may not have been fair because of its own need for immediate cash.[69] Specifically, the court read the complaint as alleging that "ARCO gained financial advantage from the immediate all-cash Transaction with [purchaser], at the expense of the minority shareholders, by sacrificing some of the value of Chemical, which might have been realized in a differently timed or structured agreement."[70] The court held that the

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[65] 747 A.2d 1098 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000).
[66] *Id.* at 1127.
[67] *Id.* at 1133.
[68] 765 A.2d 910 (Del. 2000).
[69] *Id.* at 921.
[70] *Id.* (footnote omitted).

allegation of delegation to the majority stockholder to structure and negotiate to sell all of Chemical, without an independent determination of Chemical's fair value as a going concern, if true, rebutted the presumptions of the business judgment rule and required the Chemical directors to file an answer.[71]

V. CONCLUSION

The standard of review at the motion to dismiss stage significantly affects the likelihood of success of a motion to dismiss a complaint attacking a self-dealing transaction. If a plaintiff can allege a self-dealing transaction that was not approved by a majority of disinterested and independent directors or separately ratified by fully informed stockholders not subject to coercion, then plaintiff will likely be able to defeat a motion to dismiss. A similar result may be obtained even where a majority shareholder bargains for and receives the same consideration as the minority if the plaintiff can allege that circumstances unique to the majority stockholder caused it to accept a transaction at less than the best price possible. Even where appraisal is an adequate remedy for stockholders aggrieved in a cash-out merger, well-pleaded allegations of unfair dealing, which result in an unfair price, will likely enable a plaintiff to survive a motion to dismiss, except in a complaint attacking a short-form merger. This case law demonstrates that the interests of corporations and their shareholders are best served by boards whose members include well-motivated, disinterested and independent directors who accept responsibility for recommending or approving transactions with interested directors or controlling shareholders.

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[71] *Id.* at 922.