Roadmap for Merger Decision-Making Process in Delaware

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In a string of recent cases, the Delaware courts have given public companies a roadmap for structuring the decision-making process in merger transactions. Before delving into the recent decisions, it may help to understand the various standards of review applicable to mergers in Delaware. Generally, the business judgment rule applies to the analysis of breach of fiduciary duty claims in connection with board of director decisions. The business judgment rule provides that board actions will not be overturned by the courts, so long as the directors possess no direct or indirect personal interest, the board decision is made with reasonable awareness of all reasonably available material information and after prudent consideration of the alternatives and the directors acted with good faith in furtherance of a rational corporate purpose. With respect to merger decisions specifically, boards must exercise due care and act in an informed and deliberative manner. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the Delaware Supreme Court held that directors have a duty to maximize shareholder value in a classic cash-out merger. In subsequent cases, the Delaware Supreme Court made it clear that the *Revlon* standard imposes enhanced judicial scrutiny of certain transactions involving a sale of control or where the company is being broken up, including stock-for-stock mergers and transactions involving stock and cash, as well as cash-out mergers. In situations where the board of a target corporation does not consist of a majority of disinterested directors, the entire fairness standard of review may apply. The entire fairness level of scrutiny requires the transaction to be fair as to both price and process. The entire fairness level of review is also applied to mergers involving a majority or controlling stockholder (or stockholder group). In such transactions, the controlling shareholder has the burden of proving the transaction's entire fairness. A tender offer followed by a short form merger is generally not subject to the entire fairness standard. Further, use of an independent committee of directors may trigger the more deferential business judgment standard of review or shift the burden on the issue of fairness from the controlling stockholder to the plaintiff.

In *Corwin v. KKR Financial Holdings, LLC*, 125 A.3d 304 (Del. 2015), the Delaware Supreme Court affirmed the Court of Chancery's holding that the voluntary judgment of disinterested stockholders to approve a merger invokes the business judgment rule standard of review. *Corwin* involved a stock-for-stock merger between two widely-held publicly traded companies. The plaintiffs argued that the entire fairness standard should apply because the acquiror was a controlling stockholder of the target company despite the acquiror owning less than one percent of the target and because a majority of the target board that approved the merger was not independent from the acquiror. The plaintiff's controlling stockholder theory was based on the terms of a management agreement under which an affiliate of the acquiror managed the day-to-day business of the target. The Chancery Court pointed out, however, that the target's board, which was subject to annual election, had the ultimate authority for managing the target's business and affairs, including the decision to approve the merger. Thus, the Court dismissed the plaintiff's fiduciary duty claim against the acquiror premised on the controlling stockholder theory. Further, the Court held that the target board's approval of the merger was subject to the business judgment rule because (i) the plaintiffs had not alleged facts from which a reasonable inference could be made that a majority of the target board was not disinterested in the transaction or independent from the acquiror and (ii) even if the plaintiffs had alleged facts to reasonably support such an inference, the business judgment rule would still apply because the merger was approved by a majority of disinterested stockholders in a fully-informed vote. According to the Chancellor, the business judgment rule applies to a fully-informed stockholder vote on a transaction with a non-controlling stockholder and "insulates the transaction from all attacks other than on the grounds of waste, even if a majority of the board approving the transaction was not disinterested or independent." The Supreme Court confirmed that the entire fairness standard did not apply to the merger and also held that it did not need to address the plaintiffs' *Revlon* claim because Chancellor's analysis of the effect of the uncoerced, informed stockholder vote was outcome-determinative.

In *In re Volcano Corp. Stockholder Litigation* 143 A.3d 727 (Del. Ch. June 30, 2016), the Delaware Court of Chancery extended Corwin to two-step mergers under Section 251(h) of the Delaware General Corporate Law (DGCL). Section 251(h) eliminates the need for a stockholder vote for a merger after a tender or exchange offer if certain conditions are met. In *Volcano*, the Court held that where a target company's fully informed, disinterested shareholders approve a merger by tendering a majority of the company's outstanding shares in a tender offer, the business judgment rule irrefutably applies and the merger can only be challenged on the basis that it constituted waste (i.e., "the merger cannot be attributed to any rational business purpose"). The Chancellor noted that it would be difficult to prove waste where the decision is ratified by fully informed, uncoerced, independent stockholders.

In *Larkin v. Shah*, C.A. No. 10918-VCS (Del. Ch. August 25, 2016), the Delaware Court of Chancery, applying *Corwin* and *Volcano*, held that in the absence of a controlling stockholder which received non-ratable benefits, the effect of disinterested stockholder approval of a two-step, medium form merger under Section 251(h) is reviewed under the irrebuttable business judgment rule, "even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors." Having reached this conclusion, the Chancellor said it was not necessary to address the plaintiff's Revlon claim.

In *In Re OM Group, Inc. Stockholders Litigation*, C.A. No. 11216-VCS (Del. Ch. October 12, 2016), the Delaware Court of Chancery dismissed a lawsuit brought by former OM Group Inc. (OM) stockholders alleging that the OM board breached its fiduciary duty by rushing to sell the company in order to avoid a public confrontation and proxy fight with an activist shareholder. The Chancellor held that even if all of the plaintiffs' allegations were true, the complaint must be dismissed because a majority of the fully informed, uncoerced, disinterested stockholders voted to approve the merger and plaintiffs failed to allege that the transaction amounted to waste.

Following *Larkin* and *OM Group*, the applicable standard of review in mergers is as follows:

where there is a controlling stockholder (or group) which stands on both sides of the transaction or receives a non-ratable benefit, the entire fairness doctrine applies and approval by disinterested, fully informed shareholders only shifts the burden on the issue of fairness to the plaintiff;

where there is no controlling stockholder, approval by disinterested, fully informed shareholders restores business judgment deference and insulates the transaction from fiduciary challenge on all grounds other than waste, even if the board harbored a conflict of interest (i.e., the Corwin standard); and

in a two-step merger under Section 251(h), the tenders by a stockholder majority constitute stockholder approval sufficient to invoke the Corwin standard.