COVINGTON

Delaware Court Applies Business Judgment Rule to Stockholder-Approved Transaction Involving Controlling Stockholder

February 1, 2017

Mergers & Acquisitions

The Delaware Court of Chancery earlier this week ruled that the protection of the business judgment rule afforded to directors involved in a change of control transaction that is approved by a majority of fully informed, disinterested stockholders—as reinforced by the Delaware Supreme Court in 2015 in *Corwin* v. *KKR Financial Holdings LLC*[1] (discussed in our prior alert)—applied to a merger notwithstanding the presence of a target corporation controlling stockholder that was unaffiliated with the buyer. The *In re Merge Healthcare Inc. Stockholders Litigation*[2] decision by Vice Chancellor Glasscock punctuates a series[3] of recent Chancery decisions dismissing post-closing fiduciary claims under *Corwin* with useful judicial gloss on the scope of *Corwin*'s exception to business judgment review for transactions involving controlling stockholders.[4]

The *In re Merge Healthcare Inc.* Decision

Background. Plaintiffs, putatively representing a class of stockholders of Merge Healthcare, Inc., alleged that the directors of the company breached their fiduciary duties in connection with the all-cash sale of the company to IBM. The approximately $1 billion transaction, representing a nearly 32% premium for the company's common stockholders, was structured as a merger and was approved by 77% of the company's outstanding shares, including a majority of stockholders who were not associated with the company's chairman and purported controlling stockholder, Michael Ferro, who plaintiffs alleged controlled the company through indirect ownership of 26% of its stock and his "longstanding business and other relationships" with other directors who plaintiffs alleged were beholden to him. Under a consulting agreement with the company, Ferro was owed $15 million if the company was sold for at least $1 billion but agreed to forgo that payment during negotiations in exchange for a higher per share acquisition price by IBM for all common stockholders.

---

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

[2] Consolidated C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. January 30, 2017).

[3] *See, e.g.*, *In re Solera Holdings, Inc. Stockholder Litig*., C.A. No. 11524-CB, 2017 WL 57839 (Del. Ch. Jan. 5, 2017); *Chester County Ret. Sys*. v. *Collins*, No. 12072-VCL, 2016 WL 7117924 (Del. Ch. Dec. 6, 2016); *In re OM Grp., Inc. Stockholders Litig.*, Consolidated C.A. No. 11216-VCS, 2016 WL 5929951 (Del. Ch. Oct. 12, 2016); *Larkin* v. *Shah*, C.A. No. 10918-VCS, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016); *City of Miami Gen. Emp*. v. *Comstock*, C.A. No. 9980-CB, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016); *In re Volcano Corp. Stockholder Litig.*, 143 A.3d 727 (Del. Ch. 2016) (discussed in our prior alert).

[4] *Corwin*, 125 A.3d at 306 ("For sound policy reasons, Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party *other than a controlling stockholder* is in their best interests.") (italics added); *see also Larkin*, 2016 WL 4485447, at *11 ("[T]he only transactions that are subject to entire fairness that *cannot be cleansed* by proper stockholder approval are *those involving a controlling stockholder*") (italics added).

Opinion. On a motion to dismiss plaintiffs' amended complaint after the closing of the transaction, the Court of Chancery rejected the plaintiffs' arguments that the transaction could not be subject to the business judgment rule under *Corwin* by virtue of the mere presence of a controlling stockholder on one side of the deal. While the Court acknowledged that "the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controller stockholder," the Court clarified that, "[i]mportantly, the mere presence of a controller does not trigger entire fairness *per se*."[5] Rather, the Court explained that the overriding concern in the context of a transaction involving a controller is coercion, particularly where the controller "sits on both sides of the transaction, or is on only one side but 'competes with the common stockholders for consideration,'" in which case coercion is "deemed inherently present." Interestingly, the Court set forth a test for determining when coercion is "inherently present" in transactions involving controllers—*i.e.*, whether the controlling stockholder has "extracted personal benefits" from the transaction—that focuses on the self-dealing concerns frequently associated with the duty of loyalty. Applying that test, the Court found that, in selling Merge Healthcare to IBM, Ferro's "interests were fully aligned with the other common stockholders," in light of his decision to give up the $15 million consulting payment in exchange for a higher deal price.[6] The Court also rejected Plaintiff's claims that Ferro's desire for liquidity constituted a disabling conflict, given that plaintiffs failed to allege any "crisis" or "fire sale" necessitating an immediate need for cash.[7]

Having dispensed with the issue of Ferro's controller status, the Court considered and rejected plaintiffs' disclosure claims including, notably, that Ferro's true motivation for conceding the $15 million consulting payment was to avoid the formation of a special committee to negotiate the transaction. Given that the proxy disclosure revealed that (a) the company's board of directors had considered a special committee "in light of" the consulting payment owed to Ferro, and (b) Ferro had offered to waive the consulting payment if IBM increased its offer price for all stockholders, the Court ruled any further disclosure about Ferro's rationale for this concession was immaterial.[8]

Conclusion

Subject to further word from the Delaware Supreme Court on the application of *Corwin* to transactions involving controlling stockholders, the *In re Merge Healthcare Inc. Stockholders Litigation* decision helpfully clarifies that the liability protections for directors provided by *Corwin* extend to transactions involving a controlling stockholder absent coercion of the minority stockholders and reinforces the importance of choices made in structuring transactions to minimize the risk that a court will find that coercion is "inherently present."

If you have any questions concerning the material discussed in this client alert, please contact the following co-authors or any other members of our Mergers & Acquisitions practice group:

J. D. Weinberg	+1 212 841 1037	jweinberg@cov.com
Max S. Heuer	+1 212 841 1067	mheuer@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein. Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.

[5] *Id*. at *6.
[6] *Id*. at *7-8.
[7] *Id*. at *8.
[8] *Id*. at *12-13.