THE NATIONAL LAW REVIEW

A 24% Stockholder of Seller and Seller's Board Must Face Fiduciary Duty Claims Due to Flawed Sales Process and Inadequate Merger-related Disclosures: Another Merger Challenge Demonstrates the Limits of Corwin

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- Mergers & Acquisitions

- Delaware

Monday, July 8, 2019

In its October 2015 decision in *Corwin v. KKR Financial Holdings, LLC*, [1] the Delaware Supreme Court held that, under most circumstances, approval of a transaction by a majority of fully informed, uncoerced stockholders invokes deferential business-judgment-rule review, notwithstanding that absent such approval a heightened level of scrutiny would apply. Where *Corwin* applies, the result is virtually always dismissal of the action since overcoming the business judgment rule requires allegations that the transaction constitutes corporate waste—an extremely difficult bar to clear even at the pleadings stage. But, as we have cautioned, [2] the Delaware Supreme Court has effectively tempered the force of *Corwin* by signaling, in a pair of 2018 decisions, its receptiveness to arguments that merger-related disclosures contained misstatements or omissions, thereby rendering the stockholder votes "uniformed" and allowing plaintiffs to escape the impact of *Corwin*. [3]

The adequacy of merger-related disclosures is now frequently a threshold battle in post-closing litigation, and the latest example is the Court of Chancery's decision in *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, 2019 WL 2564093 (Del. Ch. June 21, 2019). *KCG* involved a stockholder challenge to a 2017 all-cash acquisition by Virtu Financial, Inc. (a FinTech firm focusing on high-frequency trading and market-making) of then-competitor KCG Holdings, Inc. The merger was approved by more than 75% of the disinterested KCG stockholders—setting up a pleadings-stage motion to dismiss based on *Corwin* by the KCG directors. But the plaintiff argued, and the court agreed, that *Corwin*was not applicable because the complaint adequately alleged that there were material misstatements and omissions in the proxy statement soliciting approval of the merger.

With the *Corwin* bar out of the way, the court went on to conclude—through the enhanced-scrutiny lens of *Revlon* [4]—that the plaintiff's pleadings-stage allegations gave rise to a rational inference that the KCG directors had, in approving the merger, breached their fiduciary duties, that the exculpatory provision in KCG's charter did not bar those claims, and that Virtu and Jefferies LLC, a financial advisor to KCG (although not on the Virtu transaction) and a major KCG stockholder (the "Financial Advisor"), had aided and abetted those breaches.

KCG marks the latest in a trend of Delaware cases that have relied upon perceived shortcomings in merger-related disclosures as a basis to deny a transaction the benefit of the *Corwin* defense and allow fiduciary duty claims to survive a motion to dismiss.[5] We thus continue to advise that it is imperative that directors and their advisors carefully assess the adequacy of disclosures to stockholders in connection with mergers and other transactions to have the best chance of insulating the transaction from post-closing attacks.

Background

According to the complaint, Virtu became interested in acquiring KCG after concluding, in late 2016, that KCG's stock price was depressed. Virtu's controlling stockholder reached out to the Financial Advisor—which was also the owner of 24% of KCG's stock—to float the idea of an acquisition. By then, the Financial Advisor was allegedly looking to sell its KCG position, and the Financial Advisor's CEO instructed one of the firm's bankers to prepare a valuation of KCG.

The Financial Advisor based its valuation on KCG's "total book value" or TBV—the company's net asset value less intangible assets—and its valuation was based on a key assumption: that KCG would sell its bond trading platform, BondPoint. The Financial Advisor estimated that a sale of BondPoint would generate $200 million in proceeds and increase KCG's TBV to $21 to $21.50 per share, an increase of more than $2.20 per share. Armed with that valuation, the Financial Advisor's CEO met with the CEO of Virtu to discuss the potential for a transaction. Virtu's CEO proposed an acquisition in the range of $17 to $18 per share, but the Financial Advisor's CEO suggested a value of at least $21 per share based on the strategy of divesting the BondPoint platform.

Shortly thereafter, the Financial Advisor's CEO reached out to the CEO of KCG to suggest that KCG should sell its BondPoint platform. KCG's CEO demurred, in part because the BondPoint platform was experiencing rapid growth, but also because KCG was in the midst of a restructuring initiative, which the Financial Advisor itself was advising on and which the CEO believed would generate greater value than a sale to Virtu. The Financial Advisor allegedly did not inform KCG of its discussions with Virtu in this conversation.

Just over a month later, the Financial Advisor gave an hour-long presentation on KCG to Virtu, during which the Financial Advisor allegedly divulged confidential information about KCG's BondPoint platform. Over the next few days, the Financial Advisor and Virtu discussed prices that Virtu would be willing to bid and that the Financial Advisor would be willing to accept for its shares. According to the plaintiff, the Financial Advisor and Virtu "reached a meeting of the minds" that the Financial Advisor would support an acquisition at $20 per share. A few days later, the Financial Advisor's CEO informed KCG's CEO that Virtu was interested in an acquisition, but allegedly did not mention that the Financial Advisor and Virtu had been negotiating a purchase price for the prior two months.

Within a week, Virtu made a non-binding proposal in the range of $18.50 to $20 per share. At a board meeting shortly thereafter, KCG's CEO expressed his view that the restructuring plan would provide at least 25% more value for stockholders than selling the company at $20 per share, and the board agreed. But the board—at the Financial Advisor's urging—decided to continue to negotiate with Virtu. The KCG board determined to retain both legal and financial advisors to advise it on Virtu's bid, but notably retained Goldman Sachs as its banker in lieu of the Financial Advisor. It did so in part because, by this time, certain directors had become suspicious that the Financial Advisor and Virtu had been collaborating after one of the Financial Advisor's bankers disclosed to KCG that he had briefed Virtu on KCG. This information, in turn, prompted KCG to ask the Financial Advisor to provide a full accounting of its communications with Virtu. Nearly two weeks later, the Financial Advisor provided a timeline of those communications, but omitted mention of the fact that the Financial Advisor's and Virtu's CEOs had met at the outset to discuss KCG's value and that the Financial Advisor had shared with Virtu confidential information about KCG's BondPoint platform.

Approximately one month later—after an unsuccessful attempt by Goldman Sachs to solicit interest from other parties—KCG reopened negotiations with Virtu, leading to a bid of $20 per share. Virtu deemed that bid to be its "best and final" offer, and the Financial Advisor reached out to the chair of KCG's board to convey that—with its 24% stake—it would support that price. All of the KCG directors voted in favor of countering with a bid of $20.21, except for KCG's CEO, who believed that this price was inferior to KCG's expected value upon consummation of the restructuring plan. Nonetheless, he told the other directors that he would support that price if Virtu could resolve certain "closing risks" related to the post-closing retention and compensation of KCG's management, including himself.

KCG's CEO delivered the $20.21 counteroffer to Virtu the next morning, conditioned on Virtu agreeing to a "compensation and retention pool" for KCG's employees. After a day passed with no response, the chair of KCG's board urged KCG's CEO to keep negotiating, telling him, "[p]erhaps you can get the comp issue resolved and then you can resolve the price issue." [6] Virtu rejected the $20.21 counteroffer, but agreed to fund a compensation pool for KCG's employees in an amount of $13 million—roughly equal to the $13.5 million difference between a bid of $20 per share and $20.21. Despite the KCG CEO's inability to secure any additional consideration for KCG stockholders, the KCG board—including the CEO—unanimously approved an acquisition at $20 per share, subject to receipt of a fairness opinion from Goldman Sachs.

Immediately after the meeting, KCG's management prepared a revised set of financial projections that reflected a more pessimistic view of the restructuring plan. KCG's board received the projections via email and never held a meeting with management to discuss them. The directors approved the new projections that same evening, and Goldman Sachs relied on those new projections to prepare its fairness opinion. As a result of the new projections, Virtu's $20 per share bid moved from the bottom to the middle of Goldman Sachs's valuation range.

The acquisition was ultimately approved by 75.5% of KCG's disinterested stockholders.

A few months after the merger closed, Virtu sold the BondPoint platform to a third party for $276 million, resulting in a $7 million fee for the Financial Advisor, which Virtu had retained to advise it in connection with the sale.

A KCG stockholder sought post-closing damages arising from the merger in the Court of Chancery, claiming that the KCG directors breached their duties in approving the acquisition and that Virtu and the Financial Advisor aided and abetted those breaches and engaged in a civil conspiracy to secure KCG's acquisition.

Takeaways

1. <u>The Delaware courts will carefully scrutinize the quality of disclosures when a *Corwin*defense is raised</u>. *KCG* marks just the latest in a string of decisions by the Delaware courts that have relied on problems with merger-related disclosures as a basis to deny a *Corwin* defense and subject transactions to enhanced scrutiny. [7] *Corwin* can provide a powerful defense to corporate boards, and perhaps motivated in part by vocal concerns that *Corwin*, left unchecked, will have caused the "pendulum [to have] swung . . . too far" in the direction of defendants,[8] a growing number of cases have cited disclosure deficiencies in refusing to insulate transactions from attacks on *Corwin* grounds. It is therefore imperative that directors and their advisors carefully assess the adequacy of disclosure to stockholders in connection with mergers and other transactions to have the best chance of insulating the transaction from post-closing attacks.

Here, the court found a number of adequately alleged material misstatements. Notably, the proxy represented that, when Virtu and the Financial Advisor initially discussed the possibility of an acquisition of KCG, its CEO suggested to Virtu that it merely "should take into account KCG's tangible book value per share, which, following certain divestitures, could exceed $20 per share." But the court agreed with the plaintiff that this disclosure created the misleading impression that the Financial Advisor was merely speculating that KCG's TBV could exceed $20 per share when, in fact, it had singled out a sale of the BondPoint platform as a way to increase to KCG's TBV and provided Virtu with confidential information about the platform to help drive that strategy to completion. The court also agreed that the phrase "could exceed $20 per share" downplayed the Financial Advisor's true view that KCG was worth between $21 and $21.50 per share.

2. <u>The Delaware courts review the adequacy of disclosures under a flexible, circumstances-specific approach</u>. The court found that the complaint adequately alleged that the proxy omitted necessary information concerning the circumstances surrounding the KCG CEO's change of heart over the deal price. The defendants argued that the details behind one director's decision to initially oppose, only to later support, the transaction constituted immaterial "play-by-play," but the court pointed to the Delaware Supreme Court's recent decision in *Appel v. Berkman*—which we have covered previously [9]—where the court soundly rejected the notion that "a director's reasons for dissenting or abstaining from a decision of the board can never be material."[10] Here, given the circumstances surrounding the CEO's reversal—initially opposing a deal at $20 or even $20.21, only to support a deal at $20 after securing from Virtu a sizeable compensation pool for himself and other members of management—coupled with his role as a key insider supported an inference that the omission of that information was material to the stockholders' understanding of the transaction. As *Appel* held, and as *KCG* illustrates, Delaware courts eschew hard-and-fast rules on materiality, and whether a particular piece of information—like the circumstances behind the KCG CEO's change of heart—is material must be judged holistically and in the context of the facts of each case. Boards and their deal counsel therefore must take care when drafting disclosures not to assume that particular categories of information may be safely left out, but rather should assess the materiality of any omitted information in light of the unique circumstances of the transaction.

3. <u>Not all information that a stockholder would like to be, but was not, disclosed amounts to a material omission</u>. The court declined to deem two other supposed disclosure deficiencies material. The first pertained to the Financial Advisor's role in the merger negotiations. The stockholder claimed that the proxy should have provided more detail about the extent of the pressure that the Financial Advisor applied on KCG to accept Virtu's bid and the KCG board's reason for selecting Goldman Sachs to act as its financial advisor on the merger. But the court concluded that the proxy contained adequate details about the Financial Advisor's interest in the transaction and interactions with KCG and, in light of those details, did not need to further explain why KCG's board chose to retain a different financial advisor to counsel it on the deal. The court also rebuffed the stockholder's claim that the proxy did not adequately disclose Goldman Sachs's past dealings with certain parties who had an

interest in the deal, including Virtu's controlling stockholder and entities providing funding to Virtu.

4. Ceding a key role to a conflicted director risks tainting the entire board's action. Despite the fact that it was only the KCG CEO who had an apparent conflict of interest in the transaction—by virtue of his stake in the funding of a compensation pool for members of KCG management—the court concluded that it was reasonably conceivable that all of the directors had breached their duties by allowing the CEO to lead the final stage of negotiations with Virtu and by signing off on the revised management projections that bolstered the case for the deal price. The court faulted the other directors for "authoriz[ing] [him] to negotiate both the compensation pool *and* the deal price," rather than "cabining [him], or limiting his authority to negotiations over [only] the compensation pool," which made it conceivable that the other, nominally-unconflicted directors "placed the interests of members of management, who benefitted from the compensation pool, above the interests of the stockholders."[11] That conclusion followed other recent decisions from the Court of Chancery where boards were faulted for allowing conflicted directors to negotiate transactions, including *Blueblade Capital Opportunities, LLC v. Norcraft Companies, Inc.*,[12] where the board chose as their lead negotiator a director who "was at least as focused on securing benefits for himself as he was on securing the best price available for [the company],"[13] and *In re PLX Technology Inc. Stockholders Litigation*,[14] where a board chose a conflicted director to chair the special committee that ran a sales process and "permitted [him] to take control of the sale process when it mattered most."[15]

5. The Board's failure to control the sales process, including preventing or fully understanding the Financial Advisor's furtive dealings with Virtu, is extremely problematic. The court emphasized that while "directors are generally free to select the path to value maximization," they "must maintain 'an active and direct role in the context of a sale of a company from beginning to end,'" which includes "acting reasonably to learn about actual and potential conflicts faced by directors, management, and their advisors."[16] The court agreed with the plaintiff that the board's failure to "better manage[] the behind-the-scenes negotiations between [the Financial Advisor] and Virtu"—or outright prohibit them—suggested that the directors had, at the least, breached their duty of care, even though the Financial Advisor allegedly had concealed the full scope of those negotiations from the board.[17] The court declined to opine on whether those failures rose to the level of bad faith given the other bad-faith conduct alleged in the complaint, but it is well-established in Delaware that a board's failure to resolve a financial advisor's conflicts of interest can undermine a sales process. For example, in *RBC Capital Markets, LLC v. Jervis*,[18] the Delaware Supreme Court affirmed the Court of Chancery's determination that the directors of Rural/Metro Corporation breached their fiduciary duties by relying on a financial advisor whose "advice was overly biased by its financial interests" and allowing the advisor to get "too far out in front" of them,[19] all while taking "no steps to address or mitigate [the advisor's] conflicts."[20] Also on point is the Court of Chancery's decision in *In re Del Monte Foods Co.*

Shareholder Litigation,[21] where the court faulted the board of Del Monte for failing to learn of the "the behind-the-scenes efforts" its financial advisor had expended "to put Del Monte into play" and then steer the transaction to a buyer that would retain the advisor to provide buy-side financing.[22]While the court acknowledged that the "blame for what took place appear[ed] . . . to lie with [the advisor], the buck stops with the Board."[23]

6. Advisors and merger partners may face aiding and abetting liability even where the directors are not subject to monetary liability for breaches of the duty of care by virtue of a Section 102(b)(7) charter provision. While KCG's charter contained an exculpatory provision that relieved the directors of monetary liability for breaches of their duty of care,[24] the court found that the complaint's allegations sounded not only in duty-of-care violations, but also in non-exculpated breaches of the duty to act in good faith. Importantly, the court also recognized that even if the directors were exculpated, alleged aiders and abettors are not. According to the court: "Claims for breach of the duty of care, though exculpated, provide a valid predicate for claims of aiding and abetting"[25]—an observation that evokes *Del Monte*'s warning that while directors may be exculpated from monetary liability by a charter provision, "[t]he same cannot be said for the self-interested aiders and abetters."[26]

As for the aiding and abetting allegations, the court found the complaint adequately alleged that the Financial Advisor and Virtu created and exploited informational vacuums. For example, the complaint alleged that the Financial Advisor disclosed confidential information about KCG's BondPoint platform to Virtu and concealed the extent of discussions that transpired between it and Virtu. The complaint, in turn, alleged that Virtu secretly collaborated with the Financial Advisor to develop a divestiture strategy for BondPoint and allegedly exploited the KCG CEO's conflict to pressure the board to accept a less-than-value-maximizing price.

7. Projections prepared outside the ordinary course of business, especially where they lead to what appears to be a desired outcome, will attract increased judicial scrutiny and could lead to a conclusion that the directors breached fiduciary duties. The court agreed with the plaintiff that the proxy should have disclosed not only the final, more pessimistic set of financial projections that KCG's CEO prepared after the board had approved the deal, but also the earlier, more optimistic projections that would have put the $20 per share deal price at the low end of the valuation range. Those projections were prepared in the ordinary course of business, in contrast to the circumstances surrounding the preparation of the post-hoc projections that had the effect of bumping the merger consideration from the bottom to the middle of Goldman Sachs's valuation range. Together, the court found it reasonably conceivable—at the pleadings stage—that failing to include the earlier projections was a material omission. The Court of Chancery came to a similar conclusion in *In re PLX*, where it faulted a board for disclosing only a set of projections developed specifically for its financial advisor to rely on in its preparation of a fairness opinion, while withholding from shareholders a set of earlier projections that had been prepared in the ordinary course of business.[27]

Aside from the KCG board's failure to disclose the ordinary-course-of-business projections, the court faulted the board for approving the new, more pessimistic projections prepared by the CEO. By approving the revised projections—which served as a basis for the fairness opinion—the court held that it was reasonably conceivable at the pleadings stage that the directors placed the interests of KCG's CEO and other management over the interests of the stockholders.

Please click here for the full opinion.

1 125 A.3d 304 (Del. 2015).

2 *See, e.g.*, Jason Halper et al., *Corporate Governance Litigation & Regulation: A Periodic Review and Predictions for the Remainder of 2019*, Cadwalader, Wickersham & Taft LLP (May 23,2019)

3 *See Morrison v. Berry*, 191 A.3d 268 (Del. 2018); *Appel v. Berkman*, 180 A.3d 1055 (Del. 2018); *see also* Halper et al., *supra* note 2 (discussing both cases and their implications for the *Corwin* doctrine).

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

5 Aside from the Delaware Supreme Court's decisions in *Morrison* and *Appel*, *see supra*note 2, which denied defendants the benefit of the *Corwin* defense on this ground, other recent examples include the Court of Chancery's decisions in *In re Xura, Inc., Stockholder Litigation*, 2018 WL 6498677 (Del. Ch. Dec. 10, 2018) and *In re PLX Technology Inc. Stockholders Litigation*, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018).

6 2019 WL 2564093, at *8.

7 *See supra* note 5.

8 *See, e.g.*, Jeff Montgomery, *Stuart Grant Retires With A Warning For Delaware's Future*, Law360 (July 27, 2018).

9 *See* Halper et al., *supra* note 2.

10 *Appel*, 180 A.3d at 1061–62; *see* Halper et al., *supra* note 2.

11 2019 WL 2564093, at *17.

12 2018 WL 3602940 (Del. Ch. July 27, 2018).

13 *Id.* at *2.

14 2018 WL 5018535 (Del. Ch. Oct. 16, 2018), *aff'd*, 2019 WL 2144476 (Del. May 16, 2019).

15 *Id.* at *45.

16 2019 WL 2564093, at *17.

17 *Id.* at *18.

18 129 A.3d 816 (Del. 2015).

19 *Id.* at 850.

20 *Id.* at 855.

21 25 A.3d 813 (Del. Ch. 2011).

22 *Id.* at 817.

23 *Id.* at 835.

24 *See* 8 *Del. C.* § 102(b)(7).

25 2019 WL 2564093, at *3.

26 25 A.3d 818.

27 2018 WL 5018535, at *35–37.

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