DELAWARE BUSINESS COURT INSIDER

August 21, 2013

An ALM Website

# The Chancery Court as 'Gatekeeper' in M&A Litigation

*By Paul J. Collins*

In an era in which plaintiffs lawyers file multiple lawsuits in response to nearly every control transaction involving a publicly traded corporation, the Delaware Court of Chancery in several recent decisions has rigorously reviewed the plaintiff shareholders' claims at early stages in the litigation process, applied clear legal principles and denied the plaintiffs' requested relief. This article examines several recent Court of Chancery decisions, including opinions issued in *In re Morton's Restaurant Group Shareholders Litigation*, No. 7122-CS, slip op. (Del. Ch. July 23, 2013), and *Miramar Firefighters Pension Fund v. AboveNet*, No. 7376-VCN, slip op. (Del. Ch. July 31, 2013), which suggest that the court will scrutinize plaintiffs' claims at the initial stages of litigation and discourage plaintiffs lawyers from bringing marginal cases. The court's seemingly increased willingness to look at the merits early in the proceedings may be in recognition that it is inconceivable that virtually every board that sells its company breached its fiduciary duties. These cases suggest that the Court of Chancery will engage in a robust analysis of the merits of each case, using the motion to expedite and the motion to dismiss phases of the case as gateways, before imposing additional burdens and costs of further litigation.

**Background**

Lawsuits challenging sales of public companies have been a common feature of business life in the United States for decades and have significantly increased in recent years. By 2012, nearly every transaction involving the sale of a public company — 96 percent of transactions involving corporations valued at $500 million or more — resulted in suits against the target corporation's directors. According to a Cornerstone Research study published earlier this year, most transactions result in multiple suits and more than half result in litigation in more than one jurisdiction.

The claims asserted in these suits are familiar: the target company's directors breached their fiduciary duties of loyalty and care by pursuing a fundamentally "unfair process" that resulted in a transaction at an "unfair price." When proxy statements (or tender offer documents) relating to the proposed transaction are filed, the directors are commonly alleged also to have breached their duty of candor by misleading stockholders in an attempt to secure approval of the allegedly flawed transaction. Acquirors, target corporations and financial advisers are frequently "aiders and abettors" of the target board's alleged misconduct.

Almost as predictable as the near certainty of litigation is the outcome. According to Cornerstone's study, "Shareholder Litigation Involving Mergers and Acquisitions," the overwhelmingly most likely outcome of M&A litigation is a settlement. In 2012, nearly two-thirds of M&A cases settled and just 3 percent were resolved by a court in the context of motions to dismiss or for summary judgment.

**Motions to Expedite**

Against the backdrop of the nearly certain litigation, the Court of Chancery has recently used the motion to expedite proceedings in advance of a motion for preliminary injunctive relief as an opportunity to evaluate the merits of the plaintiff shareholders' claims and weed out potentially frivolous cases. In numerous cases in 2012 and thus far in 2013, the Court of Chancery denied stockholders' motions to expedite proceedings, holding that the burdens associated with expedited discovery outweigh the benefits either because (1) the claims asserted are not "colorable" or (2) there is insufficient "possibility of threatened irreparable injury." Thus, for example, the Court of Chancery has denied motions to expedite proceedings in *In re Dell Shareholder Litigation*, No. 8329-CS, transcript op. (Del. Ch. June 19, 2013); *Ehlen v. Conceptus*, No. 8560-VCG, letter op. (Del. Ch. May 24, 2013); *Coyne v. Kensey Nash*, No. 7508-VCP, transcript op. (Del. Ch. June 22, 2012); *In re Midas Shareholders Litigation*, No. 7346-VCP, transcript op. (Del. Ch. Apr. 12, 2012); and *In re C&D Technologies Shareholders Litigation*, No. 6620, transcript op. (Del. Ch. Nov. 3, 2011). In each case, the court conducted a detailed review of the plaintiffs' principal theories and denied the motion to expedite on the grounds that those theories were insufficiently colorable.

**Morton's**

The Court of Chancery also has suggested in recent cases that motions to dismiss may again serve as an appropriate vehicle to examine the merits of stockholders' claims. In two recent cases, in particular, the court has articulated increasingly clear-cut legal standards by which to evaluate claims even under the plaintiff-friendly standards applicable on a motion to dismiss.

In *Morton's*, Chancellor Leo E. Strine Jr. granted the defendants' motion to dismiss the plaintiff stockholder's *Revlon* claims. In *Morton's*, the plaintiffs alleged that Morton's directors, aided and abetted by the board's financial adviser, breached their fiduciary duties to Morton's and its stockholders by acquiescing to the desire of its private equity sponsor, Castle Harlan, to sell and then conducting an unfair process pursuant to which Morton's would be sold to Landry's Inc. for the allegedly unfair price of $6.90 per share.

Although Morton's board conducted a nine-month sale process that resulted in a transaction price 33 percent above the unaffected trading price of Morton's stock before the transaction was announced, the plaintiffs argued that the defendants' motion to dismiss should be denied because, among other things, their breach of fiduciary duty claims should be evaluated under the "entire fairness" standard rather than the more deferential business judgment rule. In support of their argument that the entire fairness standard applied, the plaintiffs argued that (1) Castle Harlan was a controlling stockholder and "had a unique liquidity need that caused it to push for a sale of Morton's at an inadequate price" and (2) the eight Morton's directors not affiliated with Castle Harlan "acquiesced in Castle Harlan's plan and approved a lowball transaction because they were willing to put the liquidity needs of the company's controller ... above their fiduciary duties to the stockholders."

The court rejected the plaintiffs' argument that the directors' conduct was subject to the entire fairness standard on two grounds. First, the court found that Castle Harlan's 27.7 percent interest, combined with its right to elect two of 10 directors, did not support "a rational inference" that Castle Harlan was in a control position over Morton's or that its alleged conflict infected the board's sale process. Second, the court held that "even if Castle Harlan could be considered a controlling shareholder, the plaintiffs ... failed to make any well-pled allegations indicating that Castle Harlan had a conflict of interest" with other Morton's stockholders. Specifically, the court held that "the plaintiffs plead no facts supporting a rational inference that it is conceivable that Castle Harlan's support for an extended market check involving an approach to over 100 bidders in a nine-month process reflected a crisis need for a fire sale."

Significantly, the court then analyzed the remainder of the plaintiffs' allegations under *Lyondell Chemical v. Ryan*, 970 A.2d 235 (Del. 2009), and Delaware General Corporation Law Section 102(b)(7). The court held that, although the *Revlon* "enhanced scrutiny" standard generally applies in the context of a change of control transaction, the plaintiffs also were required to plead facts sufficient to overcome the protections to which the directors were entitled under the exculpation clause in Morton's bylaws. "This means that the defendant directors are entitled to dismissal unless the plaintiffs have pled facts that, if true, support the conclusion that the defendant directors failed to secure the highest attainable value as a result of their own bad faith or otherwise disloyal conduct." The court then rejected as inadequate for purposes of a Rule 12(b)(6) motion to dismiss conclusory allegations that the board consciously disregarded its *Revlon* duties because the plaintiffs' various theories were not plausible given that the board oversaw a nine-month sale process involving a substantial market check and then negotiated a transaction at a substantial premium that was shared ratably among all of Morton's stockholders. The court also dismissed as "quibbles" the plaintiffs' argument that Morton's financial adviser did not adequately value Morton's stock.

The court also noted that the defendants need not have conceded that even *Revlon's* enhanced scrutiny standard applied. Citing its 2012 decision in *In re Synthes Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012), the court explained that even if Castle Harlan owned a "control" position, "the presumption is that a large blockholder, who decides to take the same price as everyone else, believes the sale is attractive, and thus is a strong indication of fairness and that judicial deference is due." The court rejected the plaintiffs' suggestion that transactions involving private equity stockholders such as Castle Harlan should be subjected to a per se rule of enhanced scrutiny: "Like other stockholders, private equity firms are entitled to sell at a good price for the benefit of their investors. For actual nonprivate equity investors who care about the performance of their investment, rather than the creation of a legal theory to help get past a motion to dismiss, the idea that they will receive their ratable share of a control premium after a full and open sales process is not a threat: it is an attractive prospect that rewards them [along] with the private equity firm." In such circumstances, the court explained, the defendant directors should be entitled to application of the business judgment rule.

**AboveNet**

Similarly, in *AboveNet* — decided July 31, just a few days after Morton's — Vice Chancellor John W. Noble dismissed breach of fiduciary duty claims against AboveNet's directors in the context of a going private sale to Zayo Group LLC. The plaintiff in *AboveNet* alleged that the directors failed to supervise adequately AboveNet's CEO, who, according to the plaintiff, "concocted a plan to sell the company to a private equity buyer so that he could retain his role as CEO and roll over his equity into [a] private venture."

The court rejected the plaintiff's allegations on the ground that they failed "to state a reasonably conceivable claim" because the plaintiff failed to allege facts suggesting either that (1) the majority of AboveNet's directors were self-interested or not independent of the CEO, or (2) they acted in the type of bad-faith conduct that would overcome the *Lyondell* "conscious disregard" standard. Like the court in *Morton's*, Noble rejected the plaintiff's argument that the directors "turned a blind eye" to changes in the financial advisers' valuations over time on the grounds that the plaintiff "has not explained adequately why any of the inputs used were per se unreasonable," "why those differences were material," "why the board should have voiced skepticism at the disparate analyses," or "how those minor differences create an inference that the AboveNet directors manipulated the sale process."

**Court's analysis of cases**

Taken together, these cases suggest that the Court of Chancery is increasingly willing to engage in a rigorous analysis of a case at stages in a case in which judicial scrutiny was once more deferential. Although the "good cause" standard applied in the context of a motion to expedite is not high, the Court of Chancery routinely engages in an analysis of the facts alleged in the complaint and other facts about the transaction that are provided by the parties or otherwise publicly available to determine whether both a colorable claim or a conceivable irreparable harm will occur in the absence of preliminary injunctive relief. Likewise, the *Morton's* and *AboveNet* cases suggest that the court is increasingly willing to apply more deferential standards of review, including the *Lyondell* standard, in the context of a motion to dismiss and examine whether claims that touch all of the elements of a claim are nevertheless inconsistent with publicly available facts.

***Paul J. Collins*** *is a securities litigation partner in the Palo Alto, Calif., office of Gibson, Dunn & Crutcher, who specializes in corporate control litigation.*