STANDARDS OF REVIEW IN CONFLICT TRANSACTIONS ON MOTIONS TO DISMISS: LESSONS LEARNED IN THE PAST DECADE

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ABSTRACT

This Article reviews how the Delaware courts have assessed whether plaintiffs have pleaded facts which overcome the business judgment standard of review in favor of enhanced scrutiny or entire fairness in challenges to conflict transactions. The standard of review remains almost outcome-determinative at the motion to dismiss stage of the proceedings. Following a discussion in Part I of three issues the Delaware Supreme Court has clarified since the publication in 2001 of Standards of Review in Conflict Transactions: An Examination of Decisions Rendered on Motions to Dismiss, 26 Del. J. Corp. Law 911, Part II discusses the standard of review for a motion to dismiss under Delaware law. Part III defines a "conflict transaction" and Part IV describes the three standards of review for challenges to conflict transactions: business judgment, enhanced scrutiny and entire fairness.

Part V analyzes the court's application of these standards of review to complaints in the past ten years challenging conflict transactions. The authors organize the analysis by complaints in which plaintiffs succeeded in rebutting the business judgment rule, complaints where they failed to do so, complaints involving the interplay of Revlon claims, and complaints involving controlling stockholders. The authors conclude that at least for transactions not involving a controlling stockholder on both sides, a plaintiffs' complaint remains unlikely to survive a motion to dismiss if a conflict transaction has been approved by a majority of fully informed, disinterested and independent directors as such a complaint will be dismissed under the business judgment standard of review. While the entire fairness standard will apply ab initio to transactions where the controlling stockholder is on both sides, whether the Delaware Supreme Court will change the standard for controlling stockholder, going-private transactions

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involving unilateral two-step freeze-outs as has been suggested by the Court of Chancery remains uncertain.

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I. INTRODUCTION

In the last decade Delaware courts have addressed motions to dismiss complaints attacking conflict of interest transactions in a variety of factual settings.[1] Such motions are critical to both plaintiffs' and defendants' counsel and their clients. The former must evaluate whether a complaint will survive a motion to dismiss to determine whether initiating litigation is worth preparing the complaint and responding to a potentially case-dispositive motion. The latter seek to avoid discovery, trial, and a potential settlement or judgment by asking a court to dismiss the complaint at the outset. Lessons from the case law since the publication of *Standards of Review 2001* should assist both plaintiffs' and defendants' counsel and their clients.

The Delaware Supreme Court has clarified at least three critical issues since 2001. First, it held that a plaintiff who sufficiently pleads that a majority of interested directors approved a merger transaction may rebut the business judgment rule and survive a motion to dismiss, even if plaintiff was unable to plead that the minority of the board who acted as a special committee to negotiate and recommend the transaction was not disinterested or independent.[2] Second, the Supreme Court affirmed that, absent fraud or other egregious misconduct, the sole remedy for plaintiffs attacking a short-form merger is appraisal, thereby eliminating equitable claims of breach of fiduciary duty.[3] Third, it held that where a corporation's charter includes an exculpatory provision pursuant to DEL. CODE ANN. tit. 8 § 102(b)(7) and an

[1]We last addressed this topic ten years ago in Lewis H. Lazarus, *Standards of Review in Conflict of Interest Transactions: An Examination of Decisions Rendered on Motions to Dismiss*, 26 DEL. J. CORP. L. 911 (2001) [hereinafter *Standards of Review 2001*].

[2]Krasner v. Moffett, 826 A.2d 277, 284-85 (Del. 2003).

[3]Glassman v. Unocal Exploration Corp., 777 A.2d 242, 248 (Del. 2001).

approving board is independent and disinterested, a plaintiff cannot state a claim that a board breached fiduciary duties in a sale process absent well-pled allegations that the board utterly failed to obtain the best price.[4] As set forth below, the Delaware Court of Chancery has applied this last holding in ruling on several complaints where plaintiffs sought damages for alleged board failures to obtain the best price.[5] These cases provide guidance to practitioners on the type of factual pleadings that will survive a motion to dismiss under the enhanced scrutiny applicable to change of control transactions.

This Article begins by discussing the plaintiff-friendly standard on a motion to dismiss, defining a conflict of interest transaction, and describing the three standards of review a Delaware court generally will apply in evaluating allegations of director misconduct: (1) business judgment; (2) enhanced scrutiny; and (3) entire fairness.[6] Next, it examines the standard of review the Delaware courts have applied to a representative sampling of transactions on motions to dismiss where plaintiffs have alleged conflicts of interest. The challenged transactions generally fall within two categories: (1) where a director(s) on a company's board allegedly has a conflict of interest with respect to a given transaction;[7] and (2) where a controlling stockholder allegedly stands on both sides of a given transaction.[8] This Article concludes by noting that the Court of Chancery has raised issues concerning the standard of review for unilateral freeze-out transactions that await resolution in the next decade.

II. STANDARD FOR MOTIONS TO DISMISS

In reviewing a motion to dismiss a complaint under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief may be granted, a court must accept as true a plaintiff's well-pled allegations and draw "all reasonable inferences that logically flow from those allegations."[9] A court should accept "even vague allegations in the Complaint as 'well-pleaded' if they provide the defendant notice of the claim . . . and deny the motion

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[4]Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239, 244 (Del. 2009).

[5]*See infra* Part V.C.

[6]Emerald Partners v. Berlin, 787 A.2d 85, 89 (Del. 2001).

[7]*See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 n.9 (Del. 1994); *see also* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995) (citing Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1153 (Del. Ch. 1994)).

[8]*See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).

[9]Nemec v. Shrader, 991 A.2d 1120, 1125 (Del. 2010) (quoting Gantler v. Stephens, 965 A.2d 695, 703-04 (Del. 2009)).

unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof."[10] The Delaware Supreme Court has cautioned, however, that Delaware courts reviewing a motion to dismiss should neither "blindly accept conclusory allegations unsupported by specific facts, nor . . . draw unreasonable inferences in the plaintiffs' favor."[11] A court will not dismiss a complaint unless "it appears with reasonable certainty that the plaintiff would not be entitled to relief under any set of facts susceptible of proof."[12]

III. WHAT IS A "CONFLICT TRANSACTION"

A conflict transaction exists where an interested director or controlling stockholder stands on both sides of a transaction.[13] "A well settled precept of Delaware corporate law is that a fiduciary is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."[14] A single director's self-interest, however, may not deprive a board of the protections of the business judgment rule unless the plaintiff can demonstrate that the interested director dominated and controlled the board.[15] Similarly, a controlling stockholder must, in fact, stand on both sides of a transaction for its participation in the transaction to deprive the board of the protections of the business judgment rule.[16]

IV. STANDARDS OF REVIEW FOR CHALLENGED CONFLICT TRANSACTIONS

A. *Business Judgment*

The business judgment standard of review is the most difficult for a plaintiff's complaint to survive a motion to dismiss.[17] The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief

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[10]Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC, 27 A.3d 531, 536 (Del. 2011).

[11]Gantler v. Stephens, 965 A.2d 695, 703-04 (Del. 2009).

[12]*Nemec*, 991 A.2d at 1125.

[13]*In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 175 (Del. Ch. 2005) (citing Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).

[14]*Id.*

[15]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363-64 (Del. 1993).

[16]*See In re* John Q. Hammons Hotels Inc. S'holder Litig., 2009 WL 3165613, at *10 (Del. Ch. Oct. 2, 2009).

[17]*See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 36 (Del. Ch. 2010).

that the action taken was in the best interests of the company."[18] The business judgment rule shields directors from liability stemming from "their decisions so long as there exist 'a business decision, disinterestedness and independence, due care, good faith and no abuse of discretion and a challenged decision does not constitute fraud, illegality, *ultra vires* conduct or waste.'"[19]

The Delaware Supreme Court has explained how the presumption reflected in the business judgment rule operates in the context of a motion to dismiss:

> Procedurally, the plaintiffs have the burden to plead facts sufficient to rebut that presumption. On a motion to dismiss, the pled facts must support a reasonable inference that in making the challenged decision, the board of directors breached either its duty of loyalty or its duty of care. If the plaintiff fails to satisfy that burden, "a court will not substitute its judgment for that of the board if the . . . decision can be 'attributed to any rational business purpose.'"[20]

B. *Enhanced Scrutiny*

"Enhanced scrutiny is Delaware's intermediate standard of review."[21] It has subjective and objective components which generally require defendant directors to "bear the burden of persuasion to show that their motivations were proper and not selfish," and that "their actions were reasonable in relation to their legitimate objective" before a court will dismiss a complaint.[22] "Enhanced scrutiny applies when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[23]

Delaware courts generally will apply enhanced scrutiny in cases where the plaintiff challenges: (1) a board's enactment of defensive measures in

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[18]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[19]Robotti & Co., LLC v. Liddell, 2010 WL 157474 at *11 (Del. Ch. Jan. 14, 2010), *reprinted in* 36 DEL. J. CORP. L. 265, 283 (2011) (citing STEPHEN A. RADIN ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES FOR CORPORATE DIRECTORS 25, 424 (6th ed. 2009) (quotation inaccurate in original)).

[20]Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009) (citing Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

[21]Reis v. Hazelett Strip-Casting Corp., 2011 WL 4346913, at *8 (Del. Ch. Feb. 1, 2011).

[22]Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 810 (Del. Ch. 2007).

[23]*Reis*, 2011 WL 2011 WL 4346913, at *8.

response to a takeover attempt; and (2) a board's actions in a change of control transaction.[24] In the former circumstance, defendant board members must demonstrate: (i) that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"; and (ii) that the response selected was "reasonable in relation to the threat posed."[25] In the latter circumstance, defendant board members "bear the burden of proving that they (i) followed a reasonable decision-making process and based their decisions on a reasonable body of information and (ii) acted reasonably in light of the circumstances then existing."[26] When applying enhanced judicial scrutiny, a court determines whether the defendant board members "made a reasonable decision, not a perfect decision."[27] As shown below, notwithstanding that defendants bear certain burdens when this standard applies, a rote incantation by plaintiffs that defendants failed to meet their duties in responding to a hostile takeover or in a transaction for the sale of control will not survive a motion to dismiss.[28]

C. *Entire Fairness*

The entire fairness standard of review is the standard most favorable to plaintiff to avoid dismissal at the pleadings stage.[29] That standard requires a court to analyze a challenged transaction for fair dealing and fair price.[30] It is not a bifurcated review but rather one "requiring an examination of all aspects of the transaction to gain a sense of whether the deal in its entirety is fair."[31] The Delaware Supreme Court has long noted that "[t]he applicable standard of judicial review often controls the outcome of the litigation on the merits."[32] That is because unless a plaintiff can rebut the business judgment rule presumption, a court will defer to the judgment of the board.[33] If entire

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[24]*See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS 4-182 (3d ed. Supp. 2011).

[25]*Unocal*, 493 A.2d at 955.

[26]*See In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 830, (Del. Ch. Feb. 14, 2011) (citing Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994)).

[27]*Id.* (quoting *Paramount*, 637 A.2d at 45).

[28]*See infra* notes 48-52 and accompanying text.

[29]*See* Reis v. Hazelett Strip-Casting Corp., 2011 WL 4346913, at *10 (Del. Ch. Feb. 1, 2011).

[30]Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

[31]Kahn v. Lynch Commc'n Sys., Inc., 669 A.2d 79, 84 (Del. 1995) (citing *Weinberger*, 457 A.2d at 711).

[32]Emerald Partners v. Berlin, 787 A.2d 85, 89 (Del. 2001) (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995)).

[33]*See In re* MONY Grp. S'holder Litig., 853 A.2d 661, 675 (Del. Ch. 2004).

fairness is the standard of review, defendants have the burden of establishing that a transaction is fair based on a non-bifurcated review of price and process.[34] That burden may shift if the board can demonstrate that a well-functioning special committee of disinterested and independent directors or fully informed and disinterested stockholders approved the transaction.[35] Generally, where a plaintiff can plead facts sufficient to have the transaction reviewed under entire fairness, the plaintiff's complaint will survive a motion to dismiss.[36]

V. CASE ANALYSES

The presumption of the business judgment rule can be rebutted where a plaintiff sufficiently alleges that a majority of directors was not disinterested or independent regarding a transaction.[37] In *Orman v. Cullman* the Court of Chancery summarized the general rule regarding what a plaintiff must do to rebut the business judgment rule at the pleadings stage:

> As a general matter, the business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the board was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders. To establish that a board was interested or lacked independence, a plaintiff must allege facts as to the interest and lack of independence of the individual members of that board. To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating "that a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director." I recognize situations can exist

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[34] *See* Emerald Partners v. Berlin, 2003 WL 21003437, at *2, *38 (Del. Ch. Apr. 28, 2003), *reprinted in* 28 DEL. J. CORP. L. 1027, 1030, 1086 (2003).

[35] *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 178 n.52 (Del. Ch. 2005).

[36] *But see* Monroe Cnty. Emps.' Ret. Sys. v. Carlson, 2010 WL 2376890, at *1 (Del. Ch. June 7, 2010) (granting defendants' motions to dismiss despite Chancellor Chandler's acknowledgment that "entire fairness" was the appropriate standard of review for the case because the complaint, if proven, would only sufficiently prove unfair dealing and not unfair price).

[37] Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003). This Article does not exhaustively cover the factors considered by the court in determining disinterestedness and independence.

> when the material interest of a number of directors less than a majority may rebut the business judgment presumption and lead to an entire fairness review. That is when an "interested director fail[ed] to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest a significant fact in the evaluation of the proposed transaction."[38]

Cases in which the courts have applied this standard and found that the plaintiff's allegations sufficed to rebut the business judgment rule are discussed below.

A. *Complaints Alleging Director Conflict of Interest Regarding a Particular Transaction that Successfully Rebut the Business Judgment Rule*

1. Transactions Negotiated and Recommended by a Special Committee but Approved by Majority Interested Boards May Not Receive Business Judgment Protection at the Pleading Stage

In 2003, the Delaware Supreme Court held that where a merger is approved by a majority of conflicted directors, the utilization of a well-functioning, independent special committee to negotiate and recommend the transaction may not suffice, at the pleadings stage, to preserve the protection of the business judgment rule.[39] Specifically, in *Krasner*, former shareholders brought an action alleging that the directors of Freeport-McMoRan Sulphur, Inc. ("FSC") breached their fiduciary duties by approving a merger with McMoRan Oil & Gas Co. ("MOXY") to form a new entity, McMoRan Exploration Co. ("MEC").[40] Plaintiffs alleged that five of the seven directors of FSC had disabling conflicts, including serving as directors of both the FSC and MOXY boards, and those conflicts resulted in the FSC board approving a transaction in which the stockholders of MOXY received disproportionate consideration in MEC.[41] The Court of Chancery held that plaintiffs sufficiently alleged facts indicating that five of

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[38] Orman v. Cullman, 794 A.2d 5, 22-23 (Del. Ch. 2002) (quoting Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 979 (Del. Ch. 2000); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995)).

[39] *Krasner*, 826 A.2d at 284.

[40] *Id.* at 281.

[41] *Id.*

the seven directors of FSC had disabling conflicts of interest in the merger.[42] The Court of Chancery, however, applied the business judgment rule and dismissed the complaint for failure to state a claim because plaintiffs failed to "allege facts sufficient to [impugn] the disinterest, independence or processes of the special committee" which negotiated the transaction.[43]

On appeal, the Delaware Supreme Court reversed, holding that:

> Because the plaintiffs have sufficiently alleged facts to suggest that the MEC transaction was "not approved by a majority consisting of disinterested directors," the plaintiffs are entitled at the pleading stage to the inferences that may lead to the conclusion that the business judgment rule would not apply to the FSC board's decision to approve the MEC merger and to recommend it to the FSC stockholders.[44]

The Supreme Court was not swayed by defendants' contention that the use of an independent special committee cleansed any conflicts and entitled defendants to a presumption of the business judgment rule at the pleadings stage.[45] In rejecting this argument, the Supreme Court stated:

> We do not, however, reach that issue because the FSC directors, not the plaintiffs, bear the burden of proving that the MEC merger was approved by a committee of disinterested directors, acting independently, with real bargaining power to negotiate the terms of the merger. The defendants cannot satisfy this burden at the pleading stage of this action.[46]

The Supreme Court reasoned that determining the independence of a special committee is a fact-intensive inquiry that could not be accomplished at the pleadings stage.[47] Accordingly, the Supreme Court's holding in *Krasner* demonstrates that well-pled allegations that a majority of interested directors approved a transaction can suffice to rebut the business judgment

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[42] *Id.*

[43] *Krasner*, 826 A.2d at 282 (quoting In re Freeport-McMoRan Sulphur, Inc. S'holders Litig., No. 16729-NC (Del. Ch. Sept. 10, 2002) (dismissing amended complaint with prejudice via bench ruling)).

[44] *Id.* at 284.

[45] *Id.* at 284-85.

[46] *Id.* (citation omitted).

[47] *Krasner*, 826 A.2d at 286.

rule, even if a special committee negotiates and recommends the transaction.[48]

2. Plaintiff May State a Claim for the Abandonment of a Sale Process by Pleading a Lack of Good Faith Pursuit of a Legitimate Corporate Interest

In *Gantler v. Stephens*, the Delaware Supreme Court held that plaintiffs had rebutted the presumption of the business judgment rule, which normally would protect a board's decision to reject a merger proposal, by adequately pleading director self-interest and a breach of the duty of loyalty.[49] Plaintiffs alleged that the defendant board members sabotaged the due diligence of a sales process, rejected a viable merger proposal, and terminated the sales process to retain the benefits of continued incumbency.[50] With those allegations, plaintiffs contended that the board's decisions should be analyzed under the entire fairness standard of review or, alternatively, enhanced scrutiny.[51] The Supreme Court confirmed the Court of Chancery's opinion that the *Unocal* enhanced scrutiny test[52] did not apply to the board's actions because plaintiffs did not allege a "hostile takeover attempt or similar threatened external action" to which the defendants could respond "defensively."[53] The Supreme Court held, however, that plaintiffs had alleged disloyal conduct sufficient to rebut the presumption of the business judgment rule.[54] The Supreme Court found that the board's termination of the sales process did not meet the two-pronged test necessary to apply the business judgment rule.[55]

The two-pronged test, as set forth in *TW Services, Inc. v. SWT Acquisition Corp.*, requires a showing that: (1) the board reached its decision to abort the sales process in good faith pursuant to a legitimate corporate

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[48]The decision in *Krasner* does not address what occurs where a board authorizes an independent special committee to act on behalf of a conflicted board without further action by the majority-interested board. As noted by the Delaware Supreme Court, that option is not available in a merger transaction because, under DEL. CODE ANN. tit. 8, § 141(c) (2011), the board as a whole must act to approve and recommend a merger transaction, and that responsibility may not be delegated to a special committee. *Krasner*, 826 A.2d at 286 n.37.

[49]Gantler v. Stephens, 965 A.2d 695, 699 (Del. 2009).

[50]*Id.* at 704.

[51]*Id.* at 705.

[52]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).

[53]*Gantler*, 965 A.2d at 705.

[54]*Id.* at 707.

[55]*Id.* at 706-07.

interest; and (2) the board did so advisedly.[56] The Supreme Court held that the complaint sufficiently pled self-interest (in addition to entrenchment motives) for a majority of the board.[57] In so holding, the Supreme Court relied on the company's proxy materials in which defendants admitted that the directors had a conflict of interest in taking the company private since they were in a position to structure the reclassification in a way that benefited their interests differently from the interests of the unaffiliated shareholders.[58] That difference from the interest of the unaffiliated shareholders was sufficient to create a conflict of interest that applied to a majority of the board and thus rebutted the business judgment rule.[59] Because the Supreme Court found a majority of the directors had a disabling self-interest, it did not analyze whether the board acted advisedly.[60]

3. Even Where a Majority of Disinterested Directors Comprise the Board that Approves a Transaction, Allegations that a Board Was Dominated by a Self-Interested Director May Rebut the Business Judgment Rule

In *In re infoUSA, Inc. Shareholders Litigation*, for example, plaintiffs challenged a panoply of company transactions, allegedly to the benefit of CEO, director, and forty-one percent shareholder Vinod Gupta.[61] The InfoUSA board consisted of nine directors.[62] Among the challenged actions was the creation and subsequent dissolution of a purported sham special committee, allegedly created to enable Gupta to purchase the company at an inequitable price.[63] The Court of Chancery found that plaintiffs adequately alleged that the Gupta-controlled majority, in an effort to create the

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[56] *Id.* at 706; *see also* TW Servs., Inc. v. SWT Acquisition Corp., 1989 WL 20290, at *11 (Del. Ch. Mar. 2, 1989), *reprinted in* 14 DEL. J. CORP. L. 1169, 1190-91 (1989) (providing the two-pronged test).

[57] *Gantler*, 965 A.2d at 707.

[58] *Id.*

[59] *Id.*

[60] The Supreme Court's ruling in *Gantler* also confirms that officers of Delaware corporations have the same fiduciary duties of loyalty and care as directors. *Id.* at 708-09. This has important implications for non-director officers of Delaware corporations, in particular because, as the court points out in a footnote, there is at present no statutory authorization for the exculpation of officers for monetary liability for breach of their duty of care. *Id.* at 709 n.37. The court also holds that a statutorily required shareholder vote, such as for the approval of a merger, does not constitute ratification of breaches of fiduciary duties. *Id.* at 714. A detailed discussion of these holdings is beyond the purview of this Article.

[61] *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 975 (Del. Ch. 2007).

[62] *Id.* at 974-75.

[63] *Id.* at 995.

appearance of due diligence in finding an acquirer for the company, created a sham special committee that would act at the behest of Gupta's directors.[64] When the special committee took its charge seriously and actively searched for a purchaser, those directors dissolved the special committee.[65] The court found the well-pled allegations of the sham going-private process sufficient to state a claim for breach of fiduciary duty and denied the motion to dismiss.[66] Similarly, the court found that the complaint sufficiently pled allegations of repeated self-dealing to the benefit of Gupta and his controlled directors to rebut the business judgment rule.[67]

In reaching its conclusion, the court held that, unlike in *Globis Partners*,[68] plaintiffs sufficiently pled that a majority of directors faced a substantial risk of personal liability arising out of their knowing dissemination of materially misleading information in Form 10-Ks to the shareholders.[69] The Form 10-Ks included mischaracterizations of company payouts for personal indulgences—including payments made to a Gupta-owned entity (under the guise of "aircraft and related services").[70] These payments were used for a personal residence, a private yacht, and private jets—primarily enjoyed by Gupta.[71] These allegations, while not the only well-pled allegation of self-interest or lack of independence, satisfied the court that a majority of the board knew about the purported mischaracterizations in the Form 10-Ks and therefore was interested and/or lacked independence regarding the disputed transactions.[72]

In another Gupta-related matter, the Court of Chancery denied a 12(b)(6) motion after finding that plaintiffs adequately pled that a former director—who was also the company's largest stockholder—so dominated the company's board through threats and intimidation that he forced the board to approve an unfair transaction.[73] In *New Jersey Carpenters Pension Fund v. InfoGROUP*, former shareholders of *info*GROUP brought an action seeking damages relating to the merger of *info*GROUP into a subsidiary of

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[64] *Id.* at 995-96.

[65] *infoUSA*, 953 A.2d at 996.

[66] *Id.*

[67] *Id.* at 1000.

[68] Globis Partners, L.P. v. Plumtree Software, Inc., 2007 WL 4292024, at *13 (Del. Ch. Nov. 30, 2007); *see also infra* Part IV.B.2.

[69] *infoUSA*, 953 A.2d at 990.

[70] *Id.*

[71] *Id.*

[72] *Id.* at 991.

[73] N.J. Carpenters Pension Fund v. InfoGROUP, Inc., 2011 WL 4825888, at *11 (Del. Ch. Oct. 6, 2011).

CCMP Capital Advisors, LLC ("CCMP").[74] Plaintiffs alleged that the directors of *info*GROUP breached their duty of loyalty in approving an unfair transaction because then-director Gupta was interested, and dominated and controlled the board.[75] Plaintiffs alleged interest based on Gupta's well-known need for liquidity to satisfy debts in excess of $25 million and to launch a new business venture.[76] Plaintiffs further alleged that Gupta lacked alternatives to finance his debts or new venture[77] which led him to act to force a sale of the company.[78]

The Court of Chancery held that the receipt of $100 million in cash, representing the proceeds of the merger, by a man in desperate need of liquidity is material.[79] After finding that Gupta was interested in the transaction, the Court focused on his purported domination of the board. The complaint detailed Gupta's threats of lawsuits against the directors if they did not agree to sell the company, along with claims that he had uncovered information evidencing financial fraud for which the directors faced liability.[80] Gupta also "denigrated and called for the firing of the Company's management" throughout 2009.[81] In finding plaintiffs' allegations sufficient to deny a motion to dismiss, the Court of Chancery also considered e-mails between directors evidencing a desire to sell the company to avoid having to deal with Gupta.[82] Based upon these factual allegations, the Court of Chancery held that plaintiffs had sufficiently alleged that a majority of the director defendants who voted for the merger was not independent and denied defendants' motion to dismiss.[83]

4. Approval of a Transaction by a Majority of Directors Designated by and Dependent Upon a Party Interested in a Transaction May Rebut the Business Judgment Rule

Standing alone, a court will not find self-interest or lack of independence simply because a shareholder designated a director to serve on the board.[84] However, should a designated director also receive benefits

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[74] *Id.* at *1.
[75] *Id.* at *7.
[76] *Id.* at *2, *7.
[77] *N.J. Carpenters Pension Fund*, at *9.
[78] *Id.*
[79] *Id.* at *10.
[80] *Id.* at *11.
[81] *N.J. Carpenters Pension Fund*, at *11.
[82] *Id.*
[83] *Id.*
[84] *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 65 (Del. 1989).

from a transaction not shared with other shareholders, a conflict may arise. For example, in *In re Trados Incorporated Shareholder Litigation*, the Court of Chancery refused to dismiss a complaint attacking the sale of a company where the plaintiffs alleged that a majority of the directors approving the sale was conflicted.[85] Plaintiffs alleged that the challenged sale favored the interests of the preferred shareholders at the expense of the common shareholders.[86] The holders of the company's preferred stock (four private equity firms) received most of their prescribed liquidation preference, and two company executives who served on the board received cash bonuses tied to the sale price, even if that price did not suffice to provide any compensation to the common stockholders.[87] Plaintiffs contended the defendant directors affiliated with the preferred stockholders sold the company when it was unnecessary to do so; thus, those directors improperly favored the interests of the preferred stockholders at the expense of—and without considering the interests of—the common stockholders.[88]

The Court of Chancery held that plaintiffs alleged sufficient facts to rebut the business judgment rule presumption.[89] The company's preferred stockholders each designated a director to the board.[90] The court held that this fact, alone, does not create a disabling conflict.[91] However, the complaint included an allegation that the four designee directors were employees of the private equity firms comprising the preferred shareholders and that two additional directors were executives who were entitled to receive incentive bonuses related to the sale price of the company whether or not the sale price resulted in any payment to the common stockholders.[92] The court found that plaintiffs sufficiently alleged that these six directors received material personal benefits as a result of the sale and were incapable of exercising disinterested and independent business judgment.[93] Based on this finding of interest and lack of independence for a majority of the board of directors, the court denied a motion to dismiss the claim for breach of fiduciary duty related to the board's approval of the merger.[94]

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[85] *In re* Trados Inc. S'holder Litig., 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009).

[86] *Id.*

[87] *Id.* at *4.

[88] *Id.* at *6.

[89] *Trados*, 2009 WL 2225958, at *8.

[90] *Id.*

[91] *Id.* & n.43 (citing Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 65 (Del. 1989)) (holding that a director's designation by one of the corporation's largest shareholders "alone did not make him an interested director").

[92] *Id.*, at *8.

[93] *Trados*, 2009 WL 2225958, at *9.

[94] *Id.*

The crux of plaintiffs' contention regarding the sale of the company was that, while the company had performed poorly in the past, more recently it had achieved profitability, exceeded its financial plan, and secured adequate debt financing.[95] Based on the well-pled allegations of the complaint, the court found it reasonable to infer that the interests of the preferred and common shareholders diverged.[96] Plaintiffs alleged that there was no reason to sell the company at the time the board authorized the sale and, in so doing, deprive the common stockholders of the possibility of reaping the rewards of better future performance.[97] The court stated in its holding that:

> it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders. . . . [P]laintiff can avoid dismissal if the Complaint contains well-pleaded facts that demonstrate that the director defendants were interested or lacked independence with respect to this decision.[98]

5. Well-Pled Allegations that the Board Was Not Informed in Approving a Conflict Transaction May Rebut the Business Judgment Rule

Where a director or group of directors comprising less than a majority of the board has a conflict of interest, the director or directors must disclose that conflict to the board; if not, a plaintiff may be able to use that conflict to rebut the business judgment rule.[99] This scenario occurred in *Teachers' Retirement System of Louisiana v. Aidinoff*, where the Court of Chancery analyzed the actions of insider directors who purportedly used a wholly owned corporation ("Starr") to siphon funds allegedly belonging to

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[95] *Id.* at *7.

[96] *Id.*

[97] *Trados*, 2009 WL 2225958, at *3, *7.

[98] *Id.* at *7.

[99] *Cf.* Cinerama, Inc., v. Technicolor Inc., 663 A.2d 1156, 1168 (Del. 1995) (noting that a material interest of "'one or more directors less than a majority of those voting' would rebut the application of the business judgment rule if the plaintiff proved that 'the interested director . . . fail[ed] to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.'") (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1153 (Del. Ch. 1994))).

American International Group ("AIG") for their own personal gain.[100] Plaintiff alleged that three insider directors diverted funds from AIG to Starr, while Starr performed no services that AIG did not—and could not—perform itself.[101] The insider directors moved to dismiss the complaint on the basis that the challenged transactions were approved by a majority of disinterested directors.[102] The court, however, determined that it did not need to perform an analysis of the interest of the remaining directors to deny defendants' motion to dismiss.[103]

The court grounded its denial of the motion to dismiss the fiduciary duty claims on the basis that, despite approval of a majority of purportedly disinterested directors, the board did not authorize any "integrity-enhancing" measures, such as a special committee, in evaluating the interested transactions.[104] Moreover, the court held that the board was not adequately informed by the insider directors of their self-interest in the challenged transactions.[105] In so holding, the court noted:

> The informed approval of a conflict transaction by an independent board majority remains an important cleansing device under our law and can insulate the resulting decision from fairness review under the appropriate circumstances. For that device to be given credit, however, the board majority must have acted in an informed manner. The conflicted insider gets no credit for bending a curve ball past a group of uncurious Georges who fail to take the time to understand the nature of the conflict transactions at issue.[106]

Based upon the court's determination that the non-insider directors were not well-informed about the challenged transactions, the court denied

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[100]Teachers' Ret. Sys. of La. v. Aidinoff, 900 A.2d 654, 658 (Del. Ch. 2006).
[101]*Id.*
[102]*Id.* at 667.
[103]*Id.* at 667-68.
[104]*Aidinoff*, 900 A.2d at 669.
[105]*Id.*
[106]*Id.* at 669-70 (citing WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 313 (1st ed. 2003) ("How then is the Court of Chancery likely to review an interested transaction between a company and one or two of its directors who are not affiliated with a controlling shareholder? It will employ business judgment review, we believe, as long as the remaining disinterested directors who approve the transaction cannot be shown to be misinformed, dominated, or manipulated in some fashion."))

defendants' motion to dismiss because it found that plaintiff's allegations sufficed to rebut the presumption of the business judgment rule.[107]

6. A Plaintiff Who is Able to Rebut the Business Judgment Rule Must Also Adequately Allege Facts Demonstrating a Transaction's Unfairness to Survive a Motion to Dismiss

Simply rebutting the business judgment rule does not guarantee that a plaintiff's claims for breach of fiduciary duty will survive a motion to dismiss. A plaintiff must also adequately plead that a transaction is not entirely fair.[108] For example, the Court of Chancery relied upon its holding in *Carlson* and dismissed certain claims for breaches of fiduciary duty in a complaint alleging that an interested board authorized self-interested stock purchase options.[109] In *Ravenswood*, an interested three-director board adopted a stock purchase option plan that permitted the self-interested directors (who, in aggregate, owned approximately 30% of the company's Class A shares and all of the Class B, or voting, shares) to expand their interest in the company.[110] The court held that because the approving directors and the beneficiaries of the options were the same, and neither an independent committee of directors nor independent stockholders approved the option grants, the defendants had to demonstrate that the transaction was entirely fair.[111] However, the court dismissed the claims because plaintiff failed to adequately allege facts demonstrating the unfairness of the transaction.[112] Supporting its conclusion, the court relied upon the fact that: (1) the option plan could only be exercised at a price not lower than the stock market value at the time of the transaction; (2) the defendants already controlled all the company's voting rights; and (3) even if all the options were granted, the defendants would not obtain a majority interest in the Class A shares.[113]

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[107] *Id.* at 667-70, 675.

[108] *See* Monroe Cnty. Emps.' Ret. Sys. v. Carlson, 2010 WL 2376890, at *1 (Del. Ch. Jun. 7, 2010).

[109] Ravenswood Inv. Co. v. Winmill, 2011 WL 2176478, at *4 (Del. Ch. May 31, 2011).

[110] *Id.* at *1-*2.

[111] *Id.* at *4.

[112] *Id.*

[113] *Ravenswood*, 2011 WL 2176478, at *4.

7. Rebutting the Business Judgment Rule at the Pleading Stage Does Not Necessarily Preclude Dismissal Based Upon the Business Judgment Rule at a Later Time in the Proceedings

While rebutting the presumption of the business judgment rule is integral to a complaint surviving a motion to dismiss, plaintiffs cannot assume that the same result will occur at a later stage of the proceedings. As set forth in the Court of Chancery's holding in *Orman*, rebuttal of the business judgment rule at the pleadings stage does not foreclose the court from applying business judgment protection to the defendants later, when presented with a fuller record.[114] In *Orman*, a shareholder of General Cigar Holdings Inc. ("GCHI") challenged the merger between GCHI and Swedish Match AB, alleging that the director defendants breached their fiduciary duty of loyalty by approving the merger.[115] Plaintiff claimed the GCHI board acted disloyally because a majority of the directors on the board was interested in the merger and/or not independent.[116] GCHI had an eleven-member board, of which defendants conceded that four directors, each affiliated with the controlling shareholder, were interested in the merger since they received benefits from the transaction that were not shared with the other shareholders.[117] Of the remaining seven directors, plaintiff sufficiently pled that two directors, each personally benefitting from a consulting agreement with the pre-existing and ultimately surviving company, lacked independence relating to the transaction.[118] In analyzing whether the two directors lacked independence, the court found that the income generated by the consulting agreements was material to each director, thus making those directors beholden to the controlling shareholder.[119]

Based on its analysis, the court held that six of the eleven directors on GCHI's board were either interested in the transaction or lacked independence.[120] Accordingly, the court denied the motion to dismiss.[121] However, the court emphasized that the pleadings stage dictated the result and that a different outcome might obtain after discovery:

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[114]Orman v. Cullman, 794 A.2d 5, 31 (Del. Ch. 2002).
[115]*Id.* at 14.
[116]*Id.* at 19.
[117]*Id.* at 24-25.
[118]*Orman*, 794 A.2d at 30-31.
[119]*Id.*
[120]*Id.* at 31.
[121]*Id.*

> Reaching this decision with regard to the loyalty of the Board that approved the merger, however, does not rebut the business judgment presumption at this stage of the litigation. It merely means that the business judgment presumption may not be used as the basis to dismiss Orman's fiduciary duty claims for failure to state a cognizable claim. Further discovery is necessary to determine whether the facts—as they truly existed at the time of the challenged transaction, rather than those accepted as necessarily true as alleged—are sufficient to rebut the business judgment rule presumption and to trigger an entire fairness review.[122]

Notably, while the complaint survived the motion to dismiss, the Court of Chancery ultimately dismissed the fiduciary duty claims on defendants' motion for summary judgment.[123] In doing so, the court found that the fully informed vote of the majority of the minority shareholders approving the transaction was not improperly coerced and acted to ratify the transaction and extinguish plaintiff's claims.[124]

B. *Complaints Dismissed for Failing to Rebut the Business Judgment Rule*

1. Allegations that Directors Benefited in a Transaction from Pre-Existing Contractual Rights Fail to Rebut the Business Judgment Rule

Demonstrating director self-interest in a transaction typically requires well-pled allegations supporting an inference that the director defendants had a material interest in the transaction inconsistent with the interest of the remaining shareholders.[125] However, where a director receives a purported benefit from a transaction based upon contractual rights held by the director prior to and wholly unrelated to the challenged transaction, such a benefit

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[122] *Orman*, 794 A.2d at 31.

[123] Orman v. Cullman, 2004 WL 2348395, at *9 (Del. Ch. Oct. 20, 2004), *reprinted in* 30 DEL. J. CORP. L. 635, 650 (2005).

[124] *Id.* at *8, 30 DEL. J. CORP. L. at 649-50. However, had *Orman* been decided post-*Gantler*, the shareholder vote approving the transaction likely would not have ratified the transaction and extinguished plaintiff's fiduciary claims. This is so because the Delaware General Corporation Law requires a shareholder vote to approve a merger. DEL. CODE ANN. tit. 8, § 251 (2011).

[125] Robotti & Co. v. Liddell, 2010 WL 157474, at *9 (Del. Ch. Jan. 14, 2010), *reprinted in* 36 DEL. J. CORP. L. 265, 278 (2011).

does not create a disabling self-interest in a transaction.[126] In *Robotti & Company, LLC v. Liddell*, plaintiffs challenged a stockholder rights offering and alleged the directors, as option holders, breached their fiduciary duty of loyalty by engaging in self-dealing and obtaining a personal financial benefit from a transaction that diluted the value of the company and, therefore, the shares held by the public stockholders.[127] The offering was intended to raise capital to fund a drilling program and also to repay an outstanding balance on a line of credit.[128] This was to be achieved by permitting current stockholders to purchase additional shares.[129] The price of the offering was below the market value of the company shares, which triggered an anti-dilution provision that permitted holders of outstanding options and warrants to exercise their options and warrants at reduced prices per share.[130] Shareholder plaintiffs argued that the triggering of the anti-dilution provisions resulted in a benefit for the directors that was not shared by the other shareholders and, therefore, constituted a self-dealing transaction.[131]

The Court of Chancery, however, held that plaintiffs had failed adequately to plead self-dealing.[132] While plaintiffs alleged that the anti-dilution provision triggered by the offering allowed the directors to increase their equity stake in the corporation, the court ruled that the provision simply allowed the directors to maintain the same ownership percentage they had prior to the offering.[133] Moreover, the price paid by the directors to maintain their stock holdings had been contractually agreed upon in their pre-offering option agreements.[134] As a result, the court found that the directors received no personal benefit that did not also accrue to the public stockholders.[135]

Similarly, the court was not persuaded by plaintiffs' allegations of bad faith resulting from the board's implementation of the stockholder rights offering.[136] The court found that the board had met several times to discuss the offering and considered alternative methods of obtaining capital, and therefore, "did not completely abdicate their fiduciary responsibilities."[137] The court also noted that the complaint lacked sufficient allegations that the

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[126] *Id.* at *1, 36 DEL. J. CORP. L. at 265.
[127] *Id.*, 36 DEL. J. CORP. L. at 265.
[128] *Id.* at *2, 36 DEL. J. CORP. L. at 267.
[129] *Robotti*, 2010 WL 157474, at *1-*2, 36 DEL. J. CORP. L. at 266-67.
[130] *Id.* at *2, 36 DEL. J. CORP. L. at 268.
[131] *Id.* at *1, 36 DEL. J. CORP. L. at 265.
[132] *Id.* at *15, 36 DEL. J. CORP. L. at 289.
[133] *Robotti*, 2010 WL 157474, at *10, 36 DEL. J. CORP. L. at 279-80.
[134] *Id.*, 36 DEL. J. CORP. L. at 280.
[135] *Id.*, 36 DEL. J. CORP. L. at 280.
[136] *Id.* at *11, 36 DEL. J. CORP. L. at 282.
[137] *Robotti*, 2010 WL 157474, at *11, 36 DEL. J. CORP. L. at 282.

directors engaged in disloyal conduct by bowing to the will of the company's controlling stockholder.[138] Because plaintiffs failed adequately to allege that the defendant directors either received a personal benefit or consciously disregarded their duties, the court held the decision to initiate the offering was protected by the business judgment rule and granted the motion to dismiss.[139]

2. Potential for Director Liability Remains a Difficult Standard to Meet when Pleading Director Conflict of Interest in a Transaction

In *Globis Partners, L.P. v. Plumtree Software, Inc.* the Court of Chancery revisited whether an allegation that directors engaged in a merger transaction to avoid personal liability constituted self-dealing.[140] In *Globis*, a class of Plumtree shareholders alleged that the Plumtree directors breached their fiduciary duties in agreeing to a low sale price for the company.[141] The plaintiffs sought to rebut the presumption of the business judgment rule by contending that the director defendants commenced a fire sale of the company to avoid personal liability in connection with a purportedly breached contract with the U.S. General Services Administration.[142] In determining whether the director defendants breached their fiduciary duties in allegedly attempting to circumvent personal liability, the court stated that the plaintiffs were "entitled to a reasonable inference of interestedness, however, where a complaint indicates a 'substantial likelihood' liability will be found."[143] This standard can be met upon a showing that: (1) the director defendants faced substantial liability; (2) the director defendants were motivated by such liability; and (3) the merger was pretextual.[144]

The court found the complaint bereft of well-pled allegations supporting plaintiffs' contention that the director defendants faced a substantial likelihood of liability.[145] In criticizing plaintiffs' effort, the court noted that "[m]erely stating Defendants were 'grossly negligent' without alleging any particularized fact to support that conclusion [was]

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[138] *Id.* at *1, 36 DEL. J. CORP. L. at 265.

[139] *Id.* at *5, 36 DEL. J. CORP. L. at 272.

[140] Globis Partners, L.P. v. Plumtree Software, Inc., 2007 WL 4292024, at *7-*8 (Del. Ch. Nov. 30, 2007).

[141] *Id.* at *3.

[142] *Id.*

[143] *Id.* at *6.

[144] *Globis*, 2007 WL 4292024, at *6 (citing Lewis v. Ward, 852 A.2d 896, 906 (Del. 2004)).

[145] *Id.*

insufficient."[146] The court also found inadequate plaintiffs' allegations that the directors were motivated to avoid liability by entering into a pretextual merger.[147] As required in *Lewis v. Ward*,[148] those allegations must be pled with particularity.[149] The court found that plaintiffs had failed to plead either that the director defendants considered potential claims against them prior to effectuating the transaction or the existence of pending or threatened lawsuits against the directors prior to the merger.[150] The complaint also failed to adequately plead facts that the director defendants were interested in the merger by receiving improper benefits.[151] While the court acknowledged that there was no "bright-line rule" for determining when merger-related benefits constitute a disabling self-interest, it found the allegations in the complaint so lacking that they did "not require the court to draw fine distinctions."[152] The court canvassed the list of the director defendants' purported benefits and concluded that they were either immaterial (i.e., the directors' indemnification rights and the CEO director's severance), untainted by conflicts of interest (i.e., acceleration of options, the value of which would increase as the purchase price rose) or shared by all shareholders (i.e., option cash-outs).[153] Thus, the court found no basis to rebut the business judgment rule and granted the motion to dismiss the breach of fiduciary duty claims.[154]

C. *The Interplay of Revlon Claims with Conflict Transactions*

Transactions involving a sale of control of a corporation bring unique issues to the pleadings stage. As previously stated, before the business judgment rule can apply to a change of corporate control transaction, a court must apply enhanced scrutiny in which the court reviews directors' actions under a "reasonableness" rather than the typical "rational basis" standard.[155] However, conclusory allegations seeking to invoke *Revlon*[156] will not rebut the presumption of the business judgment rule:

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[146] *Id.*
[147] *Id.* at *8.
[148] *Ward*, 852 A.2d at 906.
[149] *Globis*, 2007 WL 4292024, at *6.
[150] *Id.*
[151] *Id.* at *9.
[152] *Id.* at *8.
[153] *Globis*, 2007 WL 4292024, at *8
[154] *Id.* at *9.
[155] Binks v. DSL.net, Inc., 2010 WL 1713629, at *6 (Del. Ch. Apr. 29, 2010).
[156] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

> Once a board of directors determines to sell the corporation in a change of control transaction, its responsibility is to endeavor to secure the highest value reasonably attainable for the stockholders. This obligation is a contextually-specific application of the directors' duty to act in accordance with their fiduciary obligations, and there is no single blueprint that a board must follow to fulfill its duties. Rather, the board's actions must be evaluated in light of the relevant circumstances to determine whether they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule.[157]

Furthermore, for a complaint challenging a *Revlon* transaction to survive a motion to dismiss where a company's charter contains an exculpatory clause immunizing directors from personal liability resulting from breaches of their duty of care, a plaintiff must sufficiently plead that a majority of the board lacked independence, was not disinterested, or did not act in good faith.[158] As the case law indicates, this is a difficult standard to overcome.[159]

1. Absent Well-Pled Allegations that Directors Were Disloyal in Approving a Transaction Where the Company Charter Contained an Exculpatory Clause, the Board's Reasonable Decisions Regarding a Change of Control Transaction Will be Protected by the Business Judgment Rule

In *Binks v. DSL.net, Inc.*, the Court of Chancery granted a motion to dismiss all claims brought against DSL.net, Inc. ("DSL"), and various individuals and entities who had corporate dealings with DSL, by a self-represented former stockholder of DSL who challenged a financing

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[157]Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80, 85 (Del. Ch. 2004) (citations omitted).

[158]*Id.* (citing *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 734 n.38 (Del. Ch. 1999), *aff'd sub nom*, Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000)).

[159]*See, e.g.*, Wayne Cnty. Emps.' Ret. Sys. v. Corti, 2009 WL 2219260, at *1, *19 (Del. Ch. July 24, 2009), *reprinted in* 35 DEL. J. CORP. L. 738, 739, 767-68 (2010), *aff'd*, 996 A.2d 795 (Del. 2010); *In re* NYMEX S'holder Litig., 2009 WL 3206051, at *6 (Del. Ch. Sept. 30, 2009), *reprinted in* 35 DEL. J. CORP. L. 649, 658-59 (2010); *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 641 (Del. Ch. 2008); McMillan v. Intercargo Corp., 768 A.2d 492, 495, 502-03 (Del. Ch. 2000).

transaction between DSL and MegaPath, Inc. ("MegaPath").[160] In so doing, the court held that the complaint failed to sufficiently plead facts supporting plaintiff's claims.[161] The complaint included allegations that the directors of DSL breached their *Revlon* duties in connection with the financing transaction.[162] DSL entered into the financing transaction with MegaPath after DSL's financial advisor informed DSL that the MegaPath transaction was the only alternative to bankruptcy.[163] Pursuant to the financing transaction, in exchange for a loan, DSL issued convertible notes to MegaPath that would represent more than 90% of DSL's shares if fully converted.[164] Six months after completing the financing transaction, MegaPath exercised its conversion rights and effected a short-form merger.[165]

Plaintiff contended that the DSL directors breached their fiduciary duties because they failed under *Revlon* to secure the best price reasonably available when they approved the MegaPath transaction, which plaintiff characterized as a change in control transaction.[166] The court noted that when performing enhanced judicial review under *Revlon*, the "ordinarily deferential 'rational basis' review gives way to an objective 'reasonableness' standard of review, both to the process and the result, under which the Court evaluates whether the board has complied with its fundamental fiduciary duties."[167] Notwithstanding the six-month delay between the MegaPath transaction and the short-form merger, the court assumed—without deciding—that *Revlon* applied.[168] The court held that the board did not breach its *Revlon* obligations as it: (1) was independent and disinterested regarding the financing transaction; (2) was well informed by independent advisors of available alternatives; and (3) acted in good faith in light of the scarcity of options available to DSL.[169] Because "there can be several reasoned ways to try to maximize value, the court cannot find fault so long as the directors chose a *reasoned* course of action."[170] The court found such reasoned action by the board, holding that the board's pursuit of the

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[160] *Binks*, 2010 WL 1713629, at *1.

[161] *See id.* at *7 ("The Amended Complaint does not suggest any facts beyond sweepingly general allegations . . . .").

[162] *Id.* at *5.

[163] *Id.* at *4.

[164] *Binks*, 2010 WL 1713629, at *3.

[165] *Id.*

[166] *Id.* at *5.

[167] *Id.* at *6 (citing Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1994)).

[168] *Binks*, 2010 WL 1713629, at *7.

[169] *Id.*

[170] *Id.* at *9 (quoting *In re* Lear Corp. S'holder Litig., 926 A.2d 94, 115 (Del. Ch. 2007)).

MegaPath transaction was a reasonable option to maximize DSL's value.[171] Further, the court held that plaintiff failed to allege any facts to support his argument that MegaPath controlled the board of DSL before the financing transaction; as a result, the court dismissed the claims that MegaPath had breached fiduciary duties and engaged in corporate waste as a controlling stockholder of DSL.[172]

2. To Rebut the Business Judgment Rule Plaintiffs Who Contend that Directors Were Motivated by Entrenchment Must Include Well-Pled Allegations that the Directors Also Favored Their Own Self-Interest to the Detriment of the Shareholders

In *Wayne County Employees' Retirement System v. Corti*, the Court of Chancery dismissed all claims brought by a former shareholder in connection with Activision, Inc.'s ("Activision") combination with Vivendi Games, Inc. ("Vivendi"), in which Vivendi became the majority stockholder in the surviving company, Activision Blizzard.[173] Among its claims, the complaint challenged the conduct of the Activision directors in negotiating and approving the transaction.[174] The complaint contended that two Activision managers, who were also directors (the "Managers"): (1) controlled the sale process and Activision's advisors; (2) were self-interested in the transaction; and (3) favored their personal interests over and to the detriment of the interests of Activision's stockholders.[175] The plaintiff also alleged that the remaining directors breached their fiduciary duties by allowing the Managers to control the negotiations and the board's advisors, and by failing to obtain a "control premium" for stockholders.[176]

In its analysis, the court relied upon the Delaware Supreme Court holding in *Lyondell Chemical Co. v. Ryan*, to determine the proper scope of review in a change of control transaction.[177] The court noted that "[a]s the Delaware Supreme Court recently reiterated, when a board of directors decides to sell control of the corporation, 'the board must perform its fiduciary duties in the service of a specific objective: maximizing the sale

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[171] *Id.* at *10.

[172] *Binks*, 2010 WL 1713629, at *10.

[173] Wayne Cnty. Emps.' Ret. Sys. v. Corti, 2009 WL 2219260, at *1 (Del. Ch. Jul. 24, 2009), *reprinted in* 35 DEL. J. CORP. L. 738, 738-39 (2010), *aff'd*, 996 A.2d 795 (Del. 2010).

[174] *Id.*, 35 DEL. J. CORP. L. at 738.

[175] *Id.*, 35 DEL. J. CORP. L. at 738-39.

[176] *Id.* at *1, *4, 35 DEL. J. CORP. L. at 739, 743.

[177] *Wayne Cnty.*, 2009 WL 2219260, at *10, 35 DEL. J. CORP. L. at 752 (citing Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239 (Del. 2009)).

price of the enterprise."'[178] Further, "a sale of control of the corporation does not implicate additional fiduciary duties, but instead requires the directors to exercise their fiduciary duties in the context of the particular decision being made."[179] As always, the court must take into account the circumstances surrounding the decision when determining whether the directors made a well-informed business decision that they reasonably believed was in the best interests of the corporation, or whether the plaintiff has successfully rebutted the presumption of the business judgment rule.[180] It follows from the contextual nature of the directors' fiduciary duties that even in a sale of control, "there is no single blueprint that a board must follow to fulfill its duties."[181]

This analysis led the court to determine that, although allegations of management entrenchment can be a concern, the plaintiff had made no specific factual allegations suggesting that the Managers were motivated by entrenchment in considering the transaction.[182] The complaint also lacked sufficient factual allegations that the Managers favored their own "interests in creating and reigning over [a] combined empire."[183] To prevail on such a claim, a plaintiff would have to plead that the Managers' primary purpose for pursuing the transaction was their desire to increase the size of the company for their benefit.[184] As plaintiff did not so plead, the court held that the remaining directors had not abdicated their duties in permitting the Managers to be involved actively in the negotiations.[185]

In analyzing the remaining fiduciary duty claims, the court focused on whether the plaintiff had pled facts sufficient to support a claim that the directors had failed to act in good faith.[186] Based on the facts alleged in the complaint, the court determined that the remaining directors were neither interested nor lacked independence.[187] The court initially stated that to survive a motion to dismiss in this context the allegations must suggest that the director defendants "knowingly and completely failed to undertake their

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[178] *Id.*, 35 DEL. J. CORP. L. at 752 (quoting *Lyondell*, 970 A.2d at 239) (internal quotation marks omitted).

[179] *Id.*, 35 DEL. J. CORP. L. at 752 (citing McMillan v. Intercargo Corp., 768 A.2d 492, 502 (Del. Ch. 2004)).

[180] *Id.* at *11, 35 DEL. J. CORP. L. at 753.

[181] *Lyondell*, 970 A.2d at 242-43 (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)).

[182] *Wayne Cnty.*, 2009 WL 2219260, at *11 & n.52, 35 DEL. J. CORP. L. at 753-54 & n.52.

[183] *Id.* at *12, 35 DEL. J. CORP. L. at 755.

[184] *Id.*, 35 DEL. J. CORP. L. at 755.

[185] *Id.* at *13, *16, 35 DEL. J. CORP. L. at 757, 762.

[186] *Wayne Cnty.*, 2009 WL 2219260, at *14, 35 DEL. J. CORP. L. at 759-60.

[187] *Id.* at *13, 35 DEL. J. CORP. L. at 757.

responsibilities" to obtain the best sale price.[188] Plaintiff's allegations in the complaint failed to satisfy this standard.[189] Rather, the plaintiff alleged that the board formed a committee of outside directors to oversee the sale process, the board and the committee along with its financial advisor met several times leading up to the transaction, the board regularly evaluated financial reports and analyses, and no alternative bidder emerged in the roughly seven-month period between the signing and closing of the Combination.[190] In addition, there was no requirement that the board obtain separate consideration identified as a "control premium."[191] The court concluded that the plaintiff's attacks on the lack of a "control premium" were, in fact, attacks on the adequacy of the price of the transaction.[192] As a result, the court stated that "[i]f directors fulfill[] their fiduciary duties in the sale of control . . . the Court will not second guess the business decision of the board."[193] Simply stated, the court will focus on a board's decision-making process rather than making an independent judgment of whether consideration received was adequate.

3. Absent Allegations that Directors Were Dominated or Controlled by a Self-Interested Director, the Mere Fact that Directors Defer to the Board Chair Regarding a Change of Control Transaction Does Not Rebut the Business Judgment Rule

Where less than a majority of the directors on a board are deemed interested or lacking independence, it is difficult for a complaint to survive a motion to dismiss even if the plaintiffs assert that *Revlon* duties apply to the challenged transaction.[194] In *In re NYMEX Shareholder Litigation*, the Court of Chancery analyzed a complaint in which shareholders alleged that a conflicted director controlled a majority of the sixteen-director board that approved the sale of NYMEX to an entity controlled by CME Group, Inc. ("CME").[195] Plaintiffs argued, among other things, that the dominated board agreed to sell NYMEX through an unfair process at an inadequate price so

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[188] *Id.* at *14, 35 DEL. J. CORP. L. at 759-60.

[189] *Id.* at *15, 35 DEL. J. CORP. L. at 760-61.

[190] *Wayne Cnty.*, 2009 WL 2219260, at *15, *35 DEL. J. CORP. L. at 760.

[191] *Id.*, 35 DEL. J. CORP. L. at 760-61.

[192] *Id.*, 35 DEL. J. CORP. L. at 761.

[193] *Id.*, 35 DEL. J. CORP. L. at 761.

[194] *In re* NYMEX S'holder Litig., 2009 WL 3206051, at *4-*6 (Del. Ch. Sept. 30, 2009), *reprinted in* 35 DEL. J. CORP. L. 649, 655-59 (2010).

[195] *Id.* at *1 & n.10, *4, 35 DEL. J. CORP. L. at 650 & n.10, 655.

that two interested directors might obtain nearly $60 million in severance payments.[196]

Plaintiffs contended that domination could be inferred by: (1) the board's approval of the change of control severance plan; (2) the board's acceptance of CME's first offer; (3) the board's acquiescence in the two allegedly conflicted directors bypassing the special committee and negotiating on behalf of the company; (4) the board's failure to obtain a "collar" on the stock portion of the merger consideration; and (5) the directors' fear of being terminated if they opposed the conflicted directors.[197] The court held that plaintiffs failed adequately to plead that a majority of the board was interested or dominated in the transaction, specifically noting:

> That directors acquiesce in, or endorse actions by, a chairman of the board—actions that from an outsider's perspective might seem questionable—does not, without more, support an inference of domination by the chairman or the absence of directorial will. The NYMEX directors were otherwise unquestionably independent—this is not an instance where certain relationships raised some concern but not sufficient doubt to sustain a challenge to director independence. In short, the Complaint alleges nothing more than a board which relied upon, and sometimes deferred to, its chairman. It does not allege dominance such that the independence or good faith of the board may fairly be questioned.[198]

Consequently, the claim for breach of the duty of loyalty failed as a matter of law and the court granted defendants' motion to dismiss.[199]

Plaintiffs also contended that the board's approval of an unfair merger price subjected the transaction to review under *Revlon* rather than receiving protection under the business judgment rule.[200] The court, however, held that the presence of an exculpatory clause in NYMEX's certificate of incorporation required a showing of disloyalty if *Revlon* were to apply.[201]

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[196] *Id.* at *4, 35 DEL. J. CORP. L. at 655.

[197] *Id.* at *6, 35 DEL. J. CORP. L. at 659-60.

[198] *NYMEX*, 2009 WL 3206051, at *6, 35 DEL. J. CORP. L. at 660 (footnote omitted).

[199] *Id.*, 35 DEL. J. CORP. L. at 659.

[200] *Id.* at *5, 35 DEL. J. CORP. L. at 657-58.

[201] *Id.* at *6, 35 DEL. J. CORP. L. at 658-59; *see also* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239 (Del. 2008) ("Lyondell's charter includes an exculpatory provision, pursuant to 8 *Del. C.* § 102(b)(7) . . . . [T]his case turns on whether any arguable shortcomings on the part of the Lyondell directors also implicate their duty of loyalty, a breach of which is not exculpated.").

"Because the Plaintiffs' allegations [were] too conclusory to support an inference of domination," the court stated that plaintiffs needed to "convert into a loyalty claim their aversion to the process the Board employed in negotiating the merger," and the most the plaintiffs could show was that "the Board's process was not perfect."[202] In dismissing plaintiffs' breach of fiduciary duty claims the court relied upon the recent decisions in *Lyondell* and *Wayne County* in stating:

> [T]he Delaware Courts have repeatedly held that "there is no single blueprint that a board must follow to fulfill its duties." In any event, claims of flawed process are properly brought as duty of care, not loyalty, claims and, as discussed, those claims are barred by the exculpatory clause of NYMEX's Certificate of Incorporation. Moreover, to the extent the Complaint alleges that the Board acted in bad faith, such allegations must fail because, based on the facts in the Complaint, it cannot be said that the Board intentionally failed to act in the face of a known duty to act, demonstrating a conscious disregard for its duties. More precisely, the Complaint has not alleged that the Board "utterly failed to obtain the best sale price."[203]

4. Conclusory Allegations of Domination and Control Will Not Suffice to Rebut the Business Judgment Rule

In *In re Alloy, Inc. Shareholder Litigation*, the Court of Chancery reaffirmed that plaintiffs must plead specific allegations of domination or control by directors of the board to survive a motion to dismiss.[204] In *Alloy*, plaintiffs challenged a going-private cash-out merger where two inside directors, collectively holding 15 percent of Alloy's stock, remained in executive roles and received an equity stake in the surviving entity.[205] The plaintiffs alleged that the two inside directors dominated and controlled the other seven directors, forcing them to agree to consummate the transaction without searching for alternatives.[206] A seven-member special committee comprised of all the outside directors negotiated the transaction, whose price reflected an approximately 14 percent premium over Alloy's stock price the

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[202] *NYMEX*, 2009 WL 3206051, at *7, 35 DEL. J. CORP. L. at 660.
[203] *Id.* at *7, 35 DEL. J. CORP. L. at 660 (footnote omitted).
[204] *In re* Alloy, Inc. S'holder Litig., 2011 WL 4863716, at *1 (Del. Ch. Oct. 13, 2011).
[205] *Id.* at *4.
[206] *Id.* at *5.

day prior to the deal announcement and a 27 percent premium over the average stock price during the thirty days prior to the deal announcement.[207] Nevertheless, the plaintiffs asserted that the directors failed to maximize Alloy's value because of alleged domination and control by the two inside directors.[208]

The Court of Chancery held that, while the inside directors were interested in the merger, plaintiffs failed sufficiently to plead that a majority of the seven-member special committee was interested or lacked independence.[209] The court rejected plaintiffs' argument that the special committee lacked independence because it retained the same financial advisor that was advising the company in the transaction process and did not adequately search for alternatives.[210] The court found that the former did not implicate director self-interest or lack of independence and the latter reflected a duty of care breach for which the directors were exculpated under the company's charter.[211] The court similarly rejected plaintiffs' contention that the inside directors' 15 percent equity interest in Alloy allowed them to control the other directors, noting that it was the majority of outside directors who could have voted to remove the insiders as officers.[212] The court also noted that plaintiffs failed to allege that the inside directors threatened the board to approve the merger or that the inside directors' interest effectively precluded competing offers.[213] Ultimately, the Court of Chancery held that plaintiffs failed sufficiently to allege that a majority of the directors were interested or lacked independence and dismissed plaintiffs' claims for breach of the duty of loyalty.[214]

D. *Complaints Challenging Transactions Including a Majority or Controlling Shareholder*

When a controlling stockholder stands on both sides of a transaction, she is "required to demonstrate [her] utmost good faith and most scrupulous inherent fairness of the bargain."[215] In the seminal case of *Kahn v. Lynch Communication Systems, Inc.*, the Delaware Supreme Court established that

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[207] *Id.* at *4.
[208] *Alloy*, at *5.
[209] *Id.* at *8-*10.
[210] *Id.* at *8.
[211] *Id.*
[212] *Alloy*, at *8.
[213] *Id.* at *9.
[214] *Id.* at *10.
[215] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

the standard of review applicable to transactions in which a controlling stockholder "stands on both sides" of a transaction is entire fairness, which applies *ab initio* to such transactions.[216] Yet, the Court of Chancery has stated that "[t]he question whether a shareholder is a controlling one is highly contextualized and is difficult to resolve based solely on the complaint."[217] Since the entire fairness standard applies *ab initio*, well-pled allegations that a transaction involves a controlling stockholder on both sides who receives a benefit to the detriment of the remaining stockholders generally will allow a plaintiff to survive a motion to dismiss.[218]

1. Allegations that Designated Directors, Comprising a Minority of a Board, Maintained Veto Power Over all Board Action and Were Self-Interested in a Transaction in Which Their Designating Shareholders Obtained a Unique Benefit, Sufficed to Trigger Entire Fairness Review

Williamson v. Cox Communications, Inc. involved the sale of joint control of an internet service provider by two shareholders whose interests, when combined, were alleged to be controlling.[219] Plaintiff challenged the fairness of the sale of joint control to a third cable company and alleged breaches of fiduciary duties against the two shareholders with a purported controlling interest along with their two designees on the board.[220] The court found that the well-pled allegations of the complaint sufficiently asserted a nexus of facts suggesting that the defendants controlled the challenged transaction, and that they exploited the transaction for their benefit and to the detriment of the minority shareholders.[221]

The Court of Chancery, in determining that the defendants were "controlling," engaged in a detailed analysis of what constitutes a controlling shareholder:

> The test for control has two prongs: A shareholder is a "controlling" one if she owns more than 50% of the voting power in a corporation *or* if she "exercises control over the business and affairs of the corporation." Where a shareholder

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[216] *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (citing *Weinberger*, 457 A.2d at 710-11).

[217] Williamson v. Cox Commc'ns, Inc, 2006 WL 1586375, at *6 (Del. Ch. June 5, 2006), *reprinted in* 32 DEL. J. CORP. L. 307, 317 (2007).

[218] *See Kahn*, 638 A.2d at 1121.

[219] *Williamson*, 2006 WL 1586375, at *1, 32 DEL. J. CORP. L. at 308.

[220] *Id.*, 32 DEL. J. CORP. L. at 308.

[221] *Id.* at *6, 32 DEL. J. CORP. L. at 317.

> stands on both sides of a transaction and is found to be a controlling shareholder, the transaction will be viewed under the entire fairness standard as opposed to the more deferential business judgment standard.[222]

The court stated that "[s]imply alleging that [the defendants] had the *potential* ability to exercise control is not sufficient" to rebut the presumption of the business judgment rule.[223] Nonetheless, it is not necessary for a plaintiff to plead actual control over the day-to-day operations of the company.[224] The court considered that the shareholder defendants each appointed a designee to the board of directors; however, the court noted that without more, the mere fact that the defendants designated directors to the board does not establish domination or control.[225] The court found, however, that the defendants had "veto power" over the board because the charter required approval of four of the five Series B directors (of which the defendants controlled two) for any board action.[226] In its opinion, the court stated, "[t]here is no case law in Delaware, nor in any other jurisdiction that this Court is aware of, holding that board veto power *in and of itself* gives rise to a shareholder's controlling status."[227] Despite this, the court found that the presence of veto power for the defendants demonstrated "coercive leverage" over the company.[228] The court found that this leverage could allow the defendants to "obtain a far better deal then they would have in an arm's-length transaction."[229] Accordingly, the court found that the combination of well-pled facts defeated the motion to dismiss.[230]

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[222] *Id.* at *4, 32 DEL. J. CORP. L. at 313-14 (citation omitted).
[223] *Williamson*, 2006 WL 1586375, at *4, 32 DEL. J. CORP. L. at 314.
[224] *Id.*, 32 DEL. J. CORP. L. at 314.
[225] *Id.*, 32 DEL. J. CORP. L. at 314-15.
[226] *Id.* at *2, 32 DEL. J. CORP. L. at 310.
[227] *Williamson*, 2006 WL 1586375, at *5, 32 DEL. J. CORP. L. at 316.
[228] *Id.*, 32 DEL. J. CORP. L. at 316.
[229] *Id.*, 32 DEL. J. CORP. L. at 316.
[230] *Id.* at *6, 32 DEL. J. CORP. L. at 317.

2. Allegations that a Stockholder Controls a Company's Public Filings, Has Associates Filling Director Positions on the Board, and Exerts Actual Control Over the Company's Transactions May Suffice to Sustain a Complaint that a Controlling Stockholder Used its Power to Obtain a Unique Benefit

In *In re Primedia Inc. Derivative Litigation*, the Court of Chancery denied a motion to dismiss claims for breach of the fiduciary duty of loyalty brought against the directors and an alleged indirect controlling stockholder of Primedia, Inc. ("Primedia"), in connection with Primedia's redemption of four series of its preferred stock.[231] Defendant Kohlberg Kravis Roberts & Co. L.P. ("KKR") purportedly controlled approximately sixty percent of Primedia's outstanding common stock by way of a number of intermediate entities.[232] The plaintiffs alleged that KKR dominated the Primedia directors who approved the redemption.[233] In 2004 and 2005, Primedia redeemed four series of preferred stock.[234] The Series J preferred stock had no mandatory redemption date, and the mandatory redemption dates for Series D, F, and H preferred stocks were not for several years.[235] Pursuant to the terms of the Series J certificate of designation, a majority of the independent directors approved the Series J redemption.[236] No special committee approval was required for the redemptions of Series D, F, and H preferred stock.[237]

Plaintiffs contended that Primedia acted for the benefit of KKR, the controlling shareholder, and to the detriment of the company in exercising the redemptions.[238] In analyzing whether KKR exercised control over the company, the court noted that: (1) the company's SEC filings discussed KKR's control and "indicate[d] that KKR was the influential force behind the stock redemptions"; (2) KKR associates served on Primedia's board, which "supports an inference of control"; and (3) the course of dealing between the parties, specifically that no independent committee evaluated the Series D, F, and H redemptions, "suggests that KKR enjoyed actual control over the stock [January 23, 2007] redemptions."[239] These allegations

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[231] *In re* Primedia Inc. Deriv. Litig., 910 A.2d 248, 255-56 (Del. Ch. 2006).
[232] *Id.* at 251.
[233] *Id.* at 255.
[234] *Id.* at 253.
[235] *Primedia*, 910 A.2d at 253.
[236] *Id.* at 254.
[237] *Id.*
[238] *Id.* at 255.
[239] *Primedia*, 910 A.2d at 258.

were sufficient to create an inference of the controlling status of KKR and to rebut the presumption of the business judgment rule.[240]

Notably, the court engaged in a thorough discussion of which standard applies to situations where a parent entity or a controlling stockholder causes the controlled corporation to enter into a transaction that harms the controlled corporation but, at the same time, confers a unique benefit upon the parent or controlling stockholder.[241] The court noted that "in certain circumstances, when a controlling entity or stockholder causes a corporation to enter into a self-dealing transaction and controls the terms of the transaction, the business judgment rule is inapplicable."[242] Furthermore:

> A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not invoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, *by virtue of its domination or the subsidiary*, causes the subsidiary to act in such a way that *the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders* of the subsidiary.[243]

Accordingly, to rebut the presumption of the business judgment rule a plaintiff must sufficiently plead both the existence of a controlling stockholder, and that the controlling stockholder caused the subsidiary to engage in a transaction that benefited the controlling stockholder to the exclusion and detriment of the minority stockholders.[244]

3. Despite a Majority of Disinterested Directors Approving a Transaction, the Presence of a Controlling Stockholder Standing on Both Sides of a Transaction Rebuts the Business Judgment Rule

In *In re LNR Property Corp. Shareholders Litigation*, former shareholders challenged the fairness of a cash-out merger, alleging breach of fiduciary duties against a purported controlling stockholder and former

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[240] *Id.* at 259.
[241] *Id.* at 259-61.
[242] *Id.* at 260 (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971)).
[243] *Primedia*, 910 A.2d at 260 (quoting *Sinclair Oil*, 280 A.2d at 720) (emphasis in original).
[244] *Id.* at 260-61.

directors for contracting for the right to purchase a twenty-five percent equity stake in the surviving entity.[245] Plaintiffs alleged that the directors breached their fiduciary duties when they permitted the controlling shareholder to negotiate—and later vote to authorize—the merger, the terms of which the plaintiffs argued were inadequate and unfair to the public shareholders.[246] The controlling stockholder held seventy-seven percent of the voting power of the company at the time of the cash-out transaction.[247]

The court found that these allegations created a reasonable inference that the controlling stockholder had a disabling conflict and, based on the well-pled allegations of the complaint, stood on both sides of the transaction.[248] This finding sufficed to rebut the presumption of the business judgment rule and deny defendants' motion to dismiss.[249] In so holding, the court stated that when a controlling shareholder has a conflicting interest:

> the business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) . . . . Instead, Delaware law imposes an entire fairness burden when the fiduciary charged with protecting the minority in a sale of the company does not have an undivided interest to extract the highest value for the shareholders.[250]

4. While Well-Pled Allegations of a Controlling Stockholder Standing on Both Sides of a Transaction Will Rebut the Business Judgment Rule, a Complaint Must Still Sufficiently Plead that a Transaction Was Unfair as to Process and Price to Survive a Motion to Dismiss

In *Monroe County Employees' Retirement System v. Carlson*, the Court of Chancery reiterated that a complaint challenging a transaction with a controlling shareholder must contain well-pled allegations disputing the fair price and fair process of the transaction.[251] This matter involved a transaction between Telephone and Data Systems, Inc. ("TDS") and the United States Cellular Corporation ("USCC"), of which TDS was a

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[245] *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 171 (Del. Ch. 2005).
[246] *Id.* at 174.
[247] *Id.* at 172-73.
[248] *Id.* at 178.
[249] *LNR Prop.*, 896 A.2d at 178.
[250] *Id.* at 177.
[251] Monroe Cnty. Emps.' Ret. Sys. v. Carlson, 2010 WL 2376890, at *1-*2 (Del. Ch. June 7, 2010).

controlling shareholder.[252] The complaint alleged that TDS and the directors of USCC breached their duty of loyalty by authorizing a transaction between TDS and USCC unfair to the minority shareholders.[253] The parties agreed that the transaction would be subject to the entire fairness standard of review since TDS, as a controlling shareholder, stood on both sides of the transaction with USCC.[254] Defendants acknowledged that the controlling shareholder would have the burden of satisfying both prongs of the entire fairness review: fair dealing and fair price.[255] However, the parties did not agree on plaintiff's burden at the pleadings stage.[256] The plaintiff contended that it only need allege facts relating to a transaction between a controlling shareholder and the company to survive a motion to dismiss;[257] the defendants argued that the plaintiff was required to plead factual allegations supporting its argument "that the challenged transactions [were] not entirely fair."[258]

The court agreed with defendants and concluded that plaintiff had failed to allege facts supporting its contention that the transaction price was unfair.[259] In its analysis, the court noted that "[t]ransactions between a controlling shareholder and the company are not *per se* invalid under Delaware law. Such transactions are perfectly acceptable if they are entirely fair . . . ."[260] As a result, to survive a motion to dismiss, a party must allege facts that, if proven, would establish that the transaction was not entirely fair as to both unfair dealing and unfair price.[261] By failing to assert sufficient allegations that the transaction price was unfair, the court dismissed the fiduciary duty claims in plaintiff's complaint.[262]

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[252] *Id.* at *1.
[253] *Id.*
[254] *Id.*
[255] *Monroe*, 2010 WL 2376890, at *1.
[256] *Id.* at *2.
[257] *Id.*
[258] *Id.*
[259] *Monroe*, 2010 WL 2376890, at *2.
[260] *Id.*
[261] *Id.*
[262] *Id.*

5. Even in Transactions with Third Parties, a Plaintiff Can Rebut the Business Judgment Rule by Adequately Pleading that a Board Acted to Benefit a Controlling Stockholder to the Detriment of the Minority Stockholders

In *Tooley v. AXA Financial, Inc.*, the Court of Chancery reviewed a transaction involving a tender offer and cash-out merger with a non-affiliated third-party entity.[263] The complaint was brought by former shareholders of Donaldson, Lufkin & Jenrette, Inc. ("DLJ"), who alleged, among other things, that the DLJ board breached its fiduciary duties in exercising contract rights under a merger agreement which acted to treat a majority shareholder differently to the detriment of the minority shareholders.[264] Specifically, plaintiffs argued that the board's exercise of a contractually agreed upon extension of the tender offer acted to benefit the majority shareholder by potentially allowing the majority shareholder to avoid additional administrative costs.[265] These purported benefits were exclusively enjoyed by the majority shareholder, which purportedly dominated the board, and came at the expense of the minority shareholders who were deprived of the time value of their cash-out merger consideration.[266]

The court, while acknowledging that the allegations barely overcame the presumption of the business judgment rule, denied defendants' motion to dismiss.[267] In so doing, the court held that the board's exercise of the extension acted only to benefit the majority shareholder and cost the minority shareholders their immediately available tender offer proceeds.[268] Since the majority shareholder's interest in the merger was adequately pled as seventy percent equity in the surviving entity and thirty percent cash, the extension granted by the board treated differently the minority shareholders, whose interest in the merger was entirely cash.[269] Citing the Delaware Supreme Court's decision in *Sinclair Oil Corp. v. Levien*, the court stated that "when a stockholder asserts differential treatment, the motivations of the board are not relevant in determining whether differential treatment occurred, but rather, the end result of the board action is what is relevant."[270] Based on *Sinclair*, the court ruled that the majority shareholder did receive

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[263]Tooley v. AXA Financial, Inc., 2005 WL 1252378, at *7 (Del. Ch. May 13, 2005).
[264]*Id.* at *1, *5.
[265]*Id.* at *5.
[266]*Id.* at *6.
[267]*Tooley*, 2005 WL 1252378,*7.
[268]*Id.* at *6-*7.
[269]*Id.* at *6.
[270]*Id.* *6 (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721-22 (Del 1971)).

an exclusive benefit from the delay to the detriment of the minority shareholders and that this allegation rebutted the business judgment rule, thus requiring denial of defendants' motion to dismiss.[271]

6. A Controlling Stockholder Cannot be Held Liable for Breaches of its Duty of Care Where an Exculpatory Clause Exists in the Company's Charter Acquitting Directors for Breaches of their Duty of Care

In *Shandler v. DLJ Merchant Banking, Inc.*, the Court of Chancery considered a motion to dismiss claims brought on behalf of Insilco Technologies, Inc. ("Insilco") by plaintiff, a bankruptcy court-appointed Creditor Trustee.[272] Included in the complaint were claims for breach of fiduciary duty against Insilco's purported controlling stockholder, a group of affiliated funds allegedly dominated and controlled by DLJ, Inc., and a claim for breach of fiduciary duty against the DLJ-affiliated directors who comprised a majority of Insilco's board.[273] The court held, *inter alia*, that plaintiff sufficiently alleged certain claims for breach of the duty of loyalty against the DLJ-affiliated directors and DLJ, as the controlling stockholder, to survive defendants' motion to dismiss.[274] Of particular note, the court held that, based on the well-pled facts of the complaint, DLJ, Inc. controlled and presided over a "family of entities . . . that together owned 74% of Insilco's equity," which allowed the inference that the DLJ entities acted as a single controlling stockholder.[275] In reaching this conclusion, the court considered that the entities shared the same address and the same "officers or principals."[276] Noting the plaintiff-friendly motion to dismiss standard of review, the court stated that "[w]ithout conflating their existence for all purposes, there is a pleading stage inference that these entities acted jointly together as if they were a single controlling stockholder and on that basis owed fiduciary duties to Insilco."[277] Yet, the court stated that the liability of a controlling stockholder derives from its control of the company's board

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[271] *Tooley*, 2005 WL 1252378, *7.

[272] Shandler v. DLJ Merch. Banking, Inc., 2010 WL 2929654, at *1 (Del. Ch. July 26, 2010).

[273] *Id.* at *8.

[274] *Id.* at *1.

[275] *Id.* at *15.

[276] *Shandler*, 2010 WL 2929654, at *15. In making this determination, the court cited Haisfield v. Cruver, 1994 WL 497868, at *3-*4 (Del. Ch. Aug. 25, 1994), *reprinted in* 20 DEL. J. CORP. L. 382, 389 (1995), for the proposition that alter ego status could be found, at the motion to dismiss stage, where a plaintiff sufficiently pleads facts showing: (1) common financial interests; (2) board members and officers; and (3) a common address.

[277] *Shandler*, 2010 WL 2929654, at *15.

and, thus, is "largely coextensive with the liability faced by the corporation's directors."[278] Accordingly, where—as in *Shandler*—a clause exists in a company's charter exculpating directors of liability for breaches of their duty of care, the company's controlling stockholder also cannot be held liable for breach of the duty of care.[279]

7. Unresolved Issues Involving Controlling Stockholder Going-Private Transactions

The Court of Chancery's recent opinion in *In re CNX Gas Corp. Shareholders Litigation*, while not decided at the pleading stage, highlights conflicting and unresolved issues regarding the applicable standards of review for controlling stockholder going-private transactions.[280] *CNX* involved a controlling stockholder's unilateral two-step freeze-out transaction, which the plaintiffs sought to enjoin.[281] The court denied plaintiff's motion for preliminary injunction, in part based on its determination that the appropriate standard of review would be entire fairness as articulated in *Cox Communications*.[282] The court held:

> The standard of review is pivotal in corporate litigation. "It is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies." *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993). Here, at the pleadings stage, the CONSOL defendants have filed a bare-bones, single-page motion to dismiss the complaint pursuant to Rule 12(b)(6). Assuming they make arguments similar to those addressed in the Injunction Decision, their prospects for dismissal are dim. Their motion would be fairly litigable under *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002) and a likely winner under *In re Siliconix Inc.*

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[278] *Id.* at *16.

[279] *Id.* (citing Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 194 (Del. Ch. 2006); Abraham v. Emerson Radio Corp., 901 A.2d 751, 759 (Del. Ch. 2006)).

[280] *In re* CNX Gas Corp. S'holders Litig., 2010 WL 2705147, at *1 (Del. Ch. July 5, 2010).

[281] *Id.* The court identifies a "unilateral two-step freeze-out transaction" as a going-private transaction where a controlling stockholder unilaterally makes a first-step tender offer and commits to eliminating the remaining shareholders through a second-step short-form merger. This differs from a "negotiated two-step freeze-out transaction," which has the same structure but is effectuated by an agreement between the controlling stockholder and the subsidiary. Lastly, the court distinguishes a "single-step freeze-out merger" as a long-form merger. *Id.* at *1 n.1.

[282] *Id.* (citing *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005)).

Shareholders Litigation, 2001 WL 716787 (Del. Ch. Jun. 19, 2001).[283]

This statement both supports the long-held premise that the standard of review applied at the pleadings stage is paramount in determining the fate of a challenged transaction, while highlighting the relative uncertainty surrounding what standard should be followed in two-step freeze-out transactions. *CNX* identified several alternatives.

First, the *Cox Communications* test, which holds that a unilateral two-step freeze-out transaction is subject to entire fairness review unless the transaction is structured to simulate an arm's-length third-party transaction with approvals at both the board and stockholder levels.[284] "[I]f the first-step tender offer is both (i) recommended by a duly empowered special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares," then the business judgment rule should apply to the transaction.[285]

Second, the *Pure Resources* test, which holds that a two-step freeze-out transaction should not be subject to entire fairness review if: (1) the transaction is subject to a non-waivable majority of the minority tender condition; (2) the controlling stockholder promises to consummate a short-form merger at the same price if it obtains greater than 90% of the shares; (3) the controlling stockholder has made no retributive threats; and (4) the independent directors of the target board have free rein and adequate time to react to the tender offer.[286]

Third, the *Siliconix* test, which holds that a two-step freeze-out transaction will not be subjected to entire fairness review unless the tender offer is structurally coercive or contains misleading disclosure.[287] Structural coercion, in this context, is considered a "wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even worse fate later on."[288]

The distinctions in the above standards illustrate the potential for divergent rulings on motions to dismiss regarding controlling stockholder tender offers followed by short-form mergers. The standards discussed in

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[283] *Id.* at *2.

[284] *CNX*, 2010 WL 2705147, at *3 (citing *Cox Commc'ns*, 879 A.2d at 646).

[285] *Id.*

[286] *Id.* at *4 (citing *In re* Pure Resources, Inc., S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002).

[287] *Id.* at *4 (citing, inter alia, *In re* Siliconix Inc., S'holders Litig., 2001 WL 716787, at *6-*8 (Del. Ch. Jun. 21, 2001).

[288] *CNX*, 2010 WL 2705147, at *4 n.4.

CNX highlight the Court of Chancery's attempts to move away from the rigidity of the *Lynch* doctrine. The Delaware Supreme Court has previously described a controlling stockholder's tender offer as a "voluntary transaction in which the offeror generally has no obligation to pay a fair price."[289] This statement coupled with the Delaware Supreme Court's holding in *Glassman* that a short-form merger is not subject to review for entire fairness supports the argument that a unilateral two-step freeze-out could be reviewed under the more deferential *Siliconix* standard.[290] The Delaware Supreme Court, however, has held that negotiated two-step freeze-out transactions[291] and single-step freeze-out mergers[292] are subject to entire fairness review.

In the next decade we can expect that the Delaware Supreme Court will have an opportunity to resolve the conflicts in the standards articulated by the Court of Chancery.

VI. CONCLUSION

The standard of review generally portends the likelihood of success of a motion to dismiss. As has long been the case, a plaintiff's failure to rebut the presumption of the business judgment rule will result in the dismissal of fiduciary duty claims. The application of an entire fairness standard of review generally means that a complaint will survive a motion to dismiss. At least two cases, however, indicate that a plaintiff's complaint will be dismissed, even if the entire fairness standard applies, if a plaintiff fails sufficiently to allege facts supporting the claim of unfair process and unfair price.[293]

Except in situations where controlling stockholders are on both sides of a transaction and a plaintiff alleges an unfair transaction, approval of a majority of fully informed, disinterested directors typically will cleanse a conflict transaction and subject it to the presumption of the business judgment rule. If a plaintiff can plead that a majority of interested directors approved a transaction, Delaware courts are likely to find that the plaintiff has rebutted the presumption of the business judgment rule and sustain the complaint. Of particular importance, the Delaware Supreme Court has held that the presence of an independent special committee, which negotiates and

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[289] *Id*, at *5 (citing Solomon v. Pathe Commc'ns Corp., 672 A.2d 35, 39-40 (Del. 1996)).

[290] Glassman v. Unocal Exploration Corp., 777 A.2d 242, 248 (Del. 2001).

[291] *See, e.g.*, Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1111-12 (Del. 1994).

[292] *See, e.g.*, Emerald Partners v. Berlin, 726 A.2d 1215, 1218 (Del. 1999).

[293] *See* Ravenswood Inv. Co. v. Winmill, 2011 WL 2176478, at *4 (Del. Ch. May 31, 2011); Monroe Cnty. Emps.' Ret. Sys. v. Carlson, 2010 WL 2376890, at *2 (Del. Ch. June 7, 2010).

recommends a transaction to a conflicted board, does not ensure business judgment protection for the conflicted directors at the motion to dismiss stage. Rather, an allegation that a majority-interested board approved a transaction negotiated by a special committee likely rebuts business judgment protection and places the burden on the defendants to show on a fuller record that the special committee was disinterested and independent. After discovery, defendants may be able to demonstrate that they are entitled to the protections of the business judgment rule, but they cannot avoid the burden and expense of discovery by prevailing on a motion to dismiss.

Delaware law has also remained consistent regarding controlling shareholder transactions where the controlling party stands on both sides of the deal. In those situations, the entire fairness standard of review applies *ab initio*. However, uncertainty remains regarding how controlling stockholder, going-private transactions involving unilateral two-step freeze-outs will be reviewed by the Delaware Supreme Court in light of the competing standards articulated in *Cox Communications*, *Pure Resources*, and *Siliconix*. The Court of Chancery has attempted to move away from a rigid application of the standard articulated in *Lynch*, but that area of Delaware law remains unsettled.