DELAWARE CORPORATE LAW BULLETIN

Delaware Supreme Court Clarifies "Cleansing Effect" of Fully-Informed Stockholder Vote

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Court also explains that:

> *(i) Good faith reliance by corporate directors does not absolve M&A advisors from potential aiding and abetting liability; and*
>
> *(ii) Scienter is the standard for establishing aiding and abetting liability.*

INTRODUCTION

Generally, in the M&A context, stockholders of a Delaware corporation seeking to collect damages from defendant directors must prove the directors acted with gross negligence (or worse) to establish a breach of their fiduciary duty of care. However, most public

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corporations have taken advantage of Section 102(b)(7) of the Delaware General Corporation Law ("*Delaware § 102(b)(7)*"), which allows corporations to immunize their directors from personal damages for a duty of care breach. Although Delaware § 102(b)(7) does not protect directors from breaches of their duty of loyalty, the level of culpability required to establish such a breach—bad faith or willful misconduct—presents an even more difficult burden of proof for plaintiff stockholders to satisfy.

Consequently, in recent years, plaintiffs' counsel have turned to sell-side financial advisors as a potential source of damages for their clients (and to buttress claims for attorneys' fees). Most notably, in early 2014, the Delaware Court of Chancery required a sell-side financial advisor to pay $75.8 million in damages to Rural Metro Corporation stockholders on the ground that the financial advisor aided and abetted a breach by the Rural Metro board of its duty of care in connection with the sale of Rural Metro to a private equity firm.[1]

In so ruling, the *Rural Metro* Court explained that financial advisors, unlike directors, are *not* protected by Delaware § 102(b)(7). Therefore, if a plaintiff stockholder can establish, *first*, that the board has breached its fiduciary duty and, *second*, that the financial advisor aided and abetted that breach, the financial advisor could face a significant damages award.

On October 2, 2015, in *Corwin v. KKR Financial Holdings LLC*,[2] the Delaware Supreme Court provided a potential pathway for dismissal of these aiding and abetting claims. By declaring that "the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review,"[3] the Supreme Court provided an *ex post* vehicle to overcome a board's duty of care breach, thereby undercutting a related aiding and abetting claim against the board's financial advisor.

The potential impact of the *KKR* cleansing device was demonstrated almost immediately in *In re Zale Corp. Stockholders*

1. *In re* Rural Metro Corp. Stockholders Litig., 88 A.3d 54 (Del. Ch. 2014). The Delaware Supreme Court affirmed the Chancery Court award at the end of 2015 in *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816 (Del. 2015). For a detailed discussion of this ruling, see Robert S. Reder & Margaret Dodson, *Delaware Supreme Court Upholds Multi-Million Damages Award Against Sell-Side M&A Advisor*, 69 Vand. L. Rev. En Banc 27 (2016).

2. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015). In so ruling, the Supreme Court noted that "*Unocal* and *Revlon* are primarily designed to give stockholders . . . the tool of injunctive relief to address important M&A decisions in real time, before closing. They were not tools designed with post-closing money damages in mind . . . ." *Id.* at 312.

3. *Id.* at 306.

Litigation. In *Zale I*,[4] decided *before KKR*, Vice Chancellor Donald Parsons refused to dismiss an aiding and abetting claim against a sell-side financial advisor. Soon *after KKR*, in *Zale II*, Vice Chancellor Parsons reversed course.[5] Applying the deferential business judgment standard of review to the target board's conduct, the Vice Chancellor determined that plaintiffs had not established a breach of duty of care on the part of the target board and, therefore, dismissed the related aiding and abetting claim against the sell-side financial advisor. Financial advisors everywhere no doubt breathed a collective sigh of relief.[6]

I. BACKGROUND

The *Zale* decisions arose from Zale Corporation stockholder suits challenging Signet Jewelers' 2014 acquisition of Zale for a cash purchase price of $21 per share. After Signet made a formal acquisition proposal, Zale's board of directors retained Merrill Lynch[7] as its financial advisor. Merrill Lynch was hired following a presentation wherein it represented that it had " 'limited prior relationships and no conflicts with Signet.' "[8]

Despite this representation, Merrill Lynch indeed had potential conflicts. Among other things, before being retained by Zale, Merrill Lynch had made a presentation to Signet "soliciting business from Signet" by proposing "an acquisition of Zale at a value of between $17 and $21 per share."[9] Jeffrey Rose, a Merrill Lynch managing director, was a senior member of *both* the team that made this presentation to Signet as well as the team that eventually advised Zale during the sale process. Merrill Lynch did not disclose the prior Signet representation to Zale until March 23, 2014—over a month *after* the merger agreement was signed—in connection with preparation of proxy materials to be used to solicit Zale stockholder approval of the transaction.

Several Zale stockholders challenged the merger in the Chancery Court. The Chancery Court refused to preliminarily enjoin

4. *In re* Zale Corp. Stockholders Litig., No. CV 9388-VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015) [hereinafter *Zale I*].

5. *In re* Zale Corp. Stockholders Litig., No. CV 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015) [hereinafter *Zale II*].

6. For a detailed discussion of the Chancery Court decisions in the *Zale* litigation, see Robert S. Reder & Stephanie Stroup Estey, *Sell-Side Financial Advisors in the M&A Crosshairs*, 68 Vand. L. Rev. En Banc 279 (2016).

7. Merrill Lynch, Pierce, Fenner and Smith Incorporated is now the corporate and investment banking division of Bank of America.

8. *Zale I*, 2015 WL 5853693, at *3.

9. *Id.*

the transaction and, after Zale stockholders owning 53.1% of the outstanding shares approved the merger in May 2014, Signet completed the acquisition. Thereafter, plaintiffs amended their complaint to include a damages claim alleging that Merrill Lynch "aided and abetted the Director Defendants' breaches of fiduciary duties."[10] Specifically, plaintiffs alleged that Merrill Lynch "undermined the Board's ability to maximize stockholder value in the Merger by making a presentation to Signet 'with an illustrative price analysis of Zale' at a time when Merrill Lynch had access to Zale's non-public information."[11]

II. THE CHANCERY COURT'S ANALYSIS

A. Zale I*: Enhanced Scrutiny*

In *Zale I,* Vice Chancellor Parsons, while dismissing *Revlon*[12]-based claims against the Zale directors,[13] declined to dismiss the related aiding and abetting claim against Merrill Lynch. Initially, the Vice Chancellor noted that, to establish an aiding and abetting claim, plaintiffs must allege "a breach of the fiduciary's duty . . . [and] knowing participation in that breach by the defendants."

Breach of the Duty of Care. Reviewing the Zale board's actions under the *Revlon* lens of enhanced scrutiny, Vice Chancellor Parsons found it "reasonably conceivable that the Defendant Directors did not act in an informed manner," thereby breaching their duty of care by failing to do a better job "detecting a preexisting conflict when engaging a financial advisor."[14] It mattered not to the Vice Chancellor that Zale stockholders had approved the transaction. While acknowledging he found himself in an unsettled area of Delaware law, Vice Chancellor Parsons reasoned that "where, as here, the merger consideration paid to the target company's stockholders is cash, *Revlon* enhanced scrutiny applies, even after the merger has been approved by a fully informed, disinterested majority of stockholders."[15]

Knowing Participation. Next, the Vice Chancellor determined that Merrill Lynch contributed to the Zale board's potential

10. *Id.* at *7.

11. *Id.*

12. Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

13. Zale's Delaware § 102(b)(7) provision insulated the directors from any potential breach of their duty of care, and Vice Chancellor Parsons concluded that the directors' handling of Merrill Lynch's conflict "hardly constitutes the conscious disregard of the directors' duties required to demonstrate bad faith in the *Revlon* context." *Zale I*, 2015 WL 5853693, at *17.

14. *Id.* at *19.

15. *Id.* at *10.

breach of care by failing to be upfront about the firm's presentation to Signet. Referring to *Rural Metro*, he noted that Merrill Lynch's undisclosed conflicts "hampered the ability of Merrill Lynch and, consequently, the Board to seek a higher price for Zale's stockholders."[16] On this basis, the Vice Chancellor concluded that plaintiffs had successfully alleged that "Merrill Lynch knowingly participated in, and therefore aided and abetted," the board's breach of its duty of care.[17] And consistent with *Rural Metro*, Merrill Lynch was not insulated from liability by Zale's Delaware § 102(b)(7) provision.

B. Zale II*: Business Judgment Rule*

Just one day later, the Delaware Supreme Court rendered its decision in *KKR*, leading Vice Chancellor Parsons to grant Merrill Lynch's motion for re-argument. As the Vice Chancellor put it:

> I misapprehended the law regarding the cleansing effect of a fully informed, statutorily required vote by a disinterested majority of the stockholders in the circumstances of the *Zale* case. This misapprehension was both material and potentially outcome-determinative . . . because I incorrectly applied *Revlon* rather than BJR [the business judgment rule] when I reviewed the Complaint to determine whether it adequately alleged that the Defendant Directors breached their fiduciary duties.[18]

The Vice Chancellor previously concluded in *Zale I* that it was not "reasonably conceivable that . . . Zale's stockholder vote was not fully informed."[19] Accordingly, and in light of *KKR*, the Vice Chancellor ruled in *Zale II* that the more deferential business judgment rule, rather than enhanced scrutiny standard, was the proper standard for evaluating the Zale board's conduct.

This change in the standard of review completely altered the outcome of Vice Chancellor Parsons' analysis. He continued to find it "troubling" that the Zale board did not take further investigative steps to verify Merrill Lynch's claim that it had no conflicts in taking on the representation of Zale.[20] The key question, however, no longer was whether the board acted reasonably. Rather, "the standard for finding a breach of the duty of care" under the business judgment rule "is gross negligence."[21] The Vice Chancellor did not believe the board's conduct

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16. *Id.* at *20.
17. *Id.* at *22.
18. *In re* Zale Corp. Stockholders Litig., No. CV 9388-VCP, 2015 WL 6551418, at *2.
19. *Zale I*, 2015 WL 5853693, at *10.
20. *Zale II*, 2015 WL 6551418, at *5 (stating that the "conduct of Merrill Lynch in this case is troubling).
21. *Id.* at *3.

" 'was so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion' " or suggestive of " 'a *wide* disparity between the process the directors used . . . and [a process] which would have been rational.' "[22]

In this new light, Vice Chancellor Parsons did not find it "reasonably conceivable that the Zale Director Defendants breached their duty of care by acting in a grossly negligent manner as to their engagement of Merrill Lynch."[23] Thus, there was no underlying board breach for Merrill Lynch to have aided or abetted. Accordingly, the Vice Chancellor granted Merrill Lynch's motion to dismiss.

III. THE SUPREME COURT'S ANALYSIS

On May 24, 2016, the Delaware Supreme Court affirmed Vice Chancellor Parsons' decisions to (i) apply the business judgment rule to the Zale board's actions and (ii) dismiss the aiding and abetting claims against Merrill Lynch.[24] In a terse, two-paragraph opinion, however, the Supreme Court made two important points that shed further light on the "cleansing effect" of a fully-informed stockholder vote and offer further comfort to financial advisors:

First, the Supreme Court took issue with the Vice Chancellor's application of the business judgment rule. As noted above, after concluding that the business judgment rule was the applicable standard of review, the Vice Chancellor opined that "the standard for finding a breach of the duty of care" under the business judgment rule "is gross negligence."[25]

The Supreme Court rejected this approach, explaining that "[a]bsent a stockholder vote and absent an exculpatory charter provision, the damages liability standard for an independent director . . . for breach of the duty of care is gross negligence . . . ."[26] However, following "an informed, uncoerced vote of the disinterested stockholders" approving a change-of-control transaction, an analysis whether the directors acted with gross negligence "would give no standard-of-review-shifting effect to the vote."[27] Instead, "[w]hen the business judgment standard of review is invoked because of a vote,

22. *Id.* at *4.

23. *See id.* (dismissing the claim because it is not reasonably conceivable that the Director Defendants were grossly negligent).

24. Singh v. Attenborough, No. 645, 2015, 2016 WL 2765312 (Del. 2016). Chief Justice Leo E. Strine, Jr. authored the opinion on behalf of the Supreme Court.

25. *Zale II*, 2015 WL 6551418, at *3.

26. Singh, 2016 WL 2765312, at *1.

27. *Id.* at *1.

dismissal is typically the result."[28] Therefore, Vice Chancellor Parsons need not have engaged in any further analysis of the Zale board's actions once he determined to invoke the business judgment rule.

Second, the Supreme Court explained that, to the extent *Zale I* implied that "an advisor can only be held liable if it aids and abets a non-exculpated breach of fiduciary duty, that was erroneous."[29] For instance, an M&A advisor "is not absolved from liability simply because its clients' actions were taken in good-faith reliance on misleading and incomplete advice tainted by the advisor's own knowing disloyalty."[30] To the contrary, stockholders may bring an aiding and abetting claim against "an advisor whose bad-faith actions cause its board clients to breach their situational fiduciary duties (e.g., the duties *Revlon* imposes in a change-of-control transaction),"[31] even where the directors were entitled under Section 141(e) of the Delaware General Corporation Law to rely on that advice.

On the other hand, the Supreme Court also pointed out that the "defendant-friendly standard" that requires plaintiff stockholders to prove "scienter" on the part of M&A advisors effectively "awards advisors an effective immunity from due-care liability."[32] Accordingly, even in situations where (i) directors do not enjoy the insulation of a Delaware § 102(b)(7) charter provision or (ii) the "cleansing effect" of a fully-informed vote of stockholders is not present, the bar remains high for stockholders to win a damages award from an M&A advisor on an aiding and abetting theory. Proof of mere negligence, or even gross negligence, will not suffice; active and knowing wrongdoing on the part of the M&A advisor must be established. While the Supreme Court reiterated that this degree of culpability was exhibited by the financial advisor in *Rural Metro*, it noted nothing "close" to such behavior in the record of Merrill Lynch's efforts on behalf of the Zale board.[33]

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28. *Id.* The one instance when dismissal would not be appropriate would be upon a showing of corporate waste on the part of the board, a "vestigial" concept with "little real-world relevance," particularly after a stockholder vote. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* at *2.

32. *Id.* at *1, 2.

33. *Id.* at *2.