DELAWARE CORPORATE LAW BULLETIN

Delaware Court Dismisses Duty of Loyalty Claim Against Disinterested, Independent Directors

*Robert S. Reder**
*Tiffany M. Burba***

Informed Board's decision to disregard "speculative" valuation methods when recommending a company sale not so egregious as to constitute bad faith

INTRODUCTION

A corporate director's duty of loyalty requires that she act "in the interest of the corporation and its owners, the stockholders."[1] Absent entire fairness to the corporation, a director may not take actions for the benefit of herself or other principals whom she serves as agent.[2] Directorial loyalty is at the same time an "exacting, but narrow"

* Robert S. Reder, Professor of the Practice of Law at Vanderbilt University Law School, has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

** Tiffany M. Burba, a J.D./M.S. Finance Candidate at Vanderbilt University, will be starting as an associate at Cadwalader, Wickersham & Taft in the fall of 2017.

1. In Re Chelsea Therapeutics Int'l Ltd. Stockholders Litig., Consol. C.A. No. 9640-VCG, slip op. at 1 (Del. Ch. May 20, 2016) [hereinafter *In Re Chelsea*].

2. *Id.* at 1.

standard that grants boards "wide latitude," enabling them to "embrace risk for the benefit of the corporation."[3]

However, even a disinterested, independent director can breach her duty of loyalty when she acts in bad faith.[4] The bad-faith inquiry, aptly described by Chancellor William B. Chandler III as "hazy jurisprudence,"[5] permits the finding, albeit rare, of a breach of the duty of loyalty in "situations where, even though there is no indication of conflicted interest or lack of independence on the part of the directors, the nature of their action can in no way be understood as in the corporate interest . . . ."[6]

The Delaware Court of Chancery's recent analysis of a breach of loyalty claim in *In Re Chelsea* is instructive. Following the acquisition of Chelsea Therapeutics International, Ltd. ("Chelsea" or "company") via merger, disappointed Chelsea stockholders sought damages from the company's directors on account of an alleged breach of their duty of loyalty, resulting in a significant undervaluation of the company.[7] Although plaintiffs conceded the directors were independent and disinterested, they alleged the Board acted in bad faith when it "improperly instructed Chelsea's financial advisors to ignore one set of financial projections" in opining on the fairness of the merger, and "chose themselves to disregard a second set of projections" when recommending the merger to Chelsea stockholders.[8] Vice Chancellor Sam Glasscock III granted defendant-directors' motion to dismiss, finding the complaint failed to show an "extreme set of facts" establishing that "the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[9]

Vice Chancellor Glasscock's opinion illustrates the high bar faced by stockholders who seek damages from corporate directors on a breach of loyalty theory, particularly directors who are independent and disinterested. It reinforces that mere "disagreement with the actions of the Board does not plead a case of bad faith,"[10] suggesting that an

3. *Id.*

4. *Id.* (citing *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 754–55 (Del. Ch. 2005)).

5. *Id.* (quoting *In re Walt Disney*, 907 A.2d at 754).

6. *Id.* at 1–2.

7. *Id.*

8. *Id.* at 3–4.

9. *Id.* at 2, 16 (quoting *Dent v. Ramtron Int'l Corp.*, C.A. No. 7950-VCP, 2014 WL 2931180 at *6 – 7 (Del. Ch. June 30, 2014)).

10. *Id.* at 20.

informed board has broad discretion in choosing how to value a corporation in a sale transaction.

I. BACKGROUND

Chelsea is a "developmental biopharmaceutical company" that had "researched and developed a drug called NORTHERA™ ("Northera").[11] In 2013, the Chelsea Board conducted a market check, but none of the sixty-five companies contacted submitted a proposal to purchase the company. After the United States Food and Drug Administration ("FDA") granted accelerated approval of Northera in 2014, however, several potential buyers expressed interest in acquiring the company.

Despite this renewed interest, the only formal offer came from Lundbeck A/S ("Lundbeck"). On March 31, 2014, Lundbeck formally offered to purchase Chelsea for $6.44 per share in cash. The Chelsea Board found the offer insufficient after considering, among other things, an analysis prepared by its financial advisor showing "standalone value, including a discounted-cash-flow analysis that indicated that Chelsea could be worth $11.32 to $15.02 per share" if a competing drug were removed from the market.[12] In response, Lundbeck revised its offer to add "potentially lucrative contingent value rights ("CVRs")" that could provide "an additional $1.50 per share" to Chelsea stockholders "if certain annual sales targets are met."[13] The Board, after receiving a fairness opinion from its financial advisor, accepted the revised offer. Chelsea stockholders ultimately approved the transaction.

In a post-closing action for damages, plaintiffs claimed that the decision by the Cheslea Board to sell the company to Lundbeck on these terms resulted in an undervaluation of between $266 million and $558 million. This claim was premised on alternative valuation theories available to the Board. Specifically, the Board had access to several valuation models and analyses at the time Lundbeck made its revised offer:

11. *Id.* at 2. Northera is used "to treat symptomatic neurogenic orthostatic hypotension ("NOH")," a "rare disorder that causes low blood pressure upon standing . . . often associated with Parkinson's disease." *Id.* at 2, n. 4.

12. *Id.* at 7. Northera's primary competitor is a drug called Midodrine. In 2010, the FDA gave notice that it intended to take Midodrine off the market, but later changed course to allow continued Midodrine marketing while the FDA considered final approval of the drug. *Id.* at 5.

13. *Id.* at 7–8. If the CVRs returned maximum value, the price premium of the enhanced offer was between thirty and sixty percent. *Id.* at 8–9.

1. Base Case: Assumed that Northera would be used to treat NOH only and would not be applied in other contexts.
2. Adjusted Base Case: Assumed a single use for Northera but further predicted an increase in sales upon an expansion of Chelsea's sales force.
3. No-Midodrine Projections: Assumed that (i) Northera's primary competitor, Midodrine, would be taken off the market when it failed to achieve FDA approval, and (ii) as a result, Northera would benefit from an increased market share.
4. L.E.K. Study: Revealed potential revenue streams resulting from hypothetical new applications of Northera in addition to the treatment of NOH.

The "crux" of plaintiffs' claim "centers on the decision by the Board . . . to direct its financial advisors to opine on the fairness of the Transaction without considering value implied by the No-Midodrine Projections, and to recommend the Transaction without considering, or directing its financial advisors to consider, the L.E.K. study."[14] As such, plaintiffs alleged, the Board acted in bad faith when it "intentionally concealed the true, higher value of the Company from its stockholders."[15]

II. THE COURT'S ANALYSIS

At the outset, Vice Chancellor Glasscock noted that plaintiffs themselves conceded that the Chelsea directors' equity interests in the company "aligned their interests—maximum value—with the other stockholders," thereby dispelling with any notion that the directors

14. *Id.* at 15. Although plaintiffs raised several other issues regarding the sales process and terms of the transaction (such as allegedly improper deal protections and contingent-fee arrangements), as well as claims of inadequate disclosures to stockholders, these were either waived or mooted. *Id.* at 3, n. 5, 12–14, n. 48.

15. *Id.* at 16–17. Under existing severance plans, defendants were entitled to "change-in-control" payments in the event of a sale transaction. *Id.* at 17, n. 56. Plaintiffs argued these payments enabled defendants to recoup the loss of an undervalued merger at the expense of the other stockholders. The Vice Chancellor disagreed, holding the mere existence of "change-in-control" payments, without more, insufficient to support a finding of bad faith. *Id.* at 17. On the other hand, the result might have been different had there been "a well-pleaded allegation that the change-in-control payments exceeded, in a way material to Defendants, the loss engendered by an intentional undervaluation of the Company in aid of the Transaction . . . ." *Id.* Similarly, the Vice Chancellor discounted plaintiffs' complaints that "because Lundbeck expected to retain Chelsea's senior management following the Transaction, management had the opportunity—unlike Chelsea's stockholders—to participate in any future upside of the Company through future equity awards and performance-based compensation." *Id.* at 11.

were not independent and disinterested.[16] The Vice Chancellor then explained "the most difficult path" faced by plaintiffs in establishing a breach of loyalty, that is,

> . . . that the action complained of is otherwise inexplicable, so that bad faith—a motive other than the interest of the Company—*must* be at work. The question before me is, simply, was the Chelsea Board's decision . . . so egregious on its face that—notwithstanding that there are no allegations that directors are interested or lack independence—the Plaintiffs have stated a case that is reasonably conceivable that the Defendants acted in bad faith?[17]

Citing three primary reasons, the Vice Chancellor answered this question with a resounding "no." Not only was the Board's action "not without the bounds of reason," the Vice Chancellor noted, but "in fact, it is readily explicable—that the Board would decline to use the Projections to value the Company, as both are highly speculative."[18]

First, the Vice Chancellor rejected the assumption that Northera would realize an increased market share from Midodrine's removal from the market.[19] The record showed that the Chelsea Board remained unconvinced that Midodrine would ever be taken off the market, inasmuch as "the FDA ha[d] never removed a drug under similar circumstances and [there is] no assurance that they will do so in the case of [M]idodrine."[20] The Board even discussed the history of Midodrine with its financial advisors, concluding that the No-Midodrine Projection was so speculative as to be unquantifiable in a financial analysis.[21]

Second, relying on the L.E.K. Study would require the occurrence of two entirely speculative scenarios: that Northera (i) be

---

16. The Vice Chancellor also noted that the defendant-directors were "exculpated from duty-of-care claims under [DGCL] Section 102(b)(7)." *Id.* at 15. On the other hand, he was not willing to entertain defendants' argument for an extension of the rule established by the Delaware Supreme Court in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) (holding that an informed vote by disinterested stockholders can cleanse directors' due care violations in a post-closing action for damages) to bad faith claims. For a more detailed discussion of the Corwin Court's analysis, see Robert S. Reder & Stephanie Stroup Estey, Sell-Side Financial Advisors in the M&A Crosshairs, 68 Vand. L. Rev. En Banc 279 (2015), https://www.vanderbiltlawreview.org/wp-content/uploads/sites/89/2015/12/Sell-Side-Financial-Advisors-in-the-MA-Crosshairs.pdf [https://perma.cc/L4JZ-LH53]; s*ee also* Robert S. Reder, Delaware Supreme Court Clarifies "Cleansing Effect" of Fully-Informed Stockholder Vote, 69 Vand. L. Rev. En Banc 219 (2016), https://www.vanderbiltlawreview.org/wp-content/uploads/sites/89/2016/07/Delaware-Supreme-Court-Clarifies-%E2%80%9CCleansing-Effect%E2%80%9D-of-Fully-Informed-Stockholder-Vote.pdf [https://perma.cc/5KC5-ENX7].

17. *In Re Chelsea* at 18.

18. *Id.*

19. *Id.*

20. *Id.* at 18–19, n. 57.

21. *Id.* at 19, n. 57.

proven capable of treating conditions other than NOH and (ii) gain FDA approval for those uses.[22]

Third, the Vice Chancellor noted that the Board had made the No-Midodrine Projections available to potential buyers before accepting Lundbeck's offer.[23] This suggested to the Vice Chancellor that "if the Projection were a realistic indication that the Company's value was hundreds of millions of dollars higher than Lundbeck's offer, another bidder would have emerged throughout the twenty-month long sales process" in which the Company's financial advisors contacted eighty-four other potential purchasers.[24] Of course, no such offer emerged.

Finally, Vice Chancellor Glasscock noted that a stockholder's mere disagreement with a board decision could not support a claim of bad faith. Applying the *Dent*[25] standard, he declared:

> The Board, after deliberation and in consideration of the sale of the Company, instructed its advisors not to consider projections that its assets would increase in value, years in the future, on speculation that the FDA would approve one of its products for currently-prohibited uses, or would remove a competing drug from the market altogether. Both sets of projections involved contingencies over which the Company had no control, and which might never come to pass. The Board itself decided not to consider these projections in recommending the Transaction to the stockholders. *Such actions do not, on their face, plead a conceivable breach of the Directors loyalty-based duty to act in good faith. No other grounds conceivably leading to a finding of bad faith are pled.*[26]

CONCLUSION

In Re Chelsea demonstrates the difficulty faced by stockholders in bringing a claim for breach of loyalty against corporate directors, particularly when there are no allegations that the directors were conflicted. This is, in Vice Chancellor Glasscock's own words, the "most difficult path to overcome dismissal of a claim based on bad faith."[27] In this case, the Vice Chancellor suggested that plaintiffs asserting a claim for breach of the duty of loyalty on the basis of bad faith must allege particularly egregious facts, rather than mere disagreement with corporate decisions. Specifically, in a sale transaction, Delaware courts likely will defer to independent, disinterested directors' judgment regarding which financial models to use in valuing a company.

22. *Id.* at 19.

23. *Id.*

24. *Id.* at 19–20, n. 59.

25. *Dent v. Ramtron Int'l Corp.*, C.A. No. 7950-VCP, 2014 WL 2931180 at *6–7 (Del. Ch. June 30, 2014) (holding that in order to state a bad-faith claim, a plaintiff must show that "the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.").

26. *In Re Chelsea* at 20 (emphasis added).

27. *Id.* at 18.